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Clarifying the treatment of trusts under insolvency law
Submission

1 Introduction

1.1 I am a partner of the law firm Norton Rose Fulbright, but I make this submission in my personal capacity. The views I express are my own and should not be taken to reflect those of the firm or of any other partner or employee of the firm, or of any client.

1.2 I also disclose that I assisted in preparing the submission of the Australian Restructuring Insolvency & Turnaround Association (**ARITA**) and the joint submission of lawyers from Allens, Ashurst, Herbert Smith Freehills and Norton Rose Fulbright. I do not repeat here the contents of those submissions but I do endorse them.

1.3 I fully support the Consultation and welcome the opportunity to make a submission. I write as someone who has been publishing and speaking at conferences about the issues contemplated by the Consultation Paper for many years.[1]

1.4 I am a practising lawyer with several decades' experience negotiating, structuring and documenting, and enforcing, financing and commercial contracts across a wide range of transactions. Very often in Australia a party to a transaction will be a trust (or, more precisely, a person or company acting as trustee of a trust), which may also be a registered managed investment scheme (**MIS**) (ie a company acting as responsible entity of a scheme). That presents counterparties with a series of risks that do not exist when dealing with a person or company acting on their own account, particularly in insolvency. Well advised parties will take a series of additional protective measures before and as part of transacting with a trustee, not all of which will or can be entirely prophylactic against those risks in insolvency.

1.5 I do not respond to the individual questions in the Consultation Paper separately. My submission rather is of a general nature, to highlight the broader context in which the issues arise, and to make certain specific recommendations: these are set out in Annexure B.[2]

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[1] See Annexure A for a selection of publications. My PhD thesis, completed in 2012, was titled *The Trust: From Guardian to Entrepreneur. Why the Changing Role of the Trust Demands a Better Legal Framework for Allocating Stakeholder Risk*

[2] I have most recently dealt with many of the issues in N D'Angelo, *Transacting with Trusts and Trustees* (LexisNexis Butterworths Australia, 2020).

1.6 My focus is on trusts with a Corporations Act company as trustee. I say nothing specifically about trusts with a natural person as trustee or provisions of the Bankruptcy Act. However, because trusts with a human trustee can also become insolvent, any changes to the Corporations Act as a result of this Consultation ideally should be reflected appropriately in the Bankruptcy Act to ensure alignment.[3]

2 Overall themes of this submission

2.1 The overall themes of my submission are these:

(1) Despite its origins, the trust is now an established, widely used and generally accepted vehicle for engaging in commerce in the Australian economy, in some configurations competing quite successfully with the Corporations Act company. That should be allowed to continue. While reform is clearly necessary, it should not involve annihilating the benefits of the trust for those who wish to take advantage of them.

(2) Insolvency legislation should acknowledge that a trust (or trust fund), as an economic entity, may be solvent or insolvent independently of its trustee and of any other trust (or trust fund) controlled by its trustee.[4]

(3) The legislation should also acknowledge that, in insolvency:

(a) a trust (or trust fund) will have assets, liabilities, creditors and equity parties that are separate and distinct from those of the trustee as a company in its own right, and of any other trust of which it is trustee; and

(b) therefore, they should be dealt with separately (even if concurrently) in any insolvent administration.

(4) A trust, as an economic entity, is only at risk of insolvency if the trustee, in that capacity, carries on business or otherwise incurs debts and liabilities in favour of parties external to the trust (ie persons not in the capacity of a co-trustee or a beneficiary). Thus, reform should be limited to those trusts, with the objective of better protecting in insolvency external parties with whom the trustee has dealt.

(5) However, the focus of reform should not be limited solely to the insolvency provisions of the Corporations Act. A more holistic approach is recommended because many of the issues that arise in insolvency have their source at the transactional stage.

(6) Generally, if trusts, through their trustees, are to be permitted to continue to conduct business and incur debts and liabilities in the same way as Corporations Act companies (and they should), the legal risk profile in insolvency of persons who deal with them should be more closely aligned to that of those who deal with Corporations Act companies. There is no policy reason why those risk

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3 There is a constitutional question to be addressed in relation to any amendments that are to be made to the Corporations Act and/or the Bankruptcy Act, both Commonwealth statutes, given that trust law is a matter in the State jurisdiction. Some reforms may require a referral of power by the States (as was done with the Corporations Act itself and more recently with the *Personal Property Securities Act 2009*, to name but two).

4 Question 5 of the Consultation Paper asks for the most appropriate way to prescribe when a trust is taken to be insolvent. I endorse the response to this question set out in ARITA's submission, and adopt the definition suggested there for the purposes of this submission.

profiles should be as different as they are at present. Those differences are an historical accident arising from a failure of the law to keep pace with market developments.[5]

2.2 The ultimate objective of reform should be for the law to better acknowledge the economic status of the trust as a vehicle for business and to properly accommodate the commercial expectations of those who deal with them. This would bring the law in this area into alignment with commerce.

3 Background and context: why reform is needed

Commercial trusts and the 'parity myth'

3.1 As noted in the Consultation Paper and elsewhere, trusts are popular and ubiquitous in Australian commercial life.[6] Trusts (that is to say, their trustees in that capacity) can and do engage in all of the same business activities that companies acting on their own account do.[7] As MIS, they can solicit and attract investment of funds from members of the public. Their securities can even be listed on the ASX, and many are. The decision whether to establish an enterprise within a company or a trust is determined by legitimate tax considerations and/or a desire for additional structural flexibility not available with the corporate form.

3.2 Typically, commercial trusts (including those that are MIS) will be structured as unit trusts with a Corporations Act company as the trustee, creating a form of business association that is in many respects practically and functionally indistinguishable from the Corporations Act company.[8] This has even contributed to an apprehension among some participants that their rights and remedies in insolvency are or will be the same as if they had invested in or dealt with a company (something I have described as 'parity myth').

3.3 But even trusts that are not so structured can carry on business or otherwise incur external debts and liabilities.[9]

3.4 Of course trusts are not companies. While they may fairly be described as business or accounting entities (and are often spoken of - including in this submission - as entities), they do not possess separate legal personality and so are not *legal* entities. They are not regulated by the Corporations Act or supervised by ASIC in the way that companies are. Investors in them and those who transact with them do not enjoy the benefit of the statutory rights and protections that are available to those who invest in and transact with Corporations Act companies.[10]

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5 For a brief discussion of the evolution of the commercial trust in Australia, see N D'Angelo, *Commercial Trusts* (LexisNexis Butterworths Australia, 2014), Chapter 2.

6 See the statistics in *Transacting with Trusts and Trustees*, n 2, at 1.39 to 1.48. I discuss the advantages of the trust over the company, and thus some of the reasons for its popularity, at 1.51 to 1.70.

7 Trusts whose trustee engages in commercial and business activities in that capacity are sometimes described as 'trading trusts' or 'commercial trusts', although neither is a legal term of art or has a normative legal meaning within the law of trusts. A company may be a single purpose vehicle whose only purpose is to be the trustee of a single trust, or it may be trustee of multiple trusts. It may even have its own personal business or assets in addition to its role as trustee. Insolvency is materially more complicated in these latter scenarios.

8 I describe the numerous similarities between them in *Transacting with Trusts and Trustees*, n 2, at 1.49 to 1.50.

9 For example, discretionary trusts also engage in trading and business activities. Typically these are used as vehicles for family owned businesses.

10 With the exception of the 3,600 or so trusts that are MIS, which are *partially* regulated by the Corporations Act (mainly by Chapter 5C) and are supervised by ASIC under that Act. I say 'partially' because that regime largely ignores creditors; among other things, it contains no 'indoor management' protections and no insolvency provisions. Chapter 5C is clearly an *investor*

3.5 These differences are fundamental and enormously consequential for investors and creditors (and, indeed, trustees and their insolvency officials) in insolvency.

'Regulatory dissonance': company law vs trust law as regulatory regimes

3.6 In fact, despite the similarities and parallels described above, participants' positions in enforcement and insolvency differ materially depending on whether the enterprise with which they are involved is held within a company or a trust. Company law and trust law offer quite different rights, remedies, protections and outcomes to participants. I have described this as 'regulatory dissonance'.

Company law

3.7 The Corporations Act, and modern company law more generally, are the culmination of a centuries-long process of reform by legislatures and the judiciary. The Act is a sophisticated and highly evolved (and ever-evolving), policy-based, statutory regulatory regime offering relatively efficient and orderly risk allocation, and a balance of investor and creditor protection, designed with risk-taking, profit-maximising activities in mind.

3.8 This balance is reflected in the insolvency provisions in Chapter 5 of the Act. That regime throws a protective cloak around creditors and, subject to certain conditions, gives them a preferential position over investors in and around insolvency.

3.9 This can be seen as an acknowledgment by the state of the importance of companies in the economy and the need to have a transparent, efficient and commercially acceptable regulatory regime for risk allocation, to encourage investment in and dealings with them.

Trust law

3.10 By comparison trusts, including commercial trusts, are 'regulated' by the general law of trusts which has been subject to no such process and is not so configured. Complex, arcane and opaque, and mostly case law rather than statutory, it offers none of those features. There have been some identifiable piecemeal legislative responses over time but a comprehensive legislative solution is yet to be enacted. Despite the evolution and widespread use of the trust in commerce, trust law remains firmly anchored in a set of rules (most, quite ancient, developed at a time when trusts did not engage in commerce as they do today) that evidence hostility to risk-taking and relative indifference towards the interests of outsiders (including creditors), at least when compared to company law. It was not designed for, and has not been modified to accommodate entrepreneurial activities, and is highly inefficient in that context. In truth, trust law does not fully acknowledge the commercial trust or the complexities of insolvency, and that is at the heart of the issues the subject of this Consultation.

3.11 With some exceptions, trusts are effectively invisible to the Corporations Act (including, in particular, to the insolvency regime in Chapter 5) and there is no equivalent statute for them. Trusts are left to be dealt with as part of the insolvency of the corporate trustee, but with no legislative guidance as to how trust assets, liabilities and creditors should be dealt with separately from the trustee's own personal assets, liabilities and creditors. Faced with this legislative vacuum the courts have had to develop a 'common law of insolvency' for trusts in the traditional manner, via the case-by-case resolution over time of private disputes between self-interested parties in an adversarial context. This has not always been completely successful.[11] Many gaps are

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protection regime (and even then, contains no statutory limited liability for investors of the kind that is available to shareholders in companies).

11 The most recent example of this endeavour is the High Court's decision in *Carter Holt Harvey Woodproducts Australia Pty Ltd v Commonwealth of Australia* [2019] HCA 20 (sometimes called the 'Amarind' decision). I have expressed my views on that decision in *Transacting with Trusts and Trustees*, n 2, at 10.35 to 10.48.

left and insolvencies involving trusts continue to generate litigation and yield unpredictable outcomes for all stakeholders.

3.12 This can be seen as a failure by the state to acknowledge the importance of trusts in the economy and the need to have a transparent, efficient and commercially acceptable regulatory regime to allocate risks and protect creditors (and indeed beneficiaries/investors), including in insolvency.

3.13 None of this is new or a revelation. Many of the issues were identified in the Harmer Report in 1988. They have been discussed at length in the academic and practitioner literature since. They have even been noted by the courts. And yet to acknowledge that without more is to gloss over the quite extraordinary fact that almost nothing has been done about those issues, despite the enormous growth in commercial activity involving trusts (and attendant litigation in insolvency). Even the MIS regime in Chapter 5C, enacted in 1998 and thus well after Harmer, failed to adopt Harmer's recommendations in relation to insolvency.

3.14 This represents a serious dereliction of duty by our legislators.

4 Specific issues and recommendations

4.1 This Consultation is not the forum in which to suggest wholesale reform for trusts that engage in commerce. That would cast the net too wide, given the terms of the Consultation Paper.

4.2 Nevertheless, there are matters outside the strict purview of the insolvency provisions of the Corporations Act that should be considered as part of any reform, because of the effects they can have in insolvency. I offer for your consideration the recommendations in Annexure B (which are set out in no particular order of preference or priority).

5 Conclusion

5.1 The issues described in this submission, and others consistent with the themes described above, can only be properly resolved by legislation. It is inappropriate that they are left to be dealt with by private means and, when that fails, by the courts, where outcomes can be unpredictable and often out of alignment with corresponding outcomes in relation to a Corporations Act company.

5.2 It is unfortunate that, in 21st century Australia, persons who do business with a trustee or who otherwise extend credit to or transact with trustees, suffer risks, costs and losses, particularly in insolvency, that are not suffered by those who deal with a company acting on its own account.

5.3 I would welcome the opportunity to discuss these issues with you further.

Yours faithfully

N D'Angelo

ANNEXURE A

Selection of relevant publications

Books and chapters

N D'Angelo, *Transacting with Trusts and Trustees* (LexisNexis Butterworths Australia, 2020), particularly Chapter 10 (*Trusts and Insolvency*).

N D'Angelo, *Commercial Trusts* (LexisNexis Butterworths Australia, 2014), particularly Chapter 6 (*The Commercial Trust in Insolvency*) and Chapter 7 (*Reforming the Commercial Trust*).

'Reforming the Commercial Trust: Trans-Tasman Approaches', chapter in S Griffiths, S McCracken and A Wardrop (eds), *Exploring Tensions in Finance Law: Trans-Tasman Insights* (Thomson Reuters, 2014).

Articles

N D'Angelo, 'Directors of insolvent trustees and trusts: duties and liabilities in respect of beneficiaries and trust creditors' (2017) 35 *Company & Securities Law Journal* 75.

N D'Angelo, 'The trust as a surrogate company: the challenge of insolvency' (2014) 8 *Journal of Equity* 299.

N D'Angelo, 'When is a trustee or responsible entity insolvent? Can a trust or managed investment scheme be 'insolvent'?' (2011) 39 *Australian Business Law Review* 95.

N D'Angelo, 'The unsecured creditor's perilous path to a trust's assets: is a safer, more direct United States-style route available?' (2010) 84 *Australian Law Journal* 833.

N D'Angelo, 'The trust: evolution from guardian to risk-taker, and how a lagging insolvency law framework has left financiers and other stakeholders in peril' (2009) 20 *Journal of Banking & Finance Law & Practice* 279.

ANNEXURE B

Suggested reforms

1 Registration of trusts

Recommendation 1:	***ASIC should establish and maintain a publicly searchable register of trusts that carry on business in Australia or otherwise incur contract debts or liabilities in favour of external parties. Registration should be mandatory. The obligation to register should be accompanied by other obligations on the trustee that are designed to protect creditors in insolvency.***

1.1 The idea of an ASIC register for trusts is suggested in both the ARITA and law firm submissions mentioned in paragraph 1.2 of the covering letter, to support certain reforms, including indoor management protections for creditors and proper identification of any trust for which a company is acting. I support this idea. The infrastructure for such a system already exists within ASIC, for companies and MIS.

1.2 Not all trusts would need to be registered. Since the objective is better protection for external parties, the obligation to register would be engaged if a company, in a trustee capacity, either:

(1) carries on business in Australia;[1] or

(2) otherwise incurs contract debts or liabilities in favour of external parties (say, over a certain aggregate threshold amount in value) even if not as part of a business,

where the trust is not already registered or required to be registered as a MIS.

1.3 The obligation would be to register the trust, and the company itself as its duly appointed trustee, with ASIC. The company would be given a unique numeric identifier referable to the trust (eg an Australian trust number or 'ATN'[2]). A company could, of course, possess multiple ATNs if it is the trustee of multiple such trusts. A change of trustee would have to be recorded with ASIC and the register would be conclusive in relation to the identity of the trustee.[3]

1.4 The company would be obliged, when acting in a trustee capacity, to disclose the relevant ATN and the fact that they are acting as trustee of the relevant trust, in all business documents in which they were so acting, much as occurs with companies and their ACN: see s153 of the Corporations Act.

1.5 Additional creditor protections could be built into the system. For example, trustees of registered trusts could be required to comply with certain record-keeping requirements, including the maintenance of separate accounts and records for each trust of which they are trustee, and the proper segregation of trust assets, as well as lodgement and public

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[1] The rules and tests in Part 1.2 Division 3 of the Corporations Act could be made to apply.

[2] If a trust is registered for GST and already has an Australian business number (or 'ABN'), then to avoid a multiplicity of numbers that could be deemed to be its ATN as well, upon registration (and, indeed vice versa). A trust that is registered or registrable as a MIS and has or will acquire an Australian registered scheme number (or 'ARSN') would not need also to be registered under this regime.

[3] Much as it is in relation to responsible entities of MIS: see s601FS of the Corporations Act.

reporting obligations, including of the trust instrument and any amendments; external parties could only be affected by the documents so lodged.[4]

1.6 All of this information would be searchable by the public, including anyone intending to transact with the trustee and the trust.

1.7 Sanctions for a failure to register or to disclose the ATN when transacting could include non-excludable and non-indemnifiable trustee director liability for any debts incurred in so doing if they cannot be discharged out of trust assets. Those failures should not, however, negate the trustee's right of indemnity against trust assets since that would punish innocent unsecured creditors who would then have nothing to which they could subrogate on enforcement or insolvency, thus depriving them of access to those assets.

1.8 If positive incentives were desired to encourage trustees to register, they could include a reversal of the prima facie position of unlimited personal liability for trustees. Under current law, a trustee may pay properly incurred trust debts out of trust assets via an indemnity but it otherwise carries unlimited personal liability without reference to those assets, unless a limitation is contractually agreed with respect to a particular debt and creditor.[5] The prima facie liability position of a trustee of a registered trust could be reversed, ie its liability could be limited by law to trust assets *unless* unlimited liability is agreed contractually in relation to a particular debt and creditor, where the creditor in effect requires the trustee to personally 'guarantee' the trust debt (and *unless* the trustee misconducts itself in relevant ways).[6] The insolvency provisions suggested in the ARITA submission would then provide the necessary protections in and around insolvency of the trust fund.[7]

1.9 Further incentives to register are in the additional reforms that benefit stakeholders that are suggested below.

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4 In relation to registration of MIS constitutions and amendments to them, see s601GC of the Corporations Act. There could even be a set of prescribed requirements for trust instruments, including an express power to incur debts and liabilities in favour of external parties, to minimise ultra vires problems. The register could also contain other information about the trust as necessary to support the innocent outsider/indoor management reforms suggested in the law firm submission mentioned in paragraph 1.2 of the covering letter.

5 See generally the discussion in *Transacting with Trusts and Trustees*, n 2, Chapter 3 (*Trustee limitation of liability clauses*).

6 This reversal would reflect the position under trust law in many parts of the United States of America. Section 1010(a) of the US *Uniform Trust Code* provides that 'Except as otherwise provided in the contract, a trustee is not personally liable on a contract properly entered into in the trustee's fiduciary capacity in the course of administering the trust if the trustee in the contract disclosed the fiduciary capacity'.

7 In my experience, the issue of trustee limitation of liability can attract emotional and sometimes misguided commentary; 'why should a trustee be allowed to escape personal liability?' is a common refrain. It is instructive to think of liability limitation clauses as an attempt (albeit an imperfect one) to economically equate a trust to a limited liability company, and the trustee to directors, with respect to liabilities to contractual counterparties. When contracting with a company acting on its own account, a counterparty implicitly accepts the inherent risk that, if in insolvency there are insufficient assets to discharge a debt owed to them, they cannot go behind the company and pursue the directors for any shortfall, absent some relevant actionable malfeasance (such as a breach of duty or insolvent trading) or a negotiated contractual commitment (like a guarantee). Trustee limitation of liability clauses seek to achieve the same outcome for trustees. Once the trust assets are exhausted, that should be the end of the matter. There should be no recourse against the trustee personally for any shortfall except for relevant actionable malfeasance or in contractually agreed circumstances. Limiting liability in this way is important for companies that are trustees of multiple trusts and/or have their own personal businesses or assets. Trustees are not always willing to act as *de facto* 'guarantors' of trust debts.

2 Trusts and external insolvent administration

Recommendation 2:	***Trusts (or, more accurately, trust funds) ought to be administered in insolvency separately from their trustee (even if concurrently). The advantages of holding 'substantial security' should accrue to a creditor who holds security over the whole or substantially the whole of the property of a trust.***

2.1 I note that, in its submission, ARITA suggests that a trust (or, more accurately, a trust fund) ought to be recognised by insolvency legislation as an economic entity separate from its trustee, with its own assets, liabilities and creditors, and be administered in insolvency separately from its trustee (even if concurrently where the trustee itself is also insolvent). I support that submission and the point that follows may be seen as a corollary to that.[8]

2.2 Currently, a secured party who holds security over the whole or substantially the whole of the property of a company enjoys certain valuable privileges not available to other creditors if the company is placed into voluntary administration. Chief among these is the 13 business day decision period during which it can commence enforcing its security despite the enforcement moratorium that otherwise descends in voluntary administration: see s441A of the Corporations Act.

2.3 Because the voluntary administration regime in Part 5.3A of the Act operates with respect to companies and not trusts, a security interest given by a trustee over the entire trust fund to a trust creditor will not necessarily comprise security over the whole or substantially the whole of the property of the trustee as a company. The company may hold personal assets, or assets as trustee of another trust that will not be caught by the security, the value of which may in aggregate be sufficient to mean that the counterparty's security is not over 'substantially the whole of the property' of the trustee.[9] Thus, a fully secured creditor of an economic entity that is a trust is disadvantaged when compared to a fully secured creditor of an economic entity that is a company in its own right.

2.4 The Corporations Act should be amended so that the advantages of having 'substantial security' accrue to someone dealing with the trustee of a registered trust who holds security over the whole or substantially the whole of the property of the *trust*.

3 Corporate trustees and voluntary administration

Recommendation 3:	***In Part 5.3A of the Act, the test for whether a creditor holds security over the whole or substantially the whole of a company's property should exclude from the calculation the company's interests in all assets held on trust (with one exception).***

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8 Indeed I support generally the proposition in the ARITA submission that, when it comes to insolvency, the trust (or trust fund) should be treated by the law as a standalone economic (though not *legal*) entity, separate and distinct from its trustee. Many of the issues with trusts and insolvency at present stem from the fact that a trust comprises two economic entities (the trustee and the trust fund), but the law only recognises one of them.

9 There is very little judicial guidance on how much is sufficient to constitute 'substantially the whole of the property' of a company. In *National Australia Bank Ltd v Horne* [2011] VSCA 280 the Victorian Court of Appeal, in confirming the decision at first instance, held that 'substantially the whole of the property' refers to 'almost all of the assets'. On the facts before it, the court held that 68% by value of a company's property was not 'substantially the whole of the property' of the company. The approach of proceeding by reference to a percentage of value was endorsed by Robb J in *Re Beechworth Land Estates Pty Ltd (admin appt) and Griffith Estates Pty Ltd (admin appt) (No 2)* [2015] NSWSC 336 at [83].

3.1 There is currently an unresolved issue that causes anxiety for secured creditors at a critical time in the insolvency of a company that is a trustee. A company with its own own assets may have given security over the whole or substantially the whole of them to secure personal borrowings, but may also be and hold property as the trustee of one or more trusts. In the ordinary course, that trust property would be expressly excluded from the security (since it would usually be a breach of trust for a trustee to use trust assets for personal benefit like securing personal borrowings). Nevertheless, because of the nature of trusts, those assets are still in the company's name (or possibly the name of a nominee for the trustee).

3.2 The questions that arise are these:

(1) does the exclusion of the company's interest in trust assets mean that the secured creditor does *not* have security over the whole or substantially the whole of the company's property for the purposes of s441A and related provisions of the Corporations Act?

(2) what is the value of a trustee's interest in trust assets? Does it depend on the state of the trustee's indemnity and the value of any undischarged trust debts that have engaged it? How is the 'percentage of value' test (see footnote 9 in this Annexure B) to be applied in this situation?

3.3 This issue is critical because if the secured creditor moves to appoint a receiver during the 13 business day period but was not entitled to do so, it (and the receiver) could suffer serious adverse consequences.[10]

3.4 Part 5.3A of the Corporations Act should be amended to provide that the test for whether a creditor holds security over the whole or substantially the whole of a company's property *excludes* from the calculation the company's interests in all assets held on trust (and not just registered trusts). The only exception would be an interest in trust assets arising from the trustee's indemnity claim for reimbursement or recoupment of trust debts and liabilities that it has discharged with its own money, which interest is properly regarded as personal to the trustee and not held for the benefit of another.

4 Unpaid trustee remuneration vs the claims of unpaid external creditors

Recommendation 4:	***In the distribution of assets of an insolvent registered trust or MIS, a personal claim of the trustee for unpaid remuneration should be subordinated to the claims of trust creditors.***

4.1 There is an important distinction between, on the one hand, debts, liabilities and expenses incurred or paid by a trustee to *third parties* and, on the other, amounts which the trustee is entitled to take out of the trust fund *for itself* by way of remuneration. The trustee's usual indemnity out of trust assets is designed to reimburse or exonerate the trustee in respect of amounts payable or paid by the trustee to third parties in the proper administration of the trust, in effect to keep the trustee whole and protect its personal assets. This would include an expense in the nature of a fee which is paid or payable by the trustee *to a third party* (even if related to the trustee).

4.2 By contrast, a fee or other remuneration to which the trustee is entitled *personally* out of the trust fund is not a third party expense (ie does not comprise a liability of the trustee to another person) and therefore is not a matter in respect of which the indemnity can operate. The trustee is not, in those circumstances, a *trust creditor*. Rather, if a remuneration clause is included in the trust instrument, the correct characterisation is

[10] I would add that this issue has only become more acute with the High Court's decision on what constitutes 'property of the company' under the Act where the company is a trustee, in *Carter Holt Harvey Woodproducts Australia Pty Ltd v Commonwealth of Australia* [2019] HCA 20.

that the terms of trust permit the trustee to do that which prima facie would otherwise be a breach of trust, that is, to take trust assets for its own benefit.[11]

4.3 At present there is an unresolved question as to whether there is (or should be) any priority between the right of a trustee to unpaid remuneration and its right to be indemnified for unpaid unsecured trust debts (and thus to use trust assets to pay those trust creditors). Both rights entitle the trustee to a proprietary claim against the trust assets ranking ahead of the claims of beneficiaries. For so long as the fund is able to meet both rights, no issue arises. However, in insolvency, where the trust fund is inadequate to fully satisfy both, questions arise as to whether there is or should be any priority as between these separate entitlements.

4.4 Unpaid unsecured trust creditors, standing in the shoes of the trustee with respect to the indemnity by virtue of subrogation, will naturally want the trustee's entitlement to unpaid remuneration (which, as a personal asset of the trustee, would be available to the trustee's personal creditors if it is insolvent) to be subordinate to the indemnity and therefore to their own claims as trust creditors, since payment would otherwise diminish the pool of funds available to them. They would want the trustee (or its insolvency official) to wait until the trust debts are all paid in full before taking that remuneration from any remaining assets. Yet, both claims are claims of the trustee with no natural ranking between them at general law, notwithstanding that the indemnity claim is controlled or controllable by the trust creditors via subrogation.

4.5 Any statutory order of priorities for distribution of the assets of a registered trust or MIS in insolvency that is enacted as a result of this Consultation should expressly deal with this issue. In my view, the personal claim of a trustee for unpaid remuneration should be subordinated to the claims of external trust creditors (and, further, remuneration taken by the trustee within 6 months before the relation back day should be disgorged), but obviously that is a policy question to be resolved.[12]

5 Transfer of trust debts and liabilities on change of trustee

Recommendation 5:	***On a change of trustee for a registered trust, legislation should provide for a statutory transfer of assets and novation of debts and liabilities to the new trustee, similar to ss601FS and 601FT of the Corporations Act for changes of responsible entities of MIS.***

5.1 It is not unusual for a trust to undergo a change of trustee. This may be initiated by the trustee itself or by the beneficiaries. A trustee can also be removed from office in insolvency by the operation of ejection clauses embedded in the trust instrument (about which I say nothing further here; it is addressed in the ARITA submission[13]).

5.2 Because a trust is not a legal entity, all assets and liabilities of the trust are held by the trustee personally. Thus, on a change of trustee, they need to be transferred from the outgoing trustee to the incoming trustee.

11 See generally the discussion in *Transacting with Trusts and Trustees*, n 2, at 2.309 to 2.317.

12 For completeness, this is different from the competition between a trustee's claim for reimbursement for trust debts paid out of its own money and the claims of unpaid creditors. While the former is unambiguously a personal claim of the trustee, it should rank *pari passu* with the claims of unpaid creditors because in effect the trustee has replaced the paid creditor by discharging the debt and should be able to stand in its shoes in the insolvency.

13 Although I do discuss the issues in detail in *Transacting with Trusts and Trustees*, n 2, at 9.31 to 9.75.

5.3 State/Territory trusts legislation provides for the automatic statutory vesting of trust property on a change of trustee. In some States the vesting is automatic.[14] In New South Wales, the Northern Territory and the Australian Capital Territory the vesting occurs only upon and by virtue of registration of the relevant deed.[15]

5.4 However, none of these statutory provisions provide for the automatic transfer of trust debts, liabilities or other obligations owed to external parties (whether contractual or otherwise). This means that (subject to what is said below in relation to MIS), outgoing trustees continue after retirement to carry personal liability for any undischarged trust debts, liabilities and obligations from which they are not expressly released by the relevant counterparties or which are not novated to the new trustee (which, of course, would require the active participation of each relevant counterparty). This is so despite the fact that trust assets will have vested in the incoming trustee, as described above. That produces an obvious asymmetry.

5.5 Trust law's solution for that asymmetry is to allow the retiring trustee to retain its right of indemnity against the trust assets in respect of trust debts and liabilities that were properly incurred while it was trustee, and trust creditors to pursue those assets even into the hands of the new trustee by subrogating to that indemnity in the usual way. However, the simplicity of that statement disguises multiple unresolved issues and complexities for creditors in insolvency.[16] Not all of them can be fixed with a deed of retirement and appointment or other private means.

5.6 However, in relation to the replacement of a trustee that is the responsible entity of a MIS, ss601FS and 601FT of the Corporations Act address the issues directly. In particular, they effect a statutory transfer and novation so that, with some exceptions, upon a change of responsible entity both rights (which includes all scheme property) *and* obligations and liabilities of the outgoing responsible entity in that capacity become those of the incoming responsible entity.

5.7 The benefits of provisions like these should be extended to all registered trusts upon a change of trustee, to better protect the position of external parties to whom trust debts and liabilities are owed.

6 Abolition of the rule against perpetuities

Recommendation 6:	***The rules against perpetuities and remoteness of vesting should be abolished for registered trusts and MIS.***

6.1 One of the attractive features of a Corporations Act company as a business vehicle is perpetual succession. A company may potentially live forever. If it is being wound up and deregistered, that is disclosed publicly on the ASIC record so that actual and potential counterparties can know or find out about it.

6.2 With very few exceptions, trusts do not and cannot have an indefinite life. They are subject to the ancient rules against perpetuities and remoteness of vesting. Well drafted trust instruments will allow for this and have perpetuity clauses giving the trust a life of up to 80 years, but not all do. It is even possible for a trust instrument to be so defective in this regard that the trust fails to come into existence at all. It is not unusual in practice to come across trusts that, under due diligence, are exposed as suffering some defect or other in this regard, or even occasionally the possibility that the vesting date will occur during the life of a proposed transaction.

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14 See s45 of the *Trustee Act 1958* (Vic); s15 of the *Trusts Act 1973* (Qld); s10 of the *Trustees Act 1962* (WA); s16 of the *Trustee Act 1936* (SA); and s15 of the *Trustee Act 1898* (Tas).

15 See s9 of the *Trustee Act 1925* (NSW); s57 of the *Trustee Act* (NT); and s9 of the *Trustee Act 1925* (ACT).

16 See *Transacting with Trusts and Trustees*, n 2, at 9.16 to 9.19.

6.3 If this is not checked and dealt with by an intending transacting counterparty they may have serious difficulties in enforcement or insolvency.

6.4 South Australia has resolved with this problem by abolishing those rules.[17] The rules have also been abolished in relation to superannuation trusts and funds.[18]

6.5 The rules should be abolished for all registered trusts and MIS (including those that exist on the date of abolition).

7 Directors' personal liability under s588G and s197

Recommendation 7:	***Directors' personal liability for trust debts under s588G and s197 of the Corporations Act should be geared to the solvency/insolvency of the trust and decoupled from the solvency/insolvency of the trustee.***

7.1 Two provisions of the Corporations Act appear on their face to be designed to protect creditors, including trust creditors, in insolvency by fixing personal liability on directors of a corporate trustee:

(1) section 588G and the rest of Part 5.7B Division 3 (*Director's duty to prevent insolvent trading*); and

(2) section 197 (*Directors liable for debts and other obligations incurred by corporation as trustee*).

7.2 The problem with both of them is that neither operates to protect trust creditors against losses to an insolvent trust if and for so long as the corporate trustee is solvent. It is possible for a trustee to remain solvent while a trust of which it is trustee is insolvent if the trustee has contractually limited its personal liability for trust debts to its recourse to trust assets (a technique that is commonplace in Australian commerce[19]). In this way, the trustee is not obliged (as would otherwise be the position at general law) to make up any shortfall in the trust fund to discharge trust debts out of its own money, leaving its solvency unaffected by the insolvency of the trust.

Section 588G

7.3 Directors' liability for insolvent trading under s588G requires, among other things, that a debt is incurred by the company (and, although the Act does not expressly say so, that would include a trust debt), and that the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt. If a corporate trustee is not in the relevant state of insolvency at the time it incurs a trust debt, then s588G cannot operate; there is no statutory duty on the directors not to incur that trust debt.

7.4 This is so even if *the trust* is insolvent at the time the trust debt is incurred such that the trust creditor cannot be paid out of trust assets and could not recover from the trustee personally because a liability limitation clause operates.[20] Section 588G only imposes a

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17 See s61 of the *Law of Property Act 1936* (SA),

18 See s1346 of the Corporations Act, s343 of the *Superannuation Industry Supervision Act 1993* (Cth) and complementary provisions in State and Territory trusts legislation.

19 So common and accepted is the practice of trustees seeking, where possible, to limit their personal liability under material contracts, that a legal adviser who does not adequately warn an intending trustee (even an experienced one) of the issue of personal liability and the desirability of limiting it runs the risk of a negligence suit: see *Astley v Austrust Ltd* (1999) 197 CLR 1; [1999] HCA 6.

20 I would note that, while trustee liability limitation clauses commonly in use in the market do contain disapplication provisions that switch off the limitation and restore full personal liability for certain trustee misconduct, I do not recall ever seeing a provision that operates to have that

duty on directors not to allow the company to incur (trust) debts when *the company* is insolvent (or near insolvent); it does not impose a duty on them, or the company, not to incur *trust* debts if or when *the trust* is insolvent (or near insolvent).

Section 197

7.5 By s197, a person who is a director of a corporation when it incurs a liability while acting, or purporting to act, as trustee, can be personally liable (jointly and severally with the corporation itself) to discharge the whole or a part of the liability, in the circumstances described in subsections (1)(a) and (b). A creditor seeking recourse under s197 in relation to a given trust debt must first establish that the trustee is insolvent, ie that it 'has not discharged, and *cannot* discharge' that debt: s197(1)(a). However, it does not need to establish that the trust is insolvent; indeed, the state of solvency of the trust is irrelevant. This is reinforced in the official Note to s 197(1) in the Act: 'The person will not be liable under this subsection merely because there are insufficient trust assets out of which the corporation can be indemnified'.

7.6 When it comes to the trust, the catalysing circumstance for liability to fix under s197 is that the trustee's indemnity has been impaired (by a breach of trust or ultra vires act by the trustee), or negated or limited (by a term of the trust), with the result that the trustee is unable to access trust assets, or sufficient of them, to discharge the debt: s197(1)(b). That, in turn, would mean that the creditor's route of access to those assets via subrogation to the trustee's indemnity will have been concomitantly compromised, leaving it with a personal claim against the trustee only, which, as mentioned, will be insolvent – hence the right then to proceed against the directors personally.

7.7 It follows that in a situation where the trustee is solvent, in that it *can* pay the debt, but is not obliged to do so because it enjoys the benefit of a limitation clause, the aggrieved creditor falls at the first hurdle and s197 cannot operate. This is so even if one or more of the three conditions described in s197(1)(b) apply such that the indemnity is impaired or unavailable.[21]

7.8 In order for s588G and s197 to operate properly to protect creditors of registered trusts in insolvency, they need to be geared to the state of solvency of the trust and decoupled from the solvency of the trustee.

8 Limited liability for investors/beneficiaries

Recommendation 8:	***Beneficiaries of registered trusts and MIS should have statutory limited liability, like shareholders of companies.***

8.1 It is something of a curiosity that, even for trusts that are large, publicly held MIS, with the recent exception of New South Wales there is no statutory limitation of liability for trust beneficiaries, of the kind that is available for shareholders under s516 of the Corporations Act (which limits the liability of shareholders in a company limited by shares to amounts unpaid on their shares, if any). In my book *Commercial Trusts* (LexisNexis Butterworths Australia, 2014) I dedicated an entire chapter (Chapter 3) to the legal risks of beneficiaries of commercial trusts, including the risk of personal liability for enterprise debts. Promoters who are aware of the risks seek to limit investors' liability by private mans, including exclusion clauses in the trust instrument,

effect solely because the trustee incurs a debt while the trust is insolvent (although I have recommended that they should: see *Transacting with Trusts and Trustees*, n 2, at 4.68).

21 Unless, perhaps, the relevant condition is (1)(b)(i) (a breach of trust) or (1)(b)(ii) (the corporation has acted outside the scope of its powers as trustee), *and* the trustee's standard limitation of liability clause is so drafted that this triggers a disapplication provision in the clause, thus restoring full personal liability of the trustee.

but these efforts are not and cannot provide a complete solution, particularly in insolvency.

8.2 In 2017-2018 the NSW Law Reform Commission conducted a review of laws relating to beneficiaries of trusts. The issues around beneficiary liability are well ventilated in the Commission's Consultation Paper (Consultation Paper No. 19), the public submissions and the final report (NSWLRC Report No. 144).[22] As a result of that work, in 2019 the *Trustee Act 1925* (NSW) was amended to insert a new s100A which provides that beneficiaries are not liable to indemnify the trustee or make any other payment to the trustee or any other person for any act, default, obligation or liability of the trustee except in certain limited circumstances. To date, no other State or Territory has enacted an equivalent.

8.3 This reform should be adopted throughout Australia, at least for registered trusts and MIS.

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[22] See the NSWLRC's website at: www.lawreform.justice.nsw.gov.au/Pages/lrc/lrc_current_projects/Beneficiaries/Beneficiaries.aspx.