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QUISTCLOSE TRUSTS FROM A CORPORATE INSOLVENCY PERSPECTIVE: A POSITIVE AND NORMATIVE ANALYSIS

ADAM S. HOFRI-WINOGRADOW* AND GAL DAVID**

ABSTRACT. *Leading cases show* Quistclose *trusts being used by companies nearing insolvency. Their use in this context raises serious normative problems: it may prefer the beneficiary to the company's other creditors, and creates a misleading impression that trust funds are in fact free of trust. Building on the emergent normative literature on* Quistclose *trusts, we first examine which* Quistclose *trusts are currently allowed under company law and the law of corporate insolvency. We then discuss the normative question as to which* Quistclose *trusts* should *be allowed, given the principles of these branches of the law.*

KEYWORDS: Quistclose *trusts, corporate insolvency, company law, directors, creditors.*

I. INTRODUCTION

Leading cases show *Quistclose* trusts being used by companies nearing insolvency.[1] Their use in this context raises serious normative problems: allowing a lender or, in a *Re Kayford* trust, a purchaser, to make itself a beneficiary may prefer that lender or purchaser to the borrower's other creditors. Use of funds subject to a *Quistclose* trust to pay a debt of the trustee may prefer the payee to the trustee's other creditors. Because *Quistclose* trusts are not registered, outsiders to such trusts, such as borrower companies' non-trust creditors, may mistakenly believe trust funds to be trust-free.

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[1] See e.g. *Barclays Bank Ltd. v Quistclose Investments Ltd.* [1970] A.C. 567 (H.L.); *Re Kayford Ltd. (in liq)* [1975] 1 All E.R. 604 (Ch); *Re EVTR Ltd.* (1987) 3 B.C.C. 389 (C.A.); *Carreras Rothmans Ltd. v Freeman Mathews Treasure Ltd. (in liq)* [1985] Ch D 207; *Salvo v New Tel Limited* [2005] NSWCA 281.

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These problems should be considered in deciding whether and when to recognise and enforce such trusts.

This article contributes to the emerging normative literature regarding *Quistclose* trusts. We first consider which *Quistclose* trusts are currently allowed under company law and the law of corporate insolvency. Moving from positive to normative discussion, we then consider which *Quistclose* trusts *should* be allowed, given the principles of these branches of the law. Providing a lasting, principled answer to the latter question is complicated by the unstable conceptual basis of *Quistclose* trusts, as well as by the frequent changes to corporate law and the law of corporate insolvency. We attempt to overcome these obstacles by taking a comparative approach, examining both English and Australian law. England and Australia are the two jurisdictions that have devoted the most attention to the *Quistclose* trust, applying this concept in a large and growing number of cases. Yet they conceptualise the *Quistclose* trust differently. The aspects of their company and corporate insolvency laws relevant to a normative analysis of *Quistclose* trusts also differ. Our comparative approach exploits this inter-systemic variation to examine the normatively justifiable limits of the *Quistclose* trust independently of the current state of these fast-moving fields of law in either jurisdiction.

The next section provides building blocks for our analysis. We first discuss the rule that the content of directors' duties changes when they know, or should know, that the company is, or will probably become, insolvent: from that time onwards, they are required to have enhanced regard for the interests of the company's creditors as a class. (We will call the point in time when the content of directors' duties changes "the threshold".) We build on the rich literature on the topic, starting with Andrew Keay's many contributions.[2] We then provide a précis of some of the literature on *Quistclose* trusts, including, inter alia, the volume of collected essays bearing their name[3] and Emily Hudson's article delineating a normative approach to the *Quistclose* trust.[4] We distinguish three types of *Quistclose* trusts: the type where "money is forwarded with the intention of paying off specific creditors" (type A), the type where "money is forwarded for specified investment purposes" (type B) and the type where customers pre-pay for purchases, funds remitted being segregated until

[2] See e.g. A. Keay, "Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors" [2003] M.L.R. 665; A. Keay, "Directors' Duties and Creditors' Interests" (2014) 130 L.Q.R. 443; A. Keay, *Company Directors' Responsibilities to Creditors* (Abingdon 2007); A. Keay, "The Shifting of Directors' Duties in the Vicinity of Insolvency" (2015) 24 International Insolvency Review 140; A. Keay, "Financially Distressed Companies, Preferential Payments and the Director's Duty to Take Account of Creditors' Interests" (2020) 136 L.Q.R. 52.

[3] W. Swadling (ed.), *The Quistclose Trust: Critical Essays* (Oxford 2004).

[4] E. Hudson, "A Normative Approach to the Quistclose Trust" [2017] M.L.R. 775.

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products purchased are delivered (type C).[5] Type C differs from types A and B in that purchasers/beneficiaries of type C *Quistclose* trusts are not lenders, and once delivery occurs the company has no remaining obligations to them. From vendor companies' perspective, however, purchaser prepayments are a source of funding, an alternative to borrowing: while prepaid funds are segregated until delivery, they then become freely disponible

Regarding each of the three types, we examine three distinct questions, examining each question under both English and Australian law: whether a company borrowing money or receiving prepayments, once past the threshold, on *Quistclose* trust terms creates a voidable preference; whether the directors of such a company, in allowing a *Quistclose* trust to be created, breach any of their duties, given the adjustment of their contents at the threshold; and whether the creation of such a trust constitutes wrongful trading under English law, insolvent trading under Australian law, or fraudulent trading on the part of such directors.

The answers we identify allow us to delineate those *Quistclose* trusts seen, as a matter of positive law, as consonant with the principles of company law and the law of corporate insolvency. We then discuss the normative question of which *Quistclose* trusts *should* be allowed, given those principles. We identify five characteristics of permissible *Quistclose* trusts: a clear separation of the trust assets, while under the company's control, from its other funds; speedy fulfilment of the trust purpose; the intended use of the trust funds being consistent with the company's avoiding liquidation and resuming successful operation; the specificity of that use; and the presence of commercial terms that balance the lender or purchaser having obtained the protection of a trust with other terms favourable to the borrower or vendor company.

II. Building Blocks: Directors' Duties and *Quistclose* Trusts

A. Adjustment of Directors' Duties in Near-insolvent Companies

Both English and Australian courts have held that as companies approach insolvency, the contents of directors' duties shift.[6] While a director of a solvent company must, under section 172(1) of the Companies Act 2006,

[5] R. Hedlund and A.L. Rhodes distinguished Quistclose trusts of types A and B in their "Loan or Commercial Trust? The Continuing Mischief of the Quistclose Trust" [2017] Conv. 254, 254. We added type C.

[6] In England, see e.g. *BTI 2014 LLC v Sequana SA and others* [2022] 3 WLR 709, [2022] UKSC 25, at [88], [203], [207], [247(iv)]; *Brady v Brady* [1987] 3 B.C.C. 535, 552 (C.A.); *Colin Gwyer & Associates Ltd. v London Wharf (Limehouse) Ltd.* [2002] EWHC 2748, [2003] B.C.C. 885, at [74] (Ch); *Re HLC Environmental Projects Ltd.* [2013] EWHC 2876, [2014] B.C.C. 337, at [89] (Ch). In Australia, see e.g. *Kinsela v Russell Kinsela Pty Ltd.* (1986) 4 A.C.L.C. 215, 221; *Re New World Alliance Pty Ltd.* (1994) 122 A.L.R. 531, 550; *Kalls Enterprises Pty Ltd. v Baloglow* (2007) 25 A.C.L.C. 1094, at [162].

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"act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole", sub-section 172(3) subjects that duty "to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company". The latter sub-section preserves the rule of law that when directors know or should know that insolvency is imminent, or that insolvent liquidation is probable, they "are obliged to take into account the interests of the company's creditors, and the interests to be taken into account are those of the creditors as a whole".[7] As Newey J. (as he then was) observed in *GHLM Trading Ltd. v Maroo*, "[i]f a director acts to advance the interests of a particular creditor, without believing the action to be in the interests of creditors as a class … he will commit a breach of duty".[8]

The need for directors, once the threshold has been passed, to have enhanced regard for the interests of company creditors is further expressed in English and Australian statutory regimes imposing liability on directors for wrongful trading (in England) or insolvent trading (in Australia). Section 214 of the Insolvency Act 1986 "gives the court a discretion to declare that a director is liable to make a contribution to the company's assets where the company has gone into insolvent liquidation and the director at the critical date knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation or insolvent administration".[9]

[7] Keay, "Financially Distressed Companies", 52. See also *BTI v Sequana* [2022] 3 WLR 709, [2022] UKSC 25, at [81], [176], [203], [207], [227], [247(iii)]; *Re HLC Environmental Projects* [2013] EWHC 2876, at [89] (stating that "[i]t is clear that established, definite insolvency before the transaction or dealing in question is not a pre-requisite for a duty to consider the interests of creditors to arise"); *GHLM Trading Ltd. v Maroo* [2012] EWHC 61, [2012] 2 B.C.L.C. 369, at [173] (holding that "GHLM was insolvent or at any rate 'of doubtful solvency or on the verge of insolvency'. It will thus have been incumbent on the Maroos, as directors of GHLM, to have regard to the interests of the company's creditors as a class"); *Re Micra Contracts Ltd. (in liquidation)* [2016] B.C.C. 153, at [28]; *Re Cosy Seal Insulation Ltd. (in administration)* [2016] EWHC 1255 (Ch), [2016] 2 B.C.L.C. 319, at [89]; L.S. Sealy, "Directors' 'Wider' Responsibilities – Problems Conceptual, Practical and Procedural" (1987) 13 Mon. L.R. 164; Keay, *Company Directors' Responsibilities*, 153–286, 293–339; T. Bachner, *Creditor Protection in Private Companies* (Cambridge 2009), 235–44; V. Finch and D. Milman, *Corporate Insolvency Law: Perspectives and Principles*, 3rd ed. (Cambridge 2017), 592; R. Goode and K. van Zwieten, *Goode on Principles of Corporate Insolvency Law*, 5th ed. (London 2018), [14–21].

[8] *GHLM Trading Ltd. v Maroo* [2012] EWHC 61, at [168]. See discussion of the disadvantages of not distinguishing between different creditor classes in Finch and Milman, *Corporate Insolvency Law*, 587–88.

[9] G. Moss, "No Compensation for Wrongful Trading – Where Did it All Go Wrong?" (2017) 30 Insolvency Intelligence 49, 49. The relevant statutory provisions are Insolvency Act 1986, ss. 214(2)(b) (liquidation) and 246ZB(2)(b) (administration). For judicial discussion, see e.g. *Grant v Ralls* [2016] EWHC 243 (Ch), [2016] Bus. L.R. 555, at [166]–[179]; for scholarly analysis, see inter alia Moss, ibid.; D. Kershaw, *Company Law in Context: Text and Materials*, 2nd ed. (Oxford 2012), 795–806; Keay, *Company Directors' Responsibilities*, 71–150, 343–66; the theoretical law-and-economics analysis in R.J. Mokal, *Corporate Insolvency Law* (Oxford 2005), 262–304, especially 271–73; Bachner, *Creditor Protection*, 212–19; R. Williams, "What Can We Expect to Gain from Reforming the Insolvent Trading Remedy?" [2015] M.L.R. 55; Goode and van Zwieten, *Goode*, [14-29], [14-47]; Finch and Milman, *Corporate Insolvency Law*, 599–604; D.D. Prentice, "Creditors' Interests and Directors' Duties" (1990) 10 O.J.L.S. 265; R. Parry, J. Ayliffe and S. Shivji,

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Given the priority of creditors in the distribution of a company's remaining assets on winding up, they are the key victims of any loss created by wrongful trading, as well as of directors' decisions to pay only some creditors, perhaps with newly-borrowed funds. The Insolvency Act exempts from liability for wrongful trading directors who "took every step with a view to minimising the potential loss to the company's creditors … [they] ought to have taken".[10] Directors held liable to make a contribution to the company's assets due to wrongful trading may also be subjected to a disqualification order under the Company Directors Disqualification Act 1986.[11] Having been so disqualified, they may, where the conduct for which they were disqualified is held to have caused loss to one or more creditors, be ordered, or undertake, to compensate specific creditors or creditor classes.[12]

The Australian Corporations Act 2001 (Cth) provides that where a company incurs a debt while insolvent, "or becomes insolvent by incurring that debt…; and at that time, there are reasonable grounds for suspecting that the company is insolvent, or would … become insolvent"[13] by incurring that debt, a director who failed "to prevent the company from incurring the debt"[14] despite being "aware at that time that there are such grounds for so suspecting",[15] or who similarly failed while "a reasonable person in a like position in a company in the company's circumstances would be so aware",[16] is liable both to the company and to the creditor involved for any "loss or damage [the creditor suffered] in relation to the debt because of the company's insolvency".[17] A recently enacted safe harbour provides that liability for insolvent trading does not apply to a director where the debt was incurred in connection with an attempt to produce an outcome better than liquidation or administration and that attempt was reasonably likely to succeed.[18]

A large literature provides discussion of reasons for the adjustment of the contents of directors' duties at the threshold, requiring them to have enhanced regard for creditors' interests. The major reasons provided are the following. First, a company near insolvency is, by definition, barely able, at best, to pay its creditors, and given creditors' priority over shareholders in winding up, shareholders' interests are by that point worth

Transaction Avoidance in Insolvencies, 3rd ed. (Oxford 2018), [19.63]–[19.81]; K. van Zwieten, "Disciplining the Directors of Insolvent Companies" (2020) 33 Insolvency Intelligence 2.

10 Insolvency Act 1986, ss. 214(3), 246ZB(3).

11 Section 10.

12 Company Directors Disqualification Act 1986, ss. 15A–15B; see discussion in Goode and van Zwieten, *Goode*, [14-03], [14–52]; van Zwieten, "Disciplining the Directors", 28–29; Finch and Milman, *Corporate Insolvency Law*, 617.

13 Corporations Act 2001 (Cth), ss. 588G(1)(b)–(c), 588G(1A).

14 Ibid., s. 588G(2).

15 Ibid., s. 588G(2)(a).

16 Ibid., s. 588G(2)(b).

17 Ibid., s. 588M(1)(b).

18 Ibid., s. 588GA(1).

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very little. As directors go on using company assets under these circumstances, they are using assets that may very soon be payable to the creditors, not the shareholders.[19] Another frequently mentioned reason for the adjustment of directors' duties at the threshold is that, given the small value of shareholders' interests in near-insolvent companies, shareholders of such companies are interested in increased risk-taking by their directors.[20] Such risk-taking may be shareholders' only hope for increasing the value of their shares. It is necessarily undertaken, however, with assets destined to be distributed to creditors should the company be wound up. The proximity of insolvency therefore aggravates the pre-existing disjuncture between the interests of creditors and those of shareholders. Should any high-risk strategies undertaken end in failure, that failure is likely to shrink the asset pool available for distribution to creditors in winding up.[21] The interests of directors (and other managers) tend, in the vicinity of insolvency, to track those of shareholders: the former have a reputational interest that the firm stays afloat, and that they are not seen to oversee its liquidation.[22] The likelihood that directors of a financially troubled firm adopt courses of action harmful to creditors may be decreased where directors are themselves company creditors, and where they gave creditors personal guarantees of the company's debt.[23] Still, the law responds to the presumptive increase, in near-insolvent firms, of directors' incentives to undertake actions likely to harm creditors, with an adjustment in the contents of their duties requiring them to have enhanced regard for creditors' interests.[24]

Further reasons brought for this adjustment are "that the level of risk upon which credit was calculated and extended by creditors has changed [given the proximity of insolvency]";[25] that the adjustment may contribute to controlling "asset siphoning and preferential payments to insider (owner-

[19] J. Armour, "Avoidance of Transactions as a 'Fraud on Creditors' at Common Law" in J. Armour and H. Bennett (eds.), *Vulnerable Transactions in Corporate Insolvency* (Oxford 2003), [7.6], [7.67]; Keay, "Directors' Duties to Creditors", 679.

[20] Kershaw, *Company Law*, 787–88; Mokal, *Corporate Insolvency Law*, 275–76; P. Davies, "Directors' Creditor-regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency" (2006) 7 E.B.O.R. 301, 306.

[21] R.J. Mokal, "An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives and the Creditors' Bargain" [2000] C.L.J. 335, 348; Williams, "What Can We Expect to Gain?", 58; Bachner, *Creditor Protection*, 22; UNCITRAL Legislative Guide on Insolvency Law, "Directors' Obligations in the Period Approaching Insolvency" (2013), paragraph 5; cf. Williams, "What Can We Expect to Gain?", 76, noting that [studies] "failed to find empirical evidence of 'risk-shifting' to creditors in times of financial distress [and this] challenges assumptions that limited liability in fact creates significant new risks for creditors in a pre-insolvency context".

[22] Mokal, "Agency Cost Analysis", 350–51; Finch and Milman, *Corporate Insolvency Law*, 635; Williams, "What Can We Expect to Gain?", 76; cf. S. Paterson, "The Paradox of Alignment: Agency Problems and Debt Restructuring" (2016) 17 E.B.O.R. 497.

[23] Williams, "What Can We Expect to Gain?", 76.

[24] K. van Zwieten, "Director Liability in Insolvency and Its Vicinity" (2018) 38 O.J.L.S. 382, 383; see also 388–89.

[25] Keay, "Shifting of Directors' Duties", 145.

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manager) creditors in closely held firms";[26] that the adjustment is meant to "create appropriate incentives for early action through the use of restructuring negotiations or reorganization";[27] that it may lead to better monitoring of companies' financial health;[28] and that it may compensate for the ex ante vulnerability of many creditors, such as employees, customers, involuntary creditors and many trade creditors, who suffer from informational asymmetry and a weak bargaining position vis-à-vis the company.[29] Finally, the adjustment is said to enhance commercial morality by mitigating unscrupulous conduct on the part of directors.[30]

B. Quistclose *Trusts and Questions They Raise*

Obtaining new debt finance is an obvious means to try and improve the fortunes of a company nearing insolvency. Given, however, that many companies nearing insolvency are likely to have few or no unencumbered assets, their directors may make use of devices such as *Quistclose* trusts.[31] These commonly used[32] trusts are analysed differently in England and Australia. English law has since *Twinsectra v Yardley* held *Quistclose* trusts of types A and B to be resulting trusts for the lender/settlor, with a power or duty in the borrower/trustee to apply the trust assets towards a stated purpose.[33] The trustee's use of the funds towards that purpose terminates the trust, leaving a standard debt relationship.[34] Gummow J.'s contrasting approach in *Re Australian Elizabethan Theatre Trust* doubts the utility of speaking of *Quistclose* trusts as a distinct trust type, holding instead that the conceptual modelling of trusts more or less reminiscent of that in *Barclays Bank v Quistclose* should depend on the facts of each case.[35] It is apparent, however, that Gummow J. saw trusts reminiscent of that in

[26] van Zwieten, "Director Liability", 390, note 50, citing Davies, "Directors' Creditor-regarding Duties", 303, and Bachner, *Creditor Protection*, 22.
[27] UNCITRAL Legislative Guide, paragraph 7.
[28] Keay, "Directors' Duties to Creditors", 686.
[29] Ibid., at 692–8; Keay, *Company Directors' Responsibilities*, 328–36.
[30] Keay, *Company Directors' Responsibilities*, 338.
[31] R. Clarke, "The Quistclose Trust – a Welcome Facilitator of Corporate Rescue?" (2017) 26 Nott. L.J. 130, 132.
[32] Finch and Milman, *Corporate Insolvency Law*, 556.
[33] [2002] UKHL 12, [2002] 2 A.C. 164, at [100] (Lord Millett). See further analysis in *Prickly Bay Waterside v British American Insurance Company* [2022] UKPC 8, [2022] 1 W.L.R. 2087, at [21]–[44]; *Challinor v Juliet Bellis & Co.* [2015] EWCA Civ 59, [2016] W.T.L.R. 43, at [53]–[64]; and see, from among a cornucopia of literature on the subject, J. Penner, "Lord Millet's Analysis" in Swadling (ed.), *The Quistclose Trust*, 41; Hudson, "A Normative Approach", 781; L. Tucker, N. le Poidevin and J. Brightwell, *Lewin on Trusts*, 20th ed. (London 2020), [9-052]; D. Hayton, P. Matthews and C. Mitchell, *Underhill and Hayton: Law Relating to Trusts and Trustees*, 19th ed. (London 2016), [1.30]–[1.37], [23.40–23.47].
[34] *Twinsectra v Yardley* [2002] UKHL 12, at [69] (Lord Millett).
[35] *Re Australian Elizabethan Theatre Trust* (1991) 102 A.L.R. 681, 691–93. See similar views in *Raulfs v Fishy Bite Pty Ltd.* [2012] N.S.W.C.A. 135, at [51]; J. Glister, "The Nature of Quistclose Trusts: Classification and Reconciliation" [2004] C.L.J. 632, 650; Hedlund and Rhodes, "Loan or Commercial Trust?", 260, 268.

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Quistclose as express rather than resulting trusts, with either one or more "limbs" depending on the facts.[36]

Academic contributors offer a plethora of additional conceptual options, including the following. Smolyansky believed *Quistclose* trusts should be seen as constructive.[37] Swadling believed there are no *Quistclose* trusts, since "the House of Lords was wrong in *Quistclose* to find a trust and thereby give priority to the lender".[38] Chambers believed that

> some cases justify a finding of a resulting trust for the lender, as in *Twinsectra*. However in other cases there is much to be said for the borrower obtaining beneficial ownership of the property pending its use for the permitted purpose; most importantly, that purpose benefitted the borrower, not the lender. Beneficial ownership in the funds may also be shared by the two of them.[39]

Hudson wrote that "the *Quistclose* trust operates as an unsatisfactory amalgam of an express and constructive trust: intention is emphasized but not always taken seriously by judges as a matter of evidence; concepts such as unconscionability and fairness are cited without clarity as to what they add; and the economics of insolvency is largely ignored".[40]

Most scholarly analysis of the *Quistclose* trust has been either doctrinal or conceptual in nature. Given, however, that leading cases show *Quistclose* trusts arising in a corporate insolvency context, they and the law governing them should also be analysed as part of the law of corporate insolvency.[41] Once these trusts are examined from a corporate insolvency perspective, several questions arise. Are *Quistclose* trusts a form of security (hereinafter, the security question)? If so, should they be subjected to a registration regime (hereinafter, the registration question)? Does a post-threshold company borrowing money or accepting prepayments on *Quistclose* trust terms

[36] *Re Australian Elizabethan Theatre Trust* (1991) 102 A.L.R. 681, 691–93. See a similar approach in *Legal Services Board v Gillespie-Jones* [2013] H.C.A. 35, (2013) 249 C.L.R. 493, 524, at [115]; and see also D. Ong, *Trusts Law in Australia*, 5th ed. (Annandale 2018), 18–21. The authors of the current edition of *Jacobs' Law of Trusts in Australia* note that "there are indications … the difference between the Australian and English authorities … is little more than [terminological] …. To the extent that there is any substantive difference of approach, it may lie in the greater readiness on the part of Australian courts to discern an intention to create a trust": J.D. Heydon and M.J. Leeming, *Jacobs' Law of Trusts in Australia*, 8th ed. (Chatswood 2016), [2–15]. Conaglen saw the classification of *Quistclose* trusts as either express or resulting as unimportant: M. Conaglen, "Review of Swadling (ed) *The Quistclose Trust*" [2005] C.L.J. 249, 250. Cf., however, discussion of the various Australian approaches, followed by a list of three "occasions when the difference [between the English and Australian approaches] might matter" in J. Glister, "Mutual Intention and Quistclose Trusts" (2012) 6 J. Eq. 221, 228.

[37] M. Smolyansky, "Reining in the *Quistclose* Trust: A Response to *Twinsectra v Yardley*" (2010) 16 Trusts & Trustees 558.

[38] W. Swadling, "Orthodoxy" in Swadling (ed.), *The Quistclose Trust*, 9, 39.

[39] R. Chambers, "Restrictions on the Use of Money" in Swadling (ed.), *The Quistclose Trust*, 77, 93. See a similar view in Glister, "Nature of Quistclose Trusts", 650–55.

[40] Hudson, "A Normative Approach", 778. See another conceptual option in J. Payne, "Quistclose and Resulting Trusts" in P. Birks and F. Rose (eds.), *Restitution and Equity*, vol. 1 (London 2000), ch. 5 (*Quistclose* trusts are *sui generis*).

[41] See such discussion in Finch and Milman, *Corporate Insolvency Law*, 562–69, suggesting at p. 569 that "there may be a case for encouraging the use of trust-based protections for parties who supply funds in rescue scenarios", but not in "non-rescue situations".

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create a voidable preference (hereinafter, the preference question)? Do the directors of such a company, in allowing a *Quistclose* trust to be created, infringe any of their duties, as adjusted at the threshold to require that directors pay enhanced regard to the interests of creditors as a class (hereinafter, the consider-the-creditors question)? Does the creation of such a trust constitute wrongful trading under English law, insolvent trading under Australian law, or fraudulent trading on the part of such directors (hereinafter, the wrongful or fraudulent trading question)?

Scholars have begun grappling with the first three of the above questions, with no consensus emerging. We will briefly review the security and registration questions here, postponing our discussion of the preference question to the next section. Bridge wrote 30 years ago that "from a functional point of view the *Quistclose* payer is a secured creditor";[42] Ho and Smart wrote that *Quistclose* trusts are a (disguised) form of security;[43] Bennett wrote that "such a trust clearly has the practical effect of rendering the lender a secured creditor";[44] Glister opined that "a 'true' *Quistclose* trust is characterised by the transferor retaining some form of security over the property";[45] Mokal and Loi called *Quistclose* trusts "quasi-security devices";[46] and the authors of *Underhill and Hayton* wrote that "*Quistclose* trusts are useful temporary security devices".[47] Stevens argued, however, that such trusts are not a form of security, since "the debt arises as the trust assets are dissipated. The trust is not substantively a charge on the account".[48] In response, Hudson wrote that the doctrinal distinctions Stevens emphasised fail to undermine the argument that as a matter of economic substance, *Quistclose* trusts are security interests: they are created to provide lenders with protection in the event of borrowers' insolvency. She further noted that "whilst a *Quistclose* trust will dissolve if the loan is applied for the prescribed purpose, until then its characteristics dovetail with those of functional security interests, in terms of matters such as priority in insolvency and giving the lender a 'selfhelp' procedure … on the happening of certain events".[49] Like Hudson and most other authors noted above, we believe that the *Quistclose* trust is in substance a security device:

[42] M. Bridge, "The *Quistclose* Trust in a World of Secured Transactions" (1992) 12 O.J.L.S. 333, 345. Bridge repeated this point in M. Bridge, "Collectivity, Management of Estates and the *Pari Passu* Rule in Winding-up" in Armour and Bennett (eds.), *Vulnerable Transactions*, 1, [1.30].

[43] L. Ho and P. Smart, "Quistclose and Romalpa: Ambivalence and Contradiction" (2009) 39 H.K.L.J. 37, 46.

[44] H.N. Bennett, "Late Floating Charges" in Armour and Bennett (eds.), *Vulnerable Transactions*, 183, [6.59].

[45] Glister, "Nature of Quistclose Trusts", 634. Glister was later convinced by Stevens that *Quistclose* trusts are not a form of security: J. Glister, "The Role of Trusts in the *PPSA*" (2011) 34 U.N.S.W.L.J. 628, 641.

[46] Mokal, *Corporate Insolvency Law*, 134; K.C.F. Loi, "*Quistclose* Trusts and *Romalpa* Clauses: Substance and *nemo dat* in Corporate Insolvency" (2012) 128 L.Q.R. 412, 417.

[47] Hayton et al., *Underhill and Hayton*, [1.119].

[48] R. Stevens, "Insolvency" in Swadling (ed.), *The Quistclose Trust*, 153, 166.

[49] Hudson, "A Normative Approach", 808.

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the lender or prepaying purchaser grants itself rights in the funds it provided, and will be able to use those rights to fulfil its interest in repayment or restitution in case of non-delivery, respectively. While the application of funds lent subject to a *Quistclose* trust of types A or B to their intended purpose brings the lender's security to an end, the consent of a lender to lose its security under certain circumstances does not mean that it has no security if those circumstances do not come to pass. Further, Stevens' view that "the debt arises as the trust assets are dissipated"[50] contradicts Lord Millett's view in *Twinsectra* that when a *Quistclose* trust is created "[t]he lender pays the money to the borrower by way of loan, but he does not part with the entire beneficial interest in the money, and in so far as he does not it is held on a resulting trust for the lender from the outset".[51] This must mean that the settlor is both settlor and lender from the time it pays the monies to the company.

If *Quistclose* trusts are seen as a form of security, it can be argued that like other forms of security, they should be subject to registration at their creation.[52] They are not currently subject to registration in either England or Australia. English law does not impose a comprehensive registration regime on security interests in personal property, and registration of company charges at Companies House does not apply to trusts.[53] Even recent proposals for reforming the law governing security interests do not propose subjecting *Quistclose* trusts to registration.[54] In Australia, the legislature has expressly excluded *Quistclose* trusts from the registration regime applicable to security interests in personal property.[55]

The two remaining sections of this article will be dedicated, first, to a detailed examination of the preference, consider-the-creditors, and wrongful or fraudulent trading questions; and second, to a discussion of the

[50] Stevens, "Insolvency", 166.

[51] *Twinsectra v Yardley* [2002] UKHL 12, at [100].

[52] See discussion in Stevens, "Insolvency", 165–66; Hudson, "A Normative Approach", 806–10.

[53] Hudson, "A Normative Approach", 810, citing *Carreras Rothmans v Freeman Mathews Treasure (in liq)* [1985] Ch D 207, 227. For the company charges registration regime, see Companies Act 2006, ss. 859A–859Q.

[54] A discussion paper on priorities released as part of the Secured Transactions Law Reform Project refers to *Quistclose* trusts as "non-reformed interests": D. Sheehan, "Priorities", 6, available at https://stlrp.files.wordpress.com/2017/01/sheehan-priorities.pdf (last accessed 9 February 2022). Elsewhere Sheehan refers to *Quistclose* trusts as "possibly" "interests outside" a potential unitary security interest regime, noting that "a policy decision would need to be taken to re-characterise trust interests to include them": D. Sheehan, "Secured Transactions Law Reform, Priorities and the Nature of a Security Interest" (2018) 29 King's L.J. 364, 366. The latest draft of the City of London Law Society's Secured Transactions Code does not mention *Quistclose* trusts: "Secure Transactions Code: Discussion Draft", available at https://www.citysolicitors.org.uk/storage/2020/03/Secured-Transactions-Code-discussion-draft-March-2020-2.pdf (last accessed 9 February 2022).

[55] While the Personal Property Securities Act 2009 (Cth) takes, in section 12(1), a broad, functional approach to the definition of a security interest, it is careful to provide, in section 8(1), that "this Act does not apply to . . . (h) a trust over some or all of an amount provided by way of financial accommodation, if the person to whom the financial accommodation is provided is required to use the amount in accordance with a condition under which the financial accommodation is provided". See analysis of the exclusion in Glister, "Role of Trusts", 640–43.

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normative question of which *Quistclose* trusts *should* be allowed, given the principles of company law and the law of corporate insolvency. We will assume, following Lord Millett in *Twinsectra*, that the debt and trust in *Quistclose* trusts of types A and B both arise when the lender/settlor pays over the money.[56] *Quistclose* trusts of type C may be settled by either the purchasers prepaying the price into a trust account or the company transferring prepayments received into such an account.

III. The Corporate Insolvency and Directors' Liability Consequences of *Quistclose* Trusts

The preference, consider-the-creditors, and wrongful or fraudulent trading questions are three legal perspectives on the difficulties created, from a corporate insolvency perspective, by *Quistclose* trusts. One such difficulty is that where the purpose of the loan is paying a pre-existing creditor – that is, in a type A *Quistclose* trust, that creditor may enjoy fuller repayment than other creditors of the same borrower, potentially offending the pari passu principle. The creation of a type A *Quistclose* trust may therefore benefit one of two creditors, the lender and the intended payee, rather than the borrower company's creditors as a class, while it is that class, not any specific creditor, to whose interests directors must pay special regard once past the threshold.

A. The Preference Question

Does a company borrowing or receiving money in the vicinity of insolvency on *Quistclose* trust terms create a voidable preference? In England and Wales, if a company, in deciding, within six months of the onset of insolvency, to give a creditor a preference,[57] was influenced by a desire to produce in relation to that creditor the effect of putting him, "in the event of the company going into insolvent liquidation", in a better position than he would have been, in that event, if the preference had not been given, "the court shall … make such order as it thinks fit for restoring the position to what it would have been if the company had not given that preference".[58] Millett J. noted in *Re M C Bacon Ltd.*[59] that transactions could be avoided even if a desire to improve the recipient's position in the event of the

[56] *Twinsectra v Yardley* [2002] UKHL 12, at [100].

[57] Insolvency Act 1986, s. 239. The "relevant time" is defined in section 240; where the preferred creditor is connected to the company, it is 12 months within the "onset of insolvency", itself defined in section 240(3) not as the time when the company becomes insolvent, but as the time when any one of several steps are taken to institute insolvency proceedings.

[58] Insolvency Act 1986, s. 239. For the remedy to be available, the company has to either be insolvent at the time the preference is given, or to be rendered insolvent by giving it: ibid., s. 240(b). See discussion in e.g. Goode and van Zwieten, *Goode*, [13-67]–[13-101]; Parry et al., *Transaction Avoidance*, 147–96; A. Walters, "Preferences" in Armour and Bennett (eds.), *Vulnerable Transactions*, 123.

[59] [1990] B.C.C. 78, 88 (Ch). For the leading case status of *Re M C Bacon*, see *Abdulali v Finnegan* [2018] EWHC 1806, [2018] B.P.I.R. 1547, at [13]–[14] (Ch).

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company entering insolvent liquidation was just one of the factors that operated on the minds of those who decided that the transaction take place, and not the decisive factor.[60] As he emphasised, however, "[a] man is not to be taken as *desiring* all the necessary consequences of his actions".[61] Further comments Millett J. made in the same case were reformulated in *Abdulali v Finnegan* to say that "it is still possible to undertake an act that amounts to a preference, eg pay one of one's creditors off, hence preferring him, when this is done for proper commercial considerations where there is no desire to prefer".[62]

In Australia, a transaction is an unfair preference if it results in a creditor receiving from a company, in respect of an unsecured debt, more than the creditor would receive from the company in respect of the debt if the transaction were set aside and the creditor were to prove for the debt in a winding-up of the company.[63] Where, within six months of "relation-back day",[64] a company, while insolvent, enters into an unfair preference, or makes an act or omission for the purpose of giving effect to such a preference, or becomes insolvent by entering into, or making an act or omission for the purpose of giving effect to, such a preference,[65] the transaction is voidable.[66] Australian courts have emphasised that in determining whether a transaction constitutes an unfair preference, the court must look to its "ultimate effect", including, for example, its contribution to a payee-creditor being prepared to continue supplying goods or services to the debtor essential to its business.[67]

In both jurisdictions, the length of the look-back period, during which preferences given are liable to be avoided, is longer for creditors connected to the company and entities related thereto, and shorter for others.[68] While the English regime, unlike the Australian regime, requires that for a preference to be voidable, the company must have been influenced, in giving it,

[60] *Re M. C. Bacon* [1990] B.C.C. 78, 88.

[61] Ibid., at 87.

[62] *Abdulali v Finnegan* [2018] EWHC 1806, at [14]. The sentence quoted is part of a composite summary of the holdings in *Re M. C. Bacon* and *Re Ledingham Smith* [1993] B.C.L.C. 635 (Ch), made by District Judge Salmon while hearing *Abdulali v Finnegan* at first instance. Birss J. quoted the summary at length in his decision in the appeal, noting at [16] that "in my judgment everything stated in the judge's summary is correct".

[63] Corporations Act 2001 (Cth), s. 588FA(1).

[64] Defined in Corporations Act 2001 (Cth), s. 91 as, depending on the precise sequence of events, either the day an application was filed for an order that the company be wound up, the day on which winding up began, or the day administration began.

[65] Corporations Act 2001 (Cth), s. 588FC.

[66] Ibid., s. 588FE(2).

[67] For the ultimate effect doctrine, as applied under the Bankruptcy Act 1966, see *Air Services Australia v Ferrier* (1995) 185 C.L.R. 483, 501–06; and see discussion in Goode and van Zwieten, *Goode*, [13–84]. For decisions upholding the continued relevance of the doctrine under section 588FA of the Corporations Law 1993 and the later Corporations Act 2001, see *VR Dye & Co. v Peninsula Hotels Pty Ltd. (in liq)* [1999] 3 V.R. 201, 210–16; *McKern & Ors v The Minister administering the Mining Act 1978 (WA)* [2010] 28 V.R. 1, at [118].

[68] England: Insolvency Act 1986, s. 240(1). Australia: Corporations Act 2001 (Cth), s. 588FE(4).

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by a desire to better the position of the recipient, such a desire is presumed for recipients connected to the company.[69]

Given the outcome-focused nature of the Australian approach to preferences, one would expect Australian courts to take a hard line on the preference question.[70] Though no Australian case directly resolves this question, some scattered dicta by Australian courts are consistent with that expectation. Gummow J. said in *obiter* in the *Australian Elizabethan Theatre* case that the arrangement in *Carreras*, where a cigarette manufacturer deposited monies in a special bank account of a near-insolvent advertising agency, in order to put the agency in funds to pay third parties to whom the agency became indebted in the course of placing advertising for the manufacturer, "would encounter the operation of the preference provision in the [Australian] Bankruptcy Act".[71] The Full Federal Court said in *obiter* in *Re Emanuel (No 14)* that a *Quistclose* trust could be a voidable preference under the then Australian Corporations Law.[72]

Other statements by Australian courts, addressing avoidance of unfair preferences outside the *Quistclose* trust context, seem to imply, however, that a company borrowing money in the vicinity of insolvency on *Quistclose* terms does not create an unfair preference under Australian law. Given the holding in *Air Services Australia v Ferrier* that only payments to pre-existing creditors can constitute unfair preferences,[73] where a company allows a new lender to create a *Quistclose* trust simultaneously with granting a loan, this cannot be seen as an unfair preference of that lender.

In so far as scholarly commentators have addressed the preference question, they have expressed highly divergent views. Swadling believed, in line with his view that the House of Lords was wrong in *Quistclose* to find a trust, that "[i]f Rolls Razor was to be considered as having declared itself

69 For the desire requirement, see Insolvency Act 1986, s. 239(5); and see discussion in Walters, "Preferences", [4.65]–[4.79]; Goode and van Zwieten, *Goode*, [13–91]; Parry et al., *Transaction Avoidance*, [5.85]–[5.114]. For criticism of that requirement, see Mokal, *Corporate Insolvency Law*, 336–37; E. McKendrick (ed. and rev.), *Goode on Commercial Law*, 5th ed. (London 2016), [31.42]; Finch and Milman, *Corporate Insolvency Law*, 490; for the presumption, see Insolvency Act 1986, s. 239(6).

70 Stevens similarly believed that "[i]n those jurisdictions which look at the effect of the transaction rather than the purpose behind it, *Quistclose* transactions may be more readily attacked": Stevens, "Insolvency", 162.

71 *Re Australian Elizabethan Theatre Trust* (1991) 102 A.L.R. 681, 692, approving comments by L.J. Priestley, "The Romalpa Clause and the Quistclose Trust" in P.D. Finn (ed.), *Equity and Commercial Relationships* (Sydney 1989), 229, 235–36. Note, however, that section 122 of the Bankruptcy Act 1966 (Cth), the preference provision of which Gummow J. spoke, has been disapplied to company liquidation, as distinguished from individual bankruptcies, in the Corporate Law Reform Act 1992 (Cth).

72 *Re Emanuel (No 14) Pty Ltd. (in liq)* (1997) 147 A.L.R. 281, 290.

73 *Air Services Australia v Ferrier* (1995) 185 C.L.R. 483, 491. See also *McKern v The Minister* [2010] 28 V.R. 1, at [111]: "The proposition that an obligation incurred or a payment made at a time when there was no existing debt cannot constitute the giving of a preference is one of long standing."

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trustee for the dividend creditors, it would have been a fraudulent preference".[74] Stevens wrote that from a legal point of view, a *Quistclose* trust is not a preference of the intended payee, because it is an act of the lender, not of the company.[75] Glister noted, similarly, that "[a]s long as the lender is involved somehow then the preference question will not arise".[76] This argument is belied, however, by both English and Australian legislation. Under English law, the Insolvency Act includes in its definition of a preference both the case where "the company does anything" having the effect of putting a creditor or guarantor in an improved position should the company enter insolvent liquidation and the case where the company "suffers anything to be done" that has that effect.[77] The latter option may well include the settlement of a *Quistclose* trust by a lender, whether the preferred creditor is the settlor or the intended payee of a type A *Quistclose* trust. The Australian Corporations Act only requires that "the company and the creditor are parties to the transaction", not that the company be the active party.[78] Stevens further noted that from an economic point of view, the creation of a trust for an unsecured creditor, followed by distribution of the trust assets to that creditor, does prefer that creditor to the trustee's other unsecured creditors.[79] He added, however, that "[t]he only way in which the general body of creditors would be prejudiced by the typical *Quistclose* transaction would be if the [*Quistclose*] lender were to rank higher upon insolvency than those creditors who were paid off", given that when the intended payee of a type A trust is paid, one unsecured creditor is effectively replaced by another – the *Quistclose* lender.[80]

Several commentators noted that under English law, a preference is only reversible where the company "was influenced in deciding to give it by a desire" to prefer the relevant creditor, and that many companies borrowing on *Quistclose* terms are unlikely to entertain such a desire, since the creation of the trust is due to creditor pressure or a result of their having run out of security to give.[81] As Stevens noted, often "the only desire is to rescue the company and prevent winding up".[82] More than a decade earlier, Bridge noted that "[i]t is certainly very difficult to imagine any

[74] Swadling, "Orthodoxy", 12.
[75] Stevens, "Insolvency", 159. Bridge made a similar assumption: "[i]n so far as the initiative comes from the company debtor itself, as opposed to the trust arising as a result of the terms on which moneys are paid to the company, this poses the question whether the company has unlawfully preferred the beneficiary to its other creditors" (Bridge, "Collectivity", [1.30]).
[76] Glister, "Mutual Intention", 231.
[77] Insolvency Act 1986, s. 239(4)(b).
[78] Corporations Act 2001 (Cth), s. 588FA(1)(a).
[79] Stevens, "Insolvency", 160.
[80] Ibid., at 161.
[81] Glister, "Nature of Quistclose Trusts", 635–36, note 15; Loi, "*Quistclose* Trusts and *Romalpa* Clauses", 422; Stevens, "Insolvency", 161.
[82] Stevens, "Insolvency", 161.

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circumstances in which a *Quistclose* trust bringing in late value would be vulnerable to" being reversed as a preference.[83]

Our own answer to the preference question is as follows. Under English law, the availability of a restorative remedy requires a "desire to prefer". Given the economic distress characteristic of the circumstances giving rise to many *Quistclose* trusts,[84] a desire to prefer the lender or purchaser, or the payee of a type A trust, will often be absent: companies allow the creation of *Quistclose* trusts in order to try and survive. They allow trusts of types A and B to be created because creating them drives potential lenders to inject new capital into the company, improving, or so directors believe, the company's chances of survival.[85]

Monies paid to the intended payee of a type A *Quistclose* trust may not, then, be liable, as preferences, to a restorative remedy, due to the possible absence of a desire to prefer. Another reason for the same conclusion was noted in *Mundy v Brown*: because companies do not own monies lent on *Quistclose* terms beneficially, their payment to their intended payee does not constitute a preference.[86] This doctrinal point expresses what Goode called the common policy underlying the avoidance provisions: protecting "the general body of creditors against a diminution of the assets available to them".[87] Because monies subject to a type A *Quistclose* trust were never available to the company's creditors other than the intended payee and the settlor/beneficiary, their payment to the former does not prefer it at the expense of the other creditors, as is required for a restorative remedy to be available.[88] In a type A situation, the company serves as a conduit for paying the lender's money to the intended payee. Goode suggested that a company serving as such a conduit is similar to "a third party choos[ing] to pay a particular [company] creditor [directly] without this resulting in any diminution in the company's assets".[89] Payment of a company debt by another lender, whether directly or with the company serving as conduit, could, however, where the terms of the new loan are worse than those of the loan repaid, increase the demands on the company's assets available to its other creditors, and in that sense prefer the payee at their expense.

[83] Bridge, "The *Quistclose* Trust", 340.
[84] E. McKendrick, "Commerce" in Swadling (ed.), *The Quistclose Trust*, 145, 148.
[85] It is also possible, of course, that a director desires to prefer a particular creditor not as an end in itself, but as a means to the end of keeping the company afloat. We thank Lusina Ho for alerting us to this possibility.
[86] *Mundy v Brown* [2001] EWHC 377, [2011] B.P.I.R. 1056, at [29] (Ch).
[87] Goode and van Zwieten, *Goode*, [13-03], [13-04].
[88] See discussion of the requirement that for a preference to arise, a creditor, surety or guarantor must be preferred *at the expense of the other creditors*, in Goode and van Zwieten, *Goode*, [13–78], [13–85]; Walters, "Preferences", [4.54]–[4.55]; Parry et al., *Transaction Avoidance*, [5.51]–[5.54]. See discussion of the trust point in Walters, "Preferences", [4.56].
[89] Goode and van Zwieten, *Goode*, [13–85].

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Where monies are provided to a company on a *Quistclose* trust of type A, B or C, and the intended purpose is not carried out so that the monies still rest with the company, the lender or (on a type C trust) customer holding beneficial title to the monies can hardly be said to have been preferred, even apart of any desire to prefer: had the monies not been provided to the company, legal title to them would still, other things being equal, rest with the lender or customer.[90] The state of holding beneficial title to monies, with legal title to them resting with the insolvent trustee/company, can hardly be seen as better than holding legal title to the same monies. Another reason for the same conclusion is that Insolvency Act 1986, s. 239(4)(a) requires, for a payment to qualify as a preference, that the person preferred "is one of the company's creditors or a surety or guarantor for any of the company's debts or other liabilities".[91] For trusts of types A or B, this requirement means that where the lender is not, before making the loan, a creditor, surety or guarantor of the company, the simultaneous creation of a *Quistclose* trust cannot be seen as a preference, even apart of any desire to prefer.

The return of funds lent to the lender/beneficiary of a type A or B trust, without the trust purpose (either repayment of another creditor or investment) having been achieved, satisfies section 239(4)(a): once the loan has been made, the lender is obviously a creditor of the company. Such repayment does not, however, qualify as a preference, as the monies returned to their lender are trust monies, and as such unavailable to the company's other creditors: repayment could not therefore be held to occur at their expense.[92]

To sum up our discussion of the preference question under English law, the creation and operation of a *Quistclose* trust of any of the three types with an insolvent or soon-to-be-insolvent company as trustee may certainly prefer, in a factual sense, the trust beneficiary, or (in a type A trust) the payee, one of whom will receive the trust property, to the company's unsecured creditors, who may be limited to slim pickings in its insolvency. This factual preference will only, however, constitute a preference in an insolvency law sense in those type A cases where the terms of the new loan are worse than those of the loan repaid. Even in such cases, in order for a restorative remedy to be available under section 239, the company needs to have been influenced, in deciding to give the preference, by a desire to prefer the creditor repaid.

In attempting to provide an answer to the preference question under Australian law, one must recall, first, that only transactions in respect of

[90] As Goode notes, "the preference provisions are necessarily confined to existing creditors": Goode and van Zwieten, *Goode*, [13–76]; see also [13-79–13-80].

[91] See discussion in e.g. Walters, "Preferences", [4.25–4.27].

[92] Discussion of the preference issue in *Re Farepak Food and Gifts Ltd.* [2006] EWHC 3272, [2008] B.C.C. 22, at [52] (Ch) was made in the context of an express trust theory, not of the *Quistclose* trust theory discussed at [33]–[36]. Both theories failed.

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unsecured debts may be characterised as unfair preferences,[93] and second, the holding in *Air Services* that only payments to pre-existing creditors can constitute unfair preferences.[94] The latter holding means that a company's allowing a new lender to create a *Quistclose* trust, simultaneously with granting a loan, cannot be seen as an unfair preference of that lender, even if the borrower/trustee takes part in the trust's creation.[95] We believe the decision that to constitute an unfair preference, a payment has to "be received from the company's own money" and its receipt by a creditor has to have "the effect of diminishing the assets of the company available to creditors"[96] prevents the transfer of trust funds to either the intended payee of a type A trust or, where the funds were not paid to their intended payee, to the settlor/beneficiary, from qualifying as an unfair preference. When a company holds funds subject to a type A trust, those funds are only available to two of its creditors: the intended payee and the settlor/ beneficiary. Their payment to either of the two does not, therefore, diminish the company's assets available to other creditors.

In a type B trust, the trust purpose is investment rather than paying a pre-existing debt, so fulfilment of that purpose cannot, under *Air Services*, constitute an unfair preference. Where the purpose of a type B trust is not fulfilled, the payment of the trust fund back to the lender/beneficiary does not diminish the assets of the company available to its creditors, since the trust fund was never available to any creditor except the lender/ beneficiary. In a type C trust, while the supply of products to customers discharges an existing obligation of the company, it is the prepaid price rather than the products that constitutes the trust fund. The release of that price from the trust when products are supplied cannot qualify as payment to a pre-existing creditor and so cannot, under *Air Services*, constitute an unfair preference. The reimbursement of the prepaid price to its payors where the products are not supplied does not diminish the assets of the company available to its creditors, since the trust fund was never available to any creditors except the customer/beneficiaries. *Quistclose* trusts do not, then, constitute unfair preferences under Australian law.

B. The Consider-the-Creditors Question

Do directors of a near-insolvent company, in allowing a *Quistclose* trust to be created, breach any of their duties, taking into account the adjustment of the content of those duties at the threshold, requiring directors to pay enhanced regard to the interests of creditors as a class? As Keay noted,

[93] Corporations Act 2001 (Cth), s. 588FA(1)(b).
[94] *Air Services Australia v Ferrier* (1995) 185 C.L.R. 483, 491.
[95] See discussion of the "mutual intention" approach to *Quistclose* trusts in Glister, "Mutual Intention", 229–32, who opines, at p. 231, that "[t]he most straightforward approach is to see the transferor as the putative settlor".
[96] *Cant v Mad Brothers* [2020] V.S.C.A. 198, at [120].

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in near-insolvent companies "surely payments to [specific] creditors must constitute a breach unless the directors can establish that the payments were made with the aim of ultimately benefiting the class of creditors",[97] as well as that the directors believed when authorising the payment that it will be in the interests of creditors as a class.[98] While directors may give evidence that they have in fact taken the interests of creditors as a class into account when agreeing that one or more lender or customer create a *Quistclose* trust over the subject matter of the loan or prepayment, the court may choose not to give credence to such evidence.[99] Where such evidence is not proffered or is seen as untrustworthy, an English court is likely to apply the *Charterbridge Corporation* test[100] as reformulated for directors of insolvent and near-insolvent companies in *Colin Gwyer v London Wharf*. This test provides that "in considering the interests of the company the honest and intelligent director must have been capable of believing that the decision was for the benefit of the creditors".[101] The creation of a type A trust will breach directors' duties, as recalibrated at the threshold to require enhanced regard for the interests of creditors as a class, unless directors prove that at the time of its creation they believed it to be in the interests of the company's creditors as a class, or, in the absence of such proof, that an honest and intelligent director could believe that despite its potentially preferential effect, it was in the interest of the company's creditors as a class.

Some *Quistclose* trusts will justify such belief. A type A trust where monies lent are used to repay a debt secured on critical machinery or stock-in-trade, and more generally, where they are used to repay any secured debt, is likely to be in the interest of creditors as a class, given the replacement of secured with unsecured debt: the trust for the lender ends once the monies lent are used for their appointed purpose, leaving an unsecured debt. A belief that a type A trust is in the interest of the company's creditors as a whole is also justified where the debt paid off was unsecured, but its terms – interest, penalties, covenants or other terms – were worse than those agreed with the lender/beneficiary. Type A trusts where the terms of the new loan are equally or more stringent than those of the old cannot usually be said to be in the interest of the company's creditors as a whole. Type B trusts may also be in the interest of the company's creditors as a whole: that will be the case where the purpose funded by the loan is in the creditors' interest. Purposes such as funding the continued

[97] Keay, "Directors' Duties and Creditors' Interests", 469.
[98] Ibid., at 470.
[99] *Gwyer v London Wharf* [2002] EWHC 2748, at [75]–[76], quoting from *Howard Smith Ltd. v Ampol Petroleum Ltd.* [1974] A.C. 821.
[100] *Charterbridge Corp Ltd. v Lloyds Bank Ltd.* [1970] Ch 62, 74.
[101] *Gwyer v London Wharf* [2002] EWHC 2748, at [87]. The principle cited was applied in *Roberts v Frohlich* [2011] EWHC 257, [2011] 2 B.C.L.C. 625, at [94] (Ch); *Re HLC Environmental Projects* [2013] EWHC 2876, at [106], [116], [124], [131].

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operation of a company that, despite undergoing difficulties, has significant chances of future success are likely to be in the interests of the company's creditors as a class, and the same may be said of a *Quistclose* trust facilitating them. That is especially so where similar funding is not obtainable without it being subjected to a trust. Funding subjected to a trust, dedicated to supporting the continued operation of a viable company, may be more attractive to the company's existing creditors than the company taking out a new secured loan instead, since once money lent on *Quistclose* terms is used for its appointed purpose the lender remains an unsecured creditor. Finally, whether type C trusts are in the interest of the company's creditors as a whole depends on the balance of two contradictory effects. On the one hand, the company's offer to hold customer monies paid in on trust for the payors may result in additional profitable sales, increasing creditors' likely payouts. On the other hand, given the limits of demand for company products, given that customers may not know of the trust terms and given that credit and debit card purchasers are otherwise protected, sales accompanied by type C trusts may take place at the expense of other sales that would have taken place had the company not agreed to trust terms. As a result, prepaid monies that would have been received as freely available to all creditors will instead be received as trust monies, unavailable to the company's creditors until products purchased are supplied. As to all three trust types, the above analysis seems to hold both under English and Australian law.

Not only may directors' authorisation of the creation of a *Quistclose* trust breach their duties; it may under some circumstances entitle the company to a remedy. In *GHLM Trading Ltd. v Maroo*, Newey J. (as he then was) held that "a company seeking redress [against its director] in respect of a 'preference' to which section 239 does not apply is likely to need to show" the existence of one of three states of affairs.[102] Given his reference to preferences to which section 239 does not apply, such as the "preference" of a trust beneficiary to an unsecured creditor expressed in their different bundles of legal rights, his view bears application to all three types of *Quistclose* trusts: as noted above, such trusts may certainly involve preferences in the factual sense.

The first of Newey J.'s three states of affairs is where the company has suffered loss. While it might be thought that directors' authorisation of the creation of a type A trust, discharging a company debt, does not cause loss to the company,[103] the creation of such a trust can cause such loss where the terms of the new loan, regardless of the trust, are more stringent than those of the loan replaced. Type B trusts do not involve even a

[102] *GHLM Trading Ltd. v Maroo* [2012] EWHC 61, at [169]. See discussion in Parry et al., *Transaction Avoidance*, [19.31]–[19.32].
[103] See discussion of this difficulty in van Zwieten, "Director Liability", 403.

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factual preference where monies lent are put to their intended use, except perhaps the preference involved in the lender having enjoyed beneficiary status until the monies were put to that use. While the investment undertaken with trust monies may end in those monies being lost, such loss does not result from the lender having been preferred. When monies lent are instead repaid to their lender, no loss results. Type C trusts may be seen to prefer, in a sense outside section 239, prepaying purchasers to the company's creditors. Such trusts will create loss for the company where the additional income resulting from segregation of customer monies driving customers to make additional purchases is less than the value forgone by the company not being free to use the amount of income it would have made absent the trust.

The second state of affairs that will, according to Newey J., entitle a company to redress against a director in respect of a preference to which section 239 does not apply is where the director profited from the preference. Directors can clearly profit from *Quistclose* trusts of all three types. Newey J.'s third state of affairs is where the transaction in question is not binding on the company. As he explained:

> [a]s for whether the transaction is binding, ordinary agency principles indicate that a company can disavow a contract which a director has caused it to enter into if: (a) the director was acting in his own interests rather than those of the company, its members or (where appropriate) its creditors as a class, and (b) the other party to the contract had notice of the director's breach of duty.[104]

Quistclose trusts of all types can serve directors' own interests rather than those of the company or its creditors as a class. Where that is the case, and the beneficiary had notice of that being the case, the transaction, including both the loan (or, in a type C trust, the sale) and the trust, will not be binding on the company.

C. The Wrongful or Fraudulent Trading Question

Does allowing a *Quistclose* trust to be created amount to wrongful trading under English law, or insolvent trading under Australian law, on the part of the directors of a near-insolvent company? As noted above, under English law wrongful trading consists of a director of a company that has later entered insolvent liquidation or administration knowing, subjectively or objectively, "that there was no reasonable prospect that the company would avoid going into" insolvent liquidation or administration, without the director taking every step he or she ought to have taken "with a view to minimising the potential loss to the company's creditors".[105] It therefore

[104] *GHLM Trading Ltd. v Maroo* [2012] EWHC 61, at [170].

[105] Insolvency Act 1986, ss. 214(2)(b) (liquidation) and 246ZB(2)(b) (administration). See discussion in sources cited in note 9 above.

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appears that where a company has a reasonable chance of avoiding insolvent liquidation or administration, no step the company takes, including allowing a *Quistclose* trust to be created, can constitute wrongful trading. Where a company has no reasonable chance of avoiding insolvent liquidation or administration, directors who allow the creation of such a trust can avoid liability for wrongful trading where allowing its creation is consistent with taking every step the director ought to have taken with a view to minimising the potential loss to the company's creditors. Examining under what circumstances allowing the creation of a *Quistclose* trust is consistent with taking every such step is a very similar enquiry to that conducted in the sub-section immediately preceding, where we asked which *Quistclose* trusts are in the interest of the company's creditors as a whole. As discussed above, type A trusts that facilitate the replacement of secured with unsecured debt, or replace an existing loan with one at easier terms, are in the interest of the company's creditors as a whole. They are therefore consistent with directors taking every step they ought to have taken to minimise the potential loss to the company's creditors. It is even arguable that where secured debt can be replaced with unsecured, or, more generally, where debt can be refinanced at better terms, by allowing a new lender to create a *Quistclose* trust in its favour, but not in any other way, directors who do not bring up this option in negotiating, or attempting to negotiate, a new loan may be liable for wrongful trading. Allowing the creation of a type A trust that does not ease the company's overall debt burden is, however, consistent with a finding of liability for wrongful trading.

While type A trusts may be expected, at the time directors authorise their creation,[106] to minimise potential losses to company creditors even when there is no reasonable prospect of the company avoiding insolvent liquidation, the case is otherwise with type B trusts. The provision of additional debt finance may be expected to minimise potential loss to company creditors even if the funding is not used to pay any pre-existing creditor and does not suffice to avoid insolvent *administration*: such funding may enable the company to avoid liquidation and survive. Where, however, there is no reasonable prospect of avoiding liquidation, the provision of additional debt finance, whether accompanied with a trust or not, for a purpose other than paying an existing debt, is unlikely to be expected to minimise the loss to company creditors, and will therefore be consistent with ascription of liability for wrongful trading. As for type C trusts, whether their creation amounts to wrongful trading will in each case depend on the balance of the same two contradictory effects mentioned in the last sub-section. Such trusts may, where products are sold at a profit and where allowing

[106] As Goode notes, "the court should take care to avoid being influenced by hindsight": Goode and van Zwieten, *Goode*, [14–45]. Taking into account whether a trust which is authorised by directors in fact minimised company creditors' losses would be giving in to such influence.

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the creation of trusts for purchasers increases sales, minimise the potential loss to company creditors even where liquidation is practically inevitable. To the extent, however, that sales accompanied by type C trusts replace other sales that would have taken place had the company not agreed to trust terms, directors' allowing such trusts to be created may aggravate the loss to company creditors, except the customer-beneficiaries, if the company does not supply the products purchased: prepaid monies that would have been received as freely available to all creditors are instead received as trust monies and must be refunded to their settlors. Even where the company does supply the products, loss to company creditors may result from the prepaid price not being available to them until products are supplied.

The Australian insolvent trading regime is different to the wrongful trading regime under English law: it focuses not on the inevitability of insolvent liquidation or administration, but on the reality, or likelihood, of the company being insolvent while incurring a debt or becoming insolvent by incurring it. A director with the requisite degree of subjective or objective knowledge of the company's existing or impending insolvency who fails to prevent the company from incurring the debt is liable both to the company and to the creditor involved for any "loss or damage [the creditor suffered] in relation to the debt because of the company's insolvency".[107] A safe harbour provides that liability for insolvent trading does not apply to a director where the debt was incurred in connection with an attempt to produce an outcome better than liquidation or administration and that attempt was reasonably likely to succeed.[108] The safe harbour aside, a director allowing the creation of a type A trust may be held liable for insolvent trading where the company was insolvent when it incurred the debt accompanied by the trust, subject to his or her degree of knowledge respecting the company's insolvency. Cases where a company becomes insolvent by incurring a debt accompanied with a type A trust seem unlikely, though it could happen that a company, not yet insolvent but hard-pressed by a creditor, takes on new debt in order to repay that creditor, is only able to find a loan at worse terms than those of the loan to be discharged, and the difference between the terms of the two loans renders the company insolvent. Conceivably, some directors who would otherwise be held liable for insolvent trading for allowing the creation of type A trusts could be saved by the safe harbour. This may especially be the case where such a trust was created to accompany one or more loans meant to replace some or all of a company's existing debt burden with debt at easier terms, with the difference likely to facilitate an outcome better than liquidation or

[107] See sources cited in notes 13–17 above.
[108] Corporations Act 2001 (Cth), s. 588GA(1). See discussion of the safe harbour in H. Anderson, "Shelter from the Storm: Phoenix Activity and the Safe Harbour" (2018) 41 M.U.L.R. 999.

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administration, which outcome was unlikely under the former debt structure.

Analysis of type B trusts under the Australian insolvent trading regime seems similar to that of type A trusts. Once again, allowing the creation of such trusts while the company is insolvent may well lead to liability for insolvent trading being imposed, subject to each director's degree of knowledge respecting the company's insolvency. A company may become insolvent by incurring a debt accompanied with a type B trust where the intended investment is, or becomes, worth less than the company's debt to the *Quistclose* lender. And once again, directors who allow the creation of some type B trusts may be saved from liability for insolvent trading by the safe harbour. Such a result could occur where despite the company being insolvent when directors allowed the trust to be created, or becoming insolvent by incurring the debt accompanied by the trust, the trust was created in connection with an attempt to produce an outcome better than liquidation or administration that was reasonably likely to succeed.

As for type C trusts, so long as customer prepayments are not seen as loans in disguise, the creation of such trusts cannot constitute insolvent trading under the Australian regime, unless it constitutes an "uncommercial transaction" within section 588FB of the Corporations Act.[109] That section defines "uncommercial transactions" as those that a reasonable person in the company's circumstances would not have entered into, having regard to, inter alia, the benefits and detriments to the company of entering into them. Determining whether allowing the creation of a given type C trust is an "uncommercial transaction" therefore involves a similar calculation of its commercial desirability to that encountered above. How much additional income has the company earned as a result of its allowing type C trusts to be created? How much free income, not subject to any trust, was replaced by trust income as a result of the same decision? The balance of these two inquiries should guide our determination whether allowing the creation of a given type C trust is an "uncommercial transaction". If allowing the creation of such a trust is an "uncommercial transaction", then doing so when the company is insolvent constitutes insolvent trading, as does allowing such trusts to be created where their creation pushed the company into insolvency. Allowing type C trusts to be created could conceivably push a company into insolvency, as where prepayments subject to a trust replace trust-free prepayments, and the resulting reduction in trust-free funds renders the company unable to pay its creditors. And once again, the safe harbour could conceivably save some director choices to allow type C trusts to be created from constituting insolvent trading, as where

[109] Corporations Act 2001 (Cth), s. 588G(1A). This subsection lists company actions that are equated to incurring a debt for the purpose of the insolvent trading regime applying. The company entering into an "uncommercial transaction" is item (7) on the list.

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such a choice, though loss-creating in itself, was part of an attempt to produce an outcome better than liquidation or administration that was reasonably likely to succeed.

Another question is whether directors allowing the creation of *Quistclose* trusts could constitute fraudulent trading on their part. Both English and Australian legislation make a finding of intent to defraud creditors of the company or of any other person, or another fraudulent purpose, a condition for imposing liability for fraudulent trading, though "knowledge[, including blind-eye knowledge,] that the transaction in which [the respondent] was participating was intended to defraud … or was in some other way fraudulent" suffices.[110] Like any trust, *Quistclose* trusts can mislead observers of the trustee, including its creditors, into believing the trust assets to be the trustee's absolutely rather than held on trust.[111] While Stevens wrote that both in *Barclays Bank v Quistclose*[112] and in *Carreras v FMT*[113] the trusts were employed in order to create a false appearance of solvency,[114] Bridge believed that more often than not, a *Quistclose* trust does not involve creating such a false picture, as funds lent are only briefly under the borrower's control before being paid away.[115] Whether *Quistclose* trusts are employed with an intent to defraud or another fraudulent purpose will have to be resolved on a case by case basis.

IV. Which *Quistclose* Trusts Should Be Allowed?

Our next task is identifying which *Quistclose* trusts *should* be allowed as a normative matter, given the principles and purposes of company law and the law of corporate insolvency. Most obviously, there must be no intent to defraud the company's creditors, and directors may not make a personal profit from the transaction. Beyond that, we identify two normative purposes that animate the limits of the normatively justifiable *Quistclose* trust. These purposes should guide courts in interpreting and applying the existing law governing preferences and directors' duties to *Quistclose* trusts. They should also guide legislatures in developing that law, as applicable to such trusts. One such purpose is that the trust must be reasonably expected to contribute to the company's chances of survival, rather than merely to a given creditor(s)' chances of being repaid or a given purchaser(s)' chances of being reimbursed monies it prepaid should products

[110] In England, see Insolvency Act 1986, s. 213. In Australia, see Corporations Act 2001 (Cth), ss. 592(6), 593(2). See discussion of the English fraudulent trading provision in e.g. Goode and van Zwieten, *Goode*, [14–22]–[14–28], with the quoted phrase at [14–23] and the text in the first brackets interpolated from [14–26].

[111] Finch and Milman, *Corporate Insolvency Law*, 567.

[112] *Barclays Bank v Quistclose Investments* [1970] A.C. 567 (H.L.).

[113] *Carreras Rothmans v Freeman Mathews Treasure (in liq)* [1985] Ch D 207.

[114] Stevens, "Insolvency", 164.

[115] Bridge, "The *Quistclose* Trust", 361.

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purchased not be delivered. Absent such contribution, any factual preference granted to the lender or purchaser is unjustifiable, even if a restorative remedy is unavailable under current law. While a solvent company can in principle choose to pay one creditor ahead of others, once a company either is insolvent or is likely to become insolvent such preferences should entitle the company to a remedy unless they can be reasonably expected to contribute to its chances of survival. A company nearing insolvency should, in principle, obey the *pari passu* rule; a preference, offending that rule, should only be acceptable in the vicinity of insolvency where it is reasonably likely to contribute to the company returning to an economic state where preferences are allowed. The other normative purpose animating the limits of the normatively justifiable *Quistclose* trust is curtailing, to the extent possible, the risk that outsiders to the trust, such as a borrower company's non-trust creditors, mistakenly believe trust funds to be the company's beneficially.

Guided by the above normative purposes, we now suggest five characteristics of normatively permissible *Quistclose* trusts. Their presence in a given trust can be taken to signal the trust's being normatively justifiable. The first two characteristics of the five signal the trust is consistent with the first normative purpose noted above; the last three characteristics signal its consistency with the second purpose. The first characteristic is that the intended use of the trust funds contributes to the company's avoiding liquidation and resuming successful operation. Paying dividends, as in *Barclays v Quistclose*, is unlikely, for example, to be consistent with such an outcome in an insolvent or near-insolvent company. A second characteristic of normatively conforming *Quistclose* trusts is that they are created on commercial terms that balance the lender or purchaser having obtained the protection of a trust with terms favourable to the borrower or vendor company, such as an interest rate lower than that a non-trust lender would have required in the circumstances or a sale price higher than a non-trust purchaser would have been willing to pay. A third characteristic of conforming *Quistclose* trusts is a clear separation of the trust assets, while under the company's control, from its other funds, reducing the risk that non-trust creditors believe the trust assets to be part of the company's general assets. To prevent such an incorrect belief, the trust assets should be held in an account clearly marked as containing trust assets. A fourth characteristic of conforming *Quistclose* trusts is speedy fulfilment of the trust purpose, cutting short the period during which the trust assets are under the company's control. The shorter this period, the smaller the risk that non-trust creditors believe those assets to be part of the company's general assets. Finally, a fifth characteristic of normatively justifiable *Quistclose* trusts is that the intended use of the trust funds is specific: specificity increases the likelihood that the lender or the company's other creditors will be able to identify nonconforming use of the trust assets, and take

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timely, appropriate action to obtain restitution or compensation. Where the trust purpose is unspecific enough that directors or other managers have discretion regarding the use to be made of the trust assets, they must exercise that discretion in the best interests of the company, and if past the threshold, take the interests of the company's creditors as a whole into account.

V. Conclusion

This article makes two contributions to the literature on *Quistclose* trusts. The first is an examination of whether each of the three major types of *Quistclose* trusts, given a corporate trustee, breaches the applicable rules of company law and the law of corporate insolvency. Having examined this question under both English and Australian law, we find that while *Quistclose* trusts of all three types may in a factual sense prefer the beneficiary or the intended payee to the corporate trustee's other creditors, this preference will almost never entitle the company or an office-holder to a restorative remedy. Directors' authorisation of the creation of a *Quistclose* trust of each type may, however, breach their duties, and some cases where both a factual preference and a breach are present may give the company a remedy against authorising directors. Directors' authorisation of the creation of a *Quistclose* trust of each type can also constitute wrongful trading under English law, insolvent trading under Australian law, and fraudulent trading under the law of each of the two jurisdictions. Our second contribution is identifying two normative purposes that animate the limits of the normatively justifiable *Quistclose* trust and five characteristics of normatively justifiable *Quistclose* trusts. These purposes and characteristics should guide courts in interpreting and applying the law governing preferences, directors' duties and directors' liabilities to *Quistclose* trusts. They should also guide legislatures in developing that law, as applicable to such trusts.

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