

TRUSTEES' RIGHTS OF INDEMNITY, INSOLVENCY AND STATUTORY DISTRIBUTIONS TO PREFERRED CREDITORS*

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[503] In February and March 2018, the Victorian Court of Appeal and the Full Court of the Federal Court delivered substantial judgments addressing a perennial problem in the law of trusts: when a corporate trustee is wound up, how does the trustee's right of indemnity interact with the statutory scheme of distribution to creditors under s 556 of the Corporations Act 2001 (Cth) (according to which priority is given to certain creditors including the liquidator and employees)? The trustee may have incurred liabilities both in its own right, and also in the course of acting as trustee. Indeed, it may have incurred liabilities as the trustee of more than one trust. If those liabilities are to be discharged by using trust assets, there are essentially three possibilities: either the statutory scheme of distribution applies amongst all creditors, or just amongst trust creditors, or else the statute does not apply at all insofar as the trustee has recourse to trust assets.

It is to be recalled that a creditor of a trustee has a personal claim against the trustee, but may also be subrogated to the trustee's right of indemnity and thereby gain access to the trust assets.¹ In that qualified sense the creditor of the trustee may be regarded as being in some respects a secured creditor. But that is but part of the difficulty in determining how the statutory scheme applies when a corporate trustee is being wound up. The larger difficulty is that the trustee does not own the trust property beneficially. Save insofar as the trustee is entitled to the trust property pursuant to its right of indemnity, it holds the trust property for

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¹ See *In re Raybould; Raybould v Turner* [1900] 1 Ch 199; *Vacuum Oil Company Pty Ltd v Wiltshire* (1945) 72 CLR 319 at 328, 335-336. The nature of the trustee's right is analysed by Silink, "Trustee Exoneration from Trust Assets – Out on a limb?" (2018) 12 *Journal of Equity* 58.

the beneficiaries. That leads to the question: why in the event that the trustee is to be wound up, should the trustee's creditors obtain the benefit of property of which the trustee held only the legal title?

At the level of principle, the question is what precisely is the nature of the right of indemnity. At the level of authority, the issue is associated with the inconsistent Full Court decisions of *Re Enhill Pty Ltd* [1983] 1 VR 561 and *In re Suco Gold Pty Ltd (in liq)* (1983) 33 SASR 99, which have not been revisited at the appellate level for 35 years. That is so notwithstanding the problem being immensely practical: in June 2014, there were some 802,000 tax returns lodged in respect of trusts, more than companies or partnerships, and declaring total income of \$345 billion. Many of those trusts had corporate trustees, and although not all trustees trade, many do, and there must be large numbers which are wound up each year, and larger numbers of other participants in the Australian economy who are exposed to the risk of insolvency. I return to this below.

Jones v Matrix Partners Pty Ltd

Both of the recent judgments repay careful reading. Neither can be fully summarised in this note (together they are some 640 paragraphs). It is convenient to commence with the more recent decision of the Federal Court: *Jones (Liquidator) v Matrix Partners Pty Ltd, in the matter of Killarney Civil & Concrete Contractors Pty Ltd (in liq)* [2018] FCAFC 40. Killarney Civil & Concrete Contractors Pty Ltd had been the trustee of a trading trust. It carried on no business on its own account, nor as trustee of any other trust. In September 2014, Mr Jones (and others) were appointed joint administrators under s 436A of the *Corporations Act*. They caused certain of the trust assets to be realised. In December 2014, [504] KCCC's creditors resolved to wind it up, and Mr Jones (among others) was appointed its liquidator. The trust deed provided that KCCC thereupon ceased to hold office as trustee. No replacement trustee was purported to be appointed until 2016. The balance of funds received by the administrators became held by Mr Jones as liquidator. In that capacity, Mr Jones continued to realise the remaining trust assets. He also recovered from the Australian Taxation Office an amount of \$4,500,000 as an unfair preference.

In the course of the administration and the winding up, employee entitlements were paid out of funds which were subject to a charge in favour of Westpac. After all assets had been

realised (and simplifying slightly), Mr Jones held some \$4,000,000. The main liabilities of the company were some \$2,000,000 in priority unsecured debts, some \$20,000,000 in ordinary unsecured debts, and some \$1,500,000 owed to Westpac as a secured creditor. He sought directions and declarations.

It may be noted that there is nothing particularly unusual about the winding up or the facts which preceded it. Yet the liquidator, entirely appropriately, in light of the long-standing uncertainty in the authorities, sought advice and four separate questions were referred to a Full Court of the Federal Court, constituted by Allsop CJ, Siopis and Farrell JJ.

The main steps in the leading judgment of Allsop CJ were as follows. KCCC's debts were all trust debts, incurred in the course of trading. The trustee owed the creditors personally, but was entitled to be indemnified from the trust assets. The right of indemnity extended to an interest in the trust property, and took priority over the interests of the beneficiaries.

An important distinction was to be drawn between reimbursement and exoneration. If a trustee pays a creditor from the trustee's own funds, and seeks reimbursement from trust assets, then the right of reimbursement falls into the trustee's general estate without any attendant equitable obligations. But that is probably only rarely the case (many corporate trustees are companies with miniscule capital and no assets in their own right), and had not occurred in the present case. Where on the other hand a trustee seeks to be exonerated from trust assets – to use trust funds to discharge a trustee's personal liability incurred in the course of acting as trustee – then further analysis is necessary.

In *Re Enhill Pty Ltd*, a Full Court of the Supreme Court of Victoria regarded the proceeds of the right of indemnity as free to be used for all of the bankrupt trustee's creditors. Shortly afterwards, in *In re Suco Gold Pty Ltd*, a Full Court of the Supreme Court of South Australia disagreed, on the basis that a trustee which used trust property to discharge liabilities other than those incurred in the performance of the trust was using trust property for an unauthorised purpose and for the benefit of non-trust creditors. It is a rare thing for the authors of *Lewin on Trusts* to mention Australian decisions, let alone criticise them, but they state that *Re Enhill* is "clearly incorrect",² as have many other commentators (including me).

² L Tucker, N le Poidevin and J Brightwell (eds), *Lewin on Trusts* (Sweet & Maxwell, London, 19th ed 2015) at p 888.

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Allsop CJ preferred the reasoning of King CJ in *Suco Gold*: at [76]-[78]. He stated that the right of exoneration was “not a personal right devoid of connection with the purposes and working of the trust; it inheres in, and arises out of, the trust relationship that exists for a purpose – to pay the creditors and thus to exonerate the trustee”: at [48].

Allsop CJ considered that *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 entailed that the right was property of the company – it was a proprietary interest of the trustee that is held by the trustee in priority to the beneficiaries' interests: at [69]. There is a helpful close reading of the High Court’s judgment, emphasising that in that case there were only trust creditors, and expressing caution at taking generally worded propositions out of context.³

Allsop CJ considered that the powers conferred by s 477 of the *Corporations Act* did not entitle the liquidator to sell the trust property. The trustee had a lien on the property, in the sense described by [505] McPherson in *Kemtron Industries Pty Ltd v Commissioner of Stamp Duties* [1984] 1 Qd R 576 and confirmed by the High Court in *Chief Commissioner of Stamp Duties (NSW) v Buckle* (1998) 192 CLR 226, which only entitled it to apply for a judicially supervised sale. Allsop CJ held that s 477 did not supplement that power. Hence the importance of the automatic removal, under the terms of the particular trust deed, of the trustee upon the appointment of the liquidator. That said, all members of the Court indicated that it was probable that there would be no objection to leave being granted nunc pro tunc for the sales of trust assets which had occurred, because it appeared to be accepted that the right of exoneration would exhaust the trust property: at [91], [146], 152] and [198].

All members of the Court noted that all parties were agreed that the unfair preference which had been recovered should be applied in accordance with the statutory priority regime (a position which was not wholly uncontroversial): at [94]. For the reasons given by King CJ in *Suco Gold*, Allsop CJ considered that the proceeds of sale likewise were to be applied in accordance with the statutory regime, but on the basis that the realisation of the trust assets in support of right of indemnity did not alter the nature of those assets, which were to be used only to pay trust creditors. He said at [101]:

The *Corporations Act* should not be restricted to its application to only some types of property of the company. Nor should it be construed as intended to change the nature

³ The problem recurs: see, eg, *Ramsay Health Care Australia Pty Ltd v Compton* (2017) 91 ALJR 803; [2017] HCA 28 at [62]-[63].

of property of the company. In the well-known context of companies that act and carry on business on their own account and also as trustees for "business" trusts and in the context of well-known and fundamental equitable principles, the statute should be read and understood as applicable to corporations and their property of all kinds. That does not mean, however, that rights, duties and proprietary characteristics from the operation of well-known and fundamental principles should not be accommodated in the operation and working of the statute. Such rights, duties and characteristics are part of the legal groundwork and foundations against which one reads and applies the statute: the equitable principles and norms in which the statute was intended to operate.

Allsop CJ added that if that was not the result of the federal legislative scheme, then equity would follow the law: at [111]-[120]. His Honour concluded:

Here, the consistent policy of Parliaments discussed in the reasons of Farrell J has been to protect employees. The techniques have become progressively stronger, brought about by an appreciation of inadequacy in some circumstances of an earlier regime. There is, however, clear and consistent policy now based in national legislation. Equitable principle should reveal consistency with, not divergence from, public policy of such strength and consistency, when it conforms so completely with all the norms that underlie Equity.

His Honour gave a series of cases where equitable principle conformed to statute law; this may be regarded as an aspect of equity following the law.

Siopis J dissented in part, holding that the *Corporations Act*, which refers to "property of the company", was not addressed to a trustee company's right of indemnity: at [159]-[191]. Applying what Needham J had earlier held in *Re Staff Benefits Pty Ltd* [1979] 1 NSWLR 207, his Honour considered that trust creditors were to be paid by reference to equitable principles, rather than the statutory regime. In consequence, the priority regime did not apply: "the statutory priority regime in s 555 and s 556 of the *Corporations Act* has no application to trust monies which the current liquidator hold from those [unauthorised] sales": at [151]. His Honour agreed that the liquidator had lacked power to sell the trust property. Until such time as the liquidator had applied to be [506] appointed as a receiver *nunc pro tunc* in respect of

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the assets already sold, his Honour considered it was inappropriate to give advice as to the distribution of the proceeds of sale: at [156].

Farrell J substantially agreed with Allsop CJ. Her Honour considered that the proceeds of realisation were property of the company, but did so because her Honour considered that the decision of the Victorian Court of Appeal was “binding on this bench”: at [200]. Her Honour also considered that the priority payment of the liquidator’s reasonable remuneration and costs should also be recognised in equity, for the principles given by Brereton J in *Re AAA Financial Intelligence Ltd (in liq)* [2014] NSWSC 1004 at [13], but did not consider that the costs of an application to wind up the corporate trustee could constitute a trust debt: at [201]. She also agreed that the liquidator lacked power to sell the trust property. Although in an earlier decision her Honour had not been satisfied that the statutory priority scheme applied to trust creditors,⁴ her Honour expressed the view that “a court of Equity should follow the statute in giving a receiver (or liquidator acting as receiver) directions as to how trust creditors (and only trust creditors) should be paid out of trust assets): at [214].

Farrell J made two further observations which may not be immediately apparent to all readers. First, the Full Court was exercising original, not appellate jurisdiction.⁵ That explains the statement that her Honour regarded the Full Court as “bound” by the decision of the Victorian Court of Appeal, which may be read as shorthand for that decision attracting the deference, as a decision of an intermediate court of appeal on federal legislation, associated with *Australian Securities Commission v Marlborough Gold Mines Ltd* (1993) 177 CLR 485. Secondly, her Honour noted, by reference to a paper by Dr Nuncio D'Angelo,⁶ the practical significance of trusts in the Australian economy, mentioned at the outset of this note, and the desirability of legislative amendment to clarify the position (while acknowledging, with respect correctly, that amendments might not be straightforward).

Commonwealth of Australia v Byrnes

Three weeks earlier, an expanded Victorian Court of Appeal delivered judgment in an appeal raising similar issues: *Commonwealth of Australia v Byrnes* [2018] VSCA 41 (Ferguson CJ,

⁴ *Re Woodgate* [2016] FCA 1583.

⁵ At [200]. See also *Minister for Immigration and Multicultural and Indigenous Affairs v SZANS* [2005] FCAFC 41; (2005) 215 ALR 733 at [36]-[37] and *Maceldir Pty Limited v Dimovski* [2005] FCA 1528; (2005) 226 ALR 773 at [7].

⁶ “Commercial trusts in practice: the trust as a surrogate company” (paper presented at the Annual Commercial and Corporate Law Conference convened in November 2016). See also N D'Angelo, *Commercial Trusts* (LexisNexis Butterworths Australia, 2014), chapter 2.

Whelan, Kyrou, McLeish and Dodds-Streeton JJA). The joint judgment of all members of the Court contains a helpful summary and consideration of most of the authorities. The Court allowed an appeal from the primary judge, who had concluded that the corporate trustee's right of indemnity by way of exoneration was not "property of the company" and for that reason was not subject to the lender's security: at [269]-[273]. Their Honours also held that the distribution was governed by the *Corporations Act*, disagreeing with what had been held more recently in *Lane (Trustee), Re Lee (Bankrupt) v Deputy Commissioner of Taxation* [2017] FCA 953. On the vexed dispute between whether (as was held in *Re Enhill*) the statutory regime applied to all creditors or (as was held in *Re Suco Gold*) it applied only to trust [507] creditors, their Honours collected considerations favouring both approaches at [283] and [284] but declined to decide the point, this once again being a case where all creditors were trust creditors. Their Honours added at [286] that while there:

must be some doubt about which of *Re Enhill* or *Suco Gold* is correct, it suffices to say that unless and until a subsequent appellate decision decides otherwise, the law as it stands in Victoria as articulated in *Re Enhill* should continue to be followed by other trial judges in this State.

The second half of the judgment considered whether the trustee's right of indemnity was subject to a circulating security interest (formerly, a floating charge). The Court held that it was sufficient that the trust property, rather than the right of indemnity, be subject to the circulating security interest: at [314]-[315], but that in any event the right of indemnity bore the same character: at [328]-[329]:

The right of indemnity is not 'fixed' in any practical sense. It enables recourse to trust assets varying in extent over time as the trustee's liabilities expand and contract and as the value of the assets also varies. To the extent that the trust assets are circulating assets, that description befits the right of indemnity which is, after all, a means of recourse to those same assets.

The balance of the judgment contains a useful analysis of whether particular assets were circulating assets.

Conclusions

First, *Jones* is a salutary reminder to the need for liquidators of trustee companies to ensure they have power to sell trust assets.

Secondly, *Jones* is also of broader significance, in its analysis of the relationship between statute and equity.

Thirdly, the two decisions give rise to some novel questions of precedent. It is open to an appellate court to confirm the precedential value of its own earlier decision, without itself endorsing it – see for example the endorsement of *Yerkey v Jones* (1939) 63 CLR 649 in *Garcia v National Australia Bank Ltd* (although here the High Court went on to confirm the correctness of what Dixon J had said six decades earlier).⁷ However, *Suco Gold* is a more recent appellate decision which is inconsistent with *Enhill*. It seems to be novel for an appellate court to be able, as it were, to require first instance courts to disregard a more recent intermediate appellate authority on a decision of federal law or uniform State law, whilst at the same time refraining from holding that that decision, or the earlier decision, was correct. Indeed, on one view, this may cut across the uniform approach to federal or uniform State legislation.

For the moment, judges of State courts in South Australia and Victoria are bound, respectively, by the inconsistent decisions in *Enhill* and *Suco Gold* while elsewhere the position is more contestable. Federal judges are not bound by, but would naturally give great weight to, the decision of the Full Court in *Jones*. A judge at first instance in another State is faced by the two decisions mentioned in this note, as well as (without being exhaustive) the approach adopted by Brereton J in *Re Independent Contractor Services (Aust) Pty Ltd (in liq) [No 2]* (2016) 305 FLR 222, who rejected the correctness of both *Enhill* and *Suco Gold* and considered that the distribution was *pari passu* by analogy with the competing claims by beneficiaries of different trusts to trace into a mixed fund. It may be expected that those differences will inform liquidators' choice of forum.

Fourthly, it is true that many cases will not present the issues in all their complexity. The most common case is that of a trustee of a single trust and which has incurred no debts in its own right, so that all [508] creditors are trust creditors and the liquidator's costs may be seen

⁷ (1998) 194 CLR 395 at [17]. See also *Chen v Ng* [2017] UKPC 27 at [29], noted (2018) 134 *LQR* 171.

as costs incurred on behalf of the trust. This may explain why the difficulty which has now been rendered acute has not previously been resolved. However, if a principled approach is to be applied, it must surely be necessary, as Allsop CJ observed at [29], for that approach to accommodate cases where a trustee is the trustee of more than one trust, and has both trust creditors and personal creditors.

It is to be regretted that, especially in an insolvency context where there is every reason to avoid litigation and focus on an efficient and cost-effective process, the position is presently as contestable as it seems to be. The problem is acutely Australasian. Trading trusts appear to have arisen in Australia and New Zealand in the 1970s as a tax-efficient alternative to the limited liability company, suitable to operate a family business.⁸ The problems of insolvency attracted early attention from commentators including Ford, McPherson and Meagher.⁹ While Professor Ford famously described the structure as a "commercial monstrosity", it is plain that they remain an important part of the Australian economy. They do not seem to have spread to the northern hemisphere. Lewin, for example, describes using a trust to carry on business as "nowadays unusual".¹⁰

Without intending any criticism to any of the judgments, a further decision (ideally of the High Court) or legislative reform is to be welcomed. The question is not merely one which concerns a basic aspect of the law of trusts; it is also an important and recurring source of complexity and uncertainty, and therefore cost. And it affects the Commonwealth directly. In each decision the Commonwealth was a party, because it had made advances pursuant to the *Fair Entitlements Guarantee Act 2012* (Cth) to the liquidator so that priority unsecured creditors (such as employees) could be paid, which in turn (speaking generally) gave it the same rights as the priority creditors had enjoyed. The cost of the scheme (which includes that of paying advances to all insolvent employers, not merely insolvent trustees) is very substantial: no less than \$597 million for the two financial years 2014/15 and 2015/16.¹¹ Even if advances to insolvent trustees represent only a small percentage of the whole, the question is nonetheless apt to represent a recurring annual cost of millions of dollars.

⁸ See N D'Angelo, above, 76ff.

⁹ HAJ Ford "Trading Trusts and Creditors' Rights" (1981) 13 *MULR* 1; BH McPherson "The Insolvent Trading Trust" in PD Finn (ed) *Essays in Equity* (Law Book Company, Sydney, 1985) 142; RP Meagher "Insolvency of Trustees" (1979) 53 *ALJ* 648.

¹⁰ Lewin, above, 1673.

¹¹ The figures are taken from the May 2017 Consultation Paper, *Reforms to address corporate misuse of the Fair Entitlements Guarantee scheme*, published by the Treasury and the Department of Employment.