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30 November 2022

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
PO Box 6100
Parliament House
CANBERRA ACT 2600
AUSTRALIA

Inquiry into Corporate Insolvency in Australia

Submission

1 Introduction

1.1 This is a submission in response to the Terms of Reference dated 28 September 2022 for an inquiry into the effectiveness of Australia's corporate insolvency laws in protecting and maximising value for the benefit of all interested parties and the economy.

1.2 It responds particularly to paragraph 3(b) of the Terms of Reference, ie 'other potential areas for reform, such as… trusts with corporate trustees'.

1.3 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.

2 Background

2.1 In December 2021, I made a personal submission, and was involved in other submissions, to Commonwealth Treasury's Consultation on *Clarifying the Treatment of Trusts under Insolvency Law*.[1] Apart from publishing the submissions it received on its website, I am not aware of any public statement from Treasury since then regarding progress of the Consultation. Given the apparent overlap with paragraph 3(b) of this Inquiry's Terms of Reference, it is not clear what, if any, relationship there is or may be between the work of Treasury on that Consultation and the Joint Committee's work on paragraph 3(b) of this Inquiry, or even whether the Consultation will continue.

2.2 In May this year there was a change of Federal Government. The Treasury Consultation was launched under the previous administration, while this Inquiry has been initiated under the new administration. I am concerned that the Treasury Consultation may not proceed and that the submissions made to that Consultation may be wasted.

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[1] See: Clarifying the treatment of trusts under insolvency law | Treasury.gov.au

3 My submission

3.1 Thus, my submission to the Joint Committee and the Inquiry is by way of submitting the following:

(1) as **Attachment #1**: a modified version of my personal submission to the Treasury Consultation, dated 10 December 2021; and

(2) as **Attachment #2**: the joint submission of certain practitioners from Allens, Ashursts, Herbert Smith Freehills and Norton Rose Fulbright to the Treasury Consultation, dated 10 December 2021, of which I was a co-author (the other authors are named on the last page of that submission).

4 Overall themes of my submission

4.1 The overall themes of my submission are these:

(1) Despite its origins, the trust today is a well established, widely used and generally accepted vehicle for engaging in trade and commerce in the Australian economy. In some configurations (eg the trading trust and the managed investment scheme (or **MIS**)) it competes quite successfully as an alternative to the Corporations Act company. That should be allowed to continue. Reform is clearly necessary, but it should not involve annihilating the essential benefits of the trust for those who wish to take advantage of them.

(2) While it is common for a corporate trustee to be a single purpose company (ie where it acts solely as trustee of a single commercial trust) (an **SPV**), it is also possible, and not unusual, for a corporate trustee to carry on business or otherwise have assets and liabilities in its own right, and/or to act as trustee of multiple commercial trusts.

(3) Even though trusts do not have separate legal personality, commercial trusts operate and are quite commonly regarded in the market (including by creditors) as economic, business and accounting entities in their own right.

(4) The law, and in particular insolvency law as applicable to trusts, does not properly acknowledge these realities. While the law does recognise trust 'funds' or 'estates' for some limited purposes, the Corporations Act itself is all but silent in protecting trust creditors, including when a trust with a corporate trustee (including a MIS) descends into insolvency. Trust assets and liabilities are left to be dealt with in the insolvent administration of the corporate trustee as a company, by statutory provisions manifestly ill-suited to the task. This has led to copious litigation and has obliged the courts to develop over time a 'common law of insolvency' for trusts in piecemeal fashion - a project that has been (and can only ever be) partially successful, at least from the creditors' perspective.[2]

(5) Legislation should acknowledge and properly accommodate the following in relation to corporate trustees and their trusts:

(a) trusts that engage in business activities should be formally recognised via registration and be publicly searchable. Creditors and other external parties dealing with them should be afforded the same or similar

[2] Many of the current issues with trusts and insolvency stem from the fact that a trust comprises two economic entities (the trustee and the trust fund or estate), but the Corporations Act only recognises one of them. The role of the Australian courts in progressing the law of trusts, particularly with respect to commercial trusts, was recently acknowledged by the Privy Council in *Equity Trust (Jersey) Ltd v Halabi; ITG Ltd v Fort Trustees Ltd* [2022] UKPC 36.

protections to those available for persons dealing with companies in their own right (eg statutory indoor management assumptions);

(b) a trust (or, putting it another way, a trust 'fund' or 'estate') will have assets, liabilities, creditors and equity participants that are separate and distinct from those of the trustee in its own right, and of any other trust of which it is trustee, and may become insolvent independently of the trustee in its own right, and of any other such trust;[3]

(c) in an insolvent administration, a trust (or 'fund' or 'estate') should be dealt with separately from (even if concurrently with), the trustee, and each other trust of which it is trustee.[4]

(6) A trust (or 'fund' or 'estate') 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. Thus, reform should be limited to those trusts, with the objective of better protecting, in insolvency, external parties with whom the trustee has dealt.

(7) 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.

(8) 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 transacting in their own right (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 companies. There is no policy reason why those risk 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.

4.2 The ultimate objective of reform should be for the law to fully acknowledge the economic status of the trust as a business vehicle and to properly accommodate the commercial expectations of those who deal with them, particularly in insolvency.

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

Yours faithfully

N D'Angelo

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3 For a suggested definition of when a trust (or trust fund or estate) may be 'insolvent' see N D'Angelo, *Transacting with Trusts and Trustees* (LexisNexis Butterworths Australia, 2020), at 10.89. For how a corporate trustee may remain solvent while a trust it controls is insolvent, see 10.94 and following (it can occur when the trustee is protected from personal liability for trust debts by limitation of liability clauses, the use of which is very common in Australian commerce). The creditors of a trust that has become insolvent should not have to wait until the trustee becomes insolvent (if ever) before the trust assets and liabilities are taken out of the control of the trustee and placed into the hands of insolvency practitioners.

4 Not wishing to be misunderstood, I hasten to add that I am *not* advocating that trusts should be accorded or deemed to have separate *legal* personality. The suggestion is simply that, when it comes to insolvency, the applicable law should recognise and deal with them (and require insolvency practitioners to deal with them) as notionally separate, standalone business entities with their own assets, liabilities and stakeholders (one of whom may indeed be the trustee itself, eg for unpaid fees and unpaid indemnity claims).

ATTACHMENT #1

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10 December 2021

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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.[5]

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.

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[5] 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*

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.[6]

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.[7]

2 Background and context: why reform is needed

Commercial trusts and the 'parity myth'

2.1 As noted in the Consultation Paper and elsewhere, trusts are popular and ubiquitous in Australian commercial life.[8] 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.[9] 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.

2.2 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.[10] 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').

2.3 But even trusts that are not so structured can carry on business or otherwise incur external debts and liabilities.[11]

2.4 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.

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

7 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).

8 See the statistics in *Transacting with Trusts and Trustees*, n 6, 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.

9 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.

10 I describe the numerous similarities between them in *Transacting with Trusts and Trustees*, n 6, at 1.49 to 1.50.

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

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.[12]

2.5 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

2.6 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

2.7 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.

2.8 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.

2.9 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

2.10 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 the features described above. 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. The trust 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.

2.11 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,

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

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.[13] Many gaps are left and insolvencies involving trusts continue to generate litigation and yield unpredictable outcomes for all stakeholders.

2.12 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.

2.13 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 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.

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

3 Specific issues and recommendations

3.1 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.

3.2 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).

4 Conclusion

4.1 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.

4.2 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.

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

Yours faithfully

N D'Angelo

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13 The most recent high-profile 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 6, at 10.35 to 10.48.

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 the law firm submission in Attachment #2, to support 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;[14] 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'[15]). 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.[16]

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

15 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.

16 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.[17]

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

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 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). The point that follows may be seen as a corollary to that.[18]

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.[19] Thus, a fully secured creditor of an economic entity that is a trust is

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17 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 in Attachment #2.

18 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.

19 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

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).***

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 19 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.[20]

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.

'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].

[20] 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.

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 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.[21]

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.[22]

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21 See generally the discussion in *Transacting with Trusts and Trustees*, n 6, at 2.309 to 2.317.

22 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.

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[23]).

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.

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.[24] 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.[25]

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.[26] 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.

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23 Although I do discuss the issues in detail in *Transacting with Trusts and Trustees*, n 6, at 9.31 to 9.75. Some of the issues were recently canvassed by the Privy Council in *Equity Trust (Jersey) Ltd v Halabi; ITG Ltd v Fort Trustees Ltd* [2022] UKPC 36.

24 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).

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

26 See *Transacting with Trusts and Trustees*, n 6, at 9.16 to 9.19.

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.

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.[27] The rules have also been abolished in relation to superannuation trusts and funds.[28]

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[29]). In this way, the trustee is not obliged (as would otherwise be the position at general law) to make up

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

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

29 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.

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.[30] Section 588G only imposes a 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.[31]

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30 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 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 6, at 4.68).

31 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.

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, 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).[32] 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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[32] See the NSWLRC's website at: www.lawreform.justice.nsw.gov.au/Pages/lrc/lrc_current_projects/Beneficiaries/Beneficiaries.aspx.

ATTACHMENT #2

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Clarifying the treatment of trusts under insolvency law
Submission

1 Introduction

1.1 We are a group of senior banking and finance lawyers from four large Australian commercial law firms that have substantial banking and finance practices. Among other things, we act in the negotiation, structuring and documentation of debt financing facilities across the spectrum of funding options. With one exception, we are not insolvency practitioners but much of what we do is done with a careful eye to the possibility of insolvency to ensure that, to the fullest extent possible, in the event that the borrower and/or a guarantor are affected by insolvency the regime negotiated by the parties and recorded in their transaction documents will result in relatively predictable outcomes, particularly for financiers and other creditors.

1.2 A large number of economic entities trading or investing in Australia today are structured as trusts, and many of these are registered managed investment schemes (**RMIS**). These economic entities often need to borrow or give guarantees or enter into other contracts. Their financiers and other counterparties want access to the assets of the economic entity, the trust assets, on enforcement or insolvency.

1.3 But a trust is not a legal entity. It is a set of duties imposed on the trustee who holds property for beneficiaries (or, in some cases, a charitable purpose). Any loan agreement, guarantee or other contract is entered into not by 'the trust' as such, but rather by the trustee, and it is the trustee that incurs the obligations and liabilities. The financiers and other counterparties enforcing those obligations and liabilities only have access to the trust assets through the trustee, and then only if the trustee has acted properly as trustee (ie in accordance with its powers and duties). If it has not, the financier or counterparty may not have a right or ability to access the trust assets or be paid out of them, *whether or not it knew or could have known that the trustee was not acting properly*.

1.4 This presents financiers and counterparties with a series of risks and challenges that do not exist when dealing with a company on its own account. Those risks and challenges can deter financiers and other parties, retarding the availability of credit to trusts or increasing its cost.

1.5 This submission is written from that perspective and out of a desire to emphasise to Treasury that, when it comes to trusts and insolvency, lawyers and participants in transactions at the 'front end' are as vitally interested in reform as those who become involved once insolvency strikes.

1.6 We fully support the Consultation and welcome the opportunity to make a submission.

1.7 We should note that others in our respective firms (including some that are insolvency specialists) may be making their own separate submissions in response to the Consultation Paper. We should not be taken as representing the collective or exclusive position of our respective firms.

1.8 Finally, we do not respond to the questions in the Consultation Paper separately. Others will undoubtedly do that. Our submission rather is of a general nature, to highlight some of the ways in which the risks posed by trusts in insolvency affect the negotiation, structuring and documentation of financing and other commercial transactions. The issues we raise were not addressed in the Harmer Report nor have they been discussed in any detail in any other official law reform report since.[1] If anything, this submission might be seen as a response to Question 13: *Are there any other issues that need to be considered in light of the questions above?*

2 Recommendation

2.1 For the reasons set out below, we recommend that, in addition to any amendments that might be made to the insolvency provisions of the *Corporations Act 2001* (Cth) (the **Corporations Act**) as a result of this Consultation, the Act should also be amended to insert innocent outsider (or 'indoor management') protections for persons dealing with trusts that have a corporate trustee (which would include all those that are RMIS). These provisions should correspond (as applicable) to those that benefit persons dealing with companies on their own account under sections 124 to 129 of the Corporations Act, tailored to the complexities of the trust form. Some of the matters that could and should be addressed by such provisions are discussed in paragraphs 4.2 and 5 below.[2]

2.2 These provisions would protect persons who are innocent of disentitling knowledge or suspicion against adverse consequences of internal defects in the trust and trustee misconduct, and allow them to transact with trusts and trustees with a higher degree of confidence and with lower transaction costs and risks.

2.3 Importantly, they would eliminate a range of unexpected adverse outcomes for financiers and other counterparties (and associated litigation) in the insolvency of a trustee or trust. [3]

3 The market and regulatory context — the contrast with companies

3.1 As noted in the Consultation Paper and elsewhere, trusts are popular and ubiquitous in Australian commercial life, due mainly to their useful structural flexibility and the legitimate taxation advantages that are available (including 'pass-through'

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1 The 'Harmer Report' is the report of The Law Reform Commission entitled *General Insolvency Inquiry* (Report No 45, 1988). The issues are dealt with in some detail in N D'Angelo, *Transacting with Trusts and Trustees* (LexisNexis Butterworths Australia, 2020), primarily in Chapter 5.

2 There is a number of ways these provisions could be drafted. For example, they should include nullifying the impacts of the 'clear accounts rule' on trust creditors (discussed in paragraph 5), leaving 'unrelated breaches' to be dealt with between trustee and beneficiaries. For statutory assumptions to work properly it might be necessary to create a searchable public register for trusts/trustees that wish to incur external indebtedness and that would give rise to its own set of complexities. We would be happy to discuss suggestions on request.

3 We do not in this submission specifically address superannuation trusts and funds, which are regulated by the *Superannuation Industry Supervision Act 1993* (Cth) and several other statutes and regulatory instruments. Those trusts are not permitted to undertake full recourse borrowing (see section 67 of the Act) and so are not particularly prone to insolvency, but they do engage in investment and other commercial activities that involve transacting with external parties, so the protections we have suggested could apply to them also.

transparency).[4] They can and do engage in all of the same business activities that companies do, including borrowing and other activities that involve them incurring liabilities in favour of external counterparties.

3.2 Trusts that engage in commercial and business activities are sometimes described as 'trading trusts' or 'commercial trusts', although those are not legal terms of art and have no legal meanings within the law of trusts.

3.3 As banking and finance practitioners, we see commercial trusts virtually every day, in all manner of financing and other commercial transactions.

3.4 Typically, commercial trusts (including those that are RMIS) will be structured as unit trusts with a company as the trustee, so that they resemble and behave like companies. But they are not companies. While they may be described as business or accounting entities, they do not possess separate legal personality. They are not regulated by the Corporations Act or supervised by the Australian Securities and Investments Commission (**ASIC**) or any other regulator in the way that companies are.[5] Those who transact with them do not enjoy the benefit of the statutory creditor protections that are available to those who transact with Corporations Act companies. These differences are fundamental and enormously consequential for trust counterparties.

3.5 With some exceptions, trusts are effectively invisible to the Corporations Act – not only to the insolvency regime in Chapter 5 – and there is no equivalent statute for them.[6]

3.6 Company law provides generous innocent outsider (or 'indoor management') protections, including statutory assumptions, that benefit persons who transact and otherwise deal with a Corporations Act company acting on its own account. So long as they are not affected by disentitling knowledge or suspicion, counterparties may deal with a company with confidence, with minimal or no due diligence in relation to essential matters like existence, legal status, power, authority and internal compliance (including compliance with officers' duties), beyond obtaining and checking an ASIC search: see primarily sections 124 to 129 of the Corporations Act. From a policy perspective, this shifts certain internal risks in a company to its internal stakeholders to manage, and is an implicit acknowledgment by the state of the economic importance of companies and of protecting commercial parties that do business with them. It allows parties to deal with companies with confidence, and so enhances the ability of companies to transact and generally to do business.

3.7 By contrast, trust law provides very little in the way of protections for outsiders who deal with a trustee in that capacity. Such protections as there are in the general law are fragile and easily lost, and tend in their strictness to preference beneficiaries (who are commonly, though not always, investors) over outsiders (including creditors).[7] The relative invisibility of trusts on searchable public registers exacerbates this problem. From a policy perspective this appears to evidence an *absence* of official recognition of the importance of commercial trusts in the economy, and leaves external counterparties bearing risks that are internal to the trust, which risks ultimately may result in them having no access to trust assets on enforcement or insolvency.

3.8 For example, if a company purports to give an unsecured guarantee to a counterparty, and in doing so its directors are in breach of their duties to act in good faith in the best interests of the company and for a proper purpose, then under sections 128 and 129 of the Corporations Act the counterparty can still enforce the guarantee and participate in a distribution of the company's assets in insolvency, unless the counterparty actually knew of the breach or suspected it. By contrast, if the company is giving an unsecured guarantee as trustee, and in doing so is in breach of similar duties as trustee, the

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4 See the statistics in D'Angelo, n 6, at 1.39 to 1.48.

5 With the exception of those that are RMIS, which are *partially* regulated by the Corporations Act (mainly by Chapter 5C) and are supervised by ASIC under that Act.

6 Even Chapter 5C itself is 'defective' from a creditor's point of view, because it contains no innocent outsider protections and no insolvency provisions. It is clearly an *investor* protection regime with little direct protection for creditors.

7 For a comparison of the outsiders' position under the Corporations Act against their position when dealing with trusts, see D'Angelo, n 6, at 5.76 to 5.96.

counterparty does not have any access to the trust assets, whether in enforcement or in insolvency, *even if they did not know of or suspect the breach*.

4 What this means for financiers and others at the 'front end'

4.1 All of this means that financiers and others contemplating transacting with trustees (including commercial contracting counterparties in a non-financing context) must fend for themselves and seek protection (such as it is) by private means. But no matter how diligent they may be, those measures may still not fully protect them. They may price the risks by charging higher interest and other costs but in a competitive market that is not always feasible. Or they may only be prepared to provide a smaller amount of credit, or none at all, or impose more onerous or restrictive conditions. In any event the costs of transacting (including legal costs and management time) will be higher.

4.2 Well advised counterparties will be aware of the risks and will conduct (or have their advisers conduct) detailed pre-transactional due diligence of a kind that is not necessary when dealing with a company acting as principal, and even then this still may not give full protection. For example, they will seek to satisfy themselves that:

(1) the trust was properly formed and exists;

(2) the trust deed or constitution satisfies all formal requirements for efficacy and enforceability;

(3) the trustee is properly appointed and is the only trustee of the trust;

(4) the trustee has the trust power to hold and manage the enterprise assets in the manner in which they are being held and managed;

(5) the trustee has the trust power to enter into and perform obligations under the proposed transaction in that capacity;

(6) even if it is within power, that the transaction has been properly authorised and entry into it is a proper exercise by the trustee of those powers (eg it is in the best interests of the investors or beneficiaries, and the trustee is under no unauthorised conflicts);

(7) the trustee's entry into the transaction will not otherwise cause or result in a breach of trust;

(8) the trustee has the right to be indemnified out of trust assets for the debts and liabilities it will incur under the transaction, and that the counterparty as a trust creditor may subrogate to that indemnity on enforcement or in insolvency; and

(9) if the trust is a RMIS, it satisfies all of the formal requirements of Chapter 5C of the Corporations Act, and the trustee (or responsible entity) is not in breach of its duties and obligations under that Chapter generally or in entering into the proposed transaction. [8]

4.3 An undetected and unrectified defect, irregularity or deficiency in any of these matters, even if ostensibly only 'technical', can result in a counterparty, whether secured or unsecured, being left with no or diminished access to the assets held in the trust on enforcement or insolvency, and no other recourse of value.[9] In many cases, this outcome can apply regardless of whether the counterparty knew of or suspected the issue.

4.4 In addition to due diligence, well advised counterparties will seek to negotiate a series of trust-specific structural and documentary protections.

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[8] These steps are in addition to the normal due diligence a counterparty would conduct with respect to the trustee itself as a company.

[9] They might have a personal claim against the trustee but that is worthless if the trustee is of nominal value or is insolvent or, as is commonly the case, has negotiated a robust limitation of liability clause into the documentation with the creditor.

4.5 All of this leads to delay and added transaction costs, as well as the risk of error. It can and does occasionally lead to transactions being abandoned.[10]

4.6 Almost none of this is required when dealing with a Corporations Act company, thanks largely to statutory protections in the Corporations Act and the availability of searchable records kept and made publicly available by ASIC.

4.7 Of course, not everyone who deals with trusts and trustees has the benefit of expert legal advice to warn them of the risks and undertake protective steps on their behalf, and so some will transact without an awareness of the risks and therefore with full exposure.

4.8 In any case, even if a counterparty does all of the above, solutions are imperfect and risks remain. Not all risks can be identified and managed by due diligence and documentation.[11]

5 'Unrelated breaches': an example of a risk that cannot be controlled by a counterparty, no matter how diligent

5.1 Here is an example of the limitations of protection by private means. All unsecured trust creditors (whether financiers or otherwise) face a specific risk that is unique to trusts and is virtually uncontrollable. That is the risk of 'unrelated breaches', ie breaches of trust committed by the trustee that are unrelated to the specific transaction in which the creditor is involved (for example, an unrelated misappropriation of trust funds by the trustee or the trustee making an unauthorised investment or personal gain). No amount of pre-transactional due diligence can fully protect a counterparty from these breaches. They may even be unknown to the trustee itself (it does not matter if a breach is innocent or fraudulent) and may be entirely unknowable to an outsider. They may pre-date the transaction or may occur after it.

5.2 Due to the operation of the 'clear accounts rule', these breaches can have the effect of reducing the value of the trustee's indemnity, including potentially to zero.[12] Since subrogation to that indemnity is the unsecured trust creditor's *only* route of access to the trust fund on enforcement or insolvency, these breaches may result in those creditors being deprived of recovery against enterprise assets, through no fault of their own.

5.3 For example, say a responsible entity of an RMIS (which is therefore a trustee) borrows money under a loan agreement for the purposes of the trust and at every step it acts entirely properly, in accordance with its powers and duties (as confirmed by the lender's due diligence processes). Prima facie, the lender will have access to trust assets on enforcement or insolvency. But two years before that, in an entirely unrelated transaction, the responsible entity had made a large investment that was technically not in accordance with the RMIS constitution. That investment proves unsuccessful and the losses fall on the responsible entity personally, which means it must make good by paying an amount equal to the losses into the trust fund. In those circumstances the responsible entity will have no right to indemnify itself out of trust assets against a claim under the loan agreement, unless and until it makes good. If it is unable to do that, the result may be that the lender will have no access to the trust assets on enforcement or insolvency.

5.4 Thus, even after taking steps of the type described above, unrelated breaches will always be an uncovered risk. There are limits to what a trust creditor can do, practically speaking, to prevent this or protect itself against its consequences, short of taking

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10 And all of this can be particularly challenging to explain to offshore counterparties in jurisdictions that do not have trusts, or trusts that engage in commerce in the way Australian trusts do.

11 Some of the uncertainties of the insolvency process when a trust is involved have recently been exposed by several high profile cases, including in the High Court: see *Carter Holt Harvey Woodproducts Australia Pty Ltd v Commonwealth of Australia* (2019) 268 CLR 524; [2019] HCA 20. See also *Jones (Liq) v Matrix Partners Pty Ltd, Re Killarnee Civil & Concrete Contractors Pty Ltd (in liq)* (2018) 260 FCR 310; [2018] FCAFC 40.

12 The consequences for the trustee of committing breaches of this type include an obligation to restore or make good any loss caused to the trust fund, or to disgorge unauthorised profits or gains into the fund. Until it does that, it is proh bited from taking assets out of the fund for itself, including under its indemnity, unless it only takes the net amount, if any, after deducting the value of the make-good or disgorgement obligation. This is sometimes descr bed as an obligation to 'clear the accounts' of the trust.

security over trust assets (which is not always legally possible or commercially available).

5.5 This is a stark (but by no means the only) example of where the law appears to impose the consequences of trustee misconduct on outsiders, even if they are unaware and otherwise innocent of that misconduct. In effect, equity investors in the trust (ie the beneficiaries), are 'insured' in insolvency against losses caused by certain kinds of trustee misbehaviour by the trust's creditors, so that equity is preferred over debt – the exact reverse of the position when a company becomes insolvent. There is no analogue to this outcome in company law.

6 Conclusion

6.1 The issues described above for financiers and others dealing with trusts and trustees can only be properly resolved by legislation. It is inappropriate that they are left to be dealt with by private means. Indeed, it is extraordinary that persons who deal with a commercial enterprise that happens to be held within a commercial trust - a widely recognised, used and accepted business vehicle - suffer risks and costs, including particularly in insolvency, that do not exist for those who deal with a similar enterprise held by a company. If trusts are to be permitted to continue to conduct business in the same way as companies (and we do not suggest otherwise) then the legal risk profile of parties who do business with them should be more closely aligned to that of those who do business with companies.

6.2 We would be pleased to discuss these issues further. If you have any queries, please contact any of the following.

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