TRUSTEES IN FINANCIAL TRANSACTIONS - PITFALLS RELATIONS BETWEEN BANKER AND TRUSTEE-BORROWER

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Introduction

It is useful to start by directing attention to two propositions which are obvious but which tend to be lost sight of. The first is that the trust relationship which has been established, possibly for revenue purposes, cannot be disregarded. The natural tendency of a taxpayer who has been advised to carry on his trading activities through the medium of a corporate trustee is to regard this as a situation which is only relevant for the purposes of his relations with the Commissioner of Taxation while regarding the assets and the income as in reality his own. This illusion is sometimes shared by others who should know better.

The second truism is that a trustee should be approached as one who at every turn is subject to extensive obligations and whose rights can never be assumed. The concern of the lender is with the ability of the borrower to service and repay the money lent. He is concerned then with the worth of the borrower. An ordinary borrower with substantial assets is obviously a good risk. A trustee with substantial assets is not necessarily a good risk for the transaction in question at all. It must always be remembered that a trustee, especially a corporate trustee which has no other reason for existence than to trade with the trust estate holds assets which, prima facie, are not his in the ordinary way. As the lawyers say he has the bare legal estate. His worth as a borrower, apart from his personal assets, depends largely on the extent to which he is entitled to use the trust assets to discharge his obligations. Unless this is established, the assets of the trust estate are, from the lender's point of view a mirage.

Let us suppose the perhaps fanciful case of the trustee for infant children who borrows purchase of a yacht, a Mercedes, a mink coat or a trip to Europe. The likelihood of the children needing these trifles is slight. At least three questions suggest themselves:

(1) From whom can the lender recover the money advanced?

(2) Can the lender take security over the trust assets for such an advance?

(3) Can the lender in any way resort to the trust assets if the borrower defaults in repayment?

From Whom Can the Lender Recover?

The trustee borrower is personally liable in respect of the debt. The fact that he is known to be a trustee or that he contracts "as trustee" or even "as trustee but not otherwise" is not sufficient to displace his personal liability: Muir v. City of Glasgow Bank (1879) 4 App. Cas. 337: Watling v. Lewis [1911] 1 Ch. 414: Re Robinson's Settlement [1912] 1 Ch. 717: General Credits Ltd. v. Tawilla Pty. Ltd. [1984] 1 Qd. R. 388. In this respect he is in high contrast with an agent who contracts as such: Muir v. City of Glasgow Bank (supra) per Lord Penzance. Moreover, if the borrower is a company and there were no reasonable grounds to expect that it would be able to repay the debt, there is always the possibility of recovery from the directors under s. 556(1) of the Companies Code.

Can the Lender Take Security Over the Trust Assets?

A trustee with power to carry on a business has a power to mortgage for that purpose and the same power exists where he is authorised to apply capital money for any purpose or in any manner. Where the trustee is a company, its power to borrow and to mortgage needs to be established but ss. 67 and 68 of the Companies Code would seem to put this beyond question. On the other hand, the trustee's powers can only be employed for the purposes of the trust. For a trustee to use trust assets as security for a loan which to the knowledge of the lender is to be applied to his own purposes is a breach of trust and a lender with full knowledge of this situation makes himself a trustee de son tort: Barnes v. Addy (1874) 9 Ch. 244 at p. 251. Where the lender is in possession of trust assets constructive knowledge of the default of the borrower is sufficient: Consul Development Pty. Limited v. D.P.C. Estates Pty. Limited (1975) 132 C.L.R. 373. There is no reason in principle why a court of equity would refuse to order the lender to restore the security: Karak Rubber Company v. Burden (2) [1972] 1 W.L.R. 602; Rowlandson v. National Westminster Bank [1978] 1 W.L.R. 798. Any unusual dealing with an account which it is obvious is a trust account will put the bank on notice and the court will, as in Rowlandson's case order the debit to the trust account to be reversed. In the Karak case the bank, which had at least constructive knowledge that the assets of the company were being used to finance the purchase of its shares and which was in possession of assets belonging to the company found itself liable in the sum of 99,504 pounds although its fee for the exercise had been seven guineas. Once a bank is shown to be a constructive trustee there is no reason why the principle applied in these cases would not equally apply to securities taken by the bank,

even to registered mortgages, since the bank is directly liable to the beneficiary in its capacity of trustee.

What if the trustee borrower misrepresents the whole position to the bank? True it is that the bank will probably not be liable as a constructive trustee if there is nothing to put it on notice and it will have a good cause of action against the trustee-borrower for damages for fraudulent misrepresentation. The value of its security will, speaking generally, depend upon whether its security is a legal or an equitable one. If it has a registered mortgage or a legal charge, these may be expected to prevail against the equities set up by the beneficiaries but a lender to a trustee should beware of equitable securities as the equities of the beneficiaries will antedate those of the lender.

Can the Banker in any Way Resort to the Trust Assets?

The answer is that the lender may do so to the extent to which the trustee itself could do so and no further. This is because the creditor has no direct claim on the trust property and cannot execute any judgment it may obtain against the trustee on the trust assets: Jennings v. Mather [1902] 1 K.B. 1; Savage v. Union Bank of Australia Ltd. (1906) 3 C.L.R. 1170; Octavo Investments Pty. Ltd. v. Knight (1979) 144 C.L.R. 360, even though the judgment against the trustee is founded on a debt incurred by him in that capacity.

The trustee, however, has a right to indemnify out of the trust assets for liabilities incurred by him in the proper performance of his duties: Vacuum Oil Co. Pty. Ltd. v. Wiltshire 72 C.L.R. 319 at p. 324 per Lathan C.J. and at p. 335 per Dixon J. Moreover, the creditor will be subrogated to the trustee's right to indemnity: ibid. Thus the key to the banker's position is the customer-trustee having acted in the proper performance of his duties for the banker has no higher right than that of being substituted to the trustee's right of indemnity: Re Evans, Evans v. Evans (1887) 34 Ch. D. 597 at p. 601 per Cotton L.J.

When has the Trustee a Right of Indemnity?

The answer to that we have already seen is, when he has acted in the proper performance of his duties. This entails:

(a) That he has acted within power, for where trustees carry on business without power to do so, trade creditors have no right to resort to the trust assets by way of subrogation: Strickland v. Symonds (1884) 26 Ch. D. 245. This entails, from the lender's point of view, perusal both of the trust instrument and of the memorandum and articles of association. (The latter perhaps less important in the light of s. 68 of the Companies Code);

(b) The loss in respect of which the trustee seeks indemnity must not arise from a breach of trust: Shearman v. Robinson (1880) 15 Ch. D.; Re Staff Funds Benefit [1979] 1

N.S.W.L.R. 207 unless the beneficiaries authorise the act in question: Vacuum Oil; Buchan v. Ayre [1915] 2 Ch. 474;

(c) The trustee's right of indemnity must not have been limited or excluded by the trust instrument: Re German Mining Co. (1854) 4 de Gex McN & G 19. The question has been raised whether a court of equity would give effect to such a limitation which is usually seen to have the object of delaying or defeating creditors and reliance has been placed on the statement of Jessel M.R. in Re Johnson; Shearman v. Robinson (1880) 15 Ch. D. 548 at p. 552 where it is said that the cestui que trust should not get the benefit of the trade without paying the liabilities. In MacLean v. Burns Philp Trustee Company Pty. Ltd. (1985) 9 A.C.L.R. 926 Young J. concluded that a clause excluding the trustee's right of indemnity is effective except where contrary to public policy, as where the clause purports to exclude liability with respect to negligence or breach of trust or where it could be used as a cloak for fraud. In the case before Young J., the purpose of the clause was to limit the liability of investors in a unit trust and as such it was held not to be contrary to public policy.

(d) In circumstances in which the trustee must make good a default before becoming entitled to indemnity, the creditor, being subrogated to the trustee's rights, must do likewise: Re British Power Traction and Lighting Co. Ltd. [1910] 2 Ch. 470. This was the case of a receiver manager who incurred 900 pounds trade debts in carrying on the business. He failed to account for 400 pounds he had received and became bankrupt. His right to indemnity against the assets being limited to 500 pounds, so was the subrogated right of the trade creditors.

What is the Nature of the Trustee's Rights?

The trustee has rights which may broadly be described as rights of indemnity of two sorts, viz. against the trust assets on the one hand and the beneficiaries on the other. Against the trust assets and any assets acquired by the use of the trust property, he has a right of lien which means that he has the right to the possession of the assets so as to ensure that they remain available for the purposes of his indemnity. He also has the right to enforce the indemnity by action. In the event of the bankruptcy or liquidation of the trustee, the same rights accrue to the trustee in bankruptcy and they may be enforced by the liquidator of a trustee-company.

So far as the beneficiaries are concerned, it is clearly established that beneficiaries of full age who have requested the trustee to act in that capacity: Jervis v. Wolferstan (1874) L.R. 18 Eq. 18 or (which seems very much the same situation) where the beneficiary has himself created the trust: Matthews v. Ruggles-Brise [1911] 1 Ch. 194 must indemnify the trustee for losses which he incurs in the proper performance of the trust.

This is the general rule but it is subject to exceptions. There is no doubt about the position of a beneficiary who is both sui juris and the sole beneficial owner. However, it is recognised that beneficiaries in special categories such as tenants for life or beneficiaries under special trusts which exclude the right to indemnity are not personally liable. See e.g. Hardoon v. Belilios [1901] A.C. 118. Beneficiaries under a discretionary trust could scarcely be held liable to indemnify the trustee and the very nature of the transaction involved in membership of a club has been held to exclude this obligation: Wise v. Perpetual Trustee Company [1903] A.C. 139. One would think that on this principle unit trust holders would not be personally liable to the trustee.

Conclusion

It is apparent therefore, that it is essential to the lender having the fullest rights, that the trustee's right to indemnity must be maximised, for the lender can never be in a better position, as against the beneficiaries, than is the trustee. If there be an ideal trustee customer, he is one who has clear power to do what is proposed with the money, clear power to borrow for that purpose and to give security for the loan; and who acts within his authority.

Plainly enough, the trustee is not an ideal customer but so long as he is a fashionable one, lenders will obviously not omit the precaution of taking personal guarantees and will, when security is available, ensure that it is legal rather than equitable. A banker with knowledge that a transaction by a trustee customer may involve a breach of trust cannot safely avert his eyes. If in doubt as to a trustee's powers or as to a possible breach of trust, the banker should take advice. All this will no doubt prove time consuming, tedious and expensive. It is, however, inseparable from the relationship of lender and trustee-borrower. The lender who participates knowingly in a breach of trust by his customer, joins the customer in being a man with no rights and only obligations.