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

Dear Sir/Madam

Consultation on clarifying the treatment of trusts under insolvency law

McGrathNicol is a national, independent advisory firm, with services including restructuring and insolvency. Eighteen of our partners are registered liquidators. Our insolvency practice is confined to corporate matters and we have undertaken some of Australia's largest and most complex insolvency appointments. McGrathNicol partners have been involved in a variety of external administrations and receivership appointments to insolvent trustee companies.

We welcome the opportunity to provide our comments regarding potential improvements to the treatment of trusts under Australian insolvency law. McGrathNicol supports the government's focus on exploring options to enhance the insolvency regime, including provision of a specific framework for companies in financial distress that employ a trust structure.

Our response is structured in the following manner:

- Background observations to articulate our assessment of the current operation of law regulating the winding up of trading trusts, as context for the discussion of potential reforms.
- Reponses to the specific questions posed in the consultation document.

A. Background observations

We encounter trusts and corporate trustees in our insolvency and restructuring practice across a range of business sizes and industry sectors. While not generally common in large businesses, trust structures with corporate trustees are used by SME's, particularly in property and agricultural enterprises.

The term 'trust' is used generically throughout this submission; we have not sought to separately consider the implications of different types of trusts or mechanisms through which beneficiaries may hold their interests (for example discretionary trusts and unit trusts).

In our experience, the lack of insolvency legalisation to deal with insolvent trusts presents several common complicating factors. These matters are explained in detail in our submission below. The costs of resolving these matters, which frequently require Court applications, are generally borne by the creditors of the trustee company during the external administration process. In addition, given the heavy reliance on the application of caselaw to the administration of trusts, there can be costs and delays occasioned by an absence of clear precedent or conflicting lines of authority.

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Australian corporate insolvency law provides a comprehensive framework for the administration of receiverships, schemes of arrangement and external administrations. Among the benefits of having a prescriptive regime is a relatively high degree of certainty for participants, driving efficiencies and broadly consistent outcomes. This in turn engenders confidence in the process, at least as far as possible when dealing with businesses in financial distress. We agree that better alignment with more legislatively structured corporate insolvency processes would, for these reasons, as well as several practical implications, be a beneficial change to the administration of insolvent trusts for all stakeholders.

However, we note the structural challenges that this reform process may present, given that trusts are regulated by the state and territory Governments.

B. Consultation Questions

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?

We agree that there is a need for explicit references to how an insolvent trust with a corporate trustee should be administered under chapter 5 of the Corporations Act.

The full range of solvent and insolvent liquidation options should be available to properly wind up the affairs of both the corporate trustee and the trust assets and liabilities. These amendments should focus on addressing the identified issues where the trust structure presents additional complexity and potentially inconsistent outcomes compared with corporate winding up. By way of illustration, these matters include:

- eliminating the effect of auto ejection clauses on the powers and status of the liquidator or administrator of a corporate trustee;
- preventing the removal or replacement of the corporate trustee by the beneficiaries after commencement of the external administration;
- standardising the priority of repayment waterfall between trusts and companies;
- clarifying the scope of the right of indemnity of the external administrator of the corporate trustee against trust assets; and
- consistent treatment of remuneration claims of external administrators regardless of use of the trust structure.

In our view this approach is justifiable given that when either a trust or company is insolvent, the primary interested parties are the creditors. The protections afforded to the interests of beneficiaries through trust law can conflict with the interests of both the appointees and creditors in the administration of an insolvent trust. Whereas given the clear analogy in an insolvency context between the interests of beneficiaries of a trust and shareholders or a company, we believe there is a strong argument for the application of a common approach with regards to treatment of their interests and priority of payment.

In addition, while trustee companies can access the voluntary administration regime provided for in part 5.3A of chapter 5, we support the inclusion of explicit references to the treatment of trusts under this process. This would have the advantage of eliminating current areas of uncertainty and the level of Court guidance required, which the flexible and relatively fast paced voluntary administration process was designed to avoid.

Question 2: What benefits would a legislative framework deliver?

There has been a long-standing recognition in Australian insolvency law of the advantages of legislative consistency for stakeholders exposed to insolvency procedure, expressed most recently in the Explanatory Memorandum to the *Insolvency Law Reform Bill 2016*. One of the stated goals of these reforms was to "align a range of specific rules relating to the handling of personal bankruptcies and corporate insolvency administrations." [1]

Law reform to better align the procedures and outcomes of insolvent businesses, whether operating as trusts or otherwise, would offer important benefits to all stakeholders.

In addition, there would be cost savings from reduced needs for Court applications for matters such as to:

- address the effect of auto ejection clauses in trust deeds;
- resist trustee replacement attempts post appointment; and
- have remuneration and costs claims approval against trust assets.

Instead, these resources could be applied to other investigations, with a view to pursuing asset recovery actions, or applied towards a return by way of a creditor dividend.

In several liquidation appointments undertaken by McGrathNicol partners involving insolvent corporate trustees, steps have been taken to either remove the company as trustee just prior (usually on notice of a winding up application) or immediately after the external administration commences. While the various state Trustee Acts provide remedies and rights to claim against the new replacement trustee, in practise these rights can be difficult and very costly to enforce.

We have noted that this trustee replacement process may be used to in effect quarantine liabilities in essentially assetless entities (other than the right of indemnity), which may be part of an illegal phoenixing scheme. Therefore, law reform to remove the ability to replace a corporate trustee, at least after the appointment of an external administrator, would also have the benefits of serving as an impediment to misuse of this power.

Question 3: Is there potential for detrimental or unforeseen impacts if the statutory regime is extended?

Much of the protections built into the statues and caselaw governing trusts has the objective of protecting the interests of the beneficiaries of the trust. The commonplace applications for Court directions seeking guidance are due to concerns of committing a breach of trust and thereby exposing the trustee company and/or the external administrators to a claim by the beneficiaries or a replacement trustee.

Arguably the proposed alignment of trusts with corporate insolvency procedures and the removal of default ejection clauses does lessen the range of remedies available (including the right to intervene in Court directions applications) to the beneficiaries of the trust.

However, we suggest this is not in fact a detrimental outcome, but an appropriate readjustment of rights. As stated above, the interests of beneficiaries and shareholders are comparable on insolvency. For this reason, preference should be given to procedures that best preserve asset value for the benefit of creditors rather than going through a routine Court process, ostensibly to ensure that a breach of trust impacting the of beneficiaries will not occur.

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[1] At page 3.

Question 4 and 5: Should legalisation expressly set out when a trust is deemed to be insolvent? What is the most appropriate way to prescribe when a trust is taken to be insolvent?

In keeping with our support for consistency, we suggest that the same formulation of the definition as applies to an insolvent company (section 95A of the Corporations Act) should be used. Given the multiple capacities in which a corporate trustee may act, the definition should also refer to the ability of the trustee to pay all trust debts as and when they become due and payable.

Question 6: Should the power of an insolvency practitioner to administer the trust assets and liabilities be expressly provided for in legislation?

This is a critical area requiring law reform to address the very common issue of the potential lack of clarity around the scope of appointee powers. We commonly receive legal advice following appointments to trustee companies that a Court application is needed to confirm we have the powers of control and sale or to appoint a concurrent receiver and manager to supplement a lack of capacity. These applications, while rarely opposed, are not, in our opinion a good use of the insolvent company's resources. In the case of insolvent companies, the cost of these legal proceedings are in effect borne by the creditors and we see no material benefit to them of this type of legal proceeding.

We have encountered confusingly diverse positions within the common law on the extent of the powers and capacity of liquidators after winding up. Some advice we have received suggests that the section 477 powers of a liquidator are sufficient to allow the power of sale to be exercised, even where the liquidator becomes a bare trustee following the operation of an ipso facto clause, whereas others advise Court directions should be obtained.

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?

This approach is the default position in our experience and, if this type of concurrent appointment remains necessary (which we suggest should not be the case), we would support the same practitioner acting in these dual capacities. This is because there is a clear alignment of interests (similar to a corporate group of companies) and this approach promotes the most cost-effective outcome. In cases where a conflict of interest is identified between the trustee company and the trust or trusts it administers this could be addressed using similar mechanisms that are used in the case of competing claims between related parties.

Use of the concurrent appointment approach does have some adverse practical implications, however. Where a receiver and manager is appointed to a company that is already in liquidation, there end up being two sets of statutory reporting requirements (Annual Administration Return) for similar but not identical periods. It may also be unclear which transactions, of in effect the same legal entity, should be reported in which appointment category and there may be a similar lack of clarity around banking of trust funds.

Again, these issues would not arise if a legislative regime clearly prescribed the effect of the appointment of an external administrator to a trustee company on the trust and trust assets and liabilities.

Question 8: Should the affairs of a trustee company and each trust it administers be resolved separately in external administration?

Yes, we would support this methodology.

It is a fundamental tenant of trust law (and a fiduciary duty of a trustee) that the property of each trust is to be kept separate and we see no reason to modify this approach. In administering the liquidation of a trustee company, the external administrator should identify the capacity in which all assets are held and, where the company acts as trustee of multiple trusts, then all property and attendant liabilities must be

separately accounted for to enable distribution of asset realisations to the creditors (and if relevant the beneficiaries) of each trust.

The statutory lodgements required by Insolvency Practice Schedule 70-5 (Annual Administration Return), however, do not readily accommodate this separation of accounting information as they will include a full listing of all transactions of the trustee company, effectively pooling all transactions for each underlying trust.

It would be useful to include provisions to address this issue and provide better public transparency, when formulating amendments to the *Corporations Act* to accommodate the external administration of trusts.

Question 9 and 10: Should there be a statutory order of priority in the winding up of a trust? 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?

We strongly support the same order of statutory priorities as provided for section 556 of the *Corporations Act* applying in the winding up of a trust. Section 556 is underpinned by important policy objectives, particularly the well-established priority of payment afforded to employees of an insolvent company. In turn, the operation of the *Fair Entitlements Guarantee Act,* which subsidises most categories of unpaid employee entitlements on insolvency of the employer company, is also dependent upon section 556 priorities applying.

While there has been relatively recent caselaw that has confirmed that the *Corporations Act* priority waterfall should be applied to the assets of trustee companies, we suggest that this issue must have the certainty afforded by clear legislative provisions. Again, creditors and other parties impacted by insolvency should have the benefit of one clear and consistent set of rules and not potentially disparate outcomes based on a business structure they may not even be aware is being utilised.

Question 11 and 12: 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? What should be the impacts of any such limits?

The impact of auto ejection clauses that are commonly contained in trust deeds is one of the principal challenges presented to external administrators of corporate trustees. While the amendments in 2018 precluding the operation of ipso facto clauses (including to trust deeds) on insolvency were theoretically helpful, in practice they have had limited impact due to the operation being restricted to trust deeds established after July 2018. To date this has had virtually no practical impact as the trust deeds we encounter are usually dated significantly earlier.

In our view auto ejection clauses should be ineffective on insolvency, ideally from the date of appointment for most external administrations and for a Court liquidation from the date of lodgement of the (ultimately successful) winding up petition. Otherwise, the appointee is obligated to seek the costly option of Court directions at the expense of the creditors and for no other apparent benefit.

In addition, trust deeds that contain clauses seeking to limit an insolvent trustee company's right of indemnity against the assets of the trust should be stayed by operation of statute.

The effect of these changes will be to provide authority for the external administration to proceed normally without the need for Court guidance, which will in turn reduce the costs to the benefit of the company, the trust(s) it administers and the ultimately its creditors.

Question 13: Are there any other issues that need to be considered in light of the questions above?

Many of the matters addressed above relate to the winding up of trusts and trustee companies. We also support distressed trading trusts having the ability to explore restructuring options using the voluntary

administration process and suggest that controls on the operation of ipso facto and replacement clause in trust deeds should also extend to this type of appointment.

Several other issues we have referenced above should be considered as part of a reform package including:

- mitigators for the misuse of the trustee replacement power;
- clarification of the operation of the right of indemnity by a former and/or bare trustee;
- better options for statutory reporting of transactions to recognise the impact of trusts;
- alignment of the process for external administrators to claim remuneration and have it approved, regardless of the use of a corporate trust structure; and
- clearer taxation reporting obligations for multiple trusts of the same trustee.

Question 14: What is the most appropriate model by which a statutory regime could be expressed in the legislation?

Effective amendments could be made to chapter 5 of the *Corporations Act* to address most of the opportunities for reform discussed above and that it would be preferable to incorporate these potential changes into the existing liquidation and voluntary administration regimes. We do not believe that a standalone regime for insolvent trusts is warranted or desirable given the overarching objectives of consistent and effective outcomes to support confidence in insolvency processes.

Conclusion

McGrathNicol is supportive of the Government's objective of improving insolvency law to address the current challenges presented by the lack of a clear legal framework to administer insolvent trusts. This should include mechanisms which offer trading trusts encountering financial challenges, but with viable businesses, the opportunity to restructure. The overarching objective should be to provide consistent, transparent, and effective outcomes from all corporate insolvency processes as a critical element of a sophisticated financial system.

Given the increasing prevalence of this type of business structure and the multiple issues of concern identified in this consultation process, we would endorse law reform to streamline and modernise the treatment of insolvent trusts. Noting that several state jurisdictions have in recent years investigated possible changes to their Trustee Acts, proposals for reform in this area are timely.

Please do not hesitate to contact Rosemary Winser (0400 647 661) or us should you wish to discuss this matter further.

Yours faithfully

Jason Preston *Chairman*	Matthew Caddy *Head of Restructuring*