

# Liquidation of Trading Trusts: Problems for Creditors (and a lack thereof)

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# Preface

This dissertation is in two parts. Part I, comprising Chapters 1 and 2, is an introduction to trading trusts and to an important facet of trust law that relates to them: the trustee's right of indemnity. Part II, comprising chapters 3 to 5, builds on this foundation and explores the practical impacts of the trading trust structure in a liquidation context. Each chapter in this Part examines the effect of the trading trust structure on a different class of creditor in the liquidation: general creditors (Chapter 3), statutorily prioritised creditors (Chapter 4), and liquidators (Chapter 5).

This dissertation follows the New Zealand Law Style Guide in all respects apart from the formatting and numbering of headings. For consistency, all pinpoint references within secondary texts are to page numbers rather than paragraph or heading numbers.

## Acknowledgements

My supervisor, Associate Professor Jess Palmer, has been a limitless source of inspiration and encouragement throughout the process of writing this dissertation.

A special mention is also deserved by my parents, Ali and Jake, who throughout this process frequently reminded me that I was putting too much time into other things and not enough into my dissertation. The Yin to this Yang has been my flatmates, Bryn, James, Matt and Max, who never ceased to point out that I was spending far too much time in my room. In combination, these opposing forces have succeeded in providing me with a perfect work-life balance throughout the writing of this dissertation, and for this I am grateful to them all.

# Part I: Key Concepts

# Chapter 1: Introduction

*This chapter introduces the concept of the trading trust, a business structure involving an assetless company carrying out a business as trustee of a trust. This chapter also outlines the content of this dissertation.*

## 1.1 Scope of this dissertation

This dissertation deals with the trading trust, a business structure which has received much academic attention and criticism since it first arose in the 1970s. Trading trusts continue to attract attention, recently being the subject of a chapter in a Law Commission report on the law of trusts.<sup>1</sup> I will examine the extent to which historical and current concerns about the effect of trading trusts upon creditors remain valid, and whether reform is needed in this area.

This dissertation is concerned solely with trading trusts in the context of liquidation. In particular I deal with the legal and practical implications of the trading trust structure for three classes of creditor: general unsecured creditors, creditors given statutory priority, and the liquidator.

I take the view in Chapter 3 that, save perhaps for some legislative clarification of the current law, no change is needed to protect general creditors. Creditors of trading trusts are essentially no worse off than they would be if the relevant business was carried out through a limited liability company. However, some side-effects of the trading trust structure may have negative effects on priority creditors and the liquidator (to the benefit of other creditors). These parties are discussed in Chapters 4 and 5 respectively.

## 1.2 What is a trading trust?

A trading trust is a business structure involving the use of a limited liability company as the trustee of a trust, in which capacity it carries on business with trust assets.<sup>2</sup> This company (the “corporate trustee”)<sup>3</sup> is formed for the sole purpose of administering the trust, and has few or no assets of its own.<sup>4</sup> Instead, all the assets it “owns” are trust assets (of which it has legal but not beneficial ownership), and it uses these trust assets to carry on business. Profits are distributed to the trust’s

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<sup>1</sup> Law Commission *Review of the Law of Trusts* (NZLC IP31, 2012) [“IP31”] at Chapter 8.

<sup>2</sup> Definitions of a “trading trust” vary substantially between authors. The term is defined by Andrew Butler (ed) *Equity and Trusts in New Zealand* (2nd ed, Thompson Reuters, Wellington, 2009) at 416 as “a trust under which property, held by a trustee, is used to actively carry out a business”. Similar definitions are used by Vicki Ammundsen *Taxation of Trusts* (3rd ed, CCH New Zealand, New Zealand, 2016) at 15, and BH McPherson “The Insolvent Trading Trust” in PD Finn (ed) *Essays in Equity* (Law Book Company, Sydney, 1985) 142 at 142. The New Zealand Law Commission describes a trading trust as “a structure in which the trustee of a trust is a limited liability company instead of a natural person”: IP31, above n 1, at 146. Greg Kelly and Chris Kelly *Garrow and Kelly Law of Trusts and Trustees* (7th ed, LexisNexis, Wellington, 2013) at 29 uses a narrower definition, including elements of the above along with other requirements. This variety of definitions illustrates the descriptive rather than definitional nature of the term.

<sup>3</sup> Not to be confused with the term “trustee corporation” as defined in the Trustee Act 1956, s 2(1). A corporate trustee is simply a company that is a trustee. Companies are allowed to hold the office of trustee by virtue of the Companies Act 1993, s 16.

<sup>4</sup> Typically a corporate trustee will have \$100 or less of paid-up capital. See for example *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 at 361; *In Re Suco Gold Pty Ltd (In Liq)* (1983) 33 SASR 99 at 101; Kelly, above n 2, at 29.

beneficiaries. The term “trading trust” is purely descriptive: it has no legal definition, meaning that trading trusts (and their trustees) are subject to exactly the same laws as any other trust.<sup>5</sup>

The default position in trust law is that trustees have no power to carry on business with trust assets, on the basis that this requires putting the assets at risk.<sup>6</sup> Trustees of trading trusts must be expressly authorised to carry on business by the trust deed. This authorisation may be (and typically is) very broad, but it is possible for a trust deed to place restrictions on how the trustee does business.

It is important to note that, like all other trusts, a trading trust is not a legal entity.<sup>7</sup> A trust is merely a relationship or obligation, under which the trustee or trustees owe duties to the beneficiary or beneficiaries.<sup>8</sup> When a business conducted under a trading trust enters into transactions it is not the trust itself that is transacting: the corporate trustee does so on behalf of the trust.<sup>9</sup> On this note, when I refer to the liquidation of a trading trust it is technically the corporate trustee that is being liquidated; though this will generally be because the trust itself is insolvent (ie trust liabilities exceed trust assets).

### 1.3 History

Trading trusts first arose in Australia in the 1970s as a tax-efficient alternative to the limited liability company for family businesses.<sup>10</sup> Before long, insolvent trading trusts began to appear in Australian courts.<sup>11</sup> The first academic discussion of the structure seems to be Ford’s 1981 article “Trading Trusts and Creditors’ Rights”; in it he famously describes the trading trust structure as a “commercial monstrosity”.<sup>12</sup>

Commercial structures which incorporate trusts are found wherever there is trust law. Examples in New Zealand include “superannuation trusts, unit trusts used for investment and trusts used to hold securities”.<sup>13</sup> Commercial applications of trusts native to foreign jurisdictions include “Massachusetts trusts” in the USA<sup>14</sup> and investment trusts in the UK.<sup>15</sup> However, the “trading trust” as I define it appears to be unique to Australia and New Zealand.

For this reason, literature on trading trusts is scarce outside Australasia. Even when it does arise, it tends to refer to them as “Australasian trading trusts”.<sup>16</sup> The leading text on trust law in the UK makes no mention of “trading trusts”, and describes the use of a trust to carry on business as

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<sup>5</sup> Unlike, for example, “unit trusts”, which are defined and regulated by the Unit Trusts Act 1960.

<sup>6</sup> Butler, above n 2, at 140; Lynton Tucker, Nicholas Le Poidevin and James Brightwell (eds) *Lewin on Trusts* (19th ed, Sweet & Maxwell, London, 2015) (“Lewin”) at 1672. This default position is expressly altered in the context of testamentary trusts by the Trustee Act 1956, s 32.

<sup>7</sup> Butler, above n 2, at 441.

<sup>8</sup> At 44.

<sup>9</sup> At 146.

<sup>10</sup> HAJ Ford “Trading Trusts and Creditors’ Rights” (1981) 13 MULR 1, at 1; McPherson, above n 2, at 142.

<sup>11</sup> See for example *Octavo*, above n 4.

<sup>12</sup> Ford, above n 10, at 1. The topic of trading trusts was touched upon even earlier by RP Meagher “Insolvency of Trustees” (1979) 53 ALJ 648 at 652.

<sup>13</sup> Butler, above n 2, at 416.

<sup>14</sup> Kalev Crossland “Unsecured creditors and the ‘Uncorporation’: issues with trading trusts post Global Financial Crisis” (2011) 17(3) *Trusts & Trustees* 185 at 187.

<sup>15</sup> An example is the trust involved in *In re Berkeley Applegate (Investment Consultants) Ltd (In Liq)* (1989) Ch 32.

<sup>16</sup> Crossland, above n 14, at 185.

“nowadays unusual”.<sup>17</sup> By contrast, New Zealand’s leading trust law text has a chapter devoted to trading trusts.<sup>18</sup>

## 1.4 Advantages of trading trusts

Practically speaking, the trading trust is an alternative to the use of a limited liability company for conducting a business.<sup>19</sup> Typically trading trusts are used for relatively small, closely-held businesses, with the directors of the trustee being related in some way to the trust’s beneficiaries.<sup>20</sup>

Trading trusts historically had tax advantages over other corporate structures,<sup>21</sup> however their primary advantage is their flexibility of distribution: profits are released as distributions to beneficiaries rather than dividends to shareholders, allowing the use of discretionary and unequal distributions.<sup>22</sup> Whether or not the trading trust is actually a useful business structure is beyond the scope of this paper, but it is certainly plausible that the increased flexibility of the structure may be useful for some applications.

## 1.5 Prevalence of trading trusts

It is difficult to find even anecdotal evidence of the prevalence of trading trusts in New Zealand, though there seems to be a general understanding that they have become “more common in recent years”.<sup>23</sup> The Inland Revenue Department publishes statistics on the number of trusts that file tax returns in New Zealand,<sup>24</sup> but it is impossible to ascertain how many of these are “trading trusts”.

The Law Commission has noted this difficulty in assessing the prevalence of trading trusts. Submissions on their latest issues paper varied widely: some submitters thought trading trusts were widespread, and some thought they were relatively uncommon; some thought they were becoming more popular, while others thought their use was declining.<sup>25</sup>

A large part of the difficulty establishing the prevalence of trading trusts lies in the fact that they are most commonly used for small, closely-held businesses which enjoy minimal public scrutiny.<sup>26</sup> However, while their exact number cannot be reliably calculated, they are presumably prevalent enough to warrant the Law Commission’s attention. In addition, trading trust cases continue to come before the courts in both New Zealand<sup>27</sup> and (particularly) Australia.<sup>28</sup>

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<sup>17</sup> Lewin, above n 6, at 1673.

<sup>18</sup> Butler, above n 2, at Chapter 16.

<sup>19</sup> Or a partnership, sole tradership, or any other business structure.

<sup>20</sup> For example, the beneficiaries of the trading trust commonly include the “family trusts” of the directors. This was the case in *Levin v Ikiua* [2010] NZCA 509, [2011] 1 NZLR 678 [“*Levin (CA)*”] at [8] and *Octavo*, above n 4, at 364.

<sup>21</sup> Crossland, above n 14, at 187.

<sup>22</sup> Ammundsen, above n 2, at 139. For example, the trust deed may authorise the trustee to distribute to any, all or none of a list of beneficiaries, whereas dividends must be distributed proportionally based on share ownership: Companies Act 1993, s 53(2).

<sup>23</sup> Butler, above n 2, at 416.

<sup>24</sup> 346,300 in March 2016: <[www.ird.govt.nz/aboutir/external-stats/customers/reg-by-entity-type](http://www.ird.govt.nz/aboutir/external-stats/customers/reg-by-entity-type)> (retrieved 10 July 2017).

<sup>25</sup> IP31, above n 1, at 147.

<sup>26</sup> Compared, for example, to publically listed companies. Ford, above n 10, describes the use of trading trusts for “family businesses” at 1.

<sup>27</sup> A relatively recent example at Court of Appeal level is *Levin (CA)*, above n 20.

<sup>28</sup> A recent example is *Re Independent Contractor Services (Aust) Pty Limited (In Liq) (No 2)* [2016] NSWSC 106, (2016) 305 FLR 222 [“*ICS*”].



## 1.6 Problems with trading trusts

Trading trusts have often been considered problematic by academics,<sup>29</sup> judges,<sup>30</sup> and the New Zealand Law Commission.<sup>31</sup> The basic objection to the structure is that it may be detrimental to creditors upon the trustee's insolvency, on the basis that the trustee has no personal assets and the trust assets may be beyond the creditors' reach. I respond to these objections in Chapter 3, and show that in fact creditors have little to fear from the trading trust structure. Even where the trustee's indemnity fails (something which is much feared but seems not to have occurred in any trading trust case), the personal duties of directors will ensure that the creditors have someone to pursue.

While fears for the wellbeing of trading trust creditors have been largely unfounded, there are two particular classes of creditor who may be negatively affected by the trading trust structure. These are priority creditors,<sup>32</sup> and liquidators.<sup>33</sup> In Chapter 4 I show that there is a very real risk that priority creditors may effectively lose their priority status in a trading trust context, based on a recent and troubling Australian authority.<sup>34</sup> Chapter 5 addresses the position of a liquidator of a corporate trustee, and whether they are able to receive payment for their services from the assets of a trading trust. While I reach the conclusion that liquidators are unlikely to be disadvantaged in practice by the trading trust structure, the legal basis on which they receive payment is unclear. Furthermore, the process of obtaining payment may be made more complicated (and therefore more costly) by the trading trust structure.

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<sup>29</sup> The most prominent example is Ford, above n 10.

<sup>30</sup> For example, Heath J has said that "the use of an assetless corporate trustee has the potential to defeat the interests of genuine creditors of a company": *Levin v Ikuia* [2010] 1 NZLR 400 ["*Levin (HC)*"] at [101].

<sup>31</sup> IP31, above n 1, at 157. Trading trusts have also been addressed in Law Commission *Court Jurisdiction, Trading Trusts and Other Issues: Review of the Law of Trusts – Fifth Issues Paper* (NZLC IP28, 2011) at 65 and Law Commission *Some Problems in the Law of Trusts* (NZLC PP48, 2002) at 9.

<sup>32</sup> Not to be confused with secured creditors: priority creditors are simply general creditors who are afforded special priority by statute. In New Zealand the relevant provision is Companies Act 1993, s 312 and Schedule 7. Statutorily prioritised creditors are discussed in Chapter 4.

<sup>33</sup> Whether the liquidator is properly considered a creditor of the company which they liquidate is a question addressed in Chapter 5.

<sup>34</sup> *ICS*, above n 28.

# Chapter 2: The Trustee's Indemnity

*With the basic premise of the trading trust structure explained, this chapter goes on to explore in detail a crucial aspect of the structure: the trustee's right of indemnity from trust assets. This indemnity is essential to the operation of a trading trust, and its limitations are a source of concern for those who see trading trusts as potentially detrimental to creditors (discussed in Chapter 3).*

## 2.1 The role of the indemnity

Trustees are personally liable for trust liabilities, but do not have beneficial ownership of trust assets.<sup>35</sup> If that were the end of the story, trustees would have to use their own money to cover trust expenses, and would receive nothing in return. Because of the obvious unfairness of this, it has been acknowledged throughout the history of trust law that the “plainest principles of justice”<sup>36</sup> require trustees to be allowed to use trust assets to cover trust liabilities.<sup>37</sup>

To this end, all trustees have a right to indemnify themselves from the trust assets against properly incurred trust liabilities. This right (“the trustee’s indemnity” or “the indemnity”) is available in two forms: a trustee may make a trust payment personally and then reimburse itself from the trust assets (the right of recoupment), or it may simply make the payment directly from the trust assets to the relevant creditor (the right of exoneration). Trustees are sometimes described as having a “right to reimbursement”: this is synonymous with the right to indemnity through recoupment.<sup>38</sup>

In a trading trust context the indemnity will only be exercised through exoneration, because the trustee has no personal assets from which to first make a payment. The significance of this arises particularly in Chapter 4.

In New Zealand the trustee’s indemnity is given statutory force by s 38(2) of the Trustee Act 1956. It allows for indemnity for “all expenses reasonably incurred in or about the execution of the trusts or powers”, but specifically excludes indemnity for the cost of professional services.<sup>39</sup>

## 2.2 Operation of the indemnity

The indemnity arises when, and to the extent that, a trustee properly incurs a trust liability.<sup>40</sup> Properly incurred simply means incurred other than in breach of trust. Such liabilities may be incurred accidentally, and need not correlate with any benefit to the beneficiaries: a prime example being the liability to repay accidental overpayments in the New Zealand trading trust case of *Levin v Ikiua*.<sup>41</sup>

The indemnity gives rise to a charge or lien over the assets of the trust to the extent of the properly incurred liability.<sup>42</sup> The phrase “charge or lien” is commonly used in academic writing on the

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<sup>35</sup> Butler, above n 2, at 441.

<sup>36</sup> *Hardoon v Belilios* [1901] AC 118 (PC) at 123.

<sup>37</sup> Butler, above n 2, at 443.

<sup>38</sup> See for example Butler, above n 2, at 130.

<sup>39</sup> Unless authorised by the trust deed, the beneficiaries, or a court: Trustee Act 1956, s 38(2). It is likely that a trading trust deed would authorise such expenditure.

<sup>40</sup> Butler, above n 2, at 442.

<sup>41</sup> *Levin (CA)*, above n 20; and see 3.3 below.

<sup>42</sup> Butler, above n 2, at 446; *Levin (CA)*, above n 20, at [53].

indemnity, and has been since at least 1837,<sup>43</sup> however the exact meaning of the phrase is unclear.<sup>44</sup> A recent New South Wales Supreme Court case uses “charge” exclusively, describing the charge as conferring “a proprietary interest, in the nature of a security interest” in the trust property, this having “priority over the claims of beneficiaries”.<sup>45</sup> However, New Zealand academic Bill Patterson takes the view that the charge or lien “even if described as a proprietary interest ... is not a security interest”.<sup>46</sup> This view is supported by Ford, who states that the right to indemnity through exoneration<sup>47</sup> is not a property right at all, but rather a “fiduciary power to be exercised in the interests of the beneficiary”.<sup>48</sup>

Whether or not the right to indemnity from trust assets creates a property right, the right to indemnity from beneficiaries (see 2.3 below) is personal in nature.<sup>49</sup>

There is dispute as to whether the right of a creditor to subrogate the trustee’s indemnity is a caveatable interest. New Zealand case law (at High Court level) suggests that it is,<sup>50</sup> but Bill Patterson makes a strong case that this position is wrong at law.<sup>51</sup> Patterson provides many reasons for this stance, but the most convincing in my view is that no one may lodge a caveat against property of which they are the legal owner,<sup>52</sup> therefore a trustee cannot lodge a caveat against trust property (which is legally, though not beneficially, owned by them).<sup>53</sup> If a trustee cannot lodge a caveat then a subrogating creditor is also unable to do so, as subrogation cannot put the creditor in a better position than the trustee (see 2.4 below).

## 2.3 Indemnity from beneficiaries

The burden of the trustee’s indemnity always lies indirectly with the beneficiaries, as the trustee is indemnified from assets which are beneficially owned by them.<sup>54</sup> In some circumstances however, the trustee may be indemnified from a beneficiary personally (rather than from trust assets). Butler points out that the exact extent of this principle is not clear, but it seems that it applies only to beneficiaries of fixed trusts (that is, trusts under which the entitlement of each beneficiary is fixed and known).<sup>55</sup> The logic of this is easily understood: fixed beneficiaries have a certainty that they will benefit from the trust property, so it does not seem unreasonable to require them to cover the expenses of this benefit.

Trading trusts as defined by this paper have only discretionary beneficiaries – this is what gives the structure its flexibility.<sup>56</sup> This means that, in the absence of an express indemnity against

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<sup>43</sup> Thomas Lewin *A Practical Treatise on the Law of Trusts and Trustees* (1st ed, A Maxwell, London, 1837) at 453. The phrase “charge or lien” continues to be used in the most recent edition that work: *Lewin*, above n 6, at 854.

<sup>44</sup> Bill Patterson “Trustees indemnities, equitable liens, subrogation and caveats – has the law taken a wrong turn?” (paper presented to New Zealand Law Society Trusts Conference, Auckland and Wellington, June 2011) at 255.

<sup>45</sup> *ICS*, above n 28, at [11].

<sup>46</sup> Patterson, above n 44, at 259.

<sup>47</sup> The only form in which the indemnity operates in a trading trust context: see 2.1 above.

<sup>48</sup> Ford, above n 10, at 4.

<sup>49</sup> McPherson, above n 2, at 145.

<sup>50</sup> *The Official Assignee in the Property of Keith James Bainbridge v Menzies and Palmer as Trustees* (High Court, Auckland, CIV-2010-404-5457, 14 February, 2011) at [52].

<sup>51</sup> Patterson, above n 44.

<sup>52</sup> *Re Haupiri Courts Ltd (No 2)* [1969] NZLR 353, relied upon by Patterson, above n 44, at 259.

<sup>53</sup> Patterson, above n 44, at 259.

<sup>54</sup> “[The beneficiary] who gets all the benefit of the property should bear its burden”: *Hardoon*, above n 36, at 123, per Lord Lindley.

<sup>55</sup> Butler at 444; see also McPherson at 146.

<sup>56</sup> See 1.4 above.

beneficiaries granted by the trust deed or by contract,<sup>57</sup> the right to indemnity from beneficiaries will not arise in a trading trust context.

## 2.4 Subrogation of the indemnity

The trustee's indemnity may be subrogated by a creditor, allowing the creditor to make a direct claim against the assets of the trust. The earliest historical example of subrogation of the indemnity is found in *Ex parte Garland*, which provided that the creditor has, through the trustee, something "very like a lien" upon the assets of the trust.<sup>58</sup>

In the liquidation of a trading trust it is unlikely that subrogation will be required. The liquidator of the trustee is able to use the indemnity for the benefit of the relevant creditors, so creditors will be paid whether or not they subrogate the indemnity.<sup>59</sup> If for any reason there is no indemnity for the liquidator to use, there will be nothing to subrogate: subrogation cannot place a creditor in a better position than the trustee would have been.<sup>60</sup>

## 2.5 Modification of the indemnity

There is debate as to the extent to which the trustee's right to indemnity can be limited by the trust deed. It seems to be accepted in New Zealand that the right to indemnity against beneficiaries personally can be, and in practice often is, excluded.<sup>61</sup> Whether the indemnity against trust assets can be excluded is somewhat less clear.

The Law Commission suggests that the "balance of commentary" in New Zealand takes the view that the indemnity cannot be totally excluded by the trust deed.<sup>62</sup> This view is supported by Butler.<sup>63</sup> The Supreme Court of Victoria in *RWG Management v Commissioner for Corporate Affairs* takes the opposite stance,<sup>64</sup> however this case was decided under a statutory regime which appeared to allow exclusion of the indemnity.<sup>65</sup>

In my view, Butler and the Commission have adopted the right approach: the indemnity cannot be eliminated. To remove the indemnity would place the trustee in the absurd position of being personally liable for transactions from which they can receive no benefit.<sup>66</sup> No rational person would accept a trusteeship under such circumstances. Even a corporate trustee would be unable to operate under such terms, as any transaction entered into would most likely constitute a breach of directors' duties (discussed further in Chapter 3).

Whether the indemnity can be "limited" without being excluded is a more difficult question. In the Law Commission's discussion of this topic the word "limited" is used repeatedly, but only as part of the phrase "limited or excluded".<sup>67</sup> It is far from clear what form such limitation might take, or whether it is different from exclusion. As discussed in more detail in Chapter 3, the

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<sup>57</sup> Butler, above n 2, at 445.

<sup>58</sup> *Ex parte Garland* (1804) 10 Ves Jr 110 at 120. This thing "very like a lien" must be equivalent to the so-called "charge or lien" enjoyed by the trustee: see 2.2 above.

<sup>59</sup> *Levin (HC)*, above n 30, at [124]

<sup>60</sup> Lewin, above n 6, at 858.

<sup>61</sup> Butler, above n 2, at 455. In a trading trust context where all beneficiaries are discretionary, no such exclusion is required: see 2.3 above.

<sup>62</sup> IP31, above n 1, at 150.

<sup>63</sup> Butler, above n 2, at 455.

<sup>64</sup> *RWG Management Limited v Commissioner for Corporate Affairs* [1985] VR 385.

<sup>65</sup> Butler, above n 2, at 455, n 188.

<sup>66</sup> At 456.

<sup>67</sup> IP31, above n 1, at 149-151.

indemnity is necessarily limited by the terms of the trust deed. To this extent, limitation is not only allowed but is a definitive feature of the indemnity – the indemnity arises only in respect of “properly incurred” liabilities, and this is defined (and therefore limited) by the trust deed.<sup>68</sup>

## 2.6 Proposed reforms

The Law Commission’s most recent examination of trading trusts addressed the scope and limitations of the trustee’s indemnity.<sup>69</sup> In order to clarify the current law, the Commission proposed that the following principles should be “restated”.<sup>70</sup>

- (a) A trustee assumes personal liability unless there is an express limitation to the contrary in the contract.
- (b) A trustee has the right to indemnity out of trust assets (in a modernised form of section 38).
- (c) A trustee’s indemnity cannot be limited or excluded by the trust deed.
- (d) A trustee’s right to indemnity is available to a former trustee in respect of actions taken by them as trustee.

In my opinion the principles in paragraphs (a), (b) and (d) above are already well understood, though there would be no harm in their restatement.<sup>71</sup> Paragraph (c) is much more troublesome. To say that the right of indemnity *from trust assets* cannot be excluded altogether seems reasonably uncontentious (see 2.5 above). However, currently the right to indemnity against *beneficiaries personally* can be, and often is, excluded by the trust deed.<sup>72</sup>

The Commission does not discuss indemnity against beneficiaries under the heading of this proposal, but unless it intends to change this rule the proposed restatement would need to be clarified. Whether such a change should be made is another question, though it would have little or no impact in the trading trust context. This is because the beneficiaries of trading trusts tend to be discretionary rather than fixed, and the indemnity can only arise against fixed beneficiaries.<sup>73</sup>

Finally, the use of the wording “limited or excluded” in paragraph (c) is also problematic. As discussed in 2.5 above it is not clear what the Commission means by “limited”, and to some extent the indemnity is always limited by the trust deed. If this proposal were to be enacted, the word “limited” should be removed or its meaning clarified.

In summary, the law relating to the trustee’s indemnity is generally sufficiently well-understood not to need restatement. Indeed, paragraph (c) of the Law Commission’s proposal shows that an attempt at restatement risks confusing the issue by accidentally making a substantive change. Having said that, the collation of these rules into a single statutory provision may be a useful way to make the law more accessible to lay trustees and directors of corporate trustees. In my view the enactment of paragraphs (a), (b) and (d) of the Commission’s would be helpful for this purpose.

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<sup>68</sup> Butler, above n 2, at 442.

<sup>69</sup> IP31, above n 1, at 149.

<sup>70</sup> Proposal P32: IP31, above n 1, at 149.

<sup>71</sup> The Commission takes a similar view at IP31, above n 1, at 152.

<sup>72</sup> See 2.3 above.

<sup>73</sup> See 2.3 above.

Part II:  
Practical Impacts of Trading Trust  
Liquidations

# Chapter 3: General Creditors

*This is the first of three chapters dealing with the impact of the trading trust structure on three classes of creditor in the liquidation context. This chapter concerns unsecured creditors generally. While it is appropriate that creditors be subject to business risks, there is concern that they may be worse off under the trading trust structure than they would be in the case of a limited liability company. These concerns are based on the fact that the corporate trustee has no personal assets with which to satisfy creditors' claims. However, it seems that fears for trading trust creditors are generally unfounded, and that the structure is no more harmful than the limited liability company.*

## 3.1 Concerns for trading trust creditors

Trading trusts have met with substantial criticism over the four decades since their inception, with the primary concern being that they are harmful to creditors. Australian trust academic HAJ Ford famously described trading trusts as a “commercial monstrosity”, saying that their “scope for frustrating creditors is considerable.”<sup>74</sup>

More recently in New Zealand it has been said that “the use of an assetless corporate trustee has the potential to defeat the interests of genuine creditors of a company”.<sup>75</sup> In addition, the fact that the Law Commission is investigating this area is evidence that substantial concern remains.<sup>76</sup> As Heath J points out in *Levin*, it is right to have “a healthy degree of cynicism” towards the use of a company with no assets to carry on business.<sup>77</sup>

This chapter is concerned only with unsecured trust creditors. Secured creditors generally “stand outside the process” of liquidation,<sup>78</sup> and it is well established that securities can be granted and enforced against trust assets.<sup>79</sup> To the extent that a security is insufficient the secured creditor will become an unsecured creditor, and will therefore fall within the ambit of this paper.

## 3.2 The yardstick: ordinary companies

Before investigating whether trading trusts are harmful to creditors, it is worth noting that harm to creditors in itself is not a wrong to be avoided at all costs. The limited liability company is “unquestionably the most significant business structure of the modern age”,<sup>80</sup> and yet the concept of “limited liability” is inherently harmful to creditors. It is against creditors that the “liability” in question is being “limited”.

There are many reasons why we allow the existence of a structure which serves to defeat creditors: limited liability companies provide “a means of achieving economic and social benefits through the aggregation of capital for productive purposes, the spreading of economic risk, and the taking of business risks”.<sup>81</sup> For the purposes of this paper it must be assumed that companies are

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<sup>74</sup> Ford, above n 10, at 1.

<sup>75</sup> *Levin (HC)*, above n 30, at [101].

<sup>76</sup> IP31, above n 1, at 146.

<sup>77</sup> *Levin (HC)*, above n 30, at [101].

<sup>78</sup> Paul Heath and Mike Whale *Insolvency Law in New Zealand* (online looseleaf ed, LexisNexis) at 1.2.

<sup>79</sup> Butler, above n 2B, at 451.

<sup>80</sup> John H Farrar, Susan Watson and Lynne Taylor *Company and Securities Law in New Zealand* (2nd ed, Thompson Reuters, Wellington, 2013) at 15.

<sup>81</sup> Companies Act 1993, long title.

essentially a good thing. For trading trusts to be problematic therefore, they must be not only harmful to creditors, but *more* harmful than a limited liability company in the same situation.

To avoid any confusion arising from the fact that the trading trust structure necessarily involves a limited liability company,<sup>82</sup> I will refer to businesses carried on through a company not acting as a trustee as “ordinary companies”. The majority of businesses, both big and small, are conducted through ordinary companies. It is against the standard of these ordinary companies that I will assess trading trusts.

### 3.3 Loss of the trustee’s indemnity

HAJ Ford’s condemnation of trading trusts was written in the early 1980s, in response to a growing prevalence of trading trusts and their insolvencies.<sup>83</sup> In his article, he listed what he saw as the “three main barriers” facing creditors of trading trusts:<sup>84</sup>

First, a creditor will not get payment out of trust assets unless the entity, in incurring the debt, was acting within powers given to it by its creators. ...

Secondly, a creditor will not get payment out of the assets unless the organs of the entity (that is to say, trustees equated to directors) have avoided committing any breach of any of their duties to the entity. Even a breach of a duty unrelated to the creditor's transaction could prejudice him. ...

Thirdly, a creditor will not get payment out of the assets if the constitutive instrument (the trust instrument equated to the memorandum and articles of association) denies access by creditors to trust assets.

Ford’s first two concerns are founded on the basis that the trustee’s indemnity (through which the creditors are paid) may be invalidated if the trustee acts in breach of trust.<sup>85</sup> If the trustee goes beyond the trust deed in incurring the liability then no indemnity will arise in respect of that liability, and even if an indemnity does arise it may be lost as a result of a trustee’s later misconduct.<sup>86</sup>

If a corporate trustee acts outside the trust deed in incurring an obligation, the trustee loses its right to indemnity in respect of that debt. The trustee remains personally liable, but of course in a trading trust setting the trustee has no personal assets. However, to incur a liability in breach of trust may be more difficult than it sounds.

Trading trust deeds typically give a broad discretion to carry on business. For example, the trust deed in the early Australian trading trust case of *Octavo Investments v Knight* authorised the trustee “to carry on any business as it thought fit and to employ the whole or part of the trust fund in managing and carrying on such business” and “to borrow moneys on bank overdraft or otherwise and to secure the payment of such moneys as it thought fit”.<sup>87</sup> Liabilities do not even need to be deliberate in order to be validly incurred. In *Levin* the liability was to repay overpayments made by a customer for services provided by the trading trust.<sup>88</sup> This liability was

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<sup>82</sup> As the corporate trustee.

<sup>83</sup> Ford, above n 10, at 1; the increasing prevalence of trading trusts at this time is also mentioned in *Re Enhill Pty Ltd* [1983] 1 VR 561 at 567.

<sup>84</sup> Ford, above n 10, at 1-2.

<sup>85</sup> This is because the indemnity applies only to “properly incurred” liabilities: see 2.2 above.

<sup>86</sup> Butler, above n 2, at 450.

<sup>87</sup> *Octavo*, above n 4, at 364.

<sup>88</sup> *Levin (CA)*, above n 20, at [12].



not deliberately incurred or even contemplated by the trustee, yet there was no question as to its validity.

Generally, if the trust deed (such as the one in *Octavo*) provides a broad discretion to carry on business, any ordinary business transaction will fall within the scope of the deed and will therefore be properly incurred. However, it is possible for a trading trust deed to be more restrictive than this. For example, a deed may limit a trading trust to a specific industry: the deed in the Australian case of *Re Suco Gold* established a trust “for mining purposes and in particular gold mining purposes”.<sup>89</sup> If the trustee of this deed purported to incur a trust liability while carrying on a drycleaning business it would do so in breach of trust, and no indemnity would arise in respect of that liability.

It is possible to imagine even more restrictive trust deeds. For example, a deed could allow “trading during the month of January only”, or “trading only with creditors whose name begins with ‘A’”, or even “the carrying on of business, but not the payment of taxes”. Liabilities incurred outside these restrictions would not be subject to an indemnity. If a trading trust deed purported to adopt any of these restrictions, a court may see fit to vary the trust deed.<sup>90</sup> But even if this possibility is ignored, such restrictive trust deeds would be of no benefit to their creators. Trading trusts are a structure through which to do business, and to be effective they need to allow business decisions to be made.

For this reason, a narrowly proscribed trust deed is unlikely to arise in practice. Nonetheless, we must accept that trading trusts do, at least in theory, present a risk that indemnity may not arise in respect of a particular transaction. If no indemnity arises, there is no way that the trustee can pay the creditor, even where trust assets remain. This is a risk which has no equivalent in the context of an ordinary company.<sup>91</sup> Does this mean that trading trusts are inherently more harmful to creditors than ordinary companies?

### 3.4 Directors’ personal liability

As between the trustee and creditor there may be no chance of payment, but there is a third party to consider: the directors of the corporate trustee.<sup>92</sup> In any circumstance where a liability is incurred in breach of trust (and therefore where no indemnity arises), the directors will likely be personally liable for that liability by virtue of the directors’ duties found in ss 131 to 137 of the Companies Act 1993.<sup>93</sup> The most relevant for our purposes is the duty against reckless trading found in section 135:<sup>94</sup>

#### **135 Reckless trading**

A director of a company must not—

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<sup>89</sup> *Suco*, above n 4, at 101.

<sup>90</sup> The court may do so under the Trustee Act 1956, ss 64(1) and 64A, and via its inherent jurisdiction: Butler, above n 2, at 245.

<sup>91</sup> Of course it is possible for an ordinary company to run out of assets in the course of doing business, and this is a risk that creditors must accept. The equivalent of this in the trading trust context is that the trust itself running out of assets: again, this is a risk of doing business. In a trading trust setting however, it is also possible for a corporate trustee to be unable to make payments *despite the fact that assets remain* in the trust: this scenario has no parallel in the context of an ordinary company. This distinction is discussed further in the context of priority creditors at 4.1 below.

<sup>92</sup> I will use the plural “directors”, but my discussion applies equally to a corporate trustee with a single director.

<sup>93</sup> Companies Act 1993, ss 131–137.

<sup>94</sup> Companies Act 1993, s 135.

(a) agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; or

(b) cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

This section, like the other directors' duties sections, sets out a duty but does not address what happens when the duty is breached. Section 301 provides as follows:<sup>95</sup>

**301 Power of court to require persons to repay money or return property**

(1) If, in the course of the liquidation of a company, it appears to the court that a person who has taken part in the formation or promotion of the company, or a past or present director, manager, administrator, liquidator, or receiver of the company, has misapplied, or retained, or become liable or accountable for, money or property of the company, or been guilty of negligence, default, or breach of duty or trust in relation to the company, the court may, on the application of the liquidator or a creditor or shareholder,—

(a) inquire into the conduct of the promoter, director, manager, administrator, liquidator, or receiver; and

(b) order that person—

(i) to repay or restore the money or property or any part of it with interest at a rate the court thinks just; or

(ii) to contribute such sum to the assets of the company by way of compensation as the court thinks just; or

(c) where the application is made by a creditor, order that person to pay or transfer the money or property or any part of it with interest at a rate the court thinks just to the creditor.

...

The section has a broad scope, but one of its functions is to make directors personally liable for loss to creditors caused by a breach of duty.<sup>96</sup> The effect of this is that the directors of a corporate trustee which incurs a liability to which no indemnity attaches can be made personally liable for that liability, provided they have breached a duty in incurring it.

The directors' duties have been used in a trading trust context. In *Levin* a trust debt was owed to a customer for an accidental overpayment.<sup>97</sup> The business model of the trading trust involved regular distributions of profits, so that there was little trust property available at any time. The directors were well-intentioned and careful to pay all creditors before distributing to beneficiaries, but because they were not aware of the ACC overpayments they could not take these into account. However, they did make one distribution *after* learning of the possible overpayment, and on this basis the directors were required under s 301 to repay that distribution.<sup>98</sup>

The issue in *Levin* was not a lack of indemnity (the liability was validly incurred), but rather a lack of assets due to a distribution to beneficiaries. Nonetheless, this case shows that courts are

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<sup>95</sup> Companies Act 1993, s 301.

<sup>96</sup> This can be either via the liquidator under subsection (1)(b), or to the creditor directly under subsection (1)(c).

<sup>97</sup> *Levin (CA)*, above n 20, at [12].

<sup>98</sup> *Levin (CA)*, above n 20, at [55] and [69].

willing to use the directors' duties (and s 301) against directors of corporate trustees which act to the detriment of creditors, even when the directors are well-intentioned.<sup>99</sup>

It seems likely that the incurring of a liability outside the scope of the trust deed will always constitute a breach of the duty in s 135 (above).<sup>100</sup> This is because where a company has no assets of its own, the incurring of a liability outside the authorisation of the trust deed, and therefore not covered by the trustee's indemnity, must be "likely to create a substantial risk of serious loss" to the relevant creditor.<sup>101</sup>

Heath J, writing extrajudicially on the topic of trading trusts, made the comment that directors would not be liable if they "consider carefully the company's financial position and make a decision on reasonable grounds that creditors would not be prejudiced".<sup>102</sup> Here he was referring to the making of distributions to beneficiaries, rather than the incurring of trust liabilities. If an assetless corporate trustee incurs a liability to which no indemnity attaches then there is simply no possibility of repayment – even if the trustee remains solvent, payment of the liability from trust assets would constitute a breach of trust. For this reason, a decision to incur a liability without an indemnity could not be considered on "reasonable grounds" to be anything other than harmful to the relevant creditor.

### 3.5 Do directors' duties solve the problem?

It could be argued that, even with the ability to pursue directors personally, trading trust creditors may be worse off than those of ordinary companies. An example of this could be a trading trust insolvency involving substantial outstanding trust liabilities, substantial trust assets but no indemnity to access them, and relatively destitute directors. Even if the director were liable for the full amount, they may simply not have enough assets to pay it. If the same facts were applied to an ordinary company, the creditor would have no difficulty accessing the substantial remaining business assets which were inaccessible (due to lack of indemnity) in the case of the trading trust.

It is also possible to imagine a situation in which the opposite is true. For example, a trading trust may be liquidated with very few assets remaining and a substantial liability owing. If the liability was incurred in breach of trust and there is therefore no indemnity available, the creditor will have recourse against the director for the full amount. A creditor of an ordinary company in the same situation may have no recourse against the director (the transaction may have been perfectly valid but for the breach of the trust deed), and would be left with only whatever meagre assets remain in the business.

Trading trusts tend to be used for relatively small, closely-held businesses, and in this environment the liabilities incurred are not likely to be vastly in excess of the directors' personal means.<sup>103</sup> Even more importantly, directors who are aware of the risk to their own livelihood will

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<sup>99</sup> *Levin (CA)*, above n 20, at [37].

<sup>100</sup> Other sections that may be relevant include Companies Act 1993 ss 131, 133, and 137. All of these were raised by the plaintiff in *Levin (CA)*, above n 20, at [55]. In my opinion s 135 is the most readily applicable to these circumstances.

<sup>101</sup> Companies Act 1993, s 135.

<sup>102</sup> Paul Heath "Bringing Trading Trusts into the Company Line" [2010] NZLR 519 at 539 (footnotes omitted).

<sup>103</sup> This will not always be the case, especially given the tendency in New Zealand to hide assets in family trusts. However incentives for directors not to incur personal liabilities may be more than just financial: see n 104 below.

be very careful only to incur valid liabilities,<sup>104</sup> in which case there will always be a valid indemnity. If the indemnity arises in respect of all liabilities then creditors are in exactly the same position as they would be under an ordinary company – as with an ordinary company, they will only miss out if the business itself runs out of money.

I conclude that creditors of trading trusts are not systematically worse off than creditors of ordinary companies. If there is a valid trustee's indemnity, they will be in an effectively identical position. If not, they will need to pursue a different party, meaning that they may be better or worse off depending on who has the most assets. Overall however, the fears of HAJ Ford and other detractors of trading trusts are unjustified in the modern New Zealand context.

### 3.6 Proposed reforms

The Law Commission's recent examination of trading trusts was accompanied by two specific proposals which focus on protecting creditors. If, as I propose, creditors of trading trusts are currently no worse off than those of ordinary companies, then no such extra protections are needed. The first creditor-focussed proposal is the following:<sup>105</sup>

It is proposed that section 25 of the Companies Act 1993 should be amended to require a company, when acting as a trustee of a trust, to clearly describe its status as such in all communications and contracts, in the form "X Ltd acting as trustee for Y trust".

This proposal reflects the current requirement that limited liability companies affix the word "Limited" to their name in order to warn creditors of their status.<sup>106</sup> In a submission on this proposal the New Zealand Law Society "considered there was not necessarily enough of a problem with non-disclosure to warrant intervention, but thought it seemed likely that there will be situations where a contracting party is unaware they are dealing with a trust".<sup>107</sup> Such unawareness is not a problem in itself, unless a trading trust is more harmful than the ordinary company with which such creditors presumably expect to deal. In addition, even if trading trusts are problematic, the Commission acknowledges that "disclosure alone was unlikely to give adequate warning or assist unsophisticated creditors".<sup>108</sup> For these reasons I oppose this proposal.

Second, the Law Commission proposes adoption of a specific duty for directors of corporate trustees, in the style of the Australian Corporations Act s 197.<sup>109</sup> That section provides:<sup>110</sup>

**197 Directors liable for debts and other obligations incurred by corporation as trustee**

(1) A person who is a director of a corporation when it incurs a liability while acting, or purporting to act, as trustee, is liable to discharge the whole or a part of the liability if the corporation:

(a) has not discharged, and cannot discharge, the liability or that part of it; and

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<sup>104</sup> Even if a director has relatively few personal assets (and therefore not much to lose financially) they will likely want to avoid the expense and hassle of bankruptcy. One reason for this is that undischarged bankrupts are not allowed to act as directors: Insolvency Act 2006, s 436(1)(a).

<sup>105</sup> Proposal P33: IP31 at 152.

<sup>106</sup> Companies Act 1993, s 21.

<sup>107</sup> IP31, above n 1, at 153.

<sup>108</sup> At 154.

<sup>109</sup> Proposal P34: IP31, above n 1, at 157.

<sup>110</sup> Corporations Act 2001 (Cth), s 197.

(b) is not entitled to be fully indemnified against the liability out of trust assets solely because of one or more of the following:

- (i) a breach of trust by the corporation;
- (ii) the corporation's acting outside the scope of its powers as trustee;
- (iii) a term of the trust denying, or limiting, the corporation's right to be indemnified against the liability.

The person is liable both individually and jointly with the corporation and anyone else who is liable under this subsection.

Note: The person will not be liable under this subsection merely because there are insufficient trust assets out of which the corporation can be indemnified.

...

This section serves to transfer the risk of an invalid indemnity from creditors to directors, however it is my view that the directors' duties regime in New Zealand already has this effect.<sup>111</sup> There may be benefits to having a specific section dealing with the problem: for example, it would remove any doubt as to whether trading trust directors can be liable for incurring debts for which no indemnity is available. However, if the general rule in New Zealand serves the same purpose then there is no need for the addition of a specific provision. Overuse of specific rules where general rules would do results in unnecessarily lengthy statutes, and may limit the flexibility of courts in dealing with new situations. I submit that the addition of s 197 in the New Zealand context would have no practical effect, as our general duties already do the same job; instead it would unnecessarily elongate and complicate our Companies Act. I therefore also oppose the adoption of this proposal.

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<sup>111</sup> See 3.4 above.

# Chapter 4: Priority Creditors

*Trading trusts may not be harmful to creditors generally, however it is possible that the structure may serve to defeat statutory priorities given to certain classes of creditor. If this is the case, some creditors will be disadvantaged to the benefit of others. This possibility is supported by recent case law and some academic opinion in Australia, though I suggest that these authorities take the wrong approach.*

## 4.1 Statutory priorities

Both Australia and New Zealand have, as part of their liquidation regimes, requirements that certain classes of debts be paid in priority over the general unsecured creditors. These priority provisions<sup>112</sup> exist because “Parliament has determined that the public interest in providing greater protection to one or more creditors outweighs the economic and social costs of any such priority”.<sup>113</sup> Priority provisions include such things as liquidators’ expenses, employees’ wages, and various forms of tax liability.<sup>114</sup>

These provisions apply to all liquidations. However, there is some support for the view that they may not apply to liabilities discharged from assets held on trust, meaning they have no effect in trading trust liquidations. Whether or not the priority provisions apply to payments of trust debts from the trust assets depends, in my view, on whether the provisions are characterised as focussing on assets or on liabilities. They may be seen as dictating either what to do with the company’s remaining assets (“asset-based”), or alternatively the order in which to discharge the company’s liabilities (“liability-based”).

I propose that each of these interpretations is plausible, and indeed each has the same effect in most cases – if the question is “what to do with the company’s assets?” the answer is “pay out X, Y and Z creditor first”; if the question is “in what order should the liabilities be discharged?” exactly the same answer can be given. The importance of this distinction only becomes apparent in a trust context, and particularly in a trading trust where there are no personal assets.

In a trading trust scenario the answer to the question “in what order should the liabilities be discharged?” may still be answered “pay out X, Y and Z creditor first”: the corporate trustee is personally liable for the debts owed to each of X, Y and Z. On the other hand, the question “what to do with the company’s assets?” may be answered only with “nothing: the company has no assets”.

The problem with a trading trust is that the *company* can be left with no assets even though the *business* (that is, the enterprise which is being carried out through the vehicle of a trading trust) still has assets. Of course it is also possible for an ordinary company to have no assets left upon liquidation, but this can only be the case if the *business* has no assets. In an ordinary company, the company and the business are inseparable, and indeed the terms are often used interchangeably.<sup>115</sup> Creditors, priority or otherwise, must accept the risk that the *business* they

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<sup>112</sup> The New Zealand provision is found in the Companies Act 1993, s 312 (“Preferential claims”) and Schedule 7. The Australian provision is found in the Corporations Act 2001 (Cth), s 556 (“Priority payments”). I will refer to these provisions generally as “priority provisions”.

<sup>113</sup> Heath and Whale, above n 78, at 20.36.

<sup>114</sup> Classes of priority creditors are listed in Schedule 7 to the Companies Act 1993.

<sup>115</sup> Note that by “ordinary company” I mean a business carried out by a single limited liability company. Structures involving multiple companies, such as are common in larger enterprises, will also lead to a

transact with may run out of money. What creditors should not have to deal with is the risk that, through a technicality, the *company* they deal with runs out of assets even though the business as a whole retains them.<sup>116</sup>

Of course, the only parties that stand to gain if priority provisions do not apply to trading trusts are those creditors who are not prioritised. The priority creditors will continue to be creditors, but their claim will be reduced to a *pari passu* share of the assets.<sup>117</sup> I point this out to reinforce the fact that the trading trust structure is not harmful to creditors as a whole, though if an asset-based approach to priority provisions is adopted the structure may disadvantage some creditors to the benefit of others.

## 4.2 Priority provisions: asset-based or liability-based?

If the priority provisions are asset-based (that is, concerned with what to do with the assets in the liquidation) then it is right to see them as concerned only with those assets which form part of the liquidation. That is assets beneficially owned by the company, and available to general creditors. On this analysis, the priority provisions do not apply to debts payable from trust assets.

This is not the case if the priority provisions are liability-based (that is, concerned with the question of the order in which to discharge the insolvent company's liabilities). To explain this view it is important to recall that liabilities incurred as a trustee are owed by the trustee personally, so while trust assets do not form part of the company's personal assets, trust liabilities do form part of its personal liabilities.

Under a liability-based view, when the priority provisions call for payment of "X, Y and Z creditor first", it is simply stating the order in which to pay liabilities. The company was already liable to creditors X, Y and Z – the provision merely changes the order in which they must be paid. If any of X, Y or Z happen to be trust liabilities, the trustee may (via its indemnity) use trust assets to discharge them, just as it would if there were no priority provision. The priority provisions do not change the amount of the liabilities, though the amount actually paid to the priority creditors is likely to be higher (assuming there are not enough assets left to pay all creditors in full). Viewed in this way, the priority provisions can operate in respect of trust property even though such property is not beneficially owned by the insolvent company. The focus is on the personal *liabilities* of the company, not the ownership of the assets.

Which of these is the correct interpretation of the priority provisions? Are the provisions concerned primarily with how to distribute assets, or how to discharge liabilities? To answer this question I will look first to the priority provisions themselves, and then to judicial and academic opinions on the subject.

## 4.3 The legislation

From the wording of the priority provisions of Australia and New Zealand, it is not obvious whether they are asset-based or liability-based. As mentioned above, both are at least plausible

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difference between the idea of the "company" and the "business". Such structures come with their own problems, but those lie beyond the scope of this paper.

<sup>116</sup> This distinction is also discussed at n 91 above.

<sup>117</sup> Companies Act 1993, s 313(2) calls for *pari passu* distribution of assets in a liquidation, though if the priority provision is found not to apply to payments from trust assets then the same will likely be true of s 313. However, there is a "general rule of equity" that calls for *pari passu* distribution by default in a winding-up: JD Heydon and MJ Leeming *Jacobs' Law of Trusts in Australia* (7th ed, LexisNexis Butterworths, Chatswood, New South Wales, 2006) ["Jacobs"] at 577.

interpretations. The priority provision in the Australian Corporations Act provides that “the following debts and claims must be paid in priority to all other unsecured debts and claims”.<sup>118</sup> This wording could be taken to support a liability-based interpretation. It makes no mention of assets, and instead focusses on what “debts and claims must be paid”.

In New Zealand, the Companies Act 1955 (the precursor to our current Companies Act) also required that priority creditors “shall be paid in priority to all other debts”.<sup>119</sup> Again, the focus appears to be on the “debts” or liabilities, with no mention of assets. However, the current New Zealand provision found in the Companies Act 1993 is worded slightly differently, and is less favourable to a liability-based interpretation. Section 312(1) reads as follows:<sup>120</sup>

(1) The liquidator must pay out of the assets of the company the expenses, fees, and claims set out in Schedule 7 to the extent and in the order of priority specified in that schedule and that schedule applies to the payment of those expenses, fees, and claims according to its tenor.

On one hand, this section clearly requires the liquidator to “pay ... expenses, fees, and claims” – that is, to discharge liabilities. However, the section requires that such payments be made “out of the assets of the company”, a requirement which appears, at least in comparison to the Australian provisions, to be focussed on the distribution of assets rather than the satisfaction of liabilities.

Did Parliament deliberately change the wording when drafting the 1993 Act in order to promote an asset-based interpretation? An investigation into the history of the provision reveals that this is not the case. The wording of section 312 has not changed substantially since the introduction of the Companies Bill in 1990,<sup>121</sup> which in turn is substantially the same as the Law Commission’s Draft Companies Act published in 1990.<sup>122</sup> Both of these also used the phrase “out of the assets of the company”. The change, therefore, seems to have arisen from the Law Commission, which claimed to have “elected to leave the law on preferential claims unchanged”.<sup>123</sup> The difference in wording between the current New Zealand provision and the 1955 Act is therefore probably due to a modernisation of language, rather than a deliberate reform. Nonetheless, the current New Zealand provision lacks the apparent liability focus shared by its predecessor and its Australian counterpart.

Of course, all the provisions deal with both the distribution of assets *and* the satisfaction of liabilities – these are both inextricable components of the same transaction. The question is whether the sections are focused on distributing assets, and in doing so also facilitate the payment of liabilities; or alternatively whether their focus is on the satisfaction of liabilities and the distribution of assets is merely a means to this end. Based on the wording of the statutes alone, either an asset-based or liability-based interpretation is at least plausible.

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<sup>118</sup> Corporations Act 2001 (Cth), s 556.

<sup>119</sup> Companies Act 1955, s 308(1).

<sup>120</sup> Companies Act 1993 s 312(1).

<sup>121</sup> Companies Bill 1990 (50-1), cl 275(1).

<sup>122</sup> Draft Companies Act 1990 s 239(1), in Law Commission *Company Law Reform: Transition and Revision* (NZLC R16, 1990) at 341.

<sup>123</sup> Law Commission *Company Law Reform and Restatement* (NZLC R9, 1989) at 164.



#### 4.4 The purpose of priority provisions

I propose that a liability-based interpretation is to be preferred. Assuming that Parliament's reasons for preferring some creditors over others are valid,<sup>124</sup> there seems to be no reason why the provisions should not apply to some businesses simply because they happen to be carried on through the vehicle of a trading trust.

Employees (for example) of a business conducted through a trading trust will be just as vulnerable in its insolvency as employees of a general company, so if we see such people as deserving of preferential treatment in the latter situation we should do so in the former as well. The purpose of the priority provisions is clearly to protect certain classes of creditor, and the liability-based interpretation best gives effect to this purpose in all circumstances. I propose therefore that, all other things being equal, the liability-based interpretation should be preferred.

#### 4.5 Insolvency law generally

In my opinion insolvency law in general is most sensibly considered to be liability-based. Without liabilities, one cannot be insolvent. On the other hand, one can become insolvent no matter how many assets one has – the only requirement is that assets are exceeded by liabilities. Insolvency is, therefore, an inherently liability-based area of law.

Perhaps surprisingly, there is no substantial body of insolvency research to which to turn in determining the theoretical underpinnings of insolvency law. This is particularly true of Australia and New Zealand. Australian academic Christopher Symes writes:<sup>125</sup>

Insolvency research is still in its infancy even though insolvency laws have been present for centuries. Those outside the insolvency field may assume that a great deal is known about debtors and creditors, and about the reasons and justifications for the particular provisions that occur in our insolvency statutes. ... Unfortunately, nothing could be further from the truth.

There are two leading textbooks on the topic of insolvency in New Zealand, and many more overseas, but these tend to be practical guides for practitioners rather than explorations of theory.<sup>126</sup> For this reason there appears to be no academic discussion as to whether insolvency law is concerned conceptually with liabilities or assets.

#### 4.6 Case law

Like the academic world, the judiciary have been silent on the question of whether priority provisions (or insolvency law generally) are asset-based or liability-based. This is no doubt because the answer to this question would make no practical difference in most liquidations. However, support for a liability-based view is implied in various cases where the distinction is important.

An example is the Supreme Court of South Australia case of *Re Suco*.<sup>127</sup> The case involved a gold mining business carried out by a corporate trustee (Suco) of two unit trusts. This is a slight

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<sup>124</sup> If this premise is not accepted then the provisions should not apply to ordinary company liquidations either; in other words, legislative change is needed. Either way, there is no good reason to treat liabilities differently merely because a business happens to be carried out through a trading trust.

<sup>125</sup> Christopher F Symes *Statutory Priorities in Corporate Insolvency Law: an Analysis of Preferred Creditor Status* (Ashgate, Farnham, 2008) at 1.

<sup>126</sup> The leading texts in New Zealand are Heath and Whale, above n 78, and Lynne Taylor and Grant Slevin *The Law of Insolvency in New Zealand* (Thompson Reuters, Wellington, 2016).

<sup>127</sup> *Suco*, above n 4.

variation on the conventional trading trust format, but for our purposes it may be treated as a trading trust. The trustee in *Suco* had no assets of its own, and upon liquidation its trust debts exceeded trust assets.

The primary question for the court was whether the liquidator could be paid from trust assets, a question which is given the attention it deserves in Chapter 5. However in discussing this issue King CJ took the view that priority provisions do apply to the payment of trust debts, and I suggest that this is because he implicitly approached the section from a liability-based perspective. This is evidenced by the following extract:<sup>128</sup>

[The liquidator] must therefore endeavour to pay the debts in accordance with the order of priority set out in that section. To the extent that each priority debt has been incurred in the performance of a trust he should have recourse to the property of that trust for the purpose of paying it.

Note that in King CJ's opinion, the section is concerned with the order in which the liquidator must "pay the debts" – in other words, discharge the liabilities.<sup>129</sup> *Suco* may, therefore, be taken as judicial authority (albeit obiter) for a liability-based interpretation.

Another Australian trading trust case, *Re Enhill*, also assumed that priority provisions would apply to distributions of trust assets.<sup>130</sup> Young CJ said that a tax debt which fell within the relevant priority provision was "entitled to priority over other creditors and accordingly the other creditors will receive nothing."<sup>131</sup> The court found, however, that the trustee's indemnity made trust assets fall within the company's personal assets,<sup>132</sup> so Young CJ's application of the priority provisions does not necessarily rely on a liability-based interpretation of the priority provision.

#### 4.7 Australian support for an asset-based approach

The most recent case to address the applicability of priority provisions to trust liabilities (and the only case to do so other than in obiter) is the New South Wales decision of *Re Independent Contractor Services*.<sup>133</sup> This case concerned an insolvent corporate trustee of a trading trust which owed a number of debts, including to the Australian Taxation Office (ATO) for tax liabilities including a superannuation guarantee charge. The superannuation guarantee charge does not have an exact parallel in New Zealand, but is a form of tax deducted from payments to employees, and may for our purposes be analogised to New Zealand's PAYE tax. Like PAYE in New Zealand,<sup>134</sup> the superannuation guarantee charge is given statutory priority in Australia.<sup>135</sup>

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<sup>128</sup> *Suco*, above n 4, at 109 (emphasis added).

<sup>129</sup> It is worth noting that *Suco*, above n 4, along with the other cases from this era, dealt with the precursor to Australia's current Corporations Act 2001. The wording of the priority provision in the Companies Act 1962 (SA) was substantially the same as its modern equivalent, as well as the Companies Act 1955 in New Zealand: s 292 provided that priority creditors "shall be paid in priority to all other unsecured debts". Note also that, while the legislation relied on in *Suco* was a South Australian statute, identical provisions existed in the Companies Acts of all other states and territories: Symes, above n 125, at 44. For this reason, I treat s 292 as if it were federal legislation.

<sup>130</sup> *Enhill*, above n 83.

<sup>131</sup> At 562.

<sup>132</sup> At 564. This conclusion has been heavily criticised, and has not been followed: for example, it was rejected by *Suco*, above n 4, at 107.

<sup>133</sup> *ICS*, above n 28.

<sup>134</sup> Companies Act 1993, Schedule 7, cl 1(2)(d).

<sup>135</sup> Corporations Act 2001 (Cth), s 556(1)(e)(i).

An interesting feature of the trading trust in this case was that the beneficiaries of the trust were also contractors for the corporate trustee (“ICS”).<sup>136</sup> ICS, in its role as trustee, hired these “contractors” to carry out the business of the trust, the profit from which was distributed to them (both as payment for their services as contractors and as trust distributions to them as beneficiaries). The effect of this was that, in its insolvency, ICS owed money contractually to the contractor/beneficiaries for services they had provided to the business. It appears that these contractors were the most substantial group of creditors after the ATO.<sup>137</sup>

In the liquidation of ICS, the liability for superannuation guarantee charge alone exceeded the available assets of the company (all of which were held on trust). If it were paid out in priority over other creditors, the other creditors (including the contractors) would receive nothing. However, Brereton J in the Supreme Court of New South Wales reached the conclusion that the ATO was not entitled to priority, on the basis that the statutory priority payments regime applied only to assets beneficially owned by the insolvent company. Because all the assets of ICS were held on trust, the provision could not apply. That Brereton J took an asset-based view of the relevant priority provision is made clear in the following extract:<sup>138</sup>

The South Australian Full Court admittedly held in *Re Suco Gold Pty Ltd* that in respect of each trust of which the company in liquidation was trustee, liabilities were to be paid from the trust property in the order laid down in [the priority provision]. However, this is virtually universally accepted to be incorrect, although what is the correct position remains unclear. It is incorrect because s 556 is concerned only with the distribution of assets beneficially owned by a company and available for division between its general creditors.

Note the terminology used to describe s 556 – Brereton J sees the section as concerned “only with the distribution of assets”. This is an important contrast with King CJ’s focus in *Suco* on the order in which the liquidator must “pay the debts”.<sup>139</sup>

Brereton J points to a number of authorities in support of his claim that “s 556 is concerned only with the distribution of assets beneficially owned by a company and available for division between its general creditors”.<sup>140</sup> This statement is crucial to his Honour’s conclusion, so it is helpful to examine these authorities in detail.

The first authority provided is the English case of *Re Kayford*.<sup>141</sup> This case concerned an insolvent mail-order retailer, which held a number of prepayments from customers when it entered liquidation. These prepayments were in a separate account “Customers’ Trust Deposit Account”, and the court found that they were held on trust for the customers who had paid them and were therefore not available to the company’s creditors.<sup>142</sup>

*Kayford* did not deal with priority provisions or indeed any statutory provisions, and it simply is not authority for the proposition that priority provisions do not apply to trust assets. The case stands for the fact that assets held on trust do not form part of the pool available to general

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<sup>136</sup> *ICS*, above n 28, at [5].

<sup>137</sup> At [5].

<sup>138</sup> At [23] (footnotes omitted).

<sup>139</sup> *Suco*, above n 4, at 109.

<sup>140</sup> *ICS*, above n 28, at [23], n 22.

<sup>141</sup> *Re Kayford Ltd (in liq)* [1975] 1 All ER 604, 1 WLR 279.

<sup>142</sup> At 607.

creditors,<sup>143</sup> but this position does not conflict with a liability-based interpretation of the priority provisions.<sup>144</sup>

The next authority referred to in *ICS* is *McPherson: The Law of Company Liquidation*, a leading Australian textbook on the subject.<sup>145</sup> This book provides that “[the Australian priority provision] should be restricted to ‘assets’ which are beneficially owned by a company and which are available for division among the company’s general creditors in a winding up”.<sup>146</sup> However, the only authority provided for this statement is *Kayford* which, as discussed above, does not support this view at all.<sup>147</sup>

The third authority cited was the New South Wales case of *Re Staff Benefits*.<sup>148</sup> This case involved a failed investment company which held money on trust for investors, but also borrowed money from depositors. The investors were beneficiaries of the trust, and the depositors were trust creditors. The question was whether the depositor-creditors should be paid out in priority to the investor-beneficiaries; quite rightly it was held that they should.<sup>149</sup> This was nothing to do with any statutory priority provision, but rather an application of the rule that satisfaction of trust liabilities (via the trustee’s indemnity) takes priority over payment of beneficiaries.<sup>150</sup>

The only aspect of *Staff Benefits* that could be said to support the position of Brereton J in *ICS* is found in a discussion of the secondary issue of what rate of interest should be paid to the depositor-creditors. Needham J stated that the funds held on trust were not “assets of the company” for the purposes of a section determining the appropriate interest rate.<sup>151</sup> This appears to be an asset-based interpretation of the relevant provision, however it had nothing to do with the priority provision dealt with in *ICS*.

The fourth source provided is an essay by Justice McPherson (writing extrajudicially) entitled “The Insolvent Trading Trust”.<sup>152</sup> In it, his Honour makes the statement that “[the priority provisions] apply only to ‘assets’ that are beneficially owned by the company and that are available in winding-up for division amongst the creditors generally”. In support of this he cites only the three sources discussed above: *Kayford*, *McPherson*, and *Staff Benefits*.<sup>153</sup>

The fifth citation, *Jacobs’ Law of Trusts in Australia*, makes a clear statement that “[the priority provision] is addressed only to distribution of assets beneficially owned by the company and available for division between general creditors”.<sup>154</sup> No reasoning or authority is provided for this statement.

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<sup>143</sup> *Kayford*, above n 141, at 607.

<sup>144</sup> For example, *Suco*, above n 4, supports the proposition that trust assets are not available to general creditors (at 108) and also favours a liability-based approach to (at 109, as discussed in 4.6 above).

<sup>145</sup> Andrew Keay *McPherson: The Law of Company Liquidation* (4th ed, LBC Information Services, Sydney, 1999).

<sup>146</sup> Keay, above n 145, at 305-306.

<sup>147</sup> Keay, above n 145, at 306, n 353.

<sup>148</sup> *Re Staff Benefits Pty Ltd* [1979] 1 NSWLR 207;

<sup>149</sup> At 214.

<sup>150</sup> At 213.

<sup>151</sup> At 215. The relevant provisions were the Bankruptcy Act 1966 (Cth), ss 112 and 116, as imported into the law of liquidation by the Companies Act 1961 (NSW), s 291(2).

<sup>152</sup> McPherson, above n 2.

<sup>153</sup> At 154, n 21.

<sup>154</sup> Jacobs, above n 117, at 577.

Finally,<sup>155</sup> Brereton J cites the Federal Court of Australia decision of the case of *Bruton Holdings v Federal Commissioner of Taxation*.<sup>156</sup> In obiter, the judge in that case makes the following comments.<sup>157</sup>

We observe however, that a difficulty arises as to whether s 556 governs the order of priority where trust assets are insufficient to meet the claims of all trust creditors. The learned authors of *Jacobs' Law of Trusts in Australia* are of the view, at [2115], that s 556 addresses only the distribution of assets beneficially owned by an insolvent company. See also the remarks of McPherson J “The Insolvent Trading Trust”.

This statement does not support one position or the other – it merely points out that views on the subject differ.

The conclusion to be reached from this examination of Brereton J’s authorities is that, despite the suggested prevalence of an asset-based view, the issue is far from decided. No case prior to *ICS* had held that the priority provisions do not apply to trust assets. The case of *Staff Benefits* appears to lean in that direction (albeit in a different statutory context), however *Bruton* does not and *Kayford* fails to even go near the issue. Brereton J’s position is supported by three prominent academics, and this is not an endorsement to be dismissed lightly. However, none of them have spent much time explaining or justifying their stance. In summary, the issue is not as clear-cut as Brereton J would have it appear.

#### 4.8 The New Zealand position

The question of whether priority provisions apply in a trading trust context (and the broader question of whether such provisions are asset- or liability-based) seems not to have yet arisen in New Zealand. Presumably it is only a matter of time before such a case comes before the courts. Given the recent decision of *ICS*, the balance of authority seems at first glance to lean toward an asset-based interpretation, though in my view this is not the best approach. Priority provisions are concerned with the satisfaction of certain liabilities in priority to those of the insolvent company’s general creditors, and on this basis they should apply to all liabilities owed by the company – including, in the context of a trading trust, trust liabilities.

This issue was not addressed in the Law Commission’s Issues Paper (which was published before the decision of *ICS*).<sup>158</sup> Nonetheless, this is an area in which statutory reform could be useful: if Parliament confirmed that our priority provision is liability-based the problem would be solved before it ever arises, and the risk of a New Zealand court following *ICS* would be eliminated.

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<sup>155</sup> Brereton J also makes reference to “HAJ Ford Principles of the Law of Trusts (Law Book Co) [14.7310]”, but the pinpoint citation “[14.7310]” does not correspond with any edition of that work that I can locate.

<sup>156</sup> *Bruton Holdings Pty Ltd (in liq) v Federal Commissioner of Taxation* [2011] FCAFC 79, (2011) 193 FCR 442.

<sup>157</sup> *Bruton*, above n 156, at [27] (citations omitted).

<sup>158</sup> IP31, above n 1, was published in 2012; *ICS*, above n 2, was decided in 2016.

# Chapter 5: The Liquidator

*The third and final class of creditor considered by this dissertation is the liquidator. Whether the liquidator actually is a creditor is discussed in this chapter, but it is clear that, like a creditor, the liquidator seeks to be paid in the insolvency of a trading trust. The trading trust structure potentially provides obstacles to such payment, though I conclude that in practice courts will ensure that the liquidator is paid. However, the exact basis of this payment is unclear, and the process may be more complicated than in the liquidation of an ordinary company.*

## 5.1 Remuneration of the liquidator generally

In a typical liquidation the liquidator will work to realise and distribute the insolvent company's assets.<sup>159</sup> This may involve investigating what assets the company owns, selling those assets, calling in debts, and various other time-consuming tasks. In return for these services, the liquidator is entitled to be paid from the company's assets "the fees and expenses properly incurred" along with "remuneration".<sup>160</sup> For these payments the liquidator, typically a professional accountant, is entitled to priority over all other unsecured creditors.<sup>161</sup> If there are not enough assets even to pay the liquidator, they simply miss out.

Problems arise in the context of an assetless corporate trustee. A liquidator is usually paid from a company's personal assets, and this makes sense – if a company operated (and became insolvent) in its own right but also happened to hold some assets on trust, one would expect only the company's personal assets to be used in payment of the liquidator. But the logical conclusion of this approach is that, when liquidating a company which holds only trust assets, the liquidator could not be paid at all.

We must assume that liquidation is essentially a good thing. It provides a structured regime for the fair treatment of the creditors of an insolvent entity, and prevents a "free-for-all" with each creditor pursuing their own rights. If liquidation is a good thing, then liquidators provide a valuable service and deserved to be paid for their skill and time. And if liquidation is seen as useful in the context of an ordinary company then it should be equally useful in the context of an otherwise identical business conducted via a trading trust. For this reason it is universally accepted that liquidators of trading trusts deserve to be remunerated from the trust assets.<sup>162</sup> The question is, on what basis should this occur?

Trust property cannot, by default, be used to pay the liquidator's remuneration. Where courts have allowed such payments they have done so by recognising an exception to the rule: a liquidator cannot be paid from trust assets *unless the court exercises its inherent jurisdiction*;<sup>163</sup> a liquidator cannot be paid from trust assets *unless they are a trust creditor*;<sup>164</sup> a liquidator cannot be paid from trust assets *unless the trustee's indemnity makes the trust assets generally available*.<sup>165</sup> These exceptions all serve the same purpose, but all operate in different ways. Some of these exceptions

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<sup>159</sup> Throughout this chapter I will use the singular "the liquidator", although it is possible for more than one liquidator to administer a single liquidation.

<sup>160</sup> Companies Act 1993, Schedule 7, cl 1(1)(a).

<sup>161</sup> Companies Act 1993, Schedule 7, cl 1(1)(a); see also Heath and Whale, above n 78, at 22.22(a).

<sup>162</sup> Only one case has ever decided that the liquidator could not be paid in this situation, and the judge expressed concern at this outcome: *Re Byrne Australia Pty Ltd (No 1)* [1981] 1 NSWLR 394 at 399.

<sup>163</sup> *In re Berkeley Applegate (Investment Consultants) Ltd (In Liq)* [1989] Ch 32; discussed in 5.2 below.

<sup>164</sup> *Suco*, above n 4; *Byrne (No 1)*, above n 162; discussed in 5.3 below.

<sup>165</sup> *Enhill*, above n 83; discussed in 5.4 below.

have implications beyond payment of the liquidator, so it is important to determine which approach is correct.

## 5.2 The court's inherent jurisdiction

One approach courts have taken to this issue is to exercise their inherent jurisdiction to compensate the liquidator for services to the trust.

The leading case on this approach is the UK case of *Re Berkeley Applegate*.<sup>166</sup> This case did not involve a trading trust in the Australasian sense, but did involve the liquidation of a company which was trustee of a trust. The decision has subsequently been referred to in a trading trust context.<sup>167</sup> The company in this case did have assets of its own, but they were insufficient to pay the liquidator's remuneration. The liquidator sought to use trust assets to pay the balance, and was allowed to do so on the basis of the court's "inherent jurisdiction".<sup>168</sup>

The exact form this jurisdiction takes is not precisely spelled out, but analogies are drawn with a number of other cases. One such case is *Phipps v Boardman*, in which a solicitor, Boardman, who had provided a benefit to a trust, was found to be entitled to payment for his "work and skill".<sup>169</sup> Much like a liquidator, Boardman was not a trustee of the trust but was acting as a form of agent for the trustees.<sup>170</sup>

The court also noted that payment of the liquidator from trust assets was in accordance with the equitable maxim "he who seeks equity must do equity".<sup>171</sup> In this case those seeking equity are the creditors of the trust, who seek to "enforce a claim to an equitable interest" in the trust property.<sup>172</sup> Such a claim can only be satisfied by the work of the liquidator, so the creditors must see that the liquidator is fairly paid.

Under the *Berkeley* approach it seems that liquidators cannot access trust property as of right, but courts have a jurisdiction to allow access to it. This approach will lead to fair outcomes provided the court exercises its jurisdiction where required. However, this approach does require court involvement every time a liquidator seeks access to trust assets. As I will discuss below, this may not be the case if liquidators are simply treated as trust creditors.

The *Berkeley* approach has found recent support in New Zealand in the High Court decision of *Hollis v Total Debt Solutions*.<sup>173</sup> In that case the court granted permission to use trust assets for payment of the liquidator, but clearly took the *Berkeley* approach of doing so in the present case only.<sup>174</sup> The court also made reference to the following excerpt from the New Zealand decision of *Re Newsmakers International*:<sup>175</sup>

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<sup>166</sup> *Berkeley*, above n 15.

<sup>167</sup> See for example Keay, above n 145, at 306.

<sup>168</sup> *Berkeley*, above n 15, at 51.

<sup>169</sup> *Boardman v Phipps* [1966] 3 All ER 721 at 744 (per Lord Cohen). The primary question before the court was one of account of profit: Boardman was required to account for his profit to the trust, but was then granted some remuneration.

<sup>170</sup> The liquidator's relationship with the liquidated company is not purely one of agency. New Zealand's leading text on insolvency described the liquidator as "principally an agent for the company who occupies a position which is fiduciary in some respects and who is bound by the statutory duties imposed by the [Companies Act 1993]": Heath and Whale, above n 78, at 22.1.

<sup>171</sup> *Berkeley*, above n 15, at 50.

<sup>172</sup> At 50.

<sup>173</sup> *Hollis v Total Debt Solutions* (2009) Ltd [2017] NZHC 1383.

<sup>174</sup> At [12]-[15].

<sup>175</sup> *Re Newsmakers International Ltd (In Liq)* HC Napier M153/86, 24 February 1994 at 6.

[W]hen a liquidator is forced to carry out work in relation to assets held on trust, for the benefit of the beneficiaries concerned, the Court has an inherent jurisdiction to allow reasonable costs against those assets. There is an underlying and obvious equity. He who saves trust assets for the benefit of beneficiaries, properly can ask those beneficiaries to meet his proper expenses. It has been made clear that the jurisdiction does not extend to general expenses of the winding up: the activity concerned must relate to trust assets in a direct fashion.

As the most recent authority on this question (albeit only at High Court level), *Hollis* suggests that in New Zealand liquidators will not be able to access trust property without express court permission. However, there remains the possibility that New Zealand could instead adopt a treatment of liquidators as (trust) creditors.

### 5.3 The liquidator as a trust creditor

An alternative to the exercise of the court's inherent jurisdiction may be to treat the liquidator as simply a trust creditor. This approach is best exemplified by the Australian case of *Suco Gold*.<sup>176</sup>

This case was heard by the Full Court of the Supreme Court of South Australia, with two judgments delivered (by King CJ and Jacobs J) and the third judge (Matheson J) purporting to agree with the others. Both King CJ and Jacobs J agreed that the liquidator could be paid from trust assets, though each for different reasons.<sup>177</sup> King CJ justified payment of the liquidator from trust assets on the basis that the costs of a liquidator are a debt of the company,<sup>178</sup> and in a trading trust context this is a trust debt.<sup>179</sup>

Another Australian case supporting the “liquidator as a creditor” approach is *Re Byrne Australia*. This was in fact two sequential cases: *Byrne (No 1)* found that a liquidator could not be paid from trust assets unless they were a trust creditor,<sup>180</sup> and *Byrne (No 2)* found that the liquidator in that case was not a trust creditor.<sup>181</sup> Where no distinction is necessary, I will refer to the cases together as “*Byrne*”. *Byrne* was the first trading trust case to consider the issue of remuneration of the liquidator, and remains the only one in which a liquidator went unpaid due to an inability to access trust assets.

#### 5.3.1 *Is the liquidator a creditor?*

For a liquidator to be considered a trust creditor, it is of course necessary that they be considered a creditor at all. In *Suco* King CJ decided that he was, largely on the basis of the wording of the relevant priority provision. The statute called for payment of the liquidator before “other debts”, with the word “other” being taken by King CJ to mean that the liquidator's fees were also a “debt”.<sup>182</sup>

This particular reasoning cannot be applied in the New Zealand context, as the phrase “other debts” is not found in the equivalent provision. In fact, our provision does not use the word “debts” at all, but instead uses “claims” with the same meaning.<sup>183</sup> Section 312 of New Zealand's

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<sup>176</sup> *Suco*, above n 4.

<sup>177</sup> At 110 per King CJ, and at 113 per Jacobs J.

<sup>178</sup> At 110.

<sup>179</sup> On the basis that the trustee has an obligation to pay trust debts, and the liquidator facilitates this: *Suco*, above n 4, at 110.

<sup>180</sup> *Byrne (No 1)*, above n 162.

<sup>181</sup> *Re Byrne Australia Pty Ltd (No 2)* [1981] 2 NSWLR 364.

<sup>182</sup> *Suco*, above n 4, at 110.

<sup>183</sup> “Claims” is clearly used to mean “debts”, as in the phrase “all other claims” in Companies Act 1993, s 313(1).



Companies Act talks of “the expenses, fees, and claims set out in Schedule 7”,<sup>184</sup> the wording of which tends to suggest that “expenses” and “fees” are in a different category from “claims”.

Despite this, I consider it likely that a liquidator can be considered a creditor of the company. “Creditor” is defined in the Companies Act as “a person who, in a liquidation, would be entitled to claim in accordance with section 303 that a debt is owing to that person by the company”.<sup>185</sup> Section 303 provides:<sup>186</sup>

### **303 Admissible claims**

(1) Subject to subsection (2), a debt or liability, present or future, certain or contingent, whether it is an ascertained debt or a liability for damages, may be admitted as a claim against a company in liquidation.

(2) Fines, monetary penalties, and costs to which section 308 applies are not claims that may be admitted against a company in liquidation.

Liquidator’s fees do not fall within s 308 and are therefore not excluded by s 303(2). Are they, then, “a debt or liability, present or future, certain or contingent, whether it is an ascertained debt or a liability for damages”? I see no reason why liquidator’s fees cannot be encompassed by this broad definition. Further evidence that a liquidator is a creditor is provided by the fact that a liquidator can sue to recover their fees.<sup>187</sup>

#### *5.3.2 Is the liquidator a trust creditor?*

It is not enough to show that the liquidator is a creditor: to access trust assets they must be a *trust* creditor.<sup>188</sup> In the trading trust context however, this presents no obstacle. In the liquidation of an ordinary company the creditor would be dealing with the company’s personal assets and liabilities and would be a personal creditor – if this is the case, then a liquidator of a trading trust who deals only with trust assets and liabilities must be a trust creditor.

King CJ in *Suco* further pointed out that the liquidator provides a service to the trust – the trustees have a duty to pay trust debts, and upon liquidation the only person who can facilitate this is the liquidator. For this reason the liquidator must be a trust (rather than just a personal) creditor.

This reasoning would also apply to a company which holds some assets personally and some on trust. The liquidator would be a personal creditor to the extent that their work related to the personal assets and liabilities, and a trust creditor to the extent that it related to trust assets and liabilities. The exact method of calculation may be open to discussion, but I suspect it would be based simply on the hours worked in relation to each class of assets. Of course, in a trading trust as contemplated by this paper there will only ever be trust assets and liabilities.

*Byrne* has been heavily criticised for its conclusion that the liquidator could not be paid, but in fact the reasoning of *Byrne (No 1)* was largely on the right track. Needham J took the view that the liquidator could not be reimbursed from trust assets as of right, on the basis that trust assets can only be accessed via the trustee’s indemnity, and this can only arise in respect of “creditors

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<sup>184</sup> Companies Act 1993, s 312(1).

<sup>185</sup> Companies Act 1993, s 240(1).

<sup>186</sup> Companies Act 1993, s 303.

<sup>187</sup> *In re New Zealand Times Co Ltd (In Liq)* [1941] NZLR 677.

<sup>188</sup> One notable Australian case, *Enhill*, above n 83, found that the question of whether a liquidator could be paid depended only on “whether the proceeds of the [indemnity] are available for distribution among [the insolvent company’s] creditors” – in other words, the court treated the liquidator as a creditor but did not require them to be a trust creditor. This case is discussed in 5.4 below.

whose debts arose because of [the trustee's] activities as trustee of the fund".<sup>189</sup> In addition, the statutory definition of property divisible amongst the creditors expressly excluded "property held by the bankrupt on trust for another person".<sup>190</sup> In Needham J's view this definition of property applied to the statutory provision for reimbursement of liquidators, meaning that in this case there was no "property" with which the liquidator could be paid unless the liquidator was a trust creditor.<sup>191</sup>

Needham J required the liquidator to file separate submissions to support the proposition that he was a trust creditor: these were heard in *Byrne (No 2)*.<sup>192</sup> In a short judgement, Needham J found that the liquidator was not a trust creditor, on the basis that his power arose from statute rather than the trust instrument.<sup>193</sup> In my opinion this result misses the point that the liquidator's work is essential to the completion of the trustee's duty to pay trust debts. The liquidator is therefore providing a service to the trust, and should be treated as a trust creditor. This was the method by which King CJ found that the liquidator could be paid from trust assets.<sup>194</sup>

The advantage of the "liquidator as a creditor" approach, as opposed to the use of the court's inherent jurisdiction, is that a trading trust liquidator is able to pay him or herself as a creditor without needing to seek (at expense to the company's estate) the court's permission. However, one potential drawback of the creditor approach is that the liquidator relies on a statutory priority to be paid before all other creditors.<sup>195</sup> If it is found that priority provisions do not apply in the trading trust context (see Chapter 4), the liquidator will only be able to retrieve a portion of their fees proportionate to the recovery of other creditors. If this is the case, the liquidator would need to utilise the court's inherent jurisdiction in order to receive their full fee. This is another reason why the priority provisions should be seen as liability-based, and should therefore apply in the trading trust context.<sup>196</sup>

## 5.4 Alternative options

Two other approaches to the payment of liquidators from trust assets have arisen in the Australian case law, though in my view these are not good alternatives to the options discussed above. For completeness I will discuss them.

The Australian case of *Re Enhill*,<sup>197</sup> decided after *Byrne* but before *Suco*, reached the conclusion that the liquidator could be paid from trust assets because all trust assets were, as "proceeds of the right of indemnity", available to the company's general creditors and therefore to the liquidator for their fees.<sup>198</sup>

This case was factually very similar to *Byrne*, and was decided only a year later.<sup>199</sup> Once again, the question before the court was whether the liquidator could reimburse himself from trust

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<sup>189</sup> *Byrne (No 1)*, above n 162, at 398.

<sup>190</sup> Bankruptcy Act 1966 (Cth), s 116(2); note that while this provision primarily concerns personal bankruptcy, it was imported into the law of liquidation by the Companies Act 1961 (NSW), s 291(2).

<sup>191</sup> *Byrne (No 1)*, above n 162, at 397.

<sup>192</sup> *Byrne (No 2)*, above n 181.

<sup>193</sup> At 365.

<sup>194</sup> *Suco*, above n 4, at 110.

<sup>195</sup> Companies Act 1993, Schedule 7, cl 1(1)(a).

<sup>196</sup> See 4.2 above.

<sup>197</sup> *Enhill*, above n 83.

<sup>198</sup> At 564.

<sup>199</sup> The biggest difference between the cases was that in *Enhill* the trust's liabilities vastly exceeded its assets, and it was likely that most creditors will receive nothing: *Enhill*, above n 83, at 562. This was not material to the question of reimbursement of the liquidator.

assets.<sup>200</sup> The court decided that in determining this question, the “only” thing to establish was “whether the proceeds of the [trustee’s indemnity] are available for distribution among his creditors”.<sup>201</sup> It was decided that the proceeds of the indemnity were available for distribution to general creditors, and could therefore be used to pay the liquidator.<sup>202</sup>

The court accepted that “the trust fund is not ... property divisible among the trustee’s creditors”,<sup>203</sup> but found that “the trustee’s right of indemnity or lien ... exists to enable him to recoup himself for, or to provide for, the debts which he must bear personally”,<sup>204</sup> and therefore that the liquidator could apply trust assets to payment of his fees.<sup>205</sup> This conclusion shows a fundamental misunderstanding of the operation of the indemnity.

The court in *Enhill* found that the “proceeds of the indemnity” were available to the liquidator and general creditors, which is true in the context of indemnity by recoupment.<sup>206</sup> Where a trustee pays a trust debt from his or her personal assets they may recoup themselves from the trust assets. The “proceeds” of this recoupment, which were until recently trust assets, are available to the trustee’s personal creditors. However this was not the situation in *Enhill*, and nor can it be in any trading trust case. Corporate trustees of trading trusts have no assets of their own, so they cannot pay trust debts from their own assets and then seek recoupment. Instead, they must use the indemnity in the form of *exoneration* to discharge trust debts. This means that the trust debt is paid directly from trust assets, with no change to the trustee’s personal assets. In this kind of transaction there can be no “proceeds of the indemnity” in the sense discussed in *Enhill* – at no time does the trustee obtain any assets for personal use.

Lush J in *Enhill* described the trustee’s indemnity as “a power which can be, and is designed to be, used for the trustee’s own benefit”, and this is true.<sup>207</sup> But while the indemnity exists for the trustee’s benefit, this benefit takes the form of a removal of a negative, rather than conferral of a positive benefit. Indemnity through exoneration does not provide assets to the trustee, but rather serves to neutralise a liability which the trustee would otherwise have personally owed.

Take an example: a trustee incurs a trust liability for \$100. This gives the trustee a right of indemnity from trust assets to the value of \$100. The trustee may either spend \$100 of its own money in discharging the liability and take \$100 from the trust by way of reimbursement, or it may simply pay the \$100 liability directly from trust assets by way of exoneration.

In both cases the liability to which the indemnity relates must actually be discharged. If the trustee spends \$100 on a personal debt they cannot be reimbursed from the trust assets – there has been no trust payment to reimburse. Equally, if the trustee purports to use its indemnity via exoneration to pay \$100 to a personal creditor from trust assets this is not a use of the indemnity at all – it is simply a breach of trust. In both of these cases the trustee has a valid indemnity for \$100, but this does not mean that \$100 is available for general creditors or the liquidator.

*Enhill* has not been followed as authority for the proposition that the trustee’s indemnity makes all trust assets available to general creditors.<sup>208</sup> It has been mentioned as authority for the general

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<sup>200</sup> *Enhill*, above n 83, at 562.

<sup>201</sup> At 565.

<sup>202</sup> At 565.

<sup>203</sup> At 571.

<sup>204</sup> At 569.

<sup>205</sup> At 572.

<sup>206</sup> The indemnity can take the form of either recoupment or exoneration: see 2.1 above. It seems that the court in *Enhill* confused this distinction.

<sup>207</sup> *Enhill*, above n 83, at 567.

<sup>208</sup> Indeed this was expressly rejected in *Suco*, above n 4, at 105, per King CJ, and at 115, per Jacobs J.

proposition that liquidators may be paid from trust assets,<sup>209</sup> presumably by judges who did not look too closely at the reasoning, but I am confident in saying that *Enhill* does not provide a valid alternative to the two approaches discussed above.

Finally, I must mention the decision of Jacobs J in *Suco*. I have relied upon the judgment of King CJ in that case as authority for the treatment of the liquidator as a creditor, but in fact the court was not united in its approach. Jacobs J, while purportedly in agreement with King CJ,<sup>210</sup> did not find that the liquidator was a creditor – rather, he decided that the legislative provision for payment of the liquidator applies to trust assets just as it would to the assets of an ordinary company.<sup>211</sup> The reason for this conclusion was that “to hold otherwise would defeat, or at least frustrate, the legislation”.<sup>212</sup>

I find this a troublesome justification. I agree with Jacobs J that Parliament would, if asked, have most likely wanted liquidators of trading trusts to be paid from trust assets. If the purpose of the legislation is to facilitate liquidations then a finding that trading trust liquidators could not be reimbursed would indeed frustrate this purpose. But this should not be enough to allow a party other than a trust creditor to access trust assets. Such a deviation from the principles of trust law should not be taken without more explicit Parliamentary authority.

New Zealand academic AW Lockhart also objected to the reasoning of Jacobs J:<sup>213</sup>

Firstly it denies the law as laid down in *Byrne's* case and indeed as accepted and justified in the *Suco* case. It is a fundamental principle of trust law that trust assets ought only be available for legitimate trust purposes. One such purpose is to provide for trust creditors. Providing for others, including liquidators of the trustee, is contrary to this. Secondly, if a policy decision is to be made, it should at least be a correct policy. Simply letting a liquidator have access to the trust assets because of the fear that the winding up could not otherwise proceed is not, it is submitted, the correct response. The court should instead simply remove the insolvent trustee and appoint a new one.

The first limb of Lockhart’s objection is that the liquidator cannot properly access trust property unless as a trust creditor, and with this I agree. Lockhart does not consider the possibility of a *Berkeley*-style exercise of the court’s inherent jurisdiction for repayment of a creditor, but he evidently accepts the approach of King CJ in *Suco* as a sufficient solution to the problem.

In Lockhart’s second point he loses my support. To suggest replacement of the insolvent trustee with a new one misses the point that it is not merely the trustee that is insolvent – it is the trust itself. This means that trust debts exceed trust assets, and replacement of the trustee will not fix this situation.

Nonetheless, I entirely agree with what I take to be Lockhart’s primary point, which is that Jacobs J should have followed *Byrne* (as King CJ did) rather than resorting to a “policy decision”. The reason Jacobs J gave for not following *Byrne* was that the latter case involved a voluntary (rather than court-ordered) winding-up.<sup>214</sup> This distinction is unconvincing, and has not been followed in

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<sup>209</sup> For example see *Re Secureland Mortgage Investments Ltd (In Liq) (No 2)* (1988) 4 NZCLC 64,266 at 64,275.

<sup>210</sup> *Suco*, above n 4, at 111.

<sup>211</sup> At 113.

<sup>212</sup> At 113.

<sup>213</sup> AW Lockhart “Trading Trusts: An Examination of Trustees Liability and Creditors' Rights” (1986) 5(3) Auckland U L Rev 313 at 320.

<sup>214</sup> *Suco*, above n 4, at 114.

New Zealand.<sup>215</sup> The third judge in *Suco*, Matheson J, provides no help in determining which of the other two judges to follow: he purports to agree with both.<sup>216</sup>

## 5.5 The New Zealand position

In *Re Secureland Mortgage Investments* (decided before Berkeley but well after the Australian cases) Holland J made the following comments on the issue of payment of a liquidator from trust property:<sup>217</sup>

The issue has been considered in a number of cases in Australia, the most helpful of which are the decisions of the Full Court of Victoria in *Re Enhill Pty Ltd* and of the Full Court of South Australia in *Re Suco Gold Pty Ltd (in liq)*.

I have found the decision of King CJ in the latter case particularly helpful and am content to adopt his reasoning in concluding that the provisional liquidator acquired on the winding up the right of the company as trustee to retain trust assets in his hands until his expenses and remuneration as trustee were paid and that in a case such as the present that includes the costs and expenses of administering the trusts in the light of the trustee companies having been ordered to be wound up.

It seems strange that Holland J considers *Enhill* to be among “the most helpful” cases on this point, given its widely criticised reasoning and clear contradiction with *Suco* on the basis on which the liquidator is paid. One could take the cynical view that by “most helpful”, the judge meant most in alignment with the outcome he was seeking, namely that liquidators should be paid from trust assets. Nonetheless, it is clear that he places most emphasis on the judgment of King CJ in *Suco*, and therefore presumably considers the liquidator’s right to remuneration from trust assets arises from the liquidator’s status as a trust creditor.

No mention is made of *Byrne* in *Secureland*. A subsequent New Zealand case, *Re Francis James Nominees*,<sup>218</sup> does consider all three cases (as well as later Australian cases), but simply takes them all (with the exception of *Byrne*) as collective authority that “in one way or another the Liquidator was to be entitled to some remuneration for bringing in the trust assets”.<sup>219</sup> Doogue J dismisses *Byrne* as being the result of “a different effect being given to a decision of the High Court of Australia in *Octavo*”.<sup>220</sup> None of this is very helpful in revealing the actual basis on which a trading trust liquidator is remunerated in New Zealand, but it is clear that such liquidators need not fear going unpaid.

## 5.6 Going forward

Remuneration of liquidators from trust assets was one of the issues raised by the Law Commission in its discussion of trading trusts.<sup>221</sup> The Commission noted the view of one of its submitters that “whilst these issues have not been significant in New Zealand litigation so far, they are likely to increasingly emerge; this area of law is too fundamental to have so much uncertainty”.<sup>222</sup> However

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<sup>215</sup> *Re Francis James Nominees Ltd (In Liq)* (1988) 4 NZCLC 64,279 at 64,283: Doogue J rejected an argument that cases involving a Court ordered winding-up were not relevant in the case of a voluntary winding-up.

<sup>216</sup> *Suco*, above n 4, at 115.

<sup>217</sup> *Secureland*, above n 209, at 64,275 (citations omitted).

<sup>218</sup> *Francis James*, above n 215, at 64,283.

<sup>219</sup> At 64,283.

<sup>220</sup> At 64,283.

<sup>221</sup> IP31, above n 1, at 170.

<sup>222</sup> At 170.

the Commission did not discuss this issue in depth, on the basis that legislative reform in this area would encroach on company and insolvency law and so was beyond the scope of their paper.<sup>223</sup>

In my opinion the situation we are in is practically satisfactory, but not theoretically satisfying. It certainly appears that courts in New Zealand are willing to allow remuneration from trust assets where necessary, and this is a positive outcome. However, the current process involves the necessary use of court resources, and significant uncertainty as to the legal basis by which liquidators obtain this privilege. I propose that the best solution would be to legislate a position similar to that taken by King CJ in *Suco* – that is, that liquidators are creditors of the companies they liquidate, and are trust creditors to the extent that their work relates to a trust.<sup>224</sup> Under this approach, liquidators of trading trusts could be paid from trust assets without the cost and inconvenience of court intervention.

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<sup>223</sup> IP31, above n 1, at 171.

<sup>224</sup> The extent to which a liquidator's work "relates to the trust" should be calculated on the basis of time spent dealing with trust assets and creditors, as a proportion of the liquidator's total work. In the liquidation of a corporate trustee with no personal assets, the entirety of the liquidator's work will relate to the trust, and therefore the entirety of his or her fee will be payable from trust assets.

# Conclusion

The trading trust structure is not as problematic as it first appears. Despite the fact that the corporate trustee has no personal assets from which to pay creditors, general creditors are highly unlikely to be disadvantaged by the trading trust structure in practice. In fact, the greater potential for directors to be personally liable may serve to advantage trading trust creditors over their ordinary company counterparts in some circumstances.

In light of recent case law in Australia there is reason for concern that statutory priority provisions may not be applied in trading trust liquidations. In my view the Australian approach is wrong: properly understood, priority provisions are concerned with *all* liabilities, including trust liabilities. Whether New Zealand adopts the right approach remains to be seen.

Finally, liquidators of corporate trustees may face uncertainty as to the basis on which they can access trust assets, though in practice they will be paid “in one way or another”.<sup>225</sup> The liquidator is best understood as a creditor of the liquidated entity, and to the extent that the liquidator’s work relates to trust assets (which it invariably will in a trading trust context) they are a trust creditor. If this is the case, trading trust liquidators will be able to be paid for their work without seeking court permission. Ideally it is hoped that a court (or Parliament) will clarify this position.

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<sup>225</sup> *Francis James*, above n 215, at 64,283.

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