CURRENT LEGAL ISSUES RELATING TO LENDING TO TRUSTS AND PARTNERSHIPS

Commentary

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My job is to comment on the first part of the Judge's paper relating to lending to trusts.

As the Judge has said, there is little on the topic by way of new law. I agree wholeheartedly with him when he says that, "the issues which cause trouble in practice arise generally from the need to apply established principle in the relatively new environments in which trusts find themselves and in the context of the relatively new uses to which trusts are put".

I suspect that when tackling the issue of lending to trusts in these relatively new environments, one of the biggest problems is that issues are perceived to be problematic when in fact if the underlying trust law principles were applied those issues could be dealt with both from a legal and commercial perspective relatively easily.

By highlighting a few of the principles the Judge has mentioned in his paper, I hope to throw some light from a practical perspective on some of the issues which can arise in the day-to-day practice of lending to trusts and suggest some solutions for them.

TRUSTEE IS PERSONALLY LIABLE

The starting point is that where a trustee incurs a debt to a creditor it is the trustee and not the trust itself or the beneficiaries of the trust who is personally liable to repay it.[1] It follows, generally speaking, that from a trust law perspective, the creditor has no direct right of action against anyone but the trustee personally.[2]

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1 See, for example, *Farhall v Farhall* (1871) LR 7 Ch App 123 at 126.

2 For example, a creditor does not have a ***direct right to claim repayment as against the beneficiaries of the trust*** – see, for example, *Re Enhill* (1983) 7 ACLR 8 at 15, ***nor directly against the trust fund itself*** – *Worall v Harford* 32 ER 250 at 252. Nor for that matter against the settlor – *Frazer v Murdoch* (1881) 6 App Cas 855 at 872-873.

TRUSTEE IS THE LEGAL OWNER NOT THE BENEFICIAL OWNER

Although the trustee legally owns the trust assets in the strict sense (and subject to the discussion below), ***it does not have beneficial ownership in them***. This, no doubt, creates a concern for trustees because, on the one hand, the trustee is liable for the trust debts, but on the other, the trustee does not have a beneficial interest in the trust assets.

TRUSTEE PROTECTION

The trustee needs (and gets) protection. The trustee has the right to be indemnified in respect of liabilities properly incurred by the trustee in the proper performance of the trustee's obligations as trustee of the trust.

The Judge has made reference to Mr Justice B H MacPherson's paper, "The Insolvent Trading Trust".[3] In this paper Mr Justice MacPherson describes this right succinctly at page 145 where he says:

> "The right assumes two forms. The first is a right in some circumstances to be indemnified by the beneficiaries of the trust; the second a right of recourse to trust assets in order to satisfy liabilities incurred by him in his capacity as trustee. The first is personal, the second is, at least to some extent, proprietary in nature."

As to the first right, as Mr Justice Lehane has mentioned, if the beneficiary is *sui juris* and *absolutely entitled*, then a trust imposes on that beneficiary a personal obligation, which can be enforced in equity, to indemnify the trustee against liabilities which the trustee incurs in the ordinary course of his acting as trustee. Authority for this proposition can be found in *Hardeem v Belilios* (single beneficiary).[4] However, it has been said[5] that in each of the cases in this area, it was evident that in some way or other the beneficiaries had requested the trustee to act.

The second source of indemnity confirmed both by case law and statute, (for example, in New South Wales see section 59(4) of the Trustee Act 1925 (NSW)), is that the trustee has the right to be indemnified out of trust assets, by resorting to and applying those assets (where the obligations are properly incurred by the trustee in the administration of the trust and within the power conferred on the trustee by the trust document). This right arises each time a liability is properly incurred.

This latter right is regarded as a "*charge or right of lien*" on the trust property.[6] This right allows the trustee to make a deduction from trust property as against the beneficiary. It also appears that this right gives the trustee an *equitable proprietary interest* in the trust assets.[7] Relevant to creditors the right can be charged or assigned.

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3 In P D Finn, *Essays in Equity* (1985) Law Book Company, at page 142.

4 [1901] AC 118. See also McGarvie J in *J W Broomhead (Vic) Pty Limited v J W Broomhead Pty Limited* [1985] VR 891 – relating to the position where there is more than one beneficiary. There is also a Canadian authority on the point – *Clarkson v McClean* (1918) 42 OLR 1.

5 Professor H A J Ford "Trading Trusts and Creditors Rights" (1981) 13 *MULR* 1.

6 *Octavo Investments Pty Limited v Knight* (1979) 144 CLR 360 at page 367.

7 See *Octavo Investments Pty Limited v Knight* (1979) 144 CLR 360.

CAN UNSECURED CREDITORS ACCESS TRUST ASSETS – THE RIGHT OF SUBROGATION

As Mr Justice Lehane has said:

> "The lender's only recourse to trust property, as is well known, is by subrogation to the trustees own right of reimbursement or indemnity for liabilities properly incurred."

It is not unusual these days for a trustee to have limited assets (often, for example, a corporate trustee is a $2 company).

If this is the case, the fact that the trustee is personally liable for the unsecured debts owing to a creditor is not of much assistance to the creditor. In the case of a trust, the courts do in some circumstances allow creditors access to trust assets to satisfy the debt by virtue of the doctrine of subrogation, and the Judge has canvassed this issue in his paper and there is little I can usefully add to his discussion. However, there is one further point relevant, in particular, to the unsecured creditor's right of subrogation that I think is worthy of mention and it is this – where a non-trust debtor incurs a debt in the debtor's own right, an unsecured creditor (pre bankruptcy or liquidation at least) has no immediate access to the assets of the debtor to recover payment.

It is true that an unsecured creditor can, after obtaining a judgment against a debtor, obtain a writ of execution against assets of the debtor.

Unfortunately, the same does not necessarily follow for the trust assets held by a trustee in connection with trust debt. The principle here is that a trust creditor is not allowed to enforce his or her claim against the trust property unless and until circumstances are such as to lead to a conclusion that a judgment against the trustee, if obtained, would be fruitless.[8] The underlying reason for this principle is quite simple. The means of enforcement of such a claim is via a writ of "*fieri facias*", more commonly known as a writ of "*fi fa*". Where the beneficial interest in the relevant assets is not with the judgment debtor, such a writ will not ordinarily issue.[9]

In this sense, the unsecured creditor's right of subrogation might be regarded as something akin to a "mere equity" in the *Latec*[10] sense. Ordinarily, this right of subrogation is a right which will require the assistance of the court to come into effect. This is important and will no doubt impact upon the priority between for example, an unsecured creditor's claim and the claim of a secured creditor under a subsequently created equitable charge over trust assets.

SECURED CREDITORS

As the Judge made clear, secured creditors are of course in a much stronger position by virtue of their having a direct interest, legal or equitable, in the trust assets themselves.

In most cases, assuming the security is enforceable and is within the scope of the trust instrument, it is hard to see circumstances where a secured creditor's rights can be defeated by a beneficiary or by unsecured creditors. Nonetheless, for more abundant caution, it is not uncommon for the lender (at least in the case of a unit trust), to obtain the written consent of unitholders to the proposed transaction and also, to the various covenants and undertakings given by the trustee in the transaction.

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8 *Owen v Delamere* (1872) LR 15 Eq at 134. See also generally, H A J Ford and W A Lee, *Principles of the Law of Trusts*, 3rd Edition, LBC at paragraph 14080.

9 *Stevens v Hince* (1914) 110 LT 935.

10 *Latec Investments v Hotel Terrigal Pty Limited (In Liquidation)* (1965) 113 CLR at 265.

For obvious reasons, obtaining beneficiary consent is more difficult with a discretionary trust and one wonders about the benefit of seeking such a confirmation where there is a discretionary trust. However, "nailing down" those persons who are identifiable as potential discretionary beneficiaries at the relevant time probably has some benefit, in that it ought at least to create an estoppel (so far as those beneficiaries are concerned) against a claim that the transaction was not authorised or was otherwise in breach of trust.

There is no legal reason why unsecured creditors should not also adopt this practice. Particularly in the case of ***equitable*** securities, there are circumstances in which a secured creditor's position is perhaps not quite so solid. Where legal securities are taken, because of the way the priority rules as between competing legal and equitable interests operate, the secured creditor holding a security by way of a legal interest in trust property will be in a far stronger position than one holding an equitable interest (for example, a fixed and floating charge). Where the security is equitable of course, the rules relating to priorities between equitable interests apply (ie, usually first in time prevails).

Some examples of potential issues for the holder of an equitable security are first, where a prior trustee has an outstanding claim under that trustee's own right of indemnity against trust assets and subsequently, a financier takes an equitable charge security from the new trustee. Here, unless the prior trustee has engaged in postponing conduct, or there is some other waiver of the prior trustee's indemnity rights, there is a very real possibility that in a competition between the equitable chargee and the prior trustee, the prior trustee's interest, being first in time, will succeed. For this reason, when practitioners are dealing with a trust where the trustee had changed it is important to carefully consider whether there are any extant rights in the prior trustee.

Assuming the prior trustee is party to the deed of appointment of the new trustee, it is always useful to have some form of representation or warranty from that prior trustee that it has no knowledge of any outstanding claims against it or the trust (ie which might entitle that trustee to resort to its trustee's right of indemnity). The security taken from the new trustee should have a corresponding representation and warranty.

A second area is one again, which the Judge touched on, namely, where a prior trustee has granted an equitable charge over, amongst other things, future rights or property – then a new trustee is appointed. Unless the new trustee acknowledges that it is bound by the terms of the charge or the charge is novated to the new trustee, then it is unlikely to capture future property in the hands of the new trustee – because a charge over future property operates in equity as a contract to assign between the contracting parties only. In the case of a corporate trustee, regard also needs to be had to the provisions concerning registration of charges where a company acquires property, the subject of an existing charge. See in this regard Corporations Law section 264.

The practical solution here is that normally the charge document will contain restrictions on appointment of new trustees without the financier's consent and the financier should take the opportunity (assuming it is asked to give its consent in the first place) when giving its consent to require the incoming trustee to acknowledge the existing securities in a way which binds it in respect of future assets coming into its hands after the date of appointment.

The third area of interest for the secured creditor is the (albeit unusual) position where, by virtue of a right of subrogation, an unsecured creditor is permitted to look to assets of the trust and this right arises before the secured creditor takes its equitable charge. Whilst uncommon, the situation could conceivably arise in a so called "workout" where, as part of the arrangements made with the secured creditor, additional security is taken. Putting insolvency issues aside, this is an area which needs to be considered as a secured creditor's rights under an equitable charge could be placed in jeopardy.

PRACTICAL CONSIDERATIONS AND CONCLUSION

In summary, the above analysis gives rise to a number of (hopefully) useful rules for the lawyer dealing with lending to trusts. These are as follows:

1. It is the trustee and not the trust or the beneficiaries of the trust who is liable for the trust debt.

2. The trustee sources its protection in respect of liability by way of indemnity. That indemnity takes two forms. A personal indemnity against beneficiaries (this applies in limited circumstances only) and secondly, an equitable charge or lien in respect of trust assets.

3. Unsecured creditors derive access to trust assets by way of subrogation to the trustee's rights. However, it is by no means easy to become subrogated in this way. Before access will be given to trust assets it has to be clear that personal recourse to the trustee will be fruitless. Furthermore, any right of subrogation is ***only as good as the trustee's right of indemnity***. If the right of indemnity is not available or restricted for any reason then it will be of little value to creditors.

4. Accordingly, when dealing with trusts, it is fundamental that practitioners ensure that the trust is properly constituted and that the transaction is within power. This involves consideration not only of the formal trust structure and validity of the trust document, it includes a consideration of the powers of the trustee and any restriction on them or on the trustee's right of indemnity; whether the transaction is for the proper purposes of the trust, and confers an advantage on the beneficiaries of the trust and whether the trustee has exercised its powers properly having regard, amongst other things, to conflict of interest issues and the terms of the trust document. Finally, consideration needs to be given to the possibility that the trustee's right of indemnity (and therefore the financier's derivative rights) have been lost or restricted by virtue of antecedent breach.

5. When taking security (wherever possible), creditors should endeavour to take legal rather than equitable security interests and thereby obtain an advantage under the priority rules which apply to competition between legal and equitable interests.

6. Finally, although the point is probably covered at part 4, secured creditors, particularly those taking equitable securities, need to be wary of prior equitable claims and the possibility that the trustee's right of indemnity may be affected by them (as may the secured creditor's direct interest in the trust assets) by virtue of the priority rules relating to competitions between equitable interests.