

# TRADING TRUSTS AND STRAW TRUSTEES

## (Principles & Problems Reconsidered.)

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### Introduction

The attractive combination of limited liability<sup>1</sup> and taxation advantages<sup>2</sup> resulted in an explosion in popularity in the 1970s of the trading trust, using a straw corporate trustee, to carry on a business enterprise.

The legal treatment of the resulting entity throws together principles from diverse areas and the solution to a specific problem may cause an incompatibility of a principle from one of the areas with a principle from another. The resolution may cause the principle from one of those areas to be inapplicable, though it might normally be applied in less complex situations. The appointment of a nominee limited liability company with a paid-up capital of \$2 which then becomes insolvent, juxtaposes various principles of equity and in particular, those drawn from fiduciary obligations, the law of trusts, priorities, and what has been described in this context as the 'invidious' use of subrogation,<sup>3</sup> with rules drawn from company law and the law of insolvency, to produce what has been thought by some to be a 'commercial monstrosity'.<sup>4</sup>

Whilst much has been written already upon various aspects of this vexed area,<sup>5</sup> in addition to considering recent developments, this paper attempts to re-examine comprehensively the diverse rules and their implications for the respective parties and to identify those aspects which either remain in doubt or whose resolution under existing rules is questionable.

### 1. Rights and Liabilities of the Trustee

#### (a) Trustee's Personal Liability to Creditors

A trust, unlike a company,<sup>6</sup> has no separate legal identity nor is the trust fund a

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1. The alternatives of sole proprietor, partnership or direct company trading all involve continued liability — for the sole practitioner, in a personal capacity both generally and for taxation purposes; for each partner, liability to the full extent of the firm's indebtedness and pursuant to s.92 of the Income Tax Assessment Act, 1936; and for the company, corporate liability and potential liability of the directors.
2. Amendments to Division 6 of Part III of the Income Tax Assessment Act, 1936, from the end of the 1970s, have reduced the attractiveness of trusts for some purposes — in particular the change to the definition of 'net income' in s.95 rendering the trustee a resident; the deemed 'present entitlement' and deeming a beneficiary to be not under a disability in ss 95A and B; the penalty rates applicable to income to which no-one is presently entitled; the anti-trust stripping provisions of s.100A concerning tax-reimbursement agreements; and the deemed present entitlement provisions of s.101.
3. A.W. Lockhart, 'Trading Trusts: An Examination of Trustees' Liability and Creditors' Rights', (1986) *Auckland U.L.R.* 313 at 327.
4. H.A.J. Ford, 'Trading Trusts and Creditors' Rights', (1981) *Melb. U.L.R.* 1.
5. *Supra* n.3 & 4; D.R. Williams, 'Winding Up Trading Trusts: Rights of Creditors and Beneficiaries', (1983) 57 *A.L.J.* 273; R. Brett, 'The Obligation of a Beneficiary to Indemnify a Trustee' (1985) *A.T.R.* 255; C.J.L. Brabazon, 'Trusts and Personal Liabilities (1985) *Q.L.S.J.* 173; B.H. McPherson, 'The Insolvent Trading Trust' in P. Finn (ed), *Essays in Equity* (1985); R.P. Meagher, 'Insolvency of Trustees', (1979) 53 *A.L.J.* 648.
6. The artificial corporate entity is a legally recognised persona and incurs liability in its own right and is a 'person' for the purposes of the taxing provisions of s.17 of the Income Tax Assessment Act, 1936.

recognised entity.<sup>7</sup> The trust operates<sup>8</sup> only through the person of the trustee. The reason for this is rooted in pre-Judicature history, since in a creditor's action at common law upon a debt, the common law court would not recognise the existence of the trust<sup>9</sup> but would recognise the personal liability of the trustee upon the debt.<sup>10</sup> This result, at least initially, appeared to relieve a creditor from the need to obtain details of the trust.<sup>11</sup>

Accordingly, it is trite law that the trustee of a trust which trades is liable personally for trust trading debts<sup>12</sup> and that liability extends to the full extent of the trustee's personal assets.<sup>13</sup> The position of the trustee is akin to that of the executor in this respect.<sup>14</sup> The personal liability is not limited to debts but extends to tortious liability<sup>15</sup> and statutory imposts.<sup>16</sup>

There is no unfairness in the rule attributing personal liability to the trustee because the trusteeship is not forced upon the holder of the office. As Lord Eldon has said in respect of an executor trustee carrying on a business,

... he places himself in that situation by his own choice; judging for himself, whether it is fit and safe to enter into that situation, and contract that sort of responsibility.<sup>17</sup>

#### (b) Limitation of Liability to Creditors

The trustee's personal liability to the trust creditors is unlimited unless that liability is modified or excluded. Lord Westbury had expressed the view that the liability could be limited only by express stipulation<sup>18</sup> but the rule subsequently treated the question of limitation as a more general question of construction in which appropriate language in the circumstances of a dealing between trustee and creditor, though falling short of an express stipulation, may nevertheless suffice to modify or exclude liability of the trustee, provided the words are clear and not merely descriptive.<sup>19</sup>

A mere description of the capacity in which the party contracts 'as trustee' is not sufficient to exclude personal liability<sup>20</sup> but language which indicates the promise is backed

7. *Worrall v. Harford* (1802) Ves Jun 4 at 8; 32 E.R. 250 at 252.

8. A trustee may operate by converting or joining in converting any part of the trust business into a company limited by shares or promote or assist in promoting a company for carrying on trust business (see e.g. s.58 Trusts Act, 1973 (Qld) and comparable authority under the Trusts Acts of other jurisdictions e.g. s.56, W.A. and s.33, N.Z.).

9. *Wightman v. Townroe* (1813) 1 M & S 413; 105 E.R. 154.

10. *Re Graham, Pitt & Bennett* (1891) 9 N.Z.L.R. 617 at 619.

11. *Burt, Boulton & Hayward v. Bull* [1895] 1 Q.B. 276 at 281, 284.

12. *Farhall v. Farhall* (1871) L.R. 7 Ch. App. 123 at 126;

*Re Johnson* (1880) 15 Ch. D. 548 at 552;

*Vacuum Oil Co. Pty Ltd v. Wiltshire* (1945) 72 C.L.R. 319;

*Octavo Investments Pty Ltd v. Knight* (1979) 144 C.L.R. 360 at 367.

13. *Re Johnson, ibid.*

14. *Vacuum Oil supra* n.12 at 324-5.

15. *Bennett v. Wyndham* (1862) 4 De G. F. & J 259; 45 E.R. 1183; *Re Raybould* [1900] 1 Ch. 199.

16. E.g. municipal rates as in *Gladstone Town Council v. Gladstone Harbour Board* [1964] Qd.R. 505.

17. *Ex parte Garland* (1804) 10 Ves. Jun 111; 32 E.R. 786 at 789.

18. *Lumsden v. Buchanan* (1865) 4 Macq 950 at 955; (1865) 13 L.T. 174. It was also thought in some cases to be impossible because of repugnancy to the promise to repay: *Watling v. Lewis* [1911] 1 Ch. 414.

19. *Muir v. City of Glasgow Bank* (1879) 4 App. Cas. 337 at 362;

*Lally v. Edgcombe* (1883) N.Z.L.R. 1 S.C. 364;

*Watling v. Lewis supra* n.18 at 423;

*General Credits Ltd v. Tawilla Pty Ltd* [1984] 1 Qd.R. 388.

20. *Re Anderson; Ex parte Alexander* (1927) 27 S.R. (N.S.W.) 296. The position in the United States may be different as there have been cases in which contracting 'as trustee' has been held sufficient: *East River Savings Bank v. Samuels* 284 N.Y. 470 and see A.W. Scott, *The Law of Trusts* (1967), [262-3].

only by the trust assets e.g. 'as trustee *only*'<sup>21</sup> or 'as trustee *but not otherwise*'<sup>22</sup> would be sufficient to exclude the trustee's personal liability to the creditor.

The issue of limitation of a trustee's personal liability arose recently in *Helvetic Investment Corporation Ltd v. Knight*.<sup>23</sup> The question before the Court of Appeal was whether the proper construction of a guarantee evidenced an intention to limit liability. The guarantee named 'The John Knight Family Trust' as the contracting party and it was signed 'J. Knight Trustee'. At the time of trial the trust assets totalled \$30.24 and the indebtedness \$218,550.40. Overturning the trial judge, the Court held that the language used was not apt to have an exclusory effect and went no further than a description of the capacity in which Mr Knight contracted as guarantor. As Glass J.A. stated '... the use of the words was that they constitute an appropriate description of, in that case, the legal person to whom the trusts and the trust property pertained'.<sup>23a</sup>

*Helvetic* raised also the question whether a trust is a legal persona<sup>24</sup> because an argument was pressed that upon the true construction of the guarantee, no liability was incurred by any person since the promise was given by the trust which has no existence as a legal person. The case proffered in support was *Black v. Smallwood*<sup>25</sup> where there was a purported execution of an instrument by which no party was bound because the common intention was that liability should be incurred by a company which had not yet come into existence. In *Helvetic*, Glass J.A., saw no analogical force in that case and was not prepared to construe the guarantee by imputing an intention common to the parties that it should be binding only upon a non-existent legal person.

In the event of any uncertainty in the language used to modify or exclude the trustee's personal liability, it may be read against the trustee, at least if such an interpretation will ensure it is operative rather than void.<sup>26</sup>

The limitation of liability by such language to the trust assets does not have the effect of charging the trust assets unless there is clearer evidence of an intention to provide security<sup>27</sup> and, accordingly, the creditor who accepts such a limitation would normally remain unsecured and rank *pari passu* with other unsecured creditors upon the insolvency of the trustee.<sup>28</sup>

Reasons have been advanced for questioning the recognition of the trustee's right to limit personal liability. Firstly, a limitation of liability might be regarded as illegal on the basis that in limiting the creditor's rights to trust assets, it reduces the beneficiaries' security and thereby fails to protect their interests. Secondly, it may reduce the diligence of the trustee from that which would exist if he was otherwise personally liable. Such arguments have been rejected, the view being taken that the protection of the beneficiaries resides in the accountability of a trustee before the court.<sup>29</sup>

Scott points out that there should be no disparity between the rule that an agent acting

21. *Gordon v. Campbell* (1842) 1 Bell App. 428.

22. *Re Robinson's Settlement* [1912] 1 Ch. 717 at 729 ('*qua* trustees only').

23. (1984) 9 A.C.L.C. 773.

23(a). *Ibid* at 774.

24. *Supra* n.7 & 9.

25. (1967-8) 117 C.L.R. 52.

26. *Primary Producers v. Dixon* [1938] 40 W.A.L.R. 34; *Helvetic supra* n.23 per Mahoney J.A. at 777, invoking the maxim *ut res magis valeat quam pereat*.

27. *Re State Fire Insurance Co.* (1863) 1 De G. J & S 634; 46 E.R. 251.

28. Ford, *supra* n.4 at 4, notes the commercial inconvenience which would arise if successive creditors were ranked according to the creation of each charge.

29. *Parsons v. Spooner* (1846) 5 Hare 102; 67 E.R. 845. The decision of a trustee to contract 'as trustee only' would be reviewable under e.g. s.8 Trusts Act, 1973 (Qld).

on behalf of a named principal may be immunised from personal liability and the rule applicable to trustees.<sup>30</sup>

**(c) The Trustee's Rights to Indemnity**

Because the office of trustee attracts unlimited personal liability unless modified or excluded, parties would not act in that capacity unless equity recognised a countervailing indemnity.<sup>31</sup> Potentially, the indemnity could be recognised against the settlor, the trust assets themselves or the beneficiaries.

**(i) Against the Settlor**

A party who settles property on trust will not attract an obligation to indemnify the trustee even if there has been a request by the settlor for the trustee to accept the office. In the normal case the settlor is assumed to alienate property and retire from the scene. However, there are four circumstances in which a settlor may be obliged to indemnify the trustee: where the settlor requests the trustee to incur a particular liability;<sup>32</sup> where the settlor has clearly bound himself to provide it e.g. in consideration for acceptance of the office;<sup>33</sup> where the settlor retains extensive powers over the trustee;<sup>34</sup> and perhaps where the settlor is also a beneficiary.<sup>35</sup>

**(ii) Against Trust Assets**

In carrying out trust business, the trustee is entitled under the general law to apply trust funds and other assets to discharge trust liabilities.<sup>36</sup> Any property which is an asset of a trading estate carried on by a trustee is property available for this purpose,<sup>37</sup> whether corpus or income.<sup>38</sup> The right arises when the obligation has been incurred, whether or not the trustee has discharged the liability from other sources.<sup>39</sup> There is much authority for the view that the nature of the right is proprietary for it has long been described as an equitable lien<sup>40</sup> or first charge.<sup>41</sup>

The true nature of the so-called 'charge' was explained in *Kemtron Industries Pty Ltd v. Commissioner of Stamp Duties* in the following terms:

... but this is really a conclusion deriving from the fact that in proceedings in court for administration of the trust, the claim of the trustee to be indemnified will be given effect by directing that liabilities properly incurred by him are paid out of the trust

30. Scott *supra* n.20 at [262-263].

31. *Re Beddoe* [1893] 1 Ch. 547 at 558; *Jennings v. Mather* [1902] 1 K.B. 1 at 6-7.

32. *Balsh v. Hyham* (1782) 2 P. Wms 453; 24 E.R. 810; *Jervis v. Wolferstan* (1874) L.R. 18 Eq. 18 at 24.

33. *Fraser or Robinson v. Murdock* (1881) 6 App. Cas. 855 at 873.

34. The retention would have to be so extensive as to make the trustee agent for the settlor and this may itself be incompatible with the necessary exercise of independent discretion which attaches to the office and may bring the trust within the provisions of s.102 of the Income Tax Assessment Act, 1936.

35. *Hobbs v. Wayet* (1887) 36 Ch. D. 256 at 258. Here the indemnity would arise because the settlor is a beneficiary or had made a request, and not simply because of settlement of property (*Jervis v. Wolferstan supra* n.32).

36. *Ex parte Edmonds* (1862) 4 De G. F & J 488 at 498; 45 E.R. 1272 at 1277; *Re Blundell* (1888) 40 Ch. D. 370 at 376-7;

*Jennings v. Mather supra* n.31 at 6;

*Octavo Investments Pty Ltd v. Knight supra* n.12 at 371.

37. *Dowse v. Gorton* [1891] A.C. 190; *Jennings v. Mather* [1901] 1 Q.B. 108, though the trustee's lien cannot at all times attach to all assets: *Kemtron Industries Pty Ltd v. Commissioner of Stamp Duties* [1984] 1 Qd.R. 577 at 587.

38. *Stott v. Milne* (1884) 25 Ch. D. 710 at 715.

39. *In re Blundell supra* n.36; *In re Raybould supra* n.15; *Savage v. Union Bank of Australia Ltd* (1906) 3 C.L.R. 1170 at 1197; *Re Suco Gold Pty Ltd* (1982) 33 S.A.S.R. 99 at 101.

40. *Jennings v. Mather supra* n.31 at 6, 9, n.37 at 117.

41. *Re Exhall Coal Co. Ltd* (1866) 35 Beav. 449 at 453; 55 E.R. 970 at 971; *Stott v. Milne supra* n. 38; *Re Pumfrey* (1882) 22 Ch. D. 255 at 262.

assets in priority to the claims of beneficiaries to their interests in the trust property . . .<sup>42</sup>

It entitles the trustee to retain possession of the asset until discharge,<sup>43</sup> even possession against the beneficiaries until the beneficiaries have indemnified the trustee.<sup>44</sup> The Court said in *Octavo Investments*,

. . . that does not mean that the cestuis que trust are necessarily entitled to call for the delivery of the property. If the trustee has incurred liabilities in the performance of the trust then he is entitled to be indemnified against those liabilities out of the trust property and for that purpose he is entitled to retain possession of the property as against the beneficiaries.<sup>45</sup>

As with other proprietary rights, it is enforceable by judicial sale of the assets,<sup>46</sup> at least provided the trust itself will not be defeated by disposal of such assets.<sup>47</sup> As one would expect of a proprietary right, it is capable of transmission in bankruptcy.<sup>48</sup>

The general law recognition of the right to indemnity out of trust assets is now confirmed by statute e.g. s.72 Trusts Act, 1973 (Qld) provides:

A trustee may reimburse himself for or pay or discharge out of the trust property all expenses reasonably incurred in or about the execution of the trusts or powers.<sup>49</sup>

Some commentators<sup>50</sup> have drawn a clear distinction between the case where the trustee properly incurs a trust liability and discharges it personally and the case where the liability has been properly incurred but has not yet been discharged. The former has been described as a right of 'recoupment' which is regarded as proprietary in nature.<sup>51</sup> In respect of the later right of 'exoneration', Ford states:

. . . where his right is one of exoneration there can be cases where the trustee's power to apply trust property in payment of trust debts is a fiduciary power to be exercised in the interests of the beneficiary. When that is the case it seems inappropriate to describe the trustee's right as a proprietary right.<sup>52</sup>

With respect, it is difficult to find support for the distinction in principle or authority, notwithstanding the distinction being embraced by subsequent commentators.<sup>53</sup>

*Octavo Investments*<sup>54</sup> dealt squarely with the nature of the trustee's right of indemnity out of the assets. The trustee company with paid-up capital of five dollars had extensive powers conferred upon it to permit it to trade, including borrowing rights. It borrowed extensively but the trust business failed and it was wound up. One of the creditors, Octavo, had received payments within 6 months of the winding up in circumstances in which a preference was alleged. The liquidators of the corporate trustee instituted proceedings in the Supreme Court of Queensland seeking to have the payments to Octavo declared void as preferences. If the right of indemnity against the assets was held to be property it would vest in the trustee in bankruptcy pursuant to s.132(1) of the Bankruptcy Act, 1966 (C'th)

42. *Supra* n.37 at 585.

43. *Re Chennell* (1878) 8 Ch. D. 492 at 503; *Re Berry's Trusts* (1893) 7 Q.L.J. 63 at 64; *Octavo supra* n.12 at 369-70.

44. *Stott v. Milne supra* n.38; *The Governors of St. Thomas's Hospital v. Richardson* [1910] 1 K.B. 271 at 276.

45. *Supra* n.12 at 369-70 after referring to *Jennings v. Mather supra* n.37 at 111.

46. *Grissel v. Money* (1869) 38 L.J. Ch. 312.

47. *Darke v. Williamson* (1858) 25 Beav. 622, 53 E.R. 774.

48. *Official Assignee v. O'Neill* (1898) 16 N.Z.L.R. 628; *Jennings v. Mather supra* n.37 at 117; n.31 at 9.

49. S.59(4), N.S.W.; s.36(2), Vict; s.35(2), S.A.; s.71, W.A.; s.27(2), Tas; s.38(2), N.Z. and note *Octavo supra* n.12 at 369.

50. *Scott supra* n.20 at [268]; *Ford supra* n.4.

51. *Ford supra* n.4 at 4.

52. *Ibid.* at 4-5.

53. E.g. D.P. Spence, 'Solvent and Insolvent Trading Trusts', Q.L.S. C.L.E. No. 114 at 9.

54. *Supra* n.12.

and be divisible among creditors. Section 116(2) excludes trust property held by the bankrupt for another from the voidable preference provision and places such property beyond the reach of creditors. In the joint judgment of Stephen, Mason, Aickin and Wilson JJ, it was held that the trustee's right of indemnity was not trust property but it was property in the hands of the trustee. The Court said:

If the trustee has incurred liabilities in the performance of the trust then he is entitled to be indemnified against those liabilities out of the trust property and for that purpose he is entitled to retain possession of the property as against the beneficiaries . . . The trustee's interest in the trust property amounts to a proprietary interest . . . the trustee's interest in that property will pass to the trustee in bankruptcy for the benefit of the creditors of the trust trading operation should the trustee become bankrupt.<sup>55</sup>

Ford asserts that the High Court's treatment of the trustee's right of exoneration as a proprietary right is questionable and that *Octavo* is 'a hard case making bad law'.<sup>56</sup> But from the point of view of long-established principles from the law of trusts, the reasoning and ultimate classification of the trustee's indemnity as proprietary, is unimpeachable under English and Australian law. The juxtaposition of these principles with rules from the law of insolvency does lead to a result which would not normally occur under insolvency law: in effect a preference to a creditor which cannot be avoided as a preference. But the artificial distinction proposed by Ford in tampering with long-established trust principles would not resolve the problem in a satisfactory manner. The solution must lie elsewhere.

In *Re Enhill Pty Ltd*,<sup>57</sup> the straw corporate trustee with paid-up capital of \$2 became insolvent and was wound up and the court was faced with the question of priority of payment of debts to unsecured creditors. In referring to *Octavo* and Ford's criticism of it, Young C.J. stated:

I think that we are bound to treat that case as authority for the proposition that the right of a trustee to be indemnified out of the assets of the trusts, or the proceeds of the exercise of that right, are assets of the trustee in a winding up . . . subject to one consideration I should have said that the trustee's proprietary interest in the trust assets was clearly property of the company under the control of the liquidator . . .<sup>58</sup>

Later it was said:

But the High Court did recognise that the trustee's right to indemnity gave him a proprietary interest which on his bankruptcy passed to his trustee in bankruptcy or where the trustee was a company came under the control of the liquidator. No limitation was expressed upon the purposes for which the trustee in bankruptcy or the liquidator might apply the proceeds of the right. Moreover, the reasoning of the majority of the High Court and the authorities upon which their Honours rely suggest that no limitation was intended.<sup>59</sup>

Lush J. in referring to Ford's assertion that the right is not a right of property, but a power, said:

It is, however, a power which can be and is designed to be, used for the trustee's own

55. *Ibid.* at 369-70 and note the comments of Needham J. in *Re Byrne Australia Pty Ltd* [1981] 1 N.S.W.R. 394 at 398: 'The right of indemnity arises only because the trustee is liable to creditors whose debts arose because of its activities as trustee of the fund. If there is no right of indemnity there is no "proprietary interest".'

56. *Supra* n.4 at 27.

57. [1983] V.R. 561.

58. *Ibid.* at 563.

59. *Ibid.* at 564.

benefit, and is, I respectfully think, properly to be classed as a chose in action, and therefore as property of the trustee.<sup>60</sup>

(iii) **Limits Upon the Right of Indemnity Against Trust Assets**

There is a number of obvious limits to the right to indemnity. If there is no liability there is no indemnity and if the liability is contingent, the trustee may not exercise the indemnity, though a court of equity may confirm the indemnity by declaration if the contingency will necessarily be satisfied.<sup>61</sup>

The principal limitation is that the liability has been properly incurred.<sup>62</sup> Here 'properly incurred' means not improperly incurred.<sup>63</sup> In a more positive vein, the expenses will not be properly incurred if there is authority to carry on the trust business but it is not carried on diligently<sup>64</sup> or if the trustee goes beyond his powers<sup>65</sup> and, in particular, carried on business, or business of that type, without authority.<sup>66</sup>

It has been common for over a century for the trust instrument to provide the appropriate authority to trade<sup>67</sup> though there may be other sources for such authority. Executors of deceased traders have continued to trade and this long-standing practice has been given statutory authority in some jurisdictions.<sup>68</sup> A person judicially appointed derives the authority to trade from the Court appointment within the limits of the order.<sup>69</sup>

Another limit derives from the imposition of restrictions upon the assets which may be used. As the Court held in *Octavo*:

It applies to the whole range of trust assets in the trustee's possession except for those assets, if any, which under the terms of the trust deed the trustee is not authorized to use for the purposes of carrying on the business . . .<sup>70</sup>

Of course a trustee is entitled to depart from directions in the trust instrument if compliance is impossible, but deviation under other circumstances might render the trustee liable under the general law.<sup>71</sup> And in general, a breach of trust would deny a right of indemnity,<sup>72</sup> at least if the breach concerned subject matter of the indemnity.<sup>73</sup> However, a court would commit the 'violent exercise'<sup>74</sup> of denial of the trustee's right of indemnity following breach only in the case of serious breach of trust.<sup>75</sup> The right may be

60. *Ibid.* at 567. Treating the indemnity at its lowest, as a chose in action, still leads inevitably to the conclusion that it is a form of property, but it is more properly classified as greater than a mere chose: D.R. Williams *supra* n.5 at 274.

61. *Hughes-Mallett v. Indian Mammoth Gold Mines Co.* (1882) 22 Ch. D. 561 at 565; *Hobbs v. Wayet* *supra* n.35 at 258.

62. *Stott v. Milne* *supra* n.38; *Re Beddoe* *supra* n.31 at 568; *R.W.G. Management Ltd. v. Corporate Affairs Commission* [1985] V.R. 385 at 394.

63. *Re Beddoe* *ibid.* at 558.

64. *Ecclesiastical Commissioners v. Pinney* [1900] 2 Ch. 736 at 742-3.

65. *Leedham v. Chawner* (1858) 4 K & J 458; 70 E.R. 191.

66. *Vacuum Oil Co. Pty Ltd v. Wiltshire* *supra* n.12 at 325.

67. Compare the trust instrument of the nineteenth century joint stock company exemplified in *Re German Mining Company* (1854) 4 De G M & G 19; 43 E.R. 415, with that used in the modern form of trading trust exemplified in *R.W.G. Management Ltd v. Corporate Affairs Commission* *supra* n.62.

68. See s.57, Qld; s.55, W.A.

69. *Burt, Boulton & Hayward v. Bull* *supra* n.11.

70. *Supra* n.36; *Dowse v. Gorton* *supra* n.37; *Ex parte Garland* *supra* n.17; *McLean v. Burns Philp Trustee Company Pty Ltd* [1985] 2 N.S.W.L.R. 623 at 640.

71. *Harrison v. Randall* (1851) 9 Hare 397; 68 E.R. 562.

72. *Vacuum Oil* *supra* n.12 at 324-5.

73. *Re Staff Benefits Pty Ltd and the Companies Act* [1979] 1 N.S.W.L.R. 207 at 214.

74. *Re Chennell* *supra* n.43 at 502.

75. *Turner v. Hancock* (1882) 20 Ch. D. 303; *Corrigan v. Farrelly* (1896) 7 Q.L.J. 105 per Griffith C.J. at 111-2.

merely suspended whilst the accounts are audited<sup>76</sup> or the minor default rectified.<sup>77</sup>

A court may relieve a trustee who has acted honestly and reasonably, and ought fairly to be excused from personal liability for that breach.<sup>78</sup> Such relief might restore an otherwise doubtful right to indemnity. In addition, the Court has jurisdiction to confer upon a trustee the necessary power,<sup>79</sup> but the Court's 'administrative' authority will be exercised only when it is expedient.<sup>80</sup> The Court may also authorize variations of trust.<sup>81</sup>

Although an indemnity may be unavailable because the conduct was unauthorized, if the unauthorized conduct in fact produces a benefit for the trust, the trustee will retain a right of indemnity to the extent of the benefit, provided he acted in good faith.<sup>82</sup>

In the exercise of the right against trust assets, the trustee is limited in his selection of assets, as the general rule is that the charge cannot be applied differentially to selected assets.<sup>83</sup>

Further, there is authority that in respect of liabilities properly incurred, the trust property to which recourse may be had is confined to so much of the assets as is available after the liabilities have been discharged or at least provided for.<sup>84</sup>

#### (iv) Exclusion of the Right to Indemnity Against Trust Assets

Whether the right in respect of trust assets can be excluded remains doubtful. As is noted later,<sup>85</sup> the right of indemnity against the beneficiaries may be excluded by the trust instrument. However, there may be different considerations applying to exclusion of the right in respect of trust assets. *In Re German Mining Co.*<sup>86</sup> is sometimes taken to establish that the indemnity may be excluded but the words of Turner L.J. in that case do not make it clear that the right to exclude the indemnity extends to the indemnity in respect of the assets. In *Kemtron Industries*, a case was stated under s.24 of the Stamp Act 1894-1982 (Qld) raising the questions whether the transfer of an interest in a trust fund is assessable to stamp duty and in what amount. McPherson J., with whom Andrews S.P.J. (as he then was) agreed, stated:

The right of the trustee to indemnity from the assets is an incident of the office of trustee and is inseparable from it: see *Worrall v. Harford* (supra). For that reason it is probably incapable of being excluded.<sup>87</sup>

The reason was explained extra-judicially in the following terms:

A trustee in that position could not be relied upon to exercise an effective discretion knowing that any liabilities incurred by him as trustee must be paid from his own pocket. Accordingly, and because the right of indemnity from the assets is an

76. *Jennings v. Mather supra* n.31 at 9.

77. *Re Johnson supra* n.12. In *Re R.W.G. Management Ltd supra* n.62, Brooking J. said at 398: the rule that a defaulting trustee cannot claim a share in the estate unless and until he has made good his default is founded on the principle that where there is an aggregate fund in which the trustee is beneficially interested and to which he owes something, he must be taken to have paid himself that amount on account of his share.

78. S.76, Qld; s.75, W.A.; s.85, N.S.W.; s.67, Vic; s.73, N.Z.

79. S.94, Qld; s.89, W.A.; s.81, N.S.W.; s.63, Vic; s.64, N.Z.

80. *Re Craven's Estate* [1937] Ch. 431.

81. S.95, Qld.; s.90, W.A.; s.63A, Vic; s.64A, N.Z.

82. *Re German Mining Co. supra* n.67; *Vyse v. Foster* (1872) L.R. 8 Ch. App. 309; *Re Leslie* (1893) 23 Ch. D. 552; *Jesse v. Lloyd* (1883) 48 L.T. 656; *Daly v. The Union Trustee Co. of Australia Ltd* (1898) 24 V.L.R. 460; *In re Smith's Estate*; *Bilham v. Smith* [1937] Ch. 636; *Re Jones* [1917] Q.S.R. 74.

83. *Octavo Investments supra* n.12 at 367.

84. *Daly v. Union Trustee Company of Australia Ltd supra* n.82 at 469; *Kemtron Industries Pty Ltd v. Commissioner of Stamp Duties supra* n.37.

85. *Infra* part 1(a)(viii).

86. *Supra* n.67.

87. *Kemtron Industries Pty Ltd v. Commissioner of Stamp Duties supra* n.37 at 585.



incident of the office of trustee and inseparable from it, there are sound reasons of policy for saying that it may not be excluded.<sup>88</sup>

In *R.W.G. Management*, Brooking J. pointed to the effect on creditors' rights if the trustee's indemnity were permitted to be excluded:

With so much trade nowadays in the hands of corporate trustees which have a trifling capital, do not own beneficially the assets of the business and are able to incur debts without bringing the real owners under any personal liability to the creditors, it might be thought a wholesome principle that the trustee's right of indemnity which is really all that is left to the creditors, should not be ousted by the deed of trust.<sup>89</sup>

Against that must be weighed the right of a trustee to accept trusteeship with that limitation and on balance, Brooking J. concluded:

If a trustee is willing to accept office where the trust instrument ousts his indemnity, I do not see why he should not be free to do so.<sup>90</sup>

Ford goes further in suggesting that the power to discharge trust debts out of trust property must be exercised in the interests of the beneficiary<sup>91</sup> and he questions whether the trust creditor could be impeded by such an exclusion.<sup>92</sup> As recognised by the learned author, attempted parity of reasoning between a settlement confirming an interest on the settlor determinable on his bankruptcy, which is void against the settlor's trustee in bankruptcy, and denial of the right to exclude the indemnity, would not cover those cases of trust in which the settlor retains no interest, even if the analogy stood.

The matter is further complicated by the statutory recognition of the right to indemnity<sup>93</sup> and the question whether the statutory right may be excluded. In some jurisdictions<sup>94</sup> the statute permits exclusion of the statutory right to indemnity but in Queensland the statutory indemnity cannot be excluded because s.65 provides in relation to the Part in which the statutory right is contained, '... the provisions of this Part shall apply whether or not a contrary intention is expressed in the instrument (if any) creating the trust.' The presence of such a limitation in the legislation of other jurisdictions would go some way towards protecting the right of creditors.

In addition, if the trustee is a corporation, the directors who concur in accepting the corporate trusteeship with the right of indemnity excluded, may expose themselves to personal liability under the Companies legislation considered *infra* at Part 4(e)(iv).

#### (v) The Trustee's Right to Indemnity Against the Beneficiaries

It is another long-established principle of equity that absolute beneficial owners of property must in general bear the burdens incidental to that ownership and not throw such burdens upon their trustees. Whilst some unsuspecting beneficiaries may be unaware of the burdens which go with the benefits, the promoters of schemes involving trading trusts would usually seek to exclude the indemnity against the beneficiaries. In the archetypal case, *Hardoon v. Belilios*,<sup>95</sup> the Privy Council held that the defendant beneficial owner of

88. B.H. McPherson, *supra* n.5 at 150. R.P. Meagher and W.M.C. Gummow, *Jacobs Law of Trusts in Australia*, (1986) at 588 suggest there is no reason why it should not be excluded as there are other areas in which creditors may be prejudiced without the intervention of some protective legal rule.

89. *Supra* n.62 at 395.

90. *Ibid.*

91. *Supra* n.4 at 14.

92. *Ibid.* at 17-18.

93. *Supra* n.49.

94. E.g. Vic, s.2(3); W.A., s.5(3).

95. [1901] A.C. 118.

shares was bound to indemnify the trustee registered holders against calls made on the shares in the winding up. Lord Lindley said:

... where the only cestui que trust is a person sui juris, the right of the trustee to indemnity by him against liabilities incurred by the trustee by his retention of the trust property has never been limited to the trust property; it extends further, and imposes upon the cestui que trust a personal obligation enforceable in equity to indemnify his trustee. This is no new principle, but as old as trusts themselves.<sup>96</sup>

At common law, except in an unusual case, an indemnity would be enforced only to obtain reimbursement of payments already made,<sup>97</sup> but in equity, the personal indemnity is enforceable before the trustee has paid out, if the liability to pay out is imminent.<sup>98</sup> The equity court could order the beneficiary to pay the creditor direct or order that a fund be set aside or that the beneficiary pay the trustee.<sup>99</sup>

(vi) **Limits Upon the Right to Indemnity Against Beneficiaries**

In *Hardoon v. Belilios* the principle was applied to a sole beneficiary who was *sui juris* but there is no reason in principle why it should not apply to multiple beneficiaries where all are *sui juris* and entitled to the same interest or indeed to successive as well as concurrent interest. In *T.W. Broomhead (Vic) v. J.W. Broomhead*<sup>100</sup> McGarvie J. held the personal indemnity applied notwithstanding that there was more than one beneficiary of the unit trust in question, because all were, between them, absolute beneficial owners:

Neither the submissions of counsel nor the cases have revealed to me any consideration of principle, concept, fairness or practicality which would justify its restriction to a case of a sole beneficiary.<sup>101</sup>

Ford has observed that in all cases of multiple beneficiaries reported, there has been a further element, namely, a request from the beneficiaries that the liability be incurred.<sup>102</sup> That was present also in *Broomhead* but there would appear to be no justification for requiring such a request as it unnecessarily introduces quasi-contractual concepts which were soundly rejected in *Hardoon* itself.<sup>103</sup> Statute makes special provision for the case of a beneficiary who requests conduct in breach of trust.<sup>104</sup>

The right to the indemnity is limited to those who are *sui juris*. The Privy Council in *Hardoon*, after referring to tenants for life and infants, said:

... there is no beneficiary who can be justly expected or required personally to indemnify the trustee against the whole of the burdens incident to his legal ownership and the trustee accepts the trust knowing that under such circumstances and in the absence of special contract his right to indemnity cannot extend beyond the trust estate, i.e., beyond the respective interests of his cestuis que trustent.<sup>105</sup>

An unresolved problem remains if there are multiple beneficiaries, some of whom are *sui juris* and some of whom are not. Those who are, have the advantage of their share of the beneficial interest and so, arguably, ought to be subject to the personal indemnity to that

96. *Ibid.* at 124.

97. *Official Assignee v. Jarvis* [1923] 42 N.Z.L.R. 1009 at 1014.

98. *Hobbs v. Wayet supra* n.35;

*Re Richardson* [1911] 2 K.B. 705 at 709-710.

99. *Evans v. Wood* (1867) L.R. 5 Eq. 9.

100. [1985] V.R. 891.

101. *Ibid.* at 936. The beneficiaries could have combined to put an end to the trust under the rule in *Saunders v. Vautier* (1841) 4 Beav 115; 49 E.R. 282.

102. Ford *supra* n.4 at 7.

103. See R. Brett, *supra* n.5 at 259-60.

104. Though limited to the impounding of the interest of the beneficiary: s.77, Qld; s.76, W.A.; s.68, N.S.W.; s.74, N.Z.

105. *Supra* n.95 at 127.

extent, but to expect those who are *sui juris* to be subject to a greater and disproportionate share would be unreasonable. The alternative possibility that none should be liable is untenable.

With the heavy reliance upon special trust powers (commonly known as discretionary trusts), in place of a fixed trust, there is no right to an indemnity against the beneficiaries because no member of the class has an equitable interest<sup>106</sup> and the bona fide exercise of discretion to select is beyond review.<sup>107</sup> A unit trust does of course create beneficial interests.<sup>108</sup>

A beneficiary who is ignorant of the interest or of the trust, who disclaims any benefit immediately it is discovered, will not be liable personally to indemnify the trustee.<sup>109</sup>

The right to the personal indemnity will be limited by the extent to which the trustee is authorised to engage in the liability-creating activities and the extent to which the trustee acts properly in the particular transaction. As was said in *In Re Johnson* by Jessel M.R.:

But if the trustee has wronged the trust estate, that is, if he has taken money out of the assets more than sufficient to pay the debts, and instead of applying them to the payment of the debts has put them into his own pocket, then it appears to me that there is no such equity [to an indemnity], because the cestui que trust are not taking the benefit.<sup>110</sup>

(vii) **The Personal Liability of the Beneficiaries Under the Indemnity**

The interests of the beneficiaries have no bearing upon the trustee's right to an indemnity out of trust assets but the right of indemnity against the beneficiaries personally is dependent upon their interests. In a simple case e.g. as in *Broomhead*, where the beneficial interests were tied to the units, the beneficiaries will be liable under the indemnity in the same proportions.<sup>111</sup>

If one or more is unable to provide the appropriate proportion then the others should not be obliged to contribute to an extent greater than their own proportions. In *Broomhead* one of the individual beneficiaries was insolvent and it was held that the indemnity of the others should not be increased beyond the proportion equivalent to the beneficial interest.<sup>112</sup>

The trustee in bankruptcy or liquidator of the insolvent beneficiary would not be liable to indemnify the trustee<sup>113</sup> but the trustee's interest, being a form of property (the indemnity being a chose in action), would be proveable.

Of course there may be other options available to the trustee against a particular beneficiary other than exercise of the right of indemnity. A trustee might adjust an overpayment out of future payments, though there would be no right to recover these directly.<sup>114</sup>

If a beneficiary unsuccessfully sued a trustee for breach of trust, the trustee's costs are

106. *Gartside v. Inland Revenue Commisisoners* [1968] A.C. 553.

107. *Karger v. Paul* [1984] V.R. 161.

108. *Costa and Duppe Properties Pty Ltd v. Duppe* [1986] V.R. 90 where Brooking J. held at 96, 'A unit-holder has a proprietary interest in each asset of the trust notwithstanding the possible duration of the trust, the extremely wide powers of management given to the trustee and the possibility that the trust might lose the whole or part of its capital through unprofitable trading or speculation.'

109. *Broomhead supra* n.100.

110. *Re Johnson supra* n.12 at 552.

111. *Supra* n.100.

112. *Ibid.* at 940. The position under a partnership can be distinguished because each partner is liable for all partnership debts: *Matthews v. Ruggles-Brise* [1911] 1 Ch. 194.

113. *Trautwein v. Richardson* [1948] Argus L.R. 129 at 135.

114. *Merriman v. Perpetual Trustee Co. Ltd* [1896] 17 L.R. (N.S.W.) 325.

payable by the particular beneficiaries who sued and an indemnity would operate against those particular beneficiaries.<sup>115</sup>

Even in the case of a breach of trust, statutory authority is conferred on the court to order the impounding of a particular beneficiary's interest if the beneficiary instigated, requested or consented to the breach.<sup>116</sup>

One final question concerns the extent to which the beneficiaries are liable under the indemnity to pay interest to a trustee who uses his own funds to discharge a liability properly incurred as part of the trust's trading activities. To allow the trustee to claim interest under the indemnity runs counter to the principle that he should not make a personal profit.<sup>117</sup> Accordingly, the trustee is unable to claim interest.<sup>118</sup> Exceptionally, if the trust instrument, or the court or all beneficiaries (being *sui juris*) authorise interest, it will be permitted. There is one further possibility for the trustee claiming interest. Trust creditors are subrogated to the rights of the trustee but there is also an argument for reverse subrogation. If a creditor has a legal right to interest on a trust debt and the trustee discharges the indebtedness, the trustee may claim to be subrogated to the right of the creditor to interest.<sup>119</sup>

#### (viii) Exclusion of the Indemnity Against Beneficiaries Personally

Although, in an exceptional case, the nature of an arrangement may itself exclude the liability e.g. club members being liable only to the extent of their subscriptions,<sup>120</sup> exclusion will more usually arise from a clause in the trust instrument to that effect. A beneficiary cannot avoid the effect of the indemnity merely by assigning the beneficial interest.<sup>121</sup>

The right to exclude this form of indemnity has long been accepted<sup>122</sup> and there are several recent examples which have gone before the courts. The unit trust in *Kemtron Industries*<sup>123</sup> had liabilities which exceeded assets by \$202,075.00 and the trustee's right of indemnity was relevant to valuation of the units for stamp duty purposes. The exclusion clause in the trust document denied the trustee

... any power or authority to enter into any contract that shall impose any obligation whether at law or in equity on the registered holders personally or call upon them or any payments whatsoever other than the amounts of their respective subscriptions for units.

The court accepted that the right to indemnity against the beneficiaries could be excluded.<sup>124</sup>

In *McLean v. Burns Philp Trustee Company Pty Ltd* the relevant clause 48 provided:

... neither the trustee nor the manager shall have any claim of any nature against any unit holder for any liabilities incurred in connection with any investment or in respect of any action taken by either of them thereunder.<sup>125</sup>

Young J. held:

115. *Nissen v. Grunder* (1912) 14 C.L.R. 297; *National Trustees Executors and Agency Company of Australia Ltd v. Barnes* (1941) 64 C.L.R. 268.

116. *Supra* n.104.

117. *Re Jones; Hocking v. Queensland Trustees Ltd supra* n.82.

118. *Sichel v. O'Shanassy* (1877) 3 V.L.R. (E.) 208.

119. *Re Beulah Park Estate* (1872) L.R. 15 Eq. 43.

120. *Wise v. Perpetual Trustee Co. Ltd* [1903] A.C. 139.

121. *Matthews v. Ruggles-Brise supra* n.112.

122. *Gillian v. Morrison* (1847) 1 De G & Sm 421; 63 E.R. 1131; *Re German Mining Co. supra* n.67 at 427; *Hardoon v. Belilios supra* n.95.

123. *Supra* n.37.

124. *Ibid.* at 594-5; see also *R.W.G. Management supra* n.62.

125. *Supra* n.70.

The effect of a clause such as Clause 48 operates so as to deny the trustee rights against the beneficiary so that there is no right for which the creditor can be subrogated.<sup>126</sup>

It is doubtful whether the indemnity could be excluded if it resulted in some fraud. If a discretionary trust was employed to enable avoidance of creditors by hiding behind the trust vehicle, equity may step in.<sup>127</sup>

Courts may also approach exclusion clauses with caution and interpret them strictly.<sup>128</sup>

One commentator has suggested that 'it may be difficult to find a trustee willing to act, when it is known that the right of indemnity is so limited.'<sup>129</sup> But for those who are in the business of designing the entity for its commercial attractiveness, there will be no difficulty in locating appropriate limited liability companies with paid-up capital of two dollars or five dollars, and that is where the substantial problems derive from.

## 2. Creditors' Derivative Rights Through Subrogation

When creditors deal in trade with an individual or corporation, they will often be unaware of the commercial risks to which they expose themselves if the individual or corporate debtor is a trustee, particularly a limited proprietary company with the illusion of a healthy credit-worthiness given from trust assets but with only \$2 paid-up capital. The rights of the creditors may depend upon detailed knowledge of the internal workings of the trust and since this is not practically possible, creditors dealing with such entities are in need of special protection from the law.

### (a) General Nature of Subrogation

Lord Diplock has described subrogation as

a convenient way of describing a transfer of rights from one person to another, without assignment or assent of the person from whom the rights are transferred and which takes place by operation of law in a whole variety of widely different circumstances. Some rights by subrogation are contractual in their origin as in the case of contracts of insurance. Others . . . are in no way based on contract and appear to defeat classification except as an empirical remedy to prevent a particular kind of unjust enrichment.<sup>130</sup>

The effect is to place one party to a tri-partite relationship in the shoes of another, leaving all else, including the availability of defences, in place.<sup>131</sup> Thus a trust creditor will be subrogated to the rights of the trustee in respect of the trustee's indemnity to trust assets and the personal liability of the beneficiaries.

### (b) The Operation of Subrogation in the Context of a Trading Trust

Jessel M.R. described the operation in *Re Johnson* in the following terms:

I understand the doctrine to be this, that where a trustee is authorised by a testator, or by a settlor . . . to carry on a business with certain funds which he gives to the trustee for that purpose, the creditor who trusts the executor has a right to say, "I had the personal liability of the man I trusted, and I have also a right to be put in his place against the assets; that is, I have a right to the benefit of indemnity or lien which he has against the assets devoted to the purposes of the trade". The first right is his general right by contract, because he trusted the trustee or executor: he has a personal right to sue him and to get judgment and make him a bankrupt. The second right is

126. *Ibid.* at 640-1.

127. *Ibid.* at 641.

128. *Ibid.* and see *Hollier v. Rambler Motors (A.M.C.) Ltd* [1972] 2 Q.B. 71 at 78.

129. C.J.L. Brabazon, *supra* n.5 at 173.

130. *Orakpo v. Manson Investments Ltd* [1978] A.C. 94 at 104.

131. *Sydney Turf Club Ltd v. Crowley* [1971] 1 N.S.W.L.R. 724 especially at 734.

a mere corollary to those numerous cases in Equity in which persons are allowed to follow trust assets. The trust assets having been devoted to carrying on the trade, it would not be right that the cestui que trust should get the benefit of the trade without paying the liabilities.<sup>132</sup>

Allowing that the statement may not now be totally accurate if it limits the doctrine to cases of conferral of benefits in the nature of unjust enrichment,<sup>133</sup> its operation in this area has long been accepted.<sup>134</sup> But the creditors of the trustee have only limited rights with respect to the trust assets.<sup>135</sup> It is true that a judgment creditor against a trustee does not have to execute against the trustee but may go 'direct against the trust assets'.<sup>136</sup> Lord Eldon has said the creditors 'have something very like a lien upon the estate, embarked in the trade'.<sup>137</sup> But these statements must be balanced against the countervailing principle, equally well established, that the trust assets may not be taken in execution.<sup>138</sup> What is required is appropriate proceedings in which the claim may be pressed. To date, such claims which have resulted in payment to the creditor directly out of the trust assets have arisen either where a sole trust liability has been involved and the trustee acquiesced in the order, or where a general administration order has been made in respect of the trust fund.<sup>139</sup>

Prior to the sixteenth century, creditors did seek general administration of trusts but since that time the orders appear to have been restricted to deceased estates. There has been recent reconsideration of this possibility. Young J. has commented:

... questions of standing to sue are essentially policy decisions for the court in each age. In the past, it appears that creditors were permitted to bring proceedings where it was appropriate, and today in a proper case the court would listen to a creditor's application in a case involving inter vivos trust, where there was good reason for bringing this application.

Recent decisions of the High Court have shown that the classes of people whose proceedings should be entertained by a court are wider than formerly thought: see *Australian Conservation Foundation Inv. v. Commonwealth* (1980) 146 CLR 493 at 547 and *Onus v. Alcoa of Australia Ltd* (1981) 149 CLR 27.

As I have said before, the trust is the creature of Equity, rights under a trust exist only because of the orders an Equity Court may make and it is to my mind inconceivable that if a matter of mal-administration or, worse, fraud were brought to the attention of the Equity Court by a plaintiff who was a creditor, the court would not act on that motion. It certainly would not send the plaintiff away with his suit dismissed with costs because of a lack of standing.<sup>140</sup>

Because the creditor's right based upon subrogation is derivative and dependent upon the trustee's own rights, any clog or limitation upon such rights of the trustee themselves will be mirrored in a clog or limitation upon the creditor's rights and the creditor will be in no better position.<sup>141</sup> Accordingly, if the right of the trustee to an indemnity has been

132. *Supra* n.12 at 552.

133. Ford *supra* n.4 at 16.

134. *Ex parte Garland supra* n.17.

135. *Octavo supra* n.12 at 367.

136. *In Re Raybould supra* n.15 at 202.

137. *Supra* n.17.

138. *Octavo supra* n.135; *In re Morgan; Pillgrem v. Pillgrem* (1881) 18 Ch. D. 93; *Savage v. Union Bank of Australia Ltd supra* n.39 at 1186.

139. B.H. McPherson *supra* n.5 at 151.

140. *McLean v. Burns Philp Trustee Co. Pty Ltd supra* n.70 at 637.

141. *Re Johnson supra* n.12 at 552; *Re Firth* [1902] 1 Ch. 342 at 345; *Re London United Breweries Ltd* [1907] 2 Ch. 511.

excluded by the trust instrument, the creditor will have no right, or if the transaction attracting the liability was not authorised or if the trustee has breached by pocketing money, the title of the creditors to be put in the place of the trustee, is a title to get nothing, because nothing is due to the trustee.<sup>142</sup>

The derivative right may depend also upon the state of accounts between trustee and the trust since the trustee's own right to indemnity may be limited to that extent. But a creditor may pay the amount due from the trustee to the trust to clarify the accounts and in that situation takes an assignment of the equity the trustee will obtain upon settlement of the account.<sup>143</sup>

One further question arises: must a creditor wishing to exercise the derivative right first proceed against the trustee personally? In *Re Wilson; Kerr v. Wilson*, O'Bryan J. said:

There appears to be no reason in principle why a creditor must pursue his common law rights to judgment before he will be allowed to be subrogated to the trustees' indemnity against the estate. It is one thing to refuse him an order for administration as a matter of discretion if no more appears than the fact of the debt, but if he has demanded payment from his debtor and has failed to receive payment and the circumstances are such as to lead to the reasonable conclusion that a judgment, if obtained, would be fruitless, it would be a harsh and unnecessary rule that required him first to proceed to judgment.<sup>144</sup>

It will normally be necessary however, to show that if proceedings were launched personally against the trustee first, that such proceedings would in all likelihood prove unsuccessful.<sup>145</sup>

There are two problems which arise from the application of these principles. Firstly, the rights of creditors are determined by factors internal to the trust and beyond the creditors' knowledge. Secondly, the application of the equitable principle of subrogation in this context juxtaposes the normal result in equity with the conflicting principle from insolvency law that all creditors rank *pari passu*. This arises from the possibility of a vigilant creditor exercising his right of subrogation against the trust property before other creditors. Subrogation in this context exists to provide creditors with additional protection but the right may be excluded by the architects of a particular trading trust. To that extent it is deficient but it is unfair to describe it as 'invidious'<sup>146</sup> when it permits a vigilant creditor to gain access to trust assets. It is not the principle of subrogation which is invidious but the result which flows when the rules from equity and insolvency interact. Equity has long permitted preferment to the vigilant as reflected in the maxim *vigilantibus, non dormientibus, jura subveniunt*. In any event, there is already a practical limitation upon the access of any one creditor to trust assets because in practice the access has been allowed only in the course of administration. If standing is accorded to creditors to seek general administration in future, a significant degree of protection will have been provided to other creditors.<sup>147</sup> In addition, if a discretionary trust operating through a corporate trustee is being used to defraud creditors, a provisional liquidator may be appointed to permit payment of the creditors even under existing practice. The trend in the corporate sector has improved the position of creditors and relieved them from exhaustive inquiry of debtors.

142. *Re Staff Benefits Pty Ltd supra* n.73.

143. *In Re Firth supra* n.141.

144. [1942] V.L.R. 177 at 183.

145. *Owen v. Delamere* (1872) L.R. 15 Eq. 134 at 139; *Fairland v. Percy* (1875) L.R. 3 P & D 217 at 221.

146. Lockhart *supra* n.3.

147. *McLean supra* n.140; *Octavo supra* n.12 at 372; *Grime Carter & Co. Pty Ltd v. Whytes Furniture (Dubbo) Pty Ltd* [1983] 1 N.S.W.L.R. 158.

Beyond that, creditors must expect to take appropriate self-protective measures including the making of initial inquiries of the debtor's position and obtaining appropriate personal guarantees and security where necessary.

### 3. The Insolvent Trustee

Upon the insolvency of the trustee, particularly a corporate trustee, difficult questions arise. The trustee is susceptible of removal and the question of continued management of the trust arises. The insolvent trustee's right of indemnity may permit a creditor some priority over beneficiaries and other creditors through the doctrine of subrogation and the law concerning avoidance of preferences may become applicable.

#### (a) Removal From Office and Rights of Management

A trustee who or which is insolvent (whether formally bankrupt or having entered into an arrangement) has demonstrated a lack of business acumen and retention of the office of trustee would expose the trustee to temptation if permitted continued control over the property of others.<sup>148</sup> Accordingly, insolvency has always been a ground for approaching the court for removal of the trustee<sup>149</sup> and upon such application, removal has been virtually automatic unless the case is an exceptional one.<sup>150</sup>

The Trusts Acts now confirm a right of appointing new trustees if the trustee is 'unfit to act therein'.<sup>151</sup> Such right may be exercised by the person nominated by the instrument or the surviving or continuing trustee or the personal representative of the last surviving trustee. Such a conferral of statutory power permits replacement of the insolvent trustee out of court.<sup>152</sup> In addition, the Court has statutory power conferred on it to appoint new trustees if it is expedient to do so, in a range of circumstances, including the trustee's bankruptcy.<sup>153</sup> In addition, the trust instrument may provide for automatic retirement or replacement upon bankruptcy.

There is a distinction which must be drawn between the case of an individual trustee and the case of a corporate trustee. In the case of an individual trustee, the bankrupt trustee retains legal title until replaced and the beneficiaries retain the beneficial interest and the trustee in bankruptcy does not interfere in the administration of the trust. With a corporate trustee, legal title remains in the bankrupt corporation and the beneficiaries retain the beneficial interest but the directors of the insolvent corporate trustee lose their powers of management upon the winding up of the company and the liquidator may be the only convenient inheritor of the trust management.<sup>154</sup> In *Octavo* it was said:

In the case of the winding-up of a company the legal title to all company property, including trust property, remains in the company. The liquidator of the company takes the position of the directors and, in the absence of a court order . . . acquires no title to company property.<sup>155</sup>

148. *In re Barker's Trusts* (1875) 1 Ch. D. 43 at 43-4. See generally on insolvency of trustees: R.P. Meagher, *supra* n.5.

149. *Bainbrigge v. Blair* (1839) 1 Bear 495; 48 E.R. 1032.

150. *In re Adams' Trust* (1879) 12 Ch. D. 634.

151. S.12, Qld; s.7, W.A.; s.6, N.S.W.; s.41, Vic; s.43, N.Z.

152. *Miller v. Cameron* (1936) 54 C.L.R. 572.

153. S.80, Qld; s.77, W.A.; s.70, N.S.W.; s.48, Vic; s.51, N.Z.

154. *Crest Realty Pty Ltd and the Companies Act* [1977] 1 N.S.W.L.R. 664 at 672; see also *Ayerst v. C & K (Construction) Ltd* [1976] A.C. 167 at 180.

155. *Supra* n.12 at 371-2. That is why a change was made by the High Court in that case to order monies to be paid to the company instead of the liquidators because to order monies to be paid to the liquidators confused their position with that of a trustee in bankruptcy.



**(b) Effect of Insolvency on Right to Indemnity**

The proprietary nature of the trustee's right of indemnity against trust assets was noted above.<sup>156</sup> There are then two classes of persons with a beneficial interest in the assets. In *Octavo* they were described as follows:

... first, the cestui que trust, those for whose benefit the business was being carried on and secondly, the trustee in respect of his right to be indemnified out of the trust assets against personal liabilities incurred in the performance of the trust.<sup>157</sup>

The High Court held:

The latter interest will be preferred to the former, so that cestui que trust are not entitled to call for a distribution of trust assets which are subject to a charge in favour of the trustee until the charge has been satisfied.<sup>158</sup>

A trust creditor who relies upon the trustee's indemnity through subrogation will be subrogated to the beneficial interest enjoyed by the trustee.<sup>159</sup>

**(c) The Position of Liquidator, Trust Creditors and Private Creditors**

It is a general principle of insolvency law that creditors rank *pari passu*.<sup>160</sup> It is equally well established that non-trust creditors should not have access to trust funds. These principles are not applied with their normal effect in the complex situation under consideration. But one must keep in mind the clear distinction between the right of indemnity as a form of property and the trust fund itself. In *re Suco Gold Pty Ltd*, Young C.J. said:

It is clear from the *Octavo* case that the trustee company's right of indemnity is a right of property which passes to the liquidator. It is important in the resolution of the problem under consideration to maintain a clear distinction between the beneficial interest of the trustee in the trust fund, which is no more and no less than the right of indemnity and supporting lien, and the trust fund itself which is and remains trust property subject only to the trustee's beneficial interest. The beneficial interest of the trustee company, that is to say the right of indemnity and supporting lien, passes to the liquidator and is property divisible among the creditors; the residual beneficial interest remains property held in trust for another within the meaning of s.116(2) of the Bankruptcy Act and is excluded, by virtue of that section, from the property which vests in the liquidator and is divisible among the creditors. It is necessary therefore to consider what is comprehended by the right of indemnity which vests in the liquidator and is included in the property divisible among the creditors.<sup>161</sup>

If a corporate trustee is insolvent, the liquidator may need to look to trust assets for his own expenses. Whether the liquidator has such recourse remains in considerable doubt following conflicting outcomes before Supreme Courts in New South Wales, Victoria and South Australia and the question involves important considerations of policy, as without such recourse, it would be difficult to persuade a liquidator to act in respect of an insolvent corporate trustee.

156. *Supra* Part 1(c)(ii).

157. *Supra* n.12 at 367.

158. *Ibid.*

159. *Ibid.*, citing *Ex parte Garland*, *supra* n.17 at 789 (E.R.) and *Vacuum Oil Co. Pty Ltd v. Wiltshire*, *supra* n.12.

160. In *Re Alfred Shaw & Co. Ltd* (1987) 8 Q.L.J. 93 Griffith C.J. said at 96: 'the affairs of the company should be administered in such a manner as to provide for the equal treatment to all the creditors.' Under s.108 Bankruptcy Act, all debts proved in the bankruptcy are to rank equally unless otherwise provided. Distribution of assets equally is part of the corporate insolvency scheme also: ss 403, 440, 444 Code, and a liquidator who does not discharge debts *pari passu* may be liable in damages: *James Smith & Sons (Norwood) v. Goodman* [1936] Ch. 216.

161. (1983) 33 S.A.S.R. 99 at 104.

In *Re Byrne Australia Pty Ltd*<sup>162</sup> and *Re Byrne Australia Pty Ltd (No. 2)*,<sup>163</sup> the question whether the expenses of winding-up could be paid from trust assets was raised squarely and the N.S.W. Court held that trust assets could be made available only to meet the claims of trust creditors. In *Re Enhill Pty Ltd*,<sup>164</sup> the Victorian Full Court held that the liquidator could claim the expenses out of the trust assets. The question primarily depends upon what the liquidator has under his control as assets of the company out of which the winding-up costs may be paid. Young C.J. said:

I would with respect agree that the question which arises in this case was not decided by the High Court in the *Octavo* Case, and I would also agree that if there were no right of indemnity there would be no proprietary interest. But the High Court did recognize that the trustee's right to indemnity gave him a proprietary interest which on his bankruptcy passed to his trustee in bankruptcy or where the trustee was a company came under the control of the liquidator. No limitation was expressed upon the purposes for which the trustee in bankruptcy or the liquidator might apply the proceeds of the right. Moreover, the reasoning of the majority of the High Court and the authorities upon which their Honours rely suggest that no limitation was intended: In *Jennings v. Mather*, *supra*, which was one of those authorities, it was held that a trustee's right of indemnity or his lien over the assets of the trust passed to his trustee in bankruptcy.<sup>165</sup>

Lush J. stated:

It is true that the trust fund as such is not property divisible among the trustee's creditors in a liquidation, and it is true that that trustee could not indemnify himself out of the trust fund against liability for private debts, but to say this does not explain the position in a liquidation of the trustee's right to indemnity or lien; nor does it indicate an appreciation of the fact that there can never be exacted from the trust property, by the trustee or by the trust creditors, an amount which is greater than the trust debts.<sup>166</sup>

One approach, rejected in *Byrne*, would be to justify the liquidator's claim by recognising the liquidator as a trust creditor in claiming such expenses. That possibility was reconsidered in *Re Suco Gold Pty Ltd*.<sup>167</sup> That case involved a trustee company with a paid-up capital of two dollars. It incurred considerable debts in carrying on the trust trading activities and was wound up. The court was asked to rule whether trust assets could be employed to cover the costs and expenses of winding-up. King C.J. based his decision on policy grounds to some extent when he said:

It is now necessary to consider the position of the liquidator's costs, expenses and remuneration in the light of the above principles. Although I have not found myself able to agree with certain of the reasoning in *Re Enhill Pty Ltd*, it is, as a decision of the Full Supreme Court of Victoria, a highly persuasive authority for the proposition that the liquidator's costs, expenses and remuneration may be paid out of the trust property. There are clearly strong practical considerations in favour of such a course. Unless that course can be followed, the liquidation of a trustee company without assets of its own cannot proceed. It seems to me that that course can be justified by

162. [1981] 1 N.S.W.L.R. 394.

163. [1981] 2 N.S.W.R. 364.

164. *Supra* n.57.

165. *Ibid.* at 564.

166. *Ibid.* at 571.

167. *Supra* n.161. The decision has been criticised e.g. by Lockhart (*supra* n.3 at 330) who suggests removal and appointment of a new trustee as a preferable course.

reference to the obligations of the trustee company arising out of the carrying on of the business authorized by the trusts. It is part of the duty of the trustee company to incur debts for the purposes of the trust businesses and, of course, to pay those debts. Upon winding up those debts can only be paid in accordance with the provisions of the Companies Act. This requires necessarily that there be a liquidator and that he incur costs and expenses and be paid remuneration. Section 292 provides that there be paid the costs and expenses of winding up, the taxed costs of the petitioner and the remuneration of the liquidator "in priority to other unsecured debts". The expression "other unsecured debts" appears to imply that the costs and expenses of winding up, the petitioner's costs and the liquidator's remuneration are regarded by the statute as debts of the company. As the company's obligation as trustee to pay the debts incurred in carrying out the trust cannot be performed unless the liquidation proceeds, it seems to me to be reasonable to regard the expenses mentioned above as debts of the company incurred in discharging the duties imposed by the trust and as covered by the trustee's right of indemnity. If that reasoning is wrong, I would, like Lush J. in *Re Enhill Pty Ltd*, be prepared to rely on the principle enunciated by Dixon J. in *In re Universal Distributing Co. Ltd (In Liquidation)*.<sup>168</sup>

Jacobs J. was to like effect:

Looking at the whole legislative scheme, therefore, I can find nothing in the language or structure of the legislation to deny the proposition that, in a case such as this, s.292 can operate upon the trust assets to provide for the remuneration of the liquidator in priority to other claims, more particularly as the other provisions of s.292 would seem clearly to be available to regulate the rights of creditors inter se. To hold otherwise would defeat, or at least frustrate, the legislation. The liquidator is appointed by the Court, and is answerable to the Court, and is clearly entitled to remuneration for his services whether fixed by the Court or by the creditors whose proofs have been admitted. He would not be available to act unless the Act so speaks, the Court itself would be in no better position to recover the costs and expenses of the winding up, if the winding up were undertaken by the Court without the intervention of a liquidator. I cannot think that the legislature intended such a result, and I am not persuaded that the language of the Act, or the general law, compels such a result.<sup>169</sup>

Since the trust creditors are subrogated to the rights of the trustee in relation to trust property, in the event of the insolvency of the trustee, the rights may be realized against the trust property in their favour.<sup>170</sup> The fortuitous<sup>171</sup> circumstance of the existence of a trust will mean that a priority is accorded also to trust creditors over personal or private creditors because, in effect, they prove as secured creditors. Of course, failure to prove would result in a deemed surrender<sup>172</sup> and then they would be equal to the other personal or private creditors. But in reality, no advantage will be gained unless the trust assets permit a dividend in excess of that to be paid out of private assets to the personal or private creditors, because the trust creditor does not receive any dividend from private assets *unless and until* the dividend payable to the private creditors is at least equal to that payable to trust creditors out of the trust assets.<sup>173</sup>

168. *Supra* n.161 at 110.

169. *Ibid.* at 113.

170. *Octavo supra* n.12 at 370.

171. Jessel M.R. in *Re Johnson supra* n.12 described it at 552-3 as the 'lucky accident of their being a trust'.

172. S.90(2) Bankruptcy Act, 1966 (C'th).

173. *Re Standard Insurance co.* [1968] Qd.R. 118.

Whilst the trust creditor has an entitlement to prove as a secured creditor within the limits described above (such claim extending to the entirety of the indebtedness), to the extent that the trust property is inadequate to discharge such indebtedness, the trust creditor will then be able to prove as an unsecured creditor for the short-fall.<sup>174</sup>

At the same time, the exercise of the right of indemnity by the successor in title to the trustee ought properly to be for the trust creditor and not the personal or private creditors.<sup>175</sup> In *Suco Gold*, King C.J. stated:

... that the right of indemnity can only produce proceeds for division among the creditors generally if the trustee has discharged the liabilities incurred in the performance of the trust and is therefore entitled to recoup himself out of the trust property. If he has not discharged the liabilities, the right of indemnity entitles him to resort to the trust property only for the purpose of discharging those liabilities. He may apply the trust moneys directly to the payment of the trust creditors or he may take it into his own possession for that purpose. If he takes trust property into his possession to satisfy his right to be indemnified in respect of unpaid trust liabilities, it seems to me that that property retains its character as trust property and may be used only for the purpose of discharging the liabilities incurred in the performance of the trust. The exercise of the right of indemnity is for the benefit of the trustee in that it relieves him of liability for the trust debts. If the trustee is bankrupt, or being a company is in liquidation, the trustee in bankruptcy or liquidator can exercise the right of indemnity which vests in him as part of the property of the bankrupt or insolvent company. If the trust liabilities have been discharged, the trustee in bankruptcy or liquidator is entitled to recoup the bankrupt estate out of the trust property and the proceeds of the right of indemnity become part of the property divisible among the creditors. If the liabilities have not been discharged, the trustee in bankruptcy or liquidator may, by reason of the right of indemnity which vests in him, apply the trust property to the payment of the trust liabilities, thereby exonerating the bankrupt estate to the extent of the value of the available trust assets. In the latter circumstances there cannot be proceeds of the right of indemnity which are available for distribution among the general body of creditors.<sup>176</sup>

It is that conclusion which appears in conflict with the general rule of insolvency law that creditors rank equally. But the insolvency rules would not apply normally to trust assets at all and unless the insolvent trustee had a right to the indemnity the provisions would not apply here either.<sup>177</sup> In these circumstances it is true that 'luck' may circumvent the normal operation of insolvency rules but the syllogistic reasoning in applying the rules is beyond challenge.

But in a practical sense, to the extent that trust liabilities are discharged, there is a corresponding increase in the non-trust fund that will be available to satisfy private creditors of the trustee in any event.

Section 116(2)(a) of the Bankruptcy Act excludes property held by the insolvent trustee on trust from the property divisible among creditors. The trustee in bankruptcy also takes

174. S.90(3), (4) of the Bankruptcy Act applied to the corporate situation by s.438(2) Code.

175. *Re Richardson supra* n.98.

176. *Supra* n.161 at 107-8.

177. *Octavo supra* n.12 at 370. It is that aspect which Ford, (*supra* n.4 at 26) takes exception to in his charge that it confuses a power over property with the property itself, but both are forms of property, as the High Court pointed out, and the exercise of the power argued for by Ford would result in the acquisition of property in any event.

subject to all liabilities and equities.<sup>178</sup> Beneficiaries may prove in the bankruptcy in respect of claims for unliquidated damages arising from the insolvent trustee's breach of trust.<sup>179</sup> If the beneficiary accepts a composition, the right will be extinguished<sup>180</sup> but if he does not, the beneficiary may be able to pursue the claim even after discharge if fraud was involved.<sup>181</sup>

Further problems arise where there are multiple trustees, only one of whom becomes insolvent. It would seem reasonable to permit a claim for full loss against the co-trustee who becomes insolvent and there is authority to support such a conclusion.<sup>182</sup> Similarly, if a partnership is involved and the partnership is insolvent, a proof against each partner should be allowed.<sup>183</sup>

#### (d) Avoidance of Preferences

Section 122 of the Bankruptcy Act renders void as against the trustee in bankruptcy payment out of trust property to a creditor which gives a preference to that creditor over other creditors. A similar position exists in respect of insolvent companies under s.451(1) of the Companies Code.

In *Octavo*, Murphy J. expressed his concern at the prospect of the trust being used to confer a preference:

It would be a curious perversion of the doctrines of trust evolved by Equity Courts if they can be used to implement a scheme in which a straw company is used as a trading trustee, and assets can be transferred preferentially to defeat ordinary creditors. A device to defeat creditors is not improved by using a straw company instead of a straw man. Trusts, including trading trusts, should not be allowed to become instruments to undermine the protection which the law otherwise confers on creditors, as was attempted in this case.<sup>184</sup>

The joint judgment expressed similar views:

We take the view that the passing to the trustee in bankruptcy of the trustee's beneficial interest in the trust estate, even if that is all that passes, is sufficient to attract the operation of s.122 of the Bankruptcy Act. Once it is recognised that a trustee may enjoy a right of indemnity over trust property in respect of liabilities incurred by him in the administration of the trust, it follows that the creditors of a trust business may have resort to the assets of the trust to the extent of the liabilities incurred by the trustee. Section 122 is apt in the case of an individual trading trustee to render void as against the trustee in bankruptcy a payment out of the trust property in circumstances which have the effect of giving the payee a preference, priority or advantage over other creditors.<sup>185</sup>

It would appear that preference monies recovered would not be applied to those claiming a security interest but rather would be available to discharge the debts to the general creditors.<sup>186</sup>

One further problem arises: if the trustee pays a beneficiary in circumstances where trade

<sup>178</sup> *Re Clarke; Ex parte Beardmore* (1894) 2 Q.B. 393 at 410. Beneficiaries may trace trust property, in accordance with the normal rules of tracing, against the trustee in bankruptcy of a defaulting trustee and the private creditors have no rights whatsoever in respect of traced property: *Frith v. Cartland* (1865) 2 Hem & M 417, 34 L.J. Ch. 301.

<sup>179</sup> S.82(2) Bankruptcy Act; *Re James* (1862) 4 De G F & J 499, 45 E.R. 1277.

<sup>180</sup> *Nissen v. Grunder supra* n.115.

<sup>181</sup> S.153(2)(b) Bankruptcy Act.

<sup>182</sup> *Edwards v. Hood-Barrs* [1905] 1 Ch. 20.

<sup>183</sup> *Re Parkers* (1887) 19 Q.B.D. 84; *Re Macfadyen* [1908] 2 K.B. 817.

<sup>184</sup> *Octavo supra* n.12 at 372.

<sup>185</sup> *Ibid.* at 371.

<sup>186</sup> *Sharp v. Jackson* [1899] A.C. 419 at 426.

debts exist, can s.122 apply to such a payment? It would seem that in the normal case the trustee is not both trustee and debtor to his beneficiary and s.122 would apply only where the payment was as debtor to the beneficiary as creditor. This could occur in circumstances where there has been a misappropriation of the trust fund or where the trustee admitted an account.<sup>187</sup>

#### 4. The Position of Directors of Trading Trusts

Where the trustee is a corporation with a two dollar or five dollar paid-up capital, as it will be with a planned scheme, there is a need to go behind the corporate entity to attach responsibility to the directors who direct the company, if creditors are to be fully protected.

##### (a) Fiduciary Obligations

Trustees owe fiduciary obligations to their beneficiaries<sup>188</sup> and directors of a company owe fiduciary duties to the company<sup>189</sup> but the traditional position has been that beneficiaries and creditors are not owed fiduciary obligations by directors of the trustee company. This is one of those problem areas which Finn<sup>190</sup> has commented upon in attempting to adapt the conflict rule for fiduciaries to chain relationships.

The traditional rule was expressed by Cozens-Hardy M.R. as follows:

Directors stand in a fiduciary relation to the company but not to a stranger with whom the company is dealing. It is of course true that the company acts through its directors. But that does not involve the proposition that if a breach of trust is committed by a company, acting through its board, a beneficiary can maintain any action against the directors in respect of the breach of trust. Of course I except the case where trust property can be followed into the hands of a director or of any stranger with notice.<sup>191</sup>

Further,

I base my decision upon the broad principle that directors stand in a fiduciary position only to the company, not to creditors of the company, not even to individual shareholders, still less to strangers dealing with the company... This principle applies equally whether the relation between the company and the stranger is purely one of contract, such as principal and agent, or is one of trustee and cestui que trust.<sup>192</sup>

That view had not been universally accepted.<sup>193</sup> In *Coleman v. Myers*<sup>194</sup> the New Zealand Court of Appeal held that directors owed fiduciary duties to shareholders and were obliged not to make to shareholders statements on matters material to a proposed takeover and to disclose material matters such as asset-backing, which they knew of and had reason to believe the shareholders were inadequately informed about. It has long been held that directors of a company cannot ordinarily exercise a fiduciary power to allot shares for the purpose of defeating the voting power of existing shareholders by creating a new

187. *Bartlett v. Dimond* (1845) 14 M & W 49 at 56; 153 E.R. 385 at 387.

188. *Cowan v. Scargill* [1985] 1 Ch. 270; *Letterstedt v. Broers* (1884) 9 App. Cas. 371.

189. *Mills v. Mills* (1938) 60 C.L.R. 150; *Regal (Hastings) Ltd. v. Gulliver* [1942] 1 All E.R. 378 at 381.

190. P.D. Finn, *Fiduciary Obligations*, (1977) at 202.

191. *Bath v. Standard Land Co. Ltd* [1911] 1 Ch. 618 at 625.

192. *Ibid.* at 627 and see R.P. Meagher & W.M.C. Gummow, *supra* n.88 at 9-10.

193. *Kavanagh v. Workingman's Benefit Building Society* [1896] 1 I.R. 56; and see *Nicholson v. Tutin* (1857) 3 K & J 159; 69 E.R. 1063.

194. [1977] 2 N.Z.L.R. 225. It had of course been recognised that an *ad hoc* fiduciary relationship might be established between director and shareholder through some special arrangement: *Allen v. Hyatt* (1930) T.L.R. 444.

majority.<sup>195</sup> The reason, as recently expressed by the High Court in *Whitehouse v. Carlton Hotel Pty Ltd*,

lies essentially in the distinction between the indirect proprietorship and ultimate control of the shareholders on the one hand and the powers of management entrusted to the directors on the other. It is simply no part of the function of the directors as such to favour one shareholder or group of shareholders by exercising a fiduciary power to allot shares for the purpose of diluting the voting power attaching to the issued shares held by some other shareholder or group of shareholders.<sup>196</sup>

In the case of purchase of trust property by the director of a company, there is authority that a direct fiduciary obligation may be owed by the director to the beneficiaries. In *Re James*,<sup>197</sup> the court held that the duty owed by the fiduciary trustee company to the beneficiaries in relation to such a purchase applied also to the directors. But such a decision may be explained by the extension of the purchasing rule to third parties who participate in the breach e.g. a relation<sup>198</sup> or agent<sup>199</sup> or co-adventurer.<sup>200</sup>

However, statements in *Hurley v. B.G.H. Nominees Pty Ltd* have suggested a potential wider scope for recognising a duty owed to beneficiaries by directors. King C.J held:

The practical answer is that there is no authority which establishes that a director of a trustee company is under a fiduciary duty to the beneficiaries of the trust in respect of property held by the trustee company in its capacity as trustee. It may well be that when the issue arises the courts will hold that such a duty exists, but, for the time at least, it remains to be established.<sup>201</sup>

White J commented:

What of the director's duty to the beneficiaries? The law has not been fully developed in this area. There may well be some justification for the remark of the learned authors that "it will require a marked departure from current thinking and practice by the courts before a direct cause of action arises." Whatever the future developments of the law may be, it is not clear that the beneficiaries under this trust deed have a cause of action.<sup>202</sup>

In the later case of *Hurley v. B.G.H. Nominees Pty Ltd (No. 2)*, Walters J. continued this trend:

I am disposed to think that the position of the beneficiaries of a trading trust company can be no lower than that of creditors of the company. And I do not think it can rightly be said that the fiduciary responsibility of a director is owed simply to the company by virtue of his status as a director and that it does not extend to responsibility to shareholders or, indeed, to beneficiaries of a trust of which the company is trustee.<sup>203</sup>

Whilst recognition of a direct relationship in place of the traditional chain may permit

195. *Fraser v. Whalley* (1864) 2 H & M 10 at 30; 71 E.R. 361 at 369; *Howard Smith Ltd v. Ampol Ltd* [1974] A.C. 821 at 835 and see K.E. Lindgren, 'The Fiduciary Nature of a Company Board's Power to Issue Shares', (1971-2) 10 *W.A.U.L.R.* 364.

196. (1987) 70 A.L.R. 251 at 254 per Mason, Deane and Dawson JJ.

197. [1949] S.A.S.R. 143.

198. *Re Douglas* (1928) 29 S.R. (N.S.W.) 48; *Tanti v. Carlson* (1948) V.L.R. 401.

199. *Boardman v. Phipps* [1967] 2 A.C. 16.

200. *Green and Clara Pty Ltd v. Bestobell Industries Pty Ltd* [1982] W.A.R. 1; *Mansard Developments Pty Ltd v. Tilley Consultants Pty Ltd* [1982] W.A.R. 161.

201. [1982] 31 S.A.S.R. 250 at 254-5; and see M.W. Inglis, 'Personal Liability of Directors of Corporate Trustees of Trading Trusts and Superannuation Funds', (1984) 2 *C & S.L.J.* 48; A.R. Coleman, 'Duties of Directors of Corporate Trustees to Beneficiaries', (1984) 2 *C & S.L.J.* 147.

202. *Ibid.* at 259 and note the approval given to R.W. Betts et al, *Corporate Trustees*, (1979) at 77.

203. (1984) 47 S.A.S.R. 499 at 510.

access by beneficiaries or shareholders directly to the trustees, there are some major problems introduced by the proposal.

Firstly, superimposing duties upon directors to beneficiaries, in addition to those owed to the company, may place the directors in the invidious position of owing conflicting duties to each. Secondly, legislation in the corporate sphere has balanced the duties owed to the company with some protection for the director e.g. s.228 of the Companies Code in deeming a director to be not interested in certain dealings involving the company. Account would need to be taken of such matters in considering the imposition of additional duties under the general law concerning fiduciaries, without corresponding protection. Thirdly, it may be possible to insert an express authorisation for directors to act, notwithstanding conflict, and account would have to be taken of this possibility if recognition of a duty owed to beneficiaries by directors was to be entertained seriously in the future.

**(b) The Salomon Principle and Lifting the Corporate Veil**

*Salomon* blocks looking behind a corporate trustee by lifting the corporate veil except in the standard exceptions of fraud or avoidance of legal obligations.<sup>204</sup> In *Jones v. Lipman*, the limits to lifting the veil were restricted to cases where it is a 'device and a sham, a mask which he holds before his face to avoid recognition by the eye of equity'.<sup>205</sup> As unpredictable as the exception is, all the cases falling within the exception appear to have involved obligations arising first and the corporation then being created to avoid the liability. *Jones v. Lipman* itself involved an attempt to avoid a suit for specific performance by transfer of land to a company. In the trading trust situation, the corporation is created first in order to trade and thereafter attracts liability. Accordingly, there is little scope for lifting the veil in the standard situation now being considered.

**(c) An Extended Derivative Duty of Consideration**

It has been said from time to time that even when directors are obligated to discharge their duties to the company, some consideration must be given to the interests not only of shareholders but of creditors also e.g. in *Walker v. Wimborne*, Mason J. said:

It should be emphasized that the directors of a company in discharging their duties to the company must take into account the interests of its shareholders and creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them.<sup>206</sup>

There may be some scope for extending this principle by redirecting emphasis to advantages gained by directors rather than commencing with the inquiry to whom duties are owed.<sup>207</sup>

**(d) Directors as Constructive Trustees**

The limits of the rules relating to constructive trusts are ill-defined<sup>208</sup> and the traditional view has been that the flexible remedy of the constructive trust is 'not so formless as to place proprietary rights in the discretionary disposition of a court acting according to vague notions of what is fair.'<sup>209</sup>

The nature and function of the constructive trust have been the subject of recent analysis by Deane J. in *Muschinski v. Dodds*.<sup>210</sup> His Honour noted that the tendency to polarise

204. *Salomon v. Salomon* [1897] A.C. 22; *Gilford Motor Co. v. Horne* [1933] Ch. 935.

205. [1962] 1 W.L.R. 832 at 836.

206. (1976) 137 C.L.R. 1 at 7, applied by the N.S.W. Court of Appeal in *Ring v. Sutton* (1980) 5 A.C.L.C. 546 at 547. The failure to take account of creditors and its adverse effect on the company was recognised also in *Permakraft (N.Z.) Ltd. (In Liq.) v. Nicholson* (1982) 1 A.C.L.C. 488.

207. *Russell Kinsela Pty Ltd (in liq) v. Kinsela* (1983) 8 A.C.L.R. 384 at 404-5.

208. *Muschinski v. Dodds* (1986) 60 A.L.J.R. 52 per Gibbs C.J. at 56.

209. *Ibid.* per Brennan J. at 62.

210. *Ibid.* at 64-6.



discussion by reference to competing rallying points of 'remedy' and 'institution' derives from a lack of definition:

In a broad sense, the constructive trust is both an institution and a remedy of the law of equity. As a remedy, it can only properly be understood in the context of the history and the persisting distinctness of the principles of equity that enlighten and control the common law . . . The constructive trust shares, however, some of the institutionalised features of express and implied trusts. It demands the staple ingredients of those trusts . . . when established or imposed, it is a relationship governed by a coherent body of traditional and statute law.<sup>211</sup>

Three areas of traditional equitable principle concerning constructive trusts are relevant in the present context. The first concerns fiduciary obligations considered above,<sup>212</sup> particularly in respect of the self-dealing rule where a corporate trustee's acquisition of trust property is voidable *ex debito justitiae* as part of a wider principle which would extend to directors.<sup>213</sup>

The second arises in circumstances where a stranger to a trust knowingly receives trust property in breach of trust. Where the trustee is a company, the directors may be regarded as the third party strangers who ' . . . are not properly trustees, if they are found either making themselves trustees de son tort, or actually participating in any fraudulent conduct of the trustee to the injury of the cestui que trust.'<sup>214</sup> In such a case the director would be regarded as more than a mere ministerial agent of the company in the sense recognised in *Carl-Zeiss-Stiftung v. Herbert Smith and Co. (No. 2)*.<sup>215</sup>

The third, and more likely, traditional basis for application of the rules concerning constructive trusts involves the lack of probity associated with a person who knowingly assists in a dishonest or fraudulent design.<sup>216</sup> It is through the assistance of the director with knowledge that the company acts and in that sense the director of a company is in a more vulnerable position than either the company in *Selangor United Rubber Estates Ltd v. Craddock (No. 3)*<sup>217</sup> or the bank in *Karak Rubber Co. Ltd v. Burden (No. 2)*.<sup>218</sup> Both of these bases require some fraud and so in the absence of fraud, there is no scope for employing the principles in respect of a director. In any event, the director charged as constructive trustee would be so charged in respect of the company and not beneficiaries or creditors.

The constructive trust is recognised as not having outgrown its formative stages as an equitable remedy and having the potential to be applied when warranted by extensions founded upon a proper appreciation of the conceptual foundation for respected principle rather than 'the indulgence of idiosyncratic notions of fairness and justice'.<sup>219</sup> It is suggested that there is no justification for extension of the principles of constructive trust, beyond those considered above, to accommodate a need in the area under consideration, except perhaps that which may be derived from an unlikely recognition of a direct fiduciary obligation owed by a director not merely to his company, but to a beneficiary of the corporate trustee, but that ought not to extend further to the creditor.

211. *Ibid.* at 64-5 and see generally J.G. Starke Q.C., 'The High Court and the Limits of the Doctrine of Constructive Trusts', (1987) 61 *A.L.J.* 241.

212. *Supra* 4(a) and extending also to bona fide exercise of discretion: *Rowella Pty Ltd v. Hoult* [1987] 1 Qd.R. 386 at 394.

213. See *Thompson v. Thompson* [1986] 1 Ch. 99.

214. *Barnes v. Addy* (1874) L.R. 9 Ch. App. 244 per Lord Selborne L.C. at 251 and see M.J. Brindle and R.J.A. Hooley, 'Does Constructive Knowledge Make a Constructive Trustee?' (1987) 61 *A.L.J.* 281.

215. [1969] 2 Ch. 276.

216. *Belmont Finance Corp Ltd v. Williams Furniture Ltd* [1979] Ch. 250.

217. [1968] 2 All E.R. 1073.

218. [1972] 1 All E.R. 1210.

219. *Supra* n.208 at 65.

**(e) Directors — Statutory Duties and Liability**

Directors expose themselves to liability under a number of provisions of the Securities Industries and Companies Codes and the insertion of s.229A in the later Code increases considerably the potential liability of directors of trustee corporations.

**(i) Duty to Act Honestly**

Section 229(1) of the Companies Code provides that an officer of a corporation shall at all times act honestly in the exercise of his powers and the discharge of the duties of his office. A director is an officer pursuant to the definition contained in s.229(5).

The duty, like the fiduciary duty, is to the company and earlier authority was to the effect that it is not concerned with the conduct of a director in relation to creditors or other persons dealing with or concerned with the company.<sup>220</sup> But of course as is now recognised, the company's continuation in business and its creditworthy reputation will be threatened if a director's acts in relation to creditors is not honest.<sup>221</sup>

Breach entails criminal penalties, whether or not there was fraudulent intent, though the penalty is greater if such intent was present. In addition, the director may be ordered to pay compensation. The corporation (and liquidator if the company is in the course of being wound up) could proceed to recover any loss to the company and any profit made by the director under the general law and s.229 extends recovery to third party profits.

**(ii) Duty to Exercise Reasonable Care and Diligence**

Section 229(2) requires an officer to use reasonable care and diligence and breach attracts criminal sanctions and a civil action may be taken by the company pursuant to s.229(7) to recover any loss to the company and profit made by the director. The common law action for damages is preserved by s.229(10). Courts are, however, traditionally reluctant to intrude too readily into management functions undertaken in good faith.<sup>222</sup> If directors still control the corporation they will be reluctant to authorise action against themselves and if they have not personally profited, minority shareholders cannot bring a derivative action.<sup>223</sup>

**(iii) Improper Use of Information**

Section 229(3) prohibits a former or present officer (including a director) or employee from making improper use of information acquired by virtue of his position. The provision extends to cases where the party gains some advantage or a detriment is caused to the company. The duty is consistent with the obligation imposed upon fiduciaries by equity<sup>224</sup> but is punishable by criminal sanction. If the misuse of information concerns insider trading, it will, in addition, attract the provisions of the Securities Industry Code.<sup>225</sup>

In the context of this article, if a company director is aware of a real risk of the corporation's insolvency and takes steps which do not improve the ability of the company to pay creditors, the director may well have made improper use of information. For example, in *Grove v. Flavel*<sup>226</sup> the South Australian Full Court held the action of a director in such a position, who was also a director of other companies, who reduced the debts owed by the other companies to the potentially insolvent company by circulating cheques within the structure, had made improper use of information.

The statutory liability with respect to information differs from and is additional to the two general equitable bases for protection of information, the first for breach of a general

220. *Marchesi v. Barnes* [1970] V.R. 434 per Gowans J. at 438 speaking of the former s.124.

221. *Walker v. Wimborne* *supra* n.206 per Mason J. at 7.

222. *Harlowe's Nominees Pty Ltd v. Woodside (Lakes Entrance) Oil Co. N.L.* (1968) 121 C.L.R. 483 at 493.

223. Compare *Pavrides v. Jensen* [1956] Ch. 565 and *Daniels v. Daniels* [1978] Ch. 406.

224. *Boardman v. Phipps* *supra* n.199.

225. See ss 128, 130 in particular.

226. (1986) 4 A.C.L.C. 654.

fiduciary obligation through misuse of information, and the second, that arising in equity's exclusive jurisdiction in respect of confidential information, the basis of which lies in the notion of obligation of conscience arising from the circumstances in or through which the information is obtained.<sup>227</sup> One or other of these claims in equity may also be available to the corporation or its liquidator against a director who misuses information.

**(iv) Liability of Directors For Debts Incurred by a Corporation Acting as Trustee**

It has been a fundamental premise of company law that directors are not liable for debts of a company. In *Re Horsley & Weight Ltd*, Buckley L.J. said:

It is a misapprehension to suppose that the directors of a company owe a duty to the company's creditors to keep the contributed capital of the company intact.<sup>228</sup>

It has been noted that a creditor's right through subrogation may be worthless if a trustee's indemnity out of trust assets has been excluded by the trust instrument. The new section 229A added by s.66 of the Companies and Securities Legislation (Miscellaneous Amendments) Act, 1985, will go a considerable way towards bolstering action which may be available to creditors. The section provides that directors will be jointly and severally liable with the company for a debt incurred by a trustee company acting, or purporting to act, in that capacity, where the company *is not entitled to be indemnified out of trust assets*. However, the section will be of no effect if there is an indemnity out of assets but no assets to satisfy the indemnity, since that is a different matter from legal entitlement. It will not apply in jurisdictions such as Queensland where statute prevents exclusion of the indemnity.

It is intended that the imposition of personal liability under the new section will influence directors of intended corporate trustees to refrain from execution of trust deeds which are drafted in such a way as to exclude the right of indemnity with respect to trust assets and thereby deny creditors access through subrogation. The imposition of liability in these circumstances should have the desired effect as it will be difficult to persuade individuals to act as directors of trustee corporations where the architects of a scheme have excluded the indemnity against trust assets.

An 'innocent' director who would be entitled to be indemnified is exonerated under s.229(1) and (3).

In addition, s.566(1) renders a director or person who took part in management, liable both to criminal sanctions and joint and several civil liability with the company for debts incurred, if immediately before the debt was incurred, there were reasonable grounds to expect the company would not be able to pay its debts as and when they became due or there were reasonable grounds to expect that, if the company incurred the debt, it would not be able to pay all its debts as and when they became due.

Unlike s.229A, the imposition of liability under s.556(1) is dependent upon the reasonableness of the expectations of the directors at the time a debt was incurred. The section will not apply to all companies, but only those incorporated or deemed to be incorporated under the Code of the State jurisdiction in question or under corresponding previous law of the State in question. It will not apply, for example, to a company incorporated in another State and merely recognised in the local jurisdiction, even if the directors are resident in the local jurisdiction.<sup>229</sup> However, s.556(1) may still apply to a situation to which s.229A does not, namely, where the right of indemnity out of assets has not been excluded but where there are no or no sufficient assets to indemnify the trustee.

227. *Moorgate Tobacco Co. v. Phillip Morris No. 2* (1985) 59 A.L.J.R. 77 at 85 per Deane J.

228. [1982] Ch. 442 at 453-4.

229. *Re Hanlon Homes Pty Ltd* (In Liquidation) Q.L.R. 13/6/1987.

A beneficiary or creditor may claim to be a person whose interests were affected by conduct constituting an offence under the Code and thereby obtain an injunction to restrain a director from engaging in such conduct.<sup>230</sup>

### 5. Conclusion

A trustee is liable personally to creditors unless such liability has been modified or excluded in the particular transaction. If the trustee is a company with minimal paid-up capital, or if personal liability has been excluded, a trust creditor will have access to such trust assets as exist, though this will jeopardise the security of the beneficiaries.

If the trustee has properly incurred personal liability on behalf of the trust, he will have recourse to the trust assets and the beneficiaries. In the case of the right against the beneficiaries, it is beyond dispute that such right may be excluded and such a right will not arise in the case of a discretionary trust. There are lingering doubts concerning the position where there are multiple beneficiaries, some of whom are not *sui juris*.

The trust creditor is subrogated to the rights of the trustee and in many cases, reliance upon the subrogated right against trust assets may be all that is left to such creditor. For that reason, it is arguable that the indemnity should not be capable of exclusion under the trust instrument on policy grounds. Such limitation on the right of exclusion is justifiable in principle on the ground that the right is inseparable from the office of trustee.

If the trading business conducted by the trustee collapses and the trustee becomes insolvent, trust creditors relying upon their subrogated right against trust assets will have justifiable access to those assets to the exclusion of ordinary creditors and in priority to the *cestui que trust*. On principle it is doubtful whether the liquidator should have access to those assets for his expenses but denial will deter potential liquidators from assuming the office.

Scope remains to extend protection for trust creditors and beneficiaries where a corporate trustee is used, by recognition of additional liability of directors. Under the general law, scope remains for cautionary development of fiduciary duties owed by the director to beneficiaries and a derivative duty to take account of the interests of shareholders and creditors.

The companies legislation now imposes criminal and civil liability upon a director who does not act honestly or with reasonable care and diligence or who improperly uses information. Section 229A acts as a deterrent to directors agreeing to exclusion of a right of indemnity against trust assets, thereby encouraging access by trust creditors to the trust assets through subrogation. Where the indemnity against assets has not been excluded but the assets are inadequate, the directors may be liable under s.556(1).

Both the potential under the general law and the actuality under the companies legislation represent special forms of lifting the corporate veil necessitated by the misuse of the corporation as a corporate trustee. Beyond this, creditors must be cautioned by the advice: 'caveat creditor', and take normal commercial steps to inquire of the representative status of a debtor and acquire personal guarantees or security where appropriate.

The lapsed proposal<sup>231</sup> to impose an additional obligation upon corporations and their directors to advertise their representative status by noting on any relevant documentation<sup>232</sup> that the corporation was acting as trustee of a trust has continuing merit as an additional protective measure for creditors and is worthy of reconsideration.

230. Section 574.

231. A proposed new s.504B was to be introduced by the Companies and Securities Legislation (Miscellaneous Amendments) Bill No. 2, 1984 but was not proceeded with.

232. 'Document' was defined widely under proposed s.504A to include business letters, statements of account, invoices, orders for goods or services, official notices and bills of exchange.