

# Employee creditors of an insolvent corporate business to be paid as priority creditors

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In this technical update, we discuss several points of principle from the recent High Court decision in *Carter Holt Harvey Woodproducts Australia Pty Ltd v The Commonwealth* [2019] HCA 20 (**Carter**).

Carter is a significant decision of the High Court for insolvency practitioners because it decides that employee creditors of an insolvent corporate trustee are to be paid as priority creditors under section 433 of the *Corporations Act 2001* (Cth) (**Corporations Act**). Carter is also important because it discusses ten primary principles of trust law and clarifies four additional principles. These principles are necessary for insolvency practitioners to know when administering insolvency corporate trustees.

## Ten primary principles

The 10 principles are:<sup>1</sup>

1. A trust is not a separate legal entity.
2. The expressions 'trust assets' and 'trust creditors' are shorthand. Trust assets refers to the rights held on trust by the trustee. 'Trust creditors' is shorthand for the creditors of the trustee whose debts were properly incurred by the trustee, with authority in the course of trust business.
3. A trust does not have separate solvency status from the trustee.
4. A trustee is personally liable for debts incurred as trustee regardless of whether creditors knew of the existence of the trust.
5. A trustee is the legal owner of trust assets with all the powers incidental to ownership subject only to the power of beneficiaries to compel the trustee to exercise the trustee's powers in accordance with the terms of the trust.
6. Trust beneficiaries' rights are not 'cut out' of the trustee's legal estate but are rather 'engrafted' onto it as a restriction on the manner in which the trustee may deal with a trust asset.
7. A trustee has a right to be indemnified out of trust assets for such liabilities properly incurred.
8. The trustee's right of indemnity is exercised by means of two alternative powers or sub-rights:

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<sup>1</sup> Carter at [24], [29], [30], [80], [82], [83], [129], [130], [137], [139] and [142].

- (a) reimbursement (also called recoupment). This arises where the trustee has already discharged the relevant liability out of its own property and is entitled to be reimbursed for the properly incurred expense from the trust property; or
  - (b) exoneration. This arises where the trustee has incurred a liability but not yet paid that liability. In those circumstances, the trustee is entitled to use the trust property to discharge the liability directly.
9. Where trust assets are subject to a trustee's claim for indemnity, the trust assets are not held solely for the benefit of the beneficiaries and the trustee's right generates a proprietary interest in the trust fund in favour of the trustee to the extent of the trustee's interest.
10. A trustee has an equitable charge or lien over the trust assets to secure the right of indemnity. This equitable charge or lien is comparable to a security interest, although the assistance of the a Court is required to enforce it.

### Four further principles from Carter

There are four additional principles that may now be added to the list because of the decision in Carter:<sup>2</sup>

1. The right of indemnity (whether by reimbursement or exoneration) of an insolvent corporate trustee is 'property' within the meaning of section 9 of the Corporations Act but is not a 'circulating asset' for the purposes of section 433 or 561 of the Corporations Act.
2. Trust assets realised by means of reimbursement are the trustee's own property and will be divisible amongst all the creditors of the trustee; not just trust creditors.
3. Where the right of indemnity is to be exercised by the power of exoneration and not reimbursement, then the proceeds may only be used to pay trust creditors.
4. The Corporations Act priority provisions in insolvency apply to the distribution of the proceeds of trust assets by way of exoneration with respect to, at least, priority creditor claims and liquidators costs and expenses.

These principles are discussed in more detail in this article.

### Relevant facts

The relevant facts of Carter are:<sup>3</sup>

1. Amerind Pty Ltd (**Amerind**) was a company which acted solely as trustee for a single trading trust.
2. Amerind borrowed money from a bank and gave that bank security over the trust assets which included, amongst other things, its inventory.
3. On 11 March 2014, Amerind entered into voluntary administration. That same day, the bank exercised its rights including appointing receivers and managers (**Receivers**) to Amerind's inventory (amongst other assets).
4. The Receivers traded on the business for approximately one month and during that time realised most of the inventory. The bank was repaid in full leaving the Receivers with a surplus of

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<sup>2</sup> Carter at [28], [32], [43], [50], [52], [80], [84], [86], [87], [92], [95]-[97], [106], [108], [154]-[156], [169]-[171] and [186].

<sup>3</sup> Carter at [4] to [9].

approximately \$1.6 million. The Receivers did not know who was entitled to receive the surplus because there were two competing claims to it.

5. The first claim was made by the Commonwealth. It had paid \$3.8 million in employee entitlements pursuant to the Fair Entitlements Guarantee Scheme. The Commonwealth claimed that the Receivers were obliged to pay it the surplus because of section 433 and 556 of the Corporations Act.
6. The second claim was by a creditor of Amerind, Carter Holt Harvey Woodproducts Australia Pty Ltd. It submitted that section 433 did not apply or afford priority to the Commonwealth and that the surplus should be paid to all trust creditors (employees and the Commonwealth included) on a pari passu basis.

### The issues raised in Carter

Those facts gave rise to two issues on appeal to the High Court:

1. Issue 1 required the Court to determine whether Amerind's right of indemnity as trustee was 'property comprised in or subject to a circulating security interest' within the meaning of section 433(2)(a) of the Corporations Act.
2. Issue 2 required the Court to determine whether the Receivers' surplus (being the proceeds of trust assets realised by Amerind exercising its right of indemnity) was available for distribution under section 433(3) of the Corporations Act to priority employee creditors first.

To address both those issues, the High Court first had to address the threshold issue of the nature of a corporate trustee's rights of indemnity in insolvency and resolve a conflict between two competing appellate Court decisions: *Re Enhill Pty Ltd*<sup>4</sup> (**Re Enhill**) and *In re Suco Gold Pty Ltd (In liq)*<sup>5</sup> (**Re Suco Gold**).

It is convenient to discuss this threshold conflict before turning to the other issues in Carter.

### The right of indemnity in insolvency

The High Court made it clear that Carter was a case about the right of indemnity by exoneration and not reimbursement. Notwithstanding this, the High Court unanimously held that trust assets realised by means of reimbursement are the trustee's own property and will be divisible amongst the creditors of the trustee without constraint or limitation. But did the same rule apply to trust assets realised by means of the power of exoneration?

*Re Enhill* provides that trust assets realised by a liquidator in insolvency are available to be distributed amongst creditors generally, not just trust creditors. The competing approach in *Re Suco Gold* provides that trust assets can only be distributed amongst trust creditors.

The High Court unanimously endorsed the approach in *Re Suco Gold*. It found *Re Enhill* to be incorrect. Thus, the High Court held that where the right of indemnity is realised through the power of exoneration, the proceeds may only be used to pay trust creditors.<sup>6</sup>

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<sup>4</sup> [1983] 1 VR 561.

<sup>5</sup> (1983) 33 SASR 99.

<sup>6</sup> Carter at [44], [55], [92], [154], [156]. Bell, Gageler and Nettle JJ observed that the same conclusion was reached recently by the Full Court of the Federal Court in *Jones v Matrix Partners Pty Ltd; Re Killarnee Civil & Concrete Contractors Pty Ltd (in Liq)* (2018) 260 FCR 310 at 335-337 [100]-[101].

Once it was settled which creditors were entitled to benefit from the trust asset proceeds, the core issues in the appeal needed to be answered to determine whether priority employee creditors would be paid ahead of other trust creditors.

### **Section 433 of the Corporations Act**

Section 433 of the Corporations Act is a priority provision that requires a receiver to pay certain priority employee creditors before a secured creditor.

Section 433(2) of the Corporations Act defines when the section applies. Relevantly, it states that where the receiver is appointed on behalf of a secured creditor the section applies to assets '...secured by a circulating security interest, or possession is taken or control is assumed... of any property comprised in or subject to a circulating security interest.'

A 'circulating security interest' is one that applies to 'circulating assets'. Circulating assets are those that circulate in use in the ordinary course of business of the owner with the express or implied consent of the secured creditor. For example, stock or cash. And, subject to exceptions that are not relevant, property falling within the categories listed in section 340(5) of the *Personal Property Securities Act 2009* (Cth) including, relevantly, inventory and proceeds of inventory.<sup>7</sup>

If section 433(2) is satisfied, then the receiver is to pay the creditors in the order set out in section 433(3). Relevantly, the first entitled in that list in Carter were certain employee creditors, including the Commonwealth because of its payments under the FEG scheme.

### **Issue 1: Was Amerind's right of indemnity 'property comprised in or subject to a circulating security interest' within the meaning of section 433(2)(a) of the Corporations Act?**

While all members of the High Court agreed that the right of indemnity (whether by reimbursement or exoneration) conferred proprietary rights in the trustee to the extent of the trustee's entitlement to be indemnified from the trust assets,<sup>8</sup> they did not agree on the characterisation of that property as being a circulating asset and therefore subject to a circulating security interest.

The minority on this issue (Kiefel CJ, Keane and Edelman JJ) reasoned the right of indemnity was a circulating asset.<sup>9</sup> But, the majority made up of Justices Bell, Gageler and Nettle (with whom Gordon J agreed) found that the right of indemnity was a non-circulating asset. The majority reasoned that it was the inventory rather than the right of indemnity that was the circulating asset.<sup>10</sup> Justice Gordon described the right of indemnity as a 'fixed asset' and merely the gateway to reach the circulating assets.<sup>11</sup>

### **Issue 2: Was the surplus available for distribution under section 433 of the Corporations Act?**

The High Court unanimously answered this question in the affirmative. Kiefel CJ, Keane and Edelman JJ said that '[i]t would be perverse if the Corporations Act operated to deny employee creditors a particular priority over the holders of a circulating security interest solely for the reason that the company which

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<sup>7</sup> Section 340(2) of the PPSA.

<sup>8</sup> Carter at [32], [50], [52], [80], [84], [155] and [156].

<sup>9</sup> Carter at [50] and [52].

<sup>10</sup> Carter at [86]-[87].

<sup>11</sup> Carter at [108] and [186].

employed them was, perhaps even unknown to the employees, trading as trustee.<sup>12</sup> The Court also said that the application of section 433 of the Corporations Act means that, by implication, other sections governing distribution of property in insolvency (sections 555, 556 and 561) also apply to the proceeds of trust assets.<sup>13</sup>

### **Carter did not answer every issue**

Carter is binding authority for the proposition that section 433 of the Corporations Act applies to trust assets in circumstances where the insolvent company is acting solely as trustee for a *single* trust. The High Court was careful to keep its judgment focused on the issues on the appeal. The High Court expressly identified a number of complex issues which remain unanswered including:<sup>14</sup>

1. the correct order of priority between trust creditors after payment of priority debts;
2. marshalling of claims where a creditor has access to more than one fund;
3. how property should be dealt with where a corporate trustee is the trustee of more than one trust, or operating both as trustee and on its own account; and
4. how liabilities should be paid where they are attributable to multiple trusts.

But it did give guidance on the third topic, and on the issue of liquidators' costs and expenses.

### **Multiple trusts**

In *Re Suco Gold*, King CJ proposed that a liquidator of an insolvent trustee of multiple trusts treat each fund and its relevant creditors separately. Justices Bell, Gageler and Nettle said that approach cohered 'to the law of trusts and has a common sense commend to it.'<sup>15</sup> Gordon J also endorsed that approach.<sup>16</sup> The other members of the Court observed that *Re Suco Gold* 'had stood for 17 years and 'was both well-regarded and followed (though by no means universally)<sup>17</sup>

### **Liquidators' costs and expenses**

The High Court also endorsed the approach in *Re Suco Gold* on the question of payment of liquidators' costs and expenses from trust assets.<sup>18</sup> *Re Suco Gold* provides that:

1. a liquidator is entitled to have recourse to the property of each trust for the purpose of meeting the costs and expenses of winding up, the petitioner's costs and the liquidator's remuneration, so far as they are incurred in relation to each trust;

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<sup>12</sup> Carter at [58] citing *Re Killarnee* at [106].

<sup>13</sup> Carter at [51], [126] and [153].

<sup>14</sup> Carter at [56], [97].

<sup>15</sup> Carter at [97].

<sup>16</sup> Carter at [160].

<sup>17</sup> Carter at [58].

<sup>18</sup> Carter at [58], [95]-[97], [169]-[171].

2. where there are multiple trusts (and the company does not trade in its own right) all the expenses attributable to one or other of the trusts must be apportioned between them;
3. the liquidator will be able to make an estimate of the work and expense involved in the liquidation so far as it relates to each trust; and
4. where no apportionment is possible, the maxim that equality is equity should provide the solution to the problem of apportionment.<sup>19</sup>

## Other matters

There are two other matters arising from the decision in Carter.

First, Justice Gordon expressed a view that the decision in *Lane v Deputy Commissioner of Taxation*,<sup>20</sup> a bankruptcy case which held that the insolvency priority regime in section 116(2)(a) of the *Bankruptcy Act 1966* (Cth) did not apply to money from trust assets because they were not 'proceeds of the property of the bankrupt' was wrong. The High Court also rejected the reasoning of Brereton J in *Re Independent Contractor Services (Aust) Pty Ltd (In liq) [No 2]*<sup>21</sup> by holding that trust assets are property of the company.<sup>22</sup>

Second, Carter was not a case involving a bare trustee. A bare trustee has no power to realise trust assets which may be subject to a claim for indemnity without assistance from the Court. Where liquidators are appointed to a bare trustee they should consider making an application to Court to be appointed as the receivers of the relevant trust property so it can be realised for the benefit of trust creditors.<sup>23</sup>

## The significance of the decision in Carter

The decision in Carter is significant. It answers some technically difficult legal issues. While the decision does not decide all issues, it provides guidance on some of the more usual questions that arise in the winding up of corporate trustees.

Insolvency practitioners need to continue to exercise caution when dealing with trust assets. Amongst other things, this requires thorough record keeping, especially concerning work undertaken in the care, preservation and realisation of trust assets. Trust funds should always be kept separate from the company's own property.



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<sup>19</sup> Cited by Gordon J at [170]; *In re Suco Gold* (1983) 33 SASR 99 at 110.

<sup>20</sup> (2017) 253 FCR 46 at 82 [98], 88 [119], [121].

<sup>21</sup> (2016) 305 FLR 222 at 230-232 at [23]-[25].

<sup>22</sup> Carter at [53]-[55].

<sup>23</sup> For example, see the recent decision in *Staatz v Berry, in the matter of Wollumbin Horizons Pty Ltd (in liq) (No 3)* [2019] FCA 924 at [192] – [195].



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