

Some Aspects of Recovery under Contracts with Trustees

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1 Introduction

This paper concentrates on the position of the unsecured creditor of a trustee and suggests that the problems faced by the creditor in seeking payment from the trust estate, highlighted by Professor Ford in 1981¹, remain largely unresolved. It also suggests that recourse to the trust estate to satisfy an obligation under a contract may not be by means of the trustee's right of indemnity where the trustee has limited his liability under the contract.

There are also some brief comments on the position of a trust creditor on a change of trustee and in relation to the insolvency of a trustee. Reference is also made to the rights of a creditor against the directors of a trustee company and the beneficiaries of a trust.

2 Recovery from trust assets by an unsecured creditor

2.1 Personal liability of the trustee

A trust is not a legal entity. A person who wishes to contract for the benefit of a trust estate or to have recourse to a trust estate for satisfaction of obligations, contracts with the trustee of the trust. Subject to the discussion in section 5 concerning attempts by trustees to limit their personal liability, a trustee is personally liable in respect of contracts entered into or debts incurred as trustee.² A trustee is not a distinct legal person, having some representative capacity separate from his personal capacity.³

Conventionally, a trust creditor (by which is meant a creditor of a trustee where the relevant obligation was incurred in the course of executing a trust) is not permitted to proceed directly against trust assets or to take trust assets in execution of a judgment obtained against the trustee.⁴

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¹ Ford, H.A.J. 'Trading Trusts and Creditors Rights', *Melbourne University Law Review* 13 (1) June 1981 1-30.

² *Vacuum Oil Co Pty Ltd v Wiltshire* (1945) 72 CLR 319

³ *JA Pty Ltd v Jonco Holdings Pty Ltd* (2000) 33 ACSR 691

⁴ *In re Evans* (1887) 34 ChD 597; *In re Frith* [1902] 1 Ch 342

A person who has contracted with a trustee is usually obliged to proceed against the trustee personally and, if judgment against the trustee proves fruitless, seek recovery from the trust estate by being subrogated to the trustee's right of indemnity.⁵

Where pursuing common law rights against a trustee is likely to prove worthless, such as where the trustee is insolvent (or possibly where the trustee has sought to exclude his personal liability), a creditor may be permitted to seek an order for administration of the trustee estate and avoid the need to pursue his common law rights against the trustee personally.⁶

However whether proceeding by way of an administration suit or first pursuing common law remedies against a trustee, a trust creditor's access to the assets of the trust estate is dependent upon the trustee's right of indemnity.

2.2 The right of indemnity

The right of indemnity which a trustee possesses is in essence the right to resort to the trust property for the protection and preservation of the trustee's personal estate against liability which he has incurred in the proper performance of the trust.⁷

A trustee's right of indemnity from the trust fund extends to recoupment or reimbursement of expenses and liabilities satisfied by the trustee out of his own money and to the exoneration of the trustee from expenses and liabilities incurred by him as trustee but not yet paid.⁸ The right of indemnity arises at the time when the liability is incurred⁹ and irrespective of whether the trustee disclosed, at the time of contracting, that he was acting in the execution of a trust.¹⁰

In *Octavo Investments Pty Ltd v Knight*¹¹ the High Court considered the nature of a trustee's right of indemnity. The Court made the following observations:

- (a) for the purpose of enforcing his right of indemnity, the trustee possesses a charge or right of lien over trust assets;
- (b) the charge 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 authorised to use for the purposes of carrying on the business in the course of which the liability was incurred;

⁵ *Owen v Delamere* [1872] LR 15 Eq 134; *General Credits Limited v Tawilla Pty Ltd* [1984] 1 QdR 388

⁶ *In re Wilson* [1942] VLR 177.

⁷ *Re Suco Gold Pty Ltd* (1983) 33 SASR 99 at 104

⁸ *Savage v Union Bank of Australia Limited* (1906) 3 CLR 1170; *In re Blundell* (1889) 40 Ch D 370

⁹ *Custom Credit Corporation v Ravi Nominees Pty Ltd* (1992) 8 WAR 42

¹⁰ *JA Pty Ltd v Jonco Holdings Pty Ltd* (2000) 33 ACSR 691.

¹¹ (1979) 144 CLR 360

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- (c) if the right of indemnity arises there are two classes or persons having a beneficial interest in the trust assets, and the trustee's interest will be preferred to that of the beneficiaries.

A trustee cannot be compelled to surrender trust property to the beneficiaries until the claim he has pursuant to the right of indemnity has been satisfied.

Further, a court of equity may authorise the sale of assets held by the trustee so as to satisfy the right of indemnity,¹² but according to Ford and Lee¹³ a trustee will not be able to enforce his right of indemnity by a sale of trust assets where to do so would completely destroy the trusts which the trustee had undertaken to perform. In such a case the trustee would have to wait until the trust property was sold on another occasion.

In *RWG Management Limited v The Commissioner for Corporate Affairs*¹⁴ Brooking J explained that a trustee's right of indemnity derived from three sources:

- (a) decisions of the courts of equity, which indicate that the right of indemnity is incidental to the character of being a trustee and inseparable from it;
- (b) legislation such as s 36(2) of the *Trustee Act 1958 (Vic)* which provides that a trustee may reimburse himself or pay or discharge out of the trust premises all expenses incurred in or about the execution of the trusts or powers. It has been held that such legislative provisions are merely statutory recognition of the rule acted upon by the courts of equity;¹⁵ and
- (c) the instrument creating the trust.

Except in Queensland, it seems an open question whether the trust instrument may by clear language exclude the right of indemnity which would otherwise arise in equity or by virtue of trustee legislation. In *RWG Management Limited v The Commissioner for Corporate Affairs*,¹⁶ Brooking J considered that a trust instrument may be able to exclude a trustee's right of indemnity, however Santow J in *JA Pty Ltd v Jonco Holdings Pty Ltd*¹⁷ considered the better view to be that a trustee may not by agreement exclude his right of indemnity from the trust estate as it arises as a necessary incident of holding the office of trustee, is integral to the institution of a trust and is for the benefit not only of the trustee, but also his creditors.

¹² *Chief Commissioner of Stamp Duties v Buckle* (1998) 192 CLR 226.

¹³ Ford HAJ and Lee WA *Principles of the Law of Trusts*, September 2001, paragraph [14025]

¹⁴ [1985] VR 385

¹⁵ *National Trustee's Executors and Agency Co of Australasia Ltd v Barnes* (1940-41) 64 CLR 268 at 274

¹⁶ [1985] VR 385 at 394, 395

¹⁷ (2000) 33 ACSR 691. See also *Kemtron Industries Pty Ltd v Commissioner of Stamp Duties (Qld)* [1984] 1 Qd R 576 at 585

In Queensland section 65 of the *Trusts Act 1973* provides that certain provisions of the Act, including the statutory right of indemnity, apply whether or not a contrary intention is expressed in the trust instrument. In Victoria, although Brooking J in *RWG Management* considered that the *Trustee Act 1958* (Vic) permitted the statutory right of indemnity to be excluded by the trust instrument, the contrary view is arguable.¹⁸ The exclusion or modification of the statutory right of indemnity in section 59(4) of the *Trustee Act 1925* (NSW) is not expressly contemplated, whereas the Act does contemplate that other sections may be modified or affected by the trust instrument.¹⁹

The directors of a trustee company acting under a trust instrument which has excluded the right of indemnity face potential personal liability in relation to trust debts²⁰.

2.3 Conditions to the exercise of the right of indemnity

There appears to be two conditions to which the courts have subjected the exercise by a trustee of his right of indemnity. The first condition is that the liability is properly incurred. The words "properly incurred" have been said to be equivalent to "not improperly incurred"²¹. A liability will be improperly incurred if incurring it was not within the trustee's power or was unauthorised under the terms of the trust²². A liability will also be improperly incurred if it is incurred by the trustee in breach of his duty (although not in excess of power)²³ or in breach of trust²⁴.

In certain circumstances, and depending upon the terms of the trust instrument and the nature of the trust enterprise, it may be that in order for a liability not to be incurred in breach of duty (and so not be improperly incurred) the incurring of the liability needs to have been reasonable, or perhaps prudent²⁵. However in *Gatsios Holdings Pty Ltd v Nick Kritharas Holdings Pty Ltd (in liq)*²⁶, Meagher JA did not consider that the activity in respect of which indemnity is claimed must be reasonable or proper. Indeed, in that case the New South Wales Court of Appeal held that the trustee was entitled to indemnity in respect of damages awarded against it for breaches of the consumer protection provisions of the *Trade Practices*

¹⁸ Section 2(3) of the *Trustee Act 1958* (Vic) provides that the "powers and discretions conferred and the duties imposed on, and the directions give and indemnities, immunities and protection allowed to" trustees under the Act are in addition to those set out in the trust instrument but the "power discretions duties and directions provided for in this Act" (omitting reference to indemnities, immunities and protections) unless otherwise stated only apply insofar as a contrary expression is not expressed in the trust instrument.

¹⁹ See, for example, sections 14A, 14B, 53, 55, 56 and 59(3) of the *Trustee Act 1925* (NSW).

²⁰ Section 197 of the *Corporations Act 2001* (Cth)

²¹ *In re Beddoe* [1893] 1 Ch 547 at 558

²² *RWG Management Limited v The Commissioner for Corporate Affairs* [1985] VR 385

²³ *RWG Management Limited v The Commissioner for Corporate Affairs* [1985] VR 385; *Gatsios Holdings Pty Ltd v Nick Kritharas Holdings Pty Ltd (in liq)* [2002] NSWCA 29 per Spigelman CJ

²⁴ *Gatsios Holdings Pty Ltd v Nick Kritharas Holdings Pty Ltd (in liq)* [2002] NSWCA 29 per Meagher

JA

²⁵ *Carlton Clock Tower Complex Pty Ltd v Lew* (1990) V Conv R 54-389

²⁶ [2002] NSWCA 29

Act 1974 (Cth), where those breaches had occurred in the course of carrying on the trust business and the conduct involved was not fraudulent or particularly reprehensible.

The second condition to which the exercise of the right of indemnity is subject is that the trustee is only entitled to indemnity to the extent to which the amount properly claimed by him from the trust estate exceeds the amounts for which he is required to account to the trust estate; that is, on the taking of accounts between the trustee and the trust estate, the trustee is entitled to be indemnified to the extent to which there is a balance in his favour. (This will be referred to as a requirement for clear accounts). The rationale for this condition appears to be that where a trustee is in default to the trust estate he is, to the extent of that default, taken to have already paid himself the amounts he requires by way of an indemnity.

The need for a trustee to demonstrate clear accounts is not confined to circumstances in which a trustee seeks to exercise a right of recoupment in respect of liabilities incurred and paid for from the trustee's personal assets. The need to demonstrate clear accounts also applies where a trustee is seeking to exercise a right of exoneration to discharge a liability to a trust creditor²⁷.

In *In re Johnson*²⁸ a creditor was denied recovery through the trustee's right of exoneration due to the trustee's breach of trust which had caused loss to the estate. The trustee's default involved the misappropriation of trust funds. This was characterised by Jessel MR as the trustee taking money out of the trust assets more than sufficient to pay the debts properly incurred, and instead of applying the money to the payment of those debts, putting the money in his own pocket.

The fact that the matters in respect of which the trustee may be required to account to the trust estate (for example in relation to losses caused through imprudent investments or misappropriation of trust moneys) may be unrelated to the liability in respect of which the trustee is seeking indemnity, and may even have occurred after the relevant liability was incurred, does not appear to affect the operation of the clear accounts rule.

*Re Staff Benefits Pty Ltd and the Companies Act*²⁹ is sometimes seen as supporting the view that the right of indemnity is not lost by a default unrelated to the transaction in respect of which the indemnity is claimed. In *Re Staff Benefits* the company acting as trustee had gone into liquidation owing money to both investors (for whom it acted as a trustee) and depositors (who were effectively trust creditors). There was a deficiency of funds and the depositors sought priority over the investors. Needham J stated that a trustee has a prior claim for his liabilities over that of beneficiaries, and the creditors, standing in his shoes, have a like

²⁷ *In re Evans* (1887) 34 ChD 597; *In re Frith* [1902] 1 Ch 342; *Vacuum Oil Co. Pty Ltd v Wiltshire* (1945-46) 72 CLR 319; *In re Geary* [1939] NI 152; *General Credits Limited v Tawilla Pty Ltd* [1984] 1 Qd R 388

²⁸ (1880) 15 ChD 548

priority. The investors endeavoured to upset this priority by alleging breaches of trust due to an improper delegation of powers by the trustee. In addressing this submission Needham J states (at page 214):

"In my opinion it is not every breach of trust which would de-bar the trustee from indemnity - the breach must be shown to be related to the subject matter of the indemnity. In the present case, if the employment of the consultant was a breach of trust, it has not been shown that any damage to the general fund was caused by the breach".

Needham J was also not persuaded that the employment of a consultant amounted to a breach of trust.

Given that it was not shown that the alleged breach had caused any damage to the trust fund, Needham J may have been saying no more than that a breach must cause loss to the trust fund before it may operate to impair a right of indemnity under the clear accounts requirement. If the comments in *Re Staff Benefits* go beyond this to suggest that a trustee's right of indemnity will not be defeated by an unfavourable balance on the taking of accounts between the trustee and the trust, those comments would appear to be against the weight of authority.

By way of exception to the requirement that a liability in respect of which a trustee seeks indemnity must be properly incurred, the courts have recognised that:

- (a) the trustee may be entitled to be indemnified in respect of unauthorised liabilities incurred to preserve trust property;³⁰ and
- (b) a trustee may be entitled to be indemnified in respect of an improperly incurred liability to the extent to which, acting in good faith, he has benefited the trust estate.³¹

In deciding that the beneficiaries of a trust should not be allowed to retain the benefit of an improvement to the trust estate and at the same time deny the trustee his expenses in bringing about the improvement, the courts may have been influenced by notions of unjust enrichment. In *In re Walder*, AH Simpson CJ in Eq comments that "It is but common justice that this trustee should be allowed her expenditure to the extent to which it has improved the property".³²

Even where the trustee can, on these grounds, claim to be indemnified in respect of a liability which was not properly incurred, it would seem that, in principle, the second condition to the

²⁹ [1979] 1 NSWLR 207

³⁰ *Daly v The Union Trustee of Australia Limited* (1898) 24 VLR 460; *Clack v Holland* (1854) 19 Beav 262

³¹ *Vyse v Foster* (1872) LR 8 Ch App 309; *In re Walder* (1903) 3 SR(NSW) 375

³² (1903) 3 SR (NSW) 375 at 376

exercise of the right indemnity, that a favourable balance be demonstrated on the taking of accounts, should still apply³³.

2.4 Position of trust creditor

Because the conventional view is that a trust creditor's means of recourse to the trust assets is by subrogation to the trustee's right of indemnity, it is thought that the creditor can be in no better position than the trustee in seeking payment from the trust assets and that the creditor's prospects of recovery depend upon the state of the trustee's right of indemnity. In *Vacuum Oil Co Pty Ltd v Wiltshire*³⁴, Dixon J states at page 336:

"But the creditors of the trade carried on by the executor must, as in all other cases of subrogation, depend upon his rights, and in that sense their claims upon the assets of the estate are indirect. This is well shown by the example of an executor who, through his wrongful act, has lost his right of indemnity or has disentitled himself to an indemnity except on terms of making good a loss to the estate. In such a case the creditors of his trade can have no better right".

Similarly, in *In re Johnson*³⁵, Sir George Jessel MR states at pages 555-566:

"If the right of the creditors is, as is stated by Lord Justice Turner, the right to put themselves, so to speak, in the place of a trustee, who is entitled to an indemnity, of course, if the trustee is not entitled, except on terms to make good a loss to the trust estate, the creditors cannot have a better right. They do get some additional benefit so as to avoid a supposed injustice; but the injustice to be avoided is the injustice of the cestui que trust walking off with the assets which have been earned by the use of the property of the creditor: but where the cestui que trust does not get that benefit, there is no injustice as between him and the creditors, and there is no reason for the Court interfering at the instance of the creditors to give them a larger right than that they bargained for, namely, their personal right against the trustee".³⁶

The fact that the creditor's position in relation to recourse to trust assets can be no better than the position of the trustee means that the creditor is affected by the two conditions to which the exercise of the trustee's right of indemnity is subject. In particular, the creditor is affected by the requirement that there be a favourable balance on the taking of accounts between the

³³ A contrary view may be derived from *Devaynes v Robinson* (1857) 24 Beav 86 where a creditor was allowed recovery from the trust estate notwithstanding that the borrowing from the creditor was unauthorised and that there was a real prospect that the account of the borrowing trustee was in substantial deficit to the trust estate. The creditor was allowed recovery for money properly applied in administration of the estate.

³⁴ (1945) 72 CLR 319

³⁵ (1880) 15 ChD 548

trustee and the trust estate, with the consequence that unrelated breaches of trust by the trustee which cause loss to the trust estate could deny the creditor recourse to the trust estate by way of subrogation to the trustee's right of exoneration.

In an article entitled '*Trading Trusts and Creditors Rights*³⁷, Professor Ford has pointed out that under this conventional analysis of trust law the scope for frustrating creditors is considerable and he contrasts the lack of protection afforded trust creditors with the protection offered to those who contract with companies.

For example, under company law the doctrine of ultra vires has, in effect, been abolished and a creditor is largely protected from irregularities in the internal affairs of the company; reliance may be placed on the indoor management rule³⁸ and provisions such as those contained in Part 2B.2 of the *Corporations Act*. On the other hand, a creditor of a trustee may be denied recovery out of the trust assets if, when incurring the debt, the trustee was acting without power, or in breach of trust or, previously or subsequently, has caused unrelated loss to the trust estate.

From an economic stand point, it is arguable that the beneficiaries should bear the burdens which are incidental to the administration of a trust and that a creditor who has furnished goods or services properly contracted for by a trustee should be compensated out of the trust estate, at least in those cases where the remedies available against the trustee personally are not effective to compel him to satisfy his liability out of his personal assets. Dean Stone³⁹ suggests that the ability of the beneficiaries to enjoy the economic benefit of goods or services provided to the trust estate by a trust creditor without the necessity of paying for the benefit from trust property (due to unrelated breaches of trust by the trustee) is the one authentic instance in the law where one may pay his debts with his losses.

Professor Ford has argued that the clear accounts rule should not apply where a trustee seeks exoneration by applying assets from the trust fund to discharge a liability.

Notwithstanding the judgment of the High Court in *Octavo Investments Pty Lt v Knight*⁴⁰, Ford is of the view that the trustee's right of exoneration does not give rise to a beneficial interest in the trust fund but is rather a power to apply the trust property in discharging liabilities; at least in cases where the beneficiaries have an interest in seeing that the trust creditor is paid, the power is a fiduciary power to be exercised for the benefit of beneficiaries.⁴¹

³⁶ In connection with the creditor's right to seek recovery from the trust assets being no better than the trustee's right to seek recovery, see also *Re Kidd* (1894) 70 LT 648; *In re Geary* [1939] N1 152 and *General Credits Limited v Tawilla Pty Ltd* [1984] 1 Qd R 388.

³⁷ Ford, H.A.J., above, n 1.

³⁸ *Royal British Bank v Turquand* (1855) 5 E & B 248

³⁹ Stone, H.F. (later Stone CJ of the United States Supreme Court) 'A Theory of Liability of Trust Assets for the Contracts and Torts of the Trustee' *Col. Law Review* (1922) 527

⁴⁰ (1979) 144 CLR 360

⁴¹ Ford, H.A.J., above n 36.

Stone also argues that a trustee who has incurred, but not paid, a liability does not have a right of indemnity but rather a power to apply trust assets in discharging properly incurred indebtedness. This power is said to exist, at least in part, for the benefit of the trust creditor and is independent of the state of accounts of the trustee.⁴²

Although these arguments have some force, they do not represent the state of the law in Australia where a trustee has incurred a debt in the course of executing a trust and has not excluded or limited his personal liability. The position where a trustee has limited his personal liability is less clear and is discussed in section 5.

A properly drawn trust instrument can excuse a trustee from liability to beneficiaries for gross negligence or for behaviour which falls short of dishonesty or, perhaps, actual fraud.⁴³ A trust instrument could also seek to expand the trustee's right of indemnity to include liabilities which, although not properly incurred, were not incurred dishonestly.⁴⁴ It may also be possible for the trust instrument to provide that the right of indemnity in respect of a properly incurred liability was available even though the trustee owed money to the trust estate in respect of unrelated matters.

2.5 Taking security

If a lender or other person contracting with a trustee is granted security over trust assets and the grant of security was authorised and the liability the subject of the security properly incurred, the holder of the security will not need to be concerned about the clear accounts rule in seeking recourse to the trust assets. In these circumstances access to, and repayment from, trust assets is by virtue of the security held and not by means of subrogation to a possibly flawed right of indemnity. A secured creditor's right of access to trust assets is direct and not derivative.

If equitable security is granted in a manner not authorised by the terms of the trust, the interest of the security holder is likely to be inferior to the prior equitable interest of the beneficiaries. However, if a creditor taking legal security can show he is a bona fide purchaser of the legal title in good faith and without notice of any breach of trust, equity will not set the security aside even if it is subsequently shown that the grant of the security by the trustee was unauthorised.

A person taking security over land under the Torrens system may also be able to protect himself from the risk that the grant of security was unauthorised by reason of the indefeasibility provisions of the Torrens system legislation.

⁴² Stone, H.F, above n 38. See also John D. Johnston JR 'Developments in Contract Liability of Trusts and Trustees' (1966) 41 *New York University Law Review* 483.

⁴³ *Armitage v Nurse* [1997] 2 All ER 705; *Reader v Fried* [2001] VSC 495

⁴⁴ *Fitzgerald Pty Ltd v Unique Goal Pty Ltd (in liq)* [2001] FCA 1628

It is beyond the scope of this paper to discuss whether restitutionary remedies may be available to a trust creditor who has provided a benefit to the trust estate at the request of a trustee acting within his authority, and who has been denied recovery from the trust estate by subrogation to the trustee's right of indemnity because of unrelated breaches of trust by the trustee. The basis upon which the creditor contracted with the trustee is likely to be relevant to any notion of restitution for unjust enrichment, as it may be said that the creditor contracted for a certain set of rights against the trustee, knowing the inherent risks associated with the trustee's position, and cannot seek to change the basis upon which it claims against the trust estate when those risks eventuate.

3 Change of trustee

Where one trustee replaces another the assets of the trust are generally transferred from the outgoing trustee to the incoming trustee, whether by virtue of arrangements entered into between them or a vesting order of the court. However, trust liabilities incurred by the outgoing trustee generally remain his liabilities and are not transferred or novated to the incoming trustee. For example, a trustee who borrowed money and applied the proceeds of the borrowing in improving the trust estate would remain liable to repay the borrowed money when he ceased to be trustee even though the improved trust estate may have passed to the incoming trustee. Of course, some liabilities may attach to whoever holds certain types of property (for example, land or partly paid shares), and the incoming trustee will become subject to such liability when he becomes the holder of the relevant property.

The outgoing trustee's right of indemnity and supporting lien or charge remain in effect notwithstanding loss of office or the fact that possession of the trust assets or legal title in the trust assets has passed to the incoming trustee⁴⁵. The new trustee takes subject to the interests of the former trustee and the right of indemnity and supporting lien or charge of the new trustee would rank behind that of the outgoing trustee, (except, perhaps, in the unlikely event that the incoming trustee could be characterised as a bona fide purchaser of the trust assets for value without notice).

The interest of the outgoing trustee in the trust assets pursuant to his right of indemnity and charge or lien is an interest in the assets of the trust for the time being and does not relate only to those assets in existence at the time he ceased to be trustee. Nor is any claim pursuant to the right of indemnity limited to the amount of indebtedness existing at the time the outgoing trustee ceased to be trustee; interest which accumulates on debt after the outgoing trustee loses office may still be claimed under the right of indemnity.⁴⁶

⁴⁵ *Collie v Merlaw Nominees Pty Ltd (in liq)* [2001] VSC 60; *Xebec Pty Ltd (in liq) v Emthe Pty Ltd* (1987) 87 ATC 4570; *Rothmore Farms Pty Ltd (in provisional liquidation) v Belgravia Pty Ltd* (1999) 31 ACSR 88.

⁴⁶ *Rothmore Farms Pty Ltd (in provision liquidation) v Belgravia Pty Ltd* (1999) 31 ACSR 88.

Chapter 5C of the Corporations Act has introduced some changes to these general principles in so far as they apply to a change in the responsible entity of a registered managed investment scheme. Section 601FS(1) of the Corporations Act provides that if the responsible entity of a scheme changes, the rights, obligations and liabilities of the former responsible entity in relation to the scheme become rights, obligations and liabilities of the new responsible entity. The section does not expressly provide that the new responsible entity acquires the rights, obligations and liabilities in substitution for the former responsible entity, but it would seem (especially in light of the wording of section 601FS(2)) that that is the intended effect and that the section operates as a statutory transfer of trust

There are some exceptions in section 601FS(2) to the transfer of rights, obligations and liabilities provided for by section 601FS(1) including: related rights and liabilities.

- (a) any right of the former responsible entity to be indemnified for expenses it incurred before it ceased to be a responsible entity. (This may be intended to cater for a right of reimbursement where an expense has already been paid by the former responsible entity and so has not become a liability of the new responsible entity and for those situations where the transfer of liability effected by section 601FS(1) does not bind the creditor of the former responsible entity);
- (b) any liability for which the former responsible entity could not have been indemnified out of the scheme property if it had remained the scheme's responsible entity. (This exception to the transfer of liabilities would catch those liabilities for which the right of indemnity was not available because the conditions to its availability (a properly incurred liability and clear accounts) were not satisfied. It might also be read as applying where the former responsible entity could not be indemnified because the scheme property was not sufficient to meet the claim under the right of indemnity. In this context it is interesting to note that the exception uses the phrase "could not have been indemnified" rather than "not entitled to be indemnified". One also wonders how a contract in which the trustee has required the creditor to look only to the trust estate for payment is affected by these provisions. As argued in section 5, in those circumstances there may not be a liability for which the former responsible entity could have been indemnified, however there may be an obligation to apply trust assets to satisfy the claim of the creditor and such an obligation may be transferred to the new responsible entity.)⁴⁷

⁴⁷ The Australian Securities and Investments Commission indicated in IR 00/23 (and attached draft class order) that it was considering modifying section 601FS so as to prevent in some circumstances the automatic transfer to a new responsible entity of an agreement between the former responsible entity and its agent (see *ASIC Issue Paper: Managed Investments: Change of responsible entity - effect on contracts*. Dated 2/6/99). It appears such a modification of the law has not yet been made.

There is also a very wide provision in section 601FT(1) which provides that on the change of a responsible entity of a registered scheme, a document:

- (a) to which the former responsible entity is a party, in which reference is made to the former responsible entity, or under which the former responsible entity has acquired or incurred a right, obligation or liability, or might have incurred a right, obligation or liability if it had remained the responsible entity; and
- (b) that is capable of having effect after the change;

has effect as if the new responsible entity (and not the former responsible entity) were a party to it, were referred to in it or had or might have acquired or incurred the right, obligation or liability under it.

The section is said not to apply to a right, obligation or liability that remains with the former responsible entity by virtue of section 601FS(2).

One interesting effect of these provisions is that a creditor who, when contracting with the former responsible entity, chose to rely not simply on payment from the scheme property but also on the personal liability and personal assets of the former responsible entity is likely to find that on the change of responsible entity he has a contract with a new responsible entity whose personal assets may be very different from those of the former responsible entity and that consequently the risk he has assumed under the contract has changed significantly.

Similarly, an incoming responsible entity may find that he has transferred to him liability under contracts in which the personal liability of the responsible entity has not been limited and that consequently his personal assets are at risk in respect of arrangements entered into by the former responsible entity.

4 Insolvency

Because a person who incurs a debt in the course of discharging his duty as a trustee is (with some possible exceptions) personally liable (even if only in a limited way) for the debt, the creditors of the trustee on bankruptcy or liquidation will include creditors whose claims arise out of contracts entered into for trust purposes.

On a bankruptcy or liquidation trust assets are not generally available to discharge the debts of a trustee, except to the extent that access to them can be obtained through the trustee's right of indemnity. There is some uncertainty as to whether legal title to trust assets vests in the trustee in bankruptcy where the bankrupt trustee has a charge or lien over the trust assets; the High Court found it unnecessary to decide this question in *Octavo Investments Pty*

Ltd v Knight.⁴⁸ Whether or not legal title to trust assets vests in the trustee in bankruptcy, it remains the case that recourse to trust assets to pay debts of the bankrupt trustee may only generally be had through the right of indemnity.

The right of indemnity of an insolvent trustee (and the related charge or lien) is personal property of the trustee and, in the case of an individual, does pass to his trustee in bankruptcy⁴⁹ and, in the case of a company, is part of the property of the company which may be administered by the liquidator⁵⁰.

Where a trustee in bankruptcy or liquidator recovers money from the trust estate pursuant to the insolvent trustee's right of recoupment (which will arise where the insolvent trustee has previously discharged the trust liability from his own money and seeks reimbursement), the amount recovered may be applied in meeting the claims of all creditors of the insolvent trustee, including non-trust creditors. However, the better view is that money recovered from the trust estate pursuant to the insolvent trustee's right of exoneration (which will arise where the insolvent trustee has incurred a liability in execution of the trust and not discharged it) may only be applied in meeting the claims of trust creditors.⁵¹

A contrary view was taken by the Full Court of the Supreme Court of Victoria in *Re Enhill Pty Ltd*⁵² where it was considered that because a trustee company's right of indemnity forms part of the assets of the company in its winding up and is property under the control of the liquidator, trust assets recovered pursuant to the right of indemnity (including the right of exoneration) were divisible among the company's creditors generally and not merely among the trust creditors. Allowing trust property recovered through a right of exoneration to be applied in payment of non-trust creditors would seem to amount to allowing the trustee to apply trust property for his own benefit or for the benefit of third parties and not for the benefit of the trust estate. Beneficiaries are not necessarily indifferent to whether debts incurred by a trustee are discharged; for example, further performance of a contract beneficial to the trust estate may be dependent upon obligations of the trustee under the contract being met. Where an insolvent company is trustee of multiple trusts, the principles espoused in *Re Enhill Pty Ltd* could result in the property of one trust being used (at least partially) to discharge the debts of another trust. If *Re Enhill Pty Ltd* were to be considered as stating the correct legal position, it would raise a question as to whether it was prudent for a company acting as trustee to act as trustee for more than one trust or to carry on any business on its own account.

⁴⁸ (1979) 144 CLR 360 at 370 and 371.

⁴⁹ *Savage v Union Bank of Australia Limited* (1906) 3 CLR 1170

⁵⁰ *JA Pty Ltd v Jonco Holdings Pty Ltd* (2000) 33 ACSR 691; *Coates v McLnerney* (1992) 7 WAR 537.

⁵¹ *Re Byrne Australia Pty Ltd and the Companies Act (No 2)* [1981] 2 NSWLR 364; *Re Suco Gold Pty Ltd (in liq)* (1983) 33 SASR 99; *Re Matheson: Ex parte Worrell v Matheson* (1994) 49 FCR 454.

⁵² [1983] VR 561

Any right of indemnity which an insolvent trustee may have against beneficiaries of the trust would also vest in and be exercisable by the trustee in bankruptcy or form part of the property of the company which may be administered by the liquidator.

When an individual or corporation acting as trustee becomes bankrupt or goes into liquidation, it will often cease to act as trustee and a new trustee will be appointed - whether by virtue or provisions in the trust instrument or an application to the court. The fact that the insolvent company has been replaced as trustee does not deprive it of its right of indemnity and it may seek recourse to the assets of the trust through the new trustee in order to be indemnified.⁵³

On the bankruptcy or liquidation of a trustee, unsecured trust creditors will generally have equal priority in respect of moneys received from the trust estate through the insolvent trustee's right of exoneration.⁵⁴ It seems that it is possible for a trust creditor to take security over the trustee's right of indemnity so to as give the creditor priority over other trust creditors.⁵⁵ Moneys derived through the charged right of exoneration could only be applied against the actual liability owed to the creditor holding the charge, otherwise trust property would be used for an improper purpose. A trustee could also presumably charge its right of recoupment, on the basis that moneys recovered through the right of recoupment are for the benefit of the trustee personally.

Legislative provisions relating to preferences have application on the bankruptcy or winding up of a trustee where the trust estate is not sufficient to meet all claims upon it.

5 Limiting the liability of a trustee and its consequences for recovery from trust assets

5.1 Limiting the liability of a trustee

As has been noted earlier, a trustee is generally fully personally liable for a debt incurred in the course of acting as trustee. A trust creditor who obtains judgment against the trustee will generally be able to execute the judgment against the trustee's personal assets.

However, the courts have for a long time recognised that a trustee may limit the extent of his personal liability when contracting. (The ability to limit liability in this way is, of course, not generally available in relation to other forms of liability such as tortious liability or statutory liability).

In *Muir v City of Glasgow Bank* Earl Cairns, LC stated:⁵⁶

⁵³ *Coates v McInerney* (1992) 7 WAR 537; *Gatsios Holdings Pty Ltd v Nick Kritharas Holdings Pty Ltd (in liq)* [2002] NSWCA 29.

⁵⁴ For a discussion of priorities on the winding up or bankruptcy of a trustee see Mr Justice McPherson "The Insolvent Trading Trust" in *Essays in Equity* edited by P.D. Finn (1985) p.142 at pages 154-158.

⁵⁵ *Custom Credit Corporation Limited v Ravi Nominees Pty Ltd* (1992) 8 WAR 42.

⁵⁶ (1879) 4 App Cas 337 at page 355.

“My Lords whether, in any particular case, the contract of an executor or trustee is one which binds himself personally, or is to be satisfied only out of the estate of which he is representative, is, as it seems to me, a question of construction to be decided with reference to all the circumstances of the case; the nature of the contract; the subject-matter on which it is to operate, and the capacity and duty of the parties to make the contract in one form or in the other. I know of no reason why an executor, either under English or Scotch law, entering into a contract for payment of money with a person who is free to make the contract in any form he pleases, should not stipulate by apt words that he will make the payment, not personally, but out of the assets of the testator.”

Although not always expressed particularly clearly, a trustee who seeks to limit his personal liability to a trust creditor is normally seeking to limit his liability to the extent to which he can resort to trust assets to pay the trust creditor. Absent some limiting provision in the trust instrument, a trustee would normally have power to make this type of bargain in relation to a properly incurred trust liability. The other party to the contract will also normally have power to agree that his rights against the trustee will be limited to the extent to which the trustee can resort to the trust assets and that the creditor's rights will not extend to the personal assets of the trustee.⁵⁷

Clear words are needed to indicate that the liability of a trustee is to be limited. Simply providing that a trustee is contracting “as trustee” is unlikely to be sufficient.⁵⁸ Describing the contracting party as “the John Knight Family Trust” and describing the contracting party in the execution clause as “the John Knight Family Trust J Knight Trustee” was also found not sufficient to limit the liability of the trustee.⁵⁹ The fact that a provision in the trust instrument provided that the trustee was not required to accept any personal liability for borrowing was not sufficient to limit a trustee's liability in relation to a loan.⁶⁰ On the other hand, the words “as trustee only”⁶¹ and “as such trustee, but not otherwise”⁶² have been held sufficient to limit the liability of a trustee to a creditor. However, it would generally be prudent to adopt clearer words than these if the intention is to limit the liability of a trustee.

Strictly speaking, care should be taken not to exclude all personal liability on the part of the trustee. If all personal liability is excluded it may mean that there is no liability under the contract (given that a trustee is not recognised as having some additional legal personality) with the consequence that the attempt to exclude liability may be seen as repugnant to the

⁵⁷ However, in *Muir v City of Glasgow Bank* it was held that the directors of the bank did not have power to limit the trustee's liability as a member of the bank.

⁵⁸ *Muir v City of Glasgow Bank* (1879) 4 App Cas. 337; *Lumsden v Buchanan* (1865) 4 Macq 950; *General Credits Limited v Tawilla Pty Ltd* [1984] 1 QdR 388.

⁵⁹ *Helvetic Investment v Knight* (1984) 9 ACLR 773.

⁶⁰ *Elders Trustee & Executor Co Ltd v EG Reeves Pty Ltd* (1987) 78 ALR 1.

⁶¹ *Gordon v Campbell* (1842) 1 Bell's App 428

⁶² *In re Robinson's Settlement* [1912] 1 Ch 717.

promises in the contract and have no effect.⁶³ Alternatively it might be found that there is no contract because of an absence of consideration on the part of the trustee. Nonetheless, it is reasonably common to come across contractual provisions which state that the personal liability of the trustee is excluded and such language can also be found in some judgments. One suspects that a court, faced with language purporting to exclude personal liability, would be inclined to construe it as limiting personal liability and excluding recourse to the personal assets of the trustee.

If a trust creditor agrees to a limitation of the personal liability of a trustee, he needs to consider whether there should be any circumstances where the limitation will cease to apply and where he may look to the trustee's personal assets. A trust creditor who agrees to look only to the trust assets for payment may go unpaid because the trust assets are insufficient to make the payment (which is the risk the creditor probably had in mind when he agreed to the limitation of liability), or he may go unpaid because the trustee has lost his ability to have recourse to the trust assets due to his misconduct. The risk of the misconduct of the trustee may well not be a risk a trust creditor considers acceptable when agreeing to limit the liability of a trustee. It is not uncommon for contractual provisions which limit the liability of a trustee not to apply where the trustee has lost his right of indemnity or, more narrowly, where there is fraud or dishonesty on the part of the trustee.

It should also be noted that a solicitor could be in breach of duty to his trustee client if he does not advise the trustee to consider protecting himself from personal liability for the debts of the trust.⁶⁴

5.2 Recourse to trust assets where a trustee's liability is limited

Although a trustee has a well established right to limit his liability to a creditor and require the creditor to look only to the trust assets for satisfaction of the obligation owed, it is rather less clear on what basis recourse is had to the trust assets in these circumstances.

In explaining the limitation of a trustee's personal liability one finds statements in *Muir v City of Glasgow Bank* such as the following:

*"If, for example, A.B., the executor of X, contracted to make a payment as executor of X., and as executor only, to C.D., it would be difficult to suppose that any obligation except an obligation to pay out of assets was intended."*⁶⁵;

and

⁶³ *Watling v Lewis* [1911] 1 Ch 414

⁶⁴ *Astley v Austrust* (1996) 67 SASR 207. This case came about by reason of the decision in *Elders Trustee & Executor Co Ltd v EG Reeves Pty Ltd* (1987) 78 ALR 1 that the trustee was personally liable in respect of its borrowing.

⁶⁵ *Muir v City of Glasgow Bank* (1879) 4 App Cas. 337 at page 355 per Earl Cairns, L.C.

*“But to exonerate a trustee something more is necessary beyond the knowledge of those who deal with him that he is acting in that capacity, and it would not be sufficient in all cases to state that fact on the face of any contracts he may make. To exonerate him it would be necessary to show that upon a proper interpretation of any contract he had made, viewed as a whole - in its language, its incidents, and its subject-matter - the intention of the parties to that contract was apparent that his personal liability should be excluded; and that although he was a contracting party to the obligation the creditors should look to the trust estate alone”.*⁶⁶

The question is, on what basis does the trustee make the payment out of the trust assets, or on what basis does the creditor look to the trust estate alone, when the personal liability of the trustee has been excluded or limited?

A trustee who has so limited his personal liability has no need of a right of reimbursement or recoupment. The whole point of the limitation is that the trustee will not pay the creditor out of his personal funds and then seek reimbursement from the trust estate.

As discussed earlier, a right of exoneration has been upheld by the courts so as to relieve a trustee from the personal liability which would otherwise befall him and to ensure that it is not necessary for the trustee to impair his personal estate by discharging a liability before he is able to resort to the trust estate for indemnity. As noted by Lush J in *Re Enhill Pty Ltd*⁶⁷, the right of indemnity exists as the trustee's right for protection or restoration of his personal property.

The rationale for a right of exoneration appears to be absent where the trustee has contracted on the basis that at no stage will he be obliged to meet any liability out of his personal estate. Indeed, if reliance were placed on the right of exoneration there would be a mismatch of positions. The trustee promises to pay the creditor to the extent only that he is entitled to indemnity from the trust fund and the trustee is only entitled to indemnity to the extent required to protect his personal estate.

There is some judicial recognition of the difficulties of relying on a right of indemnity where personal liability has been limited or largely excluded.

In *Muir v City of Glasgow Bank*⁶⁸ Lord Selbourne discusses the unsuccessful contention of the appellant that he should not be personally liable for calls on shares held by him as trustee. At page 384 of the judgment Lord Selbourne states that if the contention advanced by the trustee was sound (and it was not sound in this case because the other contracting party lacked authority to accept such a limitation of liability):

⁶⁶ *Muir v City of Glasgow Bank* (1879) 4 App Cas 337 at page 368 per Lord Penzance.

⁶⁷ [1983] 1 VR 561 at 568

⁶⁸ (1879) 4 App Cas 337.

“it would enable a trustee - shareholder, when no other property was in trust, to become a partner without any personal liability at all, and also without any liability of any property or fund beyond the shares themselves. There is nothing in this deed [being the deed in relation to the unlimited company] to prevent any purchaser of shares in the market from causing them to be transferred in the name of a trustee declared to be such on the face of the transfer, who, according to this view, would be under no personal liability, and therefore would have no occasion for, or right to, any indemnity against the beneficiaries or against the author of the trust”.

In *Hunt Bros v Colwell*⁶⁹ a trustee sought to argue that he had no personal liability in respect of certain debts and he also argued that he had a right of indemnity against the creditor who was pursuing him. That creditor had been one of a number who had concurred in the trustee's appointment. At page 410 of the judgment Atkinson J states:

“It was always open to the trustee to contract on terms that he should not be personally liable. If the trustee is right when he says that the whole understanding was that he should not contract on terms that he was personally liable, how is it possible to say that he contracted on terms that he should get an indemnity from the creditors for a liability which ex hypothesi he was not to incur?”.

It may be that where a trustee has required a creditor to look only to the trust estate for payment, the trustee comes under an obligation to apply the trust assets in order to discharge the liability owing to the creditor and that the creditor's right of recourse to the trust assets becomes more direct (and not reliant on subrogation to the trustee's right of indemnity).⁷⁰ In *Lusmden v Buchanan*⁷¹ Lord Kingsdown suggested that there were differences between the law of Scotland and the law of England relating to trusts, in that under the law of Scotland it was simpler for a trustee to qualify his personal liability and require a creditor to look only to the assets of the trust estate. His Lordship stated at pages 968 -969 of the judgment:

“there are very serious differences between the law of Scotland and the law of England on the subject of trusts and the personal liability of trustees; that the same acts which would create personal liability in one country might not create it in the other, but instead of it might give a direct and immediate remedy against the trust estate”.

In *Williams v Hathaway*⁷² Jessel MR dealt with a situation where two vicars had contracted with a builder on the basis that they would only be liable so long as they were in a position to

⁶⁹ [1939] 4 All ER 406

⁷⁰ Stone, H, above, n 38.

⁷¹ [1865] 4 Macq 950.

⁷² [1877] 6 ChD 544

apply a building fund towards payment of the builder's costs. At page 551 of the judgment, the Master of the Rolls states:

"What they mean to say is, 'We as trustees bind the fund, but the moment we cease to be trustees we will not be liable for any breach of trust committed afterwards'. That is the meaning of the covenant as I read it. It simply binds the fund, and makes the covenantors liable to apply the fund, but not in any event; for it does not make them liable to apply the fund the moment after they have ceased to be trustees. In that case the builder must proceed against the succeeding trustees".

American trust law recognises various bases upon which a trust creditor may seek to recover from trust assets. One of those bases applies where a liability is properly incurred by a trustee and the trustee has agreed with the creditor that the creditor shall look only to the trust estate for satisfaction of the liability. In those circumstances the creditor may obtain satisfaction of his claim out of the trust estate and a suit in equity can be maintained against the trustee in his representative capacity. According to *Scott on Trusts*, the result of such a contract is that although the creditor can reach the trust estate, he has no lien upon it and his claim is not unlike the claim that was acquired under the earlier law when a married woman made contracts binding upon her separate equitable estate.⁷³

In a similar vein to *Scott on Trusts*, *The Restatement*⁷⁴ suggests that a creditor under a contract pursuant to which it is required to look only to the trust estate acquires a power in equity to reach the trust estate but does not acquire a lien upon it; one creditor does not acquire priority over subsequent creditors. Bogert⁷⁵ notes that the power of the trustee to promise to apply trust assets in making a payment to a trust creditor has sometimes been described as a power to impose a lien on the trust property in favour of the trust creditor. However, it is assumed that this means the creditor can by a suit in equity or action at law acquire a lien, upon proof of the trustee's promise and the authorized nature of the contract; this type of contract creditor is not seen as superior to other non-lien creditors until after he has obtained a judgment in his favour. Stone⁷⁶ says that in a case where the trustee "binds the trust estate" by exempting himself from personal liability, the courts in effect hold that, since the power to apply the trust property to payment of the debt resides in the trustee for the purpose for effectuating the objects of the trust, the trustee may by agreement pledge its exercise as security for payment of goods or services rendered by the creditor to the trustee for the benefit of the trust estate, and that upon their rendition the creditor may resort to equity to compel the exercise of the power by the trustee.

⁷³Scott, A and Fratcher, W. *Scott on Trusts* (4th ed) 1988 paragraph 271.

⁷⁴*The Restatement of the Law: Second, Trusts*, 2d, 1959 at paragraph 271.

⁷⁵Bogert, G.G. & Bogert G.T.B. *The Law of Trusts and Trustees*, (2000) at paragraph 715

⁷⁶Stone, H. above, n 38 at page 535.

The author of *Scott on Trusts* suggests it is uncertain as to whether the right of recovery of the creditor in these circumstances remains a derivative right and is subject to the state of the trustee's accounts or is a direct right and is unaffected by the state of the trustee's accounts⁷⁷. Bogert⁷⁸ appears to have no doubts, stating that where the trustee has contracted on the basis that the creditor is to look to the trust property, the creditor's right is direct and original and not derivative or dependent upon the state of the trustee's accounts or the possibility of getting relief from the trustee. *The Restatement of the Law*⁷⁹ agrees with Bogert's analysis.

If, where the trustee has limited his personal liability, the nature of his obligation is a promise to apply the trust fund to make payment to the creditor, it can be argued that the power of the trustee to apply the trust fund in that way is not dependent upon the state of the trustee's accounts. The requirement relating to a favourable balance on the taking of accounts comes into play only where the trustee claims a share in the trust estate. The rationale for requiring clear accounts before a trustee may exercise his right of indemnity is stated to be that where the trustee is found to owe money to the trust estate he is taken to have applied the money in meeting any legitimate claims he may have for reimbursement or exoneration. Where the trustee has no need of reimbursement or exoneration (because he has limited his liability) there is arguably no logical basis for imposing a requirement of clear accounts. The trustee does not claim a share in the trust estate when he applies trust assets in paying a trust creditor to whom he has limited his liability.

The absence of a requirement for clear accounts does not mean that the beneficiaries of a trust are at the mercy of a misbehaving trustee or illegitimate creditors. A liability would still have to be properly incurred (or have benefited the trust estate) before a trustee could promise to apply trust assets in paying it. In *Parsons v Spooner*⁸⁰ counsel argued that a contract by trustees which excluded their personal liability and provided for payment out of the fund would be illegal. The argument was put that a trustee had no right to make that type of contract because it tended to deprive the beneficiaries of the benefit of the security which they would have from the diligence of the trustee if he were acting upon his own personal responsibility. Wigram VC rejected this argument and stated that the beneficiaries would always have the security that a court will only allow a trustee expenses which are properly incurred.

⁷⁷ Scott, A and Fratcher, W., above, n 73.

⁷⁸ Bogert, above, n 75, at paragraph 715.

⁷⁹ *The Restatement of the Law: Second, Trusts, 2d*, above, n 74.

⁸⁰ [1846] 5 Hare 102

6 Liability of others for contractual obligations of the trustee

6.1 Directors of a trustee company

A director of a company does not, by reason of his position as a director, owe a duty to a creditor of the company⁸¹. There would seem to be no reason why the position should be any different in relation to a director of a company which incurs a debt in its capacity as a trustee.

However, a director of a company which is at risk of insolvency owes a duty to the company to have regard to the interests of creditors. This obligation is enforceable by the company (including a liquidator in the name of the company) and may possibly be the subject of an application by a creditor for an injunction under section 1324 of the *Corporations Act*.

A director of a corporate trustee also has to be cognizant of section 588G of the *Corporations Act* which, broadly speaking, provides that a director contravenes the Act if he fails to prevent a company of which he is a director from incurring a debt if the company is insolvent or becomes insolvent by reason of incurring the debt. Compensation may be payable by the director to the company (and, in limited circumstances, to a creditor who has suffered loss) in respect of insolvent trading⁸².

Where a corporate trustee incurs a debt in the course of acting as trustee and has not limited its personal liability, the duty to have regard to the interests of creditors and to avoid insolvent trading would apply in the normal way as the creditor could generally have recourse to all of the company's personal assets in seeking payment of its debt. (A director will also be entitled to have regard to the likelihood of the company being able to pay a properly incurred trust debt out of trust assets pursuant to its right of indemnity in assessing whether the company is solvent). Where a corporate trustee incurs a debt in the course of acting as trustee and has limited its liability to the extent of its ability have recourse to trust assets, a director will need to consider the extent of trust assets and the efficacy of the company's right of indemnity when incurring the debt. However, where the corporate trustee has limited its liability in respect of a debt to its ability to have recourse to trust assets, a director may need only to have limited regard to that debt when assessing the solvency of the company in connection with the incurring of a later debt unconnected with the trust. The trust debt would be relevant to the extent that the corporate trustee was relying on its right of recourse to trust assets to satisfy claims for reimbursement or claims of creditors in respect of which it had not limited its liability.

Where recourse to trust assets is important in establishing the solvency of a company, the directors may also need to consider the position of creditors when making a distribution of trust assets to beneficiaries.

⁸¹ *Spies v The Queen* (2000) 201 CLR 603

⁸² Sections 588J and 588M of the *Corporations Act 2001* (Cth)

A provision which is peculiar to the directors of a company which acts as a trustee is found in section 197 of the *Corporations Act*. Section 197(1) provides:

“A person who is a director of a corporation when it incurs a liability while acting, or purporting to act, as trustee, is liable to discharge the whole or a part of the liability if the corporation:

- (a) has not, and cannot, discharge the liability or that part of it; and*
- (b) is not entitled to be fully indemnified against the liability out of trust assets.*

This is so even if the trust does not have enough assets to indemnify the trustee. The person is liable both individually and jointly with the corporation and anyone else who is liable under this sub-section.”

The explanatory memorandum in respect of the *Corporations Bill 1988* explained that the statutory predecessor of section 197 was designed to discourage the insertion in trust deeds of provisions excluding the trustee's right of indemnity from trust assets and to encourage trust deeds to be drafted so as to minimize the possibility that the trustee company may be in breach of trust. The explanatory memorandum makes clear that the predecessor of section 197 was not directed to the situation where a legal entitlement to indemnity exists but the trust assets are insufficient to satisfy the entitlement and, despite some ambiguity in wording, that probably remains the case under the current provision.

In *Young v Murphy*⁸³ JD Phillips J suggested that the mischief being addressed by the section arises where a liability has been incurred such as might attract the right of indemnity, but has been incurred in circumstances where the indemnity is not available. The obvious case was said to be where indemnity is refused in respect of a liability incurred by a trustee in circumstances where the trustee was not authorised by the trust deed to incur the liability.

It could also be argued that the section applies where, although the liability was properly incurred during the course of execution of the trust, the trustee is not entitled to be indemnified because of unrelated breaches of trust which caused loss to the trust estate.

Accordingly, a director of a company acting as trustee may face personal liability in respect of trust debts (or debts purportedly incurred as trustee) where:

- (a) the right of indemnity has been excluded (or narrowed) by the trust instrument;
- (b) the liability was not properly incurred in the execution of the trust; and

⁸³ [1996] 1 VR 279

-
- (c) unrelated breaches of trust causing loss to the trust estate prevent the exercise of the right of indemnity.

The operation of section 197 in relation to a director of a corporate trustee which has incurred a debt while acting (or purporting to act) as trustee, has limited its liability to its right of recourse to trust assets and finds itself not entitled to be fully indemnified against the liability is not completely clear. It may be argued that the section is not intended to apply in those circumstances as the pre-requisite to its operation is that the trustee is not entitled to be fully indemnified and that it "has not, and cannot, discharge the liability". If the trustee has limited its liability to its right of indemnity, the fact that it is not entitled to be fully indemnified will automatically mean that it has not (and will not) discharge the liability, irrespective of its capacity to do so from its non-trust assets. A trustee company which has limited its liability may be in a position where financially it can discharge the liability from its personal assets but cannot be compelled to do so.

There are also provisions imposing personal liability on directors and some other officers of trustee companies which are authorised or registered under the Trustee Company Acts.⁸⁴

6.2 Beneficiaries

Just as a trustee may have a right of indemnity out of trust property, he may have a right of indemnity from a beneficiary personally in respect of trust liabilities. As with the right of indemnity from trust property, the liability in respect of which indemnity is sought must generally have been properly incurred in the execution of the trust. It could also be argued, by analogy with the right of indemnity from trust property, that if related breaches of trust have caused loss to the trust estate (or perhaps to the beneficiary) in an amount exceeding the liability for which indemnity is sought, an indemnity from the beneficiary may not be available until the losses are made good.

The rationale for the right of indemnity from a beneficiary is that the person who gets the benefit of the trust property should bear its burden unless he can show some good reason why his trustee should bear it.⁸⁵ The ability of the trustee to seek indemnity from a beneficiary is not confined to cases where the beneficiary requests that the relevant liability be incurred⁸⁶, although requesting that a liability be incurred may make a beneficiary who would otherwise not be liable to indemnify his trustee liable to do so.

A trustee's right to indemnity from beneficiaries is well established where all the beneficiaries of the trust are of full capacity and absolutely entitled (whether there is one beneficiary or

⁸⁴ eg *Trustee Companies Act 1984* (Vic) s.19; *Trustee Companies Act 1964* (NSW) s.31, *Trustee Companies Act 1968* (Qld) s.48, *Trustee Companies Act 1998* (SA) s.23.

⁸⁵ *Hardoon v Belilios* [1901] AC 118; *JWBroomhead (Vic) Pty Ltd v JW Broomhead Pty Ltd* [1985] VR 891.

⁸⁶ *Balkin v Peck* (1998) 43 NSWLR 706.

there are multiple beneficiaries).⁸⁷ There is some question as to whether it is necessary for all beneficiaries to be of full capacity before a right of indemnity may be asserted against those who are,⁸⁸ and some question as to whether it will always be necessary for a beneficiary to have an absolute entitlement to the trust fund or whether a beneficiary with a more limited interest (such as a life estate) may be held liable to indemnify his trustee.⁸⁹

It has been held that a trust creditor may be subrogated to the trustee's claim to indemnity against a beneficiary. There may first be a need for the trust creditor to exhaust his rights against the trustee.⁹⁰

A trustee's right of indemnity against a beneficiary may be expressly excluded in the trust instrument, except perhaps in the circumstances where public policy considerations would weigh against the exclusion, for example where it is used as a cloak for fraud⁹¹.

The trustee's right to indemnity from a beneficiary can also be excluded by implication⁹², however the entitlement to indemnity from beneficiaries is not negated by the fact that the trust instrument provides for an indemnity out of trust assets. In *Causley v Countryside (No. 3) Pty Ltd*⁹³ it was also held that the right of the trustee to indemnity from unitholders was not negated by:

- (a) the circumstances of subscription for units in a public unit trust;
- (b) the fact the promoters and managers also made profits from the trust; and
- (c) the fact that some of the liabilities were incurred before the unitholders became beneficiaries.

7 Conclusion

Sections 601FS and FT of the Corporations Act, by providing for the statutory transfer of trust liabilities from an outgoing trustee to the incoming trustee, reflect the reality that trust creditors increasingly look to the trust fund (and not to the personal assets of the trustee) for payment. A contract of any significance with a trustee is likely to seek to limit or, in looser language, exclude, the personal liability of the trustee.

⁸⁷ *Balkin v Peck* (1998) 43 NSWLR 706; *JWBroomhead (Vic) Pty Ltd v JW Broomhead Pty Ltd* [1985] VR 891; *Selkis Pty Ltd v Bagoda Pty Ltd* (WA Supreme Court, 9 December 1994, unreported).

⁸⁸ *Poignand v NZI Securities Australia Ltd* (1992) 37 FCR 363

⁸⁹ *Balkin v Peck* (1998) 43 NSWLR 706 at page 713.

⁹⁰ *Ron Kingham Real Estate Pty Ltd v Edgar* [1999] 2 Qd R 439; *Belar Pty Ltd (in liq) v Mahaffey* [2000] 1 Qd R 477.

⁹¹ *Selkis Pty Ltd v Bagoda Pty Ltd* (WA Supreme Court, 9 December 1994, unreported); *Ron Kingham Real Estate Pty Ltd v Edgar* [1999] 2 Qd R 439.

⁹² *Wyse v Perpetual Trustee Co* [1903] AC 139

⁹³ *Causley v Countryside (No. 3) Pty Ltd*, NSWCA, No40710 of 1994, (Unreported - Clarke, Cole and Beazley JJA) BC9603947 - 02/09/1996.

Where the creditor and the trustee have agreed (in a manner not inconsistent with the trust instrument) that the creditor should look to the trust fund alone for payment it is difficult (as a matter of economic sense and legal reasoning) to see why the creditor's claim on the trust fund should be defeated by loss caused to the trust fund through unrelated misconduct by the trustee.

