BANKRUPTCY AND DISCRETIONARY TRUSTS

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1. Property Provisions in the Bankruptcy Act

Under the Bankruptcy Act ("the Act") there is a distinction between "property" and "income".

Under s58(1) of the Act both "the property of the bankrupt" and "after acquired property of the bankrupt" vest in the bankruptcy trustee.

"The property of the bankrupt" is defined in s5(1) of the Act (listed alphabetically under "the" and not under "property") in terms of property "divisible" among the bankrupt's creditors.

"After acquired property" is defined in s58(6) as property divisible among creditors which is acquired after the date of bankruptcy.

Section 116(1) then defines divisible property widely but subject to certain specified exceptions in s116(2). Section 116(1)(a) limits after acquired property to property acquired before discharge from bankruptcy.

The s116(2) exceptions include personal injury claim proceeds and superannuation. Importantly for present purposes s116(2)(a) provides that "property held by the bankrupt in trust for another person" is not divisible property. It follows that such property will not vest in the bankruptcy trustee.

Although a bankrupt can be the trustee of a trust, a bankrupt cannot be a director of a company which is trustee of a trust. Section 206B(3) of the Corporations Act provides that a bankrupt is disqualified from managing a corporation.

2. Income Provisions in the Bankruptcy Act

Part VI Division 4B (which start with s139J) deals with income contributions payable by a bankrupt. In short, a bankrupt who derives more than a specified threshold level of after-tax income must pay one half of the excess to the bankruptcy trustee by way of income contributions.

S139L(1) defines income as having "its ordinary meaning". This is subject to s139L(1)(a) which specifically includes various items as income regardless of whether or not they fall within the ordinary meaning of income. It is also subject to s139L(1)(b) which specifically excludes certain items even if they do come within the ordinary meaning of income.

S139L(1)(a)(iv) specifically includes as income "an amount received by the bankrupt as a beneficiary under a trust to the extent that the amount was paid out of income of the trust".

In *Combis, the Trustee of the Property of Landers, a Bankrupt v Harding, Billington and Regan as Executors of the Deceased Estate of Billington* [2014] FCA 1391 the court applied this provision in relation to a testamentary trust (not a discretionary trust) established under the will of the bankrupt's mother. The will provided that the deceased's house was to be sold and the proceeds invested. 25% of the investment income was to be paid to the bankrupt during his lifetime with the capital sum from that 25% to be paid to the deceased's granddaughter (the daughter of the bankrupt) when the bankrupt died. The bankruptcy trustee claimed (as vested property) the whole of the payments which the executors were required to make to the bankrupt under the terms of the will. The bankruptcy trustee relied partly on the AFSA website which stated that the interest of a bankrupt in a deceased estate is property which vests in the trustee. Siopis J agreed with the executors' view that the payments to the bankrupt from the deceased estate were income and not property.

S139L(1)(a)(v) specifically includes as income the value of a benefit which any person (the provider) provides to the bankrupt and which would be a benefit under the Fringe Benefits Tax Assessment Act if that provider were the employer of the bankrupt.

S139L(1)(a)(vii) includes as income "the amount of any money, or the value of any other consideration, received by a person other than the bankrupt from another person as a result of work done or services performed by the bankrupt, less any expenses (other than expenses of a capital nature) necessarily incurred by the first-mentioned person in connection with the work or services". "Person" includes a body corporate as well as an individual by virtue of section 2C of the Acts Interpretation Act (Cth).

3. Structure of a Typical Discretionary Trust

1) The typical discretionary trust is established by a trust deed under which an independent party as settlor agrees to pay a nominal amount to the trustee of the trust.

2) The trustee will typically be one or two individuals or a company.

3) The beneficiaries will be a broad class of persons usually associated with the trustee(s) or director(s) of the trustee company. Various relatives such as parents, parents-in-law, spouses, children, grandchildren etc will be named as beneficiaries.

4) The trust deed will usually have an appointor who has the power to remove and appoint trustees.

5) A trustee can cease to be trustee by:

    (a) Being removed by the Appointor
    (b) Resigning
    (c) Upon an event (e.g. bankruptcy or liquidation) which the trust deed says automatically ceases the trustee's position.

6) Trust deeds often have a guardian who needs to be consulted in relation to the exercise of various powers by the trustee and/or appointor. However, the

guardian is often the same person as the appointor and it appears that in recent times some trust deeds are no longer providing for a guardian.

7) The trustee has the discretion to distribute property and income of the trust to beneficiaries selected by the trustee from the class of beneficiaries and in such amounts as the trustee thinks fit. The trustee usually distributes all of the income to beneficiaries each year as higher rates of tax apply if the income is kept in the trust undistributed.

8) The trust distributions of income to beneficiaries may not actually be paid to them and may be recorded in the financial statements of the trust as loans owed by the trust to the beneficiaries.

9) When bankruptcy intervenes the bankrupt could be a sole trustee, a trustee jointly with another person or a director of a trustee company. A bankrupt could also be a sole or joint appointor of the trust.

4. Nature of a Beneficiary's interest in a Discretionary Trust

In *Donovan v Sheahan as Trustee of the Bankrupt Estate of Donovan* [2013] FCA 437 Mansfield J at [32-33] summarised the position of the beneficiary of a trust as follows:

> "Consequently, the objects of the Trust have no beneficial interest in the property of the Trust and their only interest is a mere expectancy coupled with a right to due administration of the Trust, including a right to due consideration in the exercise of the trustee's discretionary power to distribute capital and income; see *Australian Securities & Investments Commission v Carey* (No 6) (2006) 153 FCR 509; *Kennon v Spry* (2008) 238 CLR at [165].

A bankrupt beneficiary therefore has no property interest in a discretionary trust which can vest in a bankruptcy trustee. The bankruptcy trustee of a beneficiary will have no direct claim to trust assets and only a mere hope or expectancy of being considered for a distribution.

5. Bankrupt as Appointor of Discretionary Trust

In *Re Burton: Wily v Burton* [1994] FCA 1146 Davies J held that the power of a bankrupt appointor to remove a trustee and appoint a new trustee was not property which vested in the bankruptcy trustee under the provisions of the Bankruptcy Act. It was held that "the power remains with Mr Burton and he may exercise it".

This was applied by the Supreme Court of New South Wales Court of Appeal in *Lewis v Condon; Condon v Lewis* [2013] NSWCA 204. Leeming JA (with whom McColl JA and Sackville AJA agreed) said at [94] that if the bankrupt "were the Appointor, there is no reason to think that the power now vests in Mr Condon. The power to remove and replace a trustee is precisely that: a power, not property".

A bankruptcy trustee cannot therefore exercise the powers of appointor to appoint himself/herself as trustee of the trust (or another friendly trustee who would distribute from the trust to the bankrupt) with a view to the bankrupt estate getting a benefit from the trust.

6. Trust Principles & Change of Trustee

In *Custom Credit Corporation Limited v Ravi Nominees Pty Ltd* (1992) 8 WAR 42 at 52 Owen J (with whom Malcolm CJ and Walsh J agreed) outlined "the basic principles which underlie the law of trusts" including the following:

1) A trustee is personally liable for debts incurred as trustee in the administration of the trust fund.

2) A trustee has a right to reimburse itself out of trust property for all expenses reasonably and properly incurred in the execution of its powers and duties as trustee. Alternatively, the trustee can pay those expenses out of trust property.

3) The right of indemnity arises at the time when the liability is incurred.

4) A trustee has a charge or lien over trust property so that the trustee can enforce the right of indemnity.

5) It is an incident of the equitable charge or lien which supports the right of indemnity that a trustee is entitled (as against beneficiaries) to retain possession of the trust property until the right of indemnity has been satisfied.

In *Coates v McInerney* (1992) 7 WAR 537 Anderson J held as follows:

1) Upon termination of a trustee's office (i.e. ceasing to be trustee of the trust) the trustee of the trust did not lose the right to be indemnified from trust assets in respect of liabilities incurred before that time and in his capacity as trustee.

2) The company in liquidation as former trustee was entitled to be indemnified out of the trust's assets for liabilities the company had incurred whilst acting as trustee.

3) In his capacity as liquidator of the company, the plaintiff was entitled to enforce that right of indemnity.

4) The new trustee of the trust was ordered to deliver up the trust assets to the liquidator of the former trustee company.

5) The plaintiff who was the liquidator of the former trustee company was appointed as receiver of those assets for the purpose of realising those assets to discharge the indemnity to which the company and the plaintiff as its liquidator were entitled.

7. No Trustee

It is a fundamental principle of trusts law that a trust does not fail (cease to exist) for want of a trustee e.g. if an individual who holds land as trustee on trust for someone dies, the land still exists as a trust asset and the beneficiary is still the beneficial owner of the land.

(a) In *Piggott (trustee), in the matter of Hodgkinson (Bankrupt) v Hodgkinson* [2013] FCA 598 the court appointed the bankruptcy trustee as receiver and manager of trust assets (an accounting practice for which an offer of $498,750 was received). The bankrupt had incurred debts in his capacity as the former trustee of the trust and there was no present trustee of the trust. The bankrupt had a right of indemnity over trust assets and this right of indemnity was property which vested in the bankruptcy trustee under the Bankruptcy Act. At [11] the court said that it was "arguable" that the bankruptcy trustee is entitled to take possession of and sell trust assets to satisfy right of indemnity "without the need for any order by the Court". However, a court order may be needed if the bankruptcy trustee wants to be remunerated for work done in relation to trust assets.

(b) In *Fordyce v Ryan & Anor; Fordyce v Quinn & Anor* [2016] QSC 307 the bankruptcy trustee unsuccessfully applied to the court for the appointment of a receiver to "wind up" two unit trusts and one discretionary trust. There was no application for a new trustee to be appointed to the trusts and no right of indemnity issue.

The trustee of each trust was a company which had become de-registered. The bankrupt had been the director and sole shareholder of the trustee company of the discretionary trust.

At [75] the court said that "the applicant's ultimate goal in all this is for a distribution to be made in the Fairdinks Discretionary Trust in favour of the bankrupt. But the question of a distribution from the assets of that trust is one of the exercise of a fiduciary or trust power in the interests of the first principal beneficiary and the general beneficiaries (of whom the bankrupt is but one). ... It would be inappropriate for the court to appoint a receiver who is not subject to the same fiduciary obligations".

(c) In *Re Cooper Street Property Trust (No 2)* [2017] VSC 291 the bankruptcy trustee unsuccessfully applied for the appointment of a new trustee to a trust where the

trustee company had become deregistered and the trust was without a trustee. The bankrupt was a beneficiary of the trust but there was no right of indemnity issue. The court noted at [2] that none of the avenues set out in the trust deed to appoint a new trustee were applicable in the circumstances.

At [39] the court found that the bankruptcy trustee had no standing under s64 of the Trustee Act 1958 (Vic) and no legal interest in the property of the trust. The court dismissed the bankruptcy trustee's application for the appointment of a new trustee but directed that a copy of the judgement be forwarded to other parties with an interest in the matter and at [37] said that the trust monies should be paid into court.

Section 93 of the Trustees Act 1962 (WA) is almost identical to s64 of the above Trustee Act (Vic).

In short, the bankruptcy trustee succeeded in *Piggott* as he had a right of indemnity against trust assets but failed in the other two cases as the bankrupt was beneficiary only (with a mere hope of a distribution) with no right of indemnity claim.

8. Exercising the Right of Indemnity

In *Winter Holdings (WA) Pty Ltd* [2015] WASC 162 at [69] the court said that "the old trustee is entitled to retain only sufficient assets to cover its indemnity and not more". ("Assets" was a reference to trust assets). It is therefore necessary to identify and calculate the total debts incurred by the bankrupt acting as trustee of a trust and to exercise the right of indemnity for that amount only (regardless of whether or not the bankrupt has other personal "non-trust" debts).

In cases where a company in liquidation acted only as trustee of a trust (and did nothing in its own right) the courts have generally allowed the liquidator to have recourse to the trust assets for remuneration and expenses. In *Re Mackie Group Pty Ltd (in liq) (in its capacity as Trustee of the Jupelina Unit Trust)* [2017] VSC 477 the court at [94] (2)(a) found that the liquidators "are entitled to have recourse to the assets of the Trust (Trust Property) for remuneration and general expenses

reasonably incurred in administering the trust and in respect of the winding up". This extends to general liquidation work such as lodgement of ASIC reports.

It would be rare for a bankrupt to have incurred debt purely in the capacity of trustee of a trust. A bankrupt who has acted as a trustee of a trust will also usually have other personal "non-trust" debts. In that situation there is an issue as to:

(a) how a bankruptcy trustee's remuneration and expenses would be treated in terms of being paid out of trust money recovered pursuant to the right of indemnity.
(b) whether money recovered under the right of indemnity by a bankruptcy trustee should be available only to trust creditors or to the general body of creditors i.e. both trust creditors and non-trust creditors.

In *Lane (Trustee), in the matter of Lee (Bankrupt) v Deputy Commissioner of Taxation* [2017] FCA 953 the court at [2] ordered that monies received by the bankruptcy trustee from a trustee's right of indemnity out of trust assets were "available to be distributed to trust creditors to the exclusion of non-trust creditors" and those distributions should be made "prior to the payment of any dividend from the bankrupt's estate". It was further held that the priority provisions in s109 of the Bankruptcy Act and rateable distribution provision in s108 Bankruptcy Act did not apply to the distribution of the trust monies which were to be paid to trust creditors rateably.

The court said that the exercise of the right of indemnity "does not result in beneficial receipt of funds by the bankrupt's estate which might be used to meet the claims of non-trust creditors".

It was further ordered that the bankruptcy trustees were entitled to be paid a fixed amount of $89,326.56 remuneration for their "costs, expenses and remuneration relating to work undertaken in respect of causing the trust creditors to be paid by the application of the trustee's right of indemnity". In other words, remuneration and expenses of the bankruptcy trustee for general bankruptcy administration work could not be paid out of trust property (i.e. trust monies recovered under the right of indemnity from trust assets).

Two very recent court decisions have dealt with these issues in relation to company liquidations:

(1) *Commonwealth v Byrnes and Hewitt* [2018] VSCA 41 (28 February 2018) ("the *Amerind case*")
(2) *Jones (liquidator) v Matrix Partners Pty Ltd, in the matter of Killarnee Civil & Concrete Contractors Pty Ltd (in liq)* [2018] FCAFC 40 (21 March 2018) ("*Killarnee*").

Amarind was decided by five judges of the Victorian Court of Appeal and there were three parties involved all represented by SCs / QCs. *Killarnee* was decided by three Federal Court judges and there were four parties each represented by SCs/QCs. Accordingly, these are complicated issues.

In *Amarind* at [282] the court noted that it did not need to decide whether the distribution of funds could only be made to trust creditors as all of Amarind's creditors were trust creditors.

In *Killarnee* the court said that if a liquidator wishes to exercise a power of sale pursuant to the right of indemnity over trust assets then it expected liquidators to approach the court for authority to sell trust assets – [44], [91] & [139].

9. Void Transactions – ss120 & 121

These sections allow the bankruptcy trustee to set aside transfers of property in the period leading up to bankruptcy. They apply to transfers to any party and not just to discretionary trusts. These sections would give rise to a whole seminar topic in themselves and are only mentioned briefly here.

Where a transfer of property which is void under s120 and /or 121 has been made to a discretionary trust then the bankruptcy trustee would make the claim against the recipient of the property which was transferred. This would be whoever was the trustee of the trust at the time that the transfer occurred. If a change of trustee has occurred since then, the claim would be against the old trustee. This would give rise to a debt or a liability which the old trustee incurred whilst acting as the trustee of the

trust so that the old trustee would then have a right of indemnity against trust assets in order to be able to meet the bankruptcy trustee's claims.

In *Anscor Pty Ltd v Clout (Trustee)* [2004] FCAFC 71 various propositions were set out in relation to s120 including the following:

> "(h) If the property the subject of a transfer made void by s120 as a result of the trustee's election to avoid, still exists *in specie* as at the commencement of the bankruptcy, it will vest in the trustee in bankruptcy forthwith upon the debtor's becoming a bankrupt if it also still exits then …".
>
> "(i) If the property the subject of a transfer made void by s120 as a result of the trustee's election to avoid, no longer exists *in specie* as at the commencement of the bankruptcy, but can be seen to exist as at that date in an identifiable substitute form of property, such as a fund representing the proceeds of sale of the property, that substitute property will vest in the trustee in bankruptcy forthwith upon the debtor's becoming a bankrupt …".

It seems that these trading principles would also enable the bankruptcy trustee to claim the property even if there has been a subsequent change of trustee of the trust (to which the bankrupt transferred property).

10. Loan Accounts

It is relatively common for trusts to make distributions of income to beneficiaries at the end of a financial year but to not actually pay the amount to the beneficiary. The amount is then recorded in the financial statements of the trust as a loan owed by the trust to the beneficiary. There may be distributions over several years so that the loan account balance accrues and becomes substantial. Where a beneficiary who is owed money by a trust becomes bankrupt then the bankruptcy trustee steps into the shoes of the beneficiary in relation to the loan account. In other words the rights to the loan account vest in the bankruptcy trustee as property of the bankrupt.

In *Euroasian Holdings Pty Ltd v Ron Diamond Plumbing (in liq)* [1996] FCA 1262 a company which was the trustee of a discretionary trust applied to set aside a

statutory demand issued by a beneficiary of the discretionary trust. The statutory demand was based on money which the trustee had resolved to distribute to the beneficiary but which the beneficiary had not received i.e. unpaid trust distributions. The court set aside the statutory demand for reasons which included a finding that the claim was not a "debt" within the then Corporations Law as was required in order for there to be a statutory demand. The court found that the rights of the beneficiary were enforceable in equity only.

However, in *Chianti Pty Ltd v Leume Pty Ltd* [2007] WASCA 270 Buss JA (with whom Martin CJ and Pullin JA agreed) at para 76 said that:

> "The authorities establish that financial statements (including the balance sheet and the notes to the accounts) can constitute an acknowledgement of debt, and that individual creditors comprised in the aggregate sums shown in the financial statements can be identified by extrinsic evidence, where the financial statements have been received by the creditor who sues in reliance on them".

At para 77 Buss JA went on to find that the amounts referred to in the financial statements as an "Unpaid Beneficiary Entitlement" led to the conclusion that there was an admission on the part of the trustee "of an obligation to pay on demand".

Accordingly, a loan account balance shown in the financial statements of a discretionary trust as being owed by the trustee to a bankrupt beneficiary is payable to a bankruptcy trustee on demand.

11. Sham Trusts

In *Sharrment Pty Ltd v Official Trustee in Bankruptcy* [1988] FCA 179; (1988) 18 FCR 449 the Full Court of the Federal Court dealt with an appeal described at para 3 as follows:

> "In essence his Honour found that each of the relevant companies involved in the complicated series of transactions in 1979 and 1980 were "alter egos" of the late Mr Wynyard and that the elaborate juggling of funds and thicket of book entries were all a cloak, artifice or sham intended to create the appearance of a

> debt due by Mr. Wynyard to one of his family trusts known as the Wynyard Family Trust (No. 4) ("the No. 4 Trust"). The Official Trustee argued that the transactions were undertaken for the purpose of putting assets in the amount of some $420,000 out of reach of Mr. Wynyard's creditors and hiding those assets behind the cloak or mask of a debt. The companies concerned were said to be Mr. Wynyard's puppets. Although no such accusation was levelled against the trustee of the No. 4 Trust, being the nominee company of solicitors acting for Mr Wynyard, it was said that Mr. Wynyard could control the trusts by his power as appointor of removing the trustee and appointing another trustee in its place".

The appeal was allowed so that the bankruptcy trustee was unsuccessful. The reasoning of the Full Court was encapsulated by Beaumont J at para 21 as follows:

> "The facts that the companies had little paid-up capital and that Mr. Wynyard controlled their affairs do not justify the conclusion that the assets of the companies are, in truth, or, "in reality", the beneficial property of Mr. Wynyard. Even if Mr. Wynyard, as controller of the affairs of the companies, had acted without due regard for the interests of their shareholders or creditors (see Walker v. Wimborne (1976) 137 CLR 1 per Mason J. at pp 6-7) it would not follow that the property of the companies became the property of Mr. Wynyard in some informal way. In such circumstances, the controller may be liable for misfeasance or for breach of fiduciary duty. But it does not follow from the use, or even abuse, of control of the companies' affairs that their controller acquired any of the companies' property by some informal process. A misfeasance could hardly effect an acquisition of property".

In *Lewis v Condon* (referred to above) the bankrupt-to-be Colleen Lewis wished to acquire a property but wished to conceal her interest in that property for the purposes of Family Court proceedings between herself and her former husband. Accordingly, a discretionary trust effectively controlled by the bankrupt was established and a property purchased through that entity.

At para 66 Leeming JA (with whom McColl JA and Sackville AJA agreed) identified the issue as being whether the property was held “on a bare trust or a resulting trust” for the bankrupt or pursuant to a “discretionary trust in accordance with the trust deed”.

At para 73 it was said that “in order for there to be a sham, it was necessary that there be an intention that the discretionary trust deed created by Mr Fraser not bear its apparent legal consequence”.

At para 75 Leeming JA said as follows:

> “… the creation of a genuine discretionary trust was entirely consistent with Colleen’s objectives as stated by her in the conversation with Mr. Fraser. Colleen wanted to conceal her interest in the Property, presumably from her husband and the Family Court. But she also wished to be able to resume full beneficial entitlement to the Property when the need for secrecy was over. The creation of the discretionary trust enabled her to achieve both objectives. The Property was placed in the name of Appinville. Yet Colleen could effectively bring the trust to an end whenever she chose, thereby regaining the beneficial (and indeed, if she wanted, legal) title to the Property”.

At para 76 Leeming JA reached the conclusion that the circumstances were “wholly consistent with the absence of a sham”.

Finally, at para 81 Leeming JA said:

> “A trust once validly constituted does not change in nature because the trustee and some of the beneficiaries subsequently chooses no longer to abide by the obligations of the trust relationship. Such conduct may amount to a breach of trust, and may lead to the removal of the trustee, but does not destroy the proprietary and personal rights and obligations which came into existence when the trust was created”.

There is a debate about "emerging sham trusts". In an article "Sham Trusts" [2012] Vic J Schol 5 G.T. Pagone notes that "A number of cases have considered the possibility of trusts, or parts of trusts, becoming shams (and presumably ceasing to be shams) after their creation". He observed that in *Raftland Pty Ltd as trustee of the Raftland Trust v Federal Commissioner of Taxation* [2008] HCA 21; (2008) 238 CLR 516 at 563 Kirby J accepted that a sham could "develop over time if there is a departure from the original agreement and the parties knowingly do nothing to alter the provisions of their documents as a consequence". The article goes on to note the opposing view which is to the effect that a trustee "who has bona fide accepted office cannot divest himself of his fiduciary obligation by his own improper acts" " and says that "whether sham may emerge in a trust that began genuinely raises questions about the dividing line between sham and breach"

The bottom line is that it will be very difficult for a bankruptcy trustee to succeed on either a sham trust or emerging sham trust argument.

12. Controlled Entity Provisions (s139A – 139H)

These provisions are rarely used in practice as there are too many elements which a bankruptcy trustee has to prove.

The controlled entity provisions are sections 139A to 139H (Division 4A of Part VI). Under sections 139D and 139E the Court can make an order transferring certain property from an entity other than a natural person including a trust ("the entity") to the trustee in bankruptcy. There are separate provisions within that Division relating to natural persons (s139DA & 139EA). Before an order can be made under sections 139D and 139E the trustee must show that:

(a) during the 'examinable period' and before the end of the bankruptcy, the bankrupt supplied 'personal services' to, for or on behalf of the entity at a time when the bankrupt 'controlled' the entity (ss139D(1)(a), 139E(1)(a)); and

(b) the bankrupt received no remuneration or less than reasonable remuneration for those services (ss139D(1)(b), 139E(1)(b)); and

(c) either:

(i) the entity acquired an estate in particular property as a direct or indirect result of, or of matters including, the bankrupt's supply of the services (and still has an estate in the property); and the bankrupt used the property, or derived a benefit from it, while controlling the entity in relation to the property (ss139D(1)(c), (d), (e)); or

(ii) at any time during the examinable period, the entity's 'net worth' was substantially more than it would have been if the bankrupt had not supplied the services (s139E(1)(c)).