TRUSTEES IN FINANCIAL TRANSACTIONS - PITFALLS

Comment by

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Thank you Judge for your enlightening discourse on the pitfalls one encounters in dealing with trustees in financial transactions. The complexities of this area, I am sure, would astound the originators of the concept of Trusts (which has no parallel in Continental systems of law). I believe it was during the Crusades when Knights, wishing to ensure that their manorial estates were still intact on their return and that they were capable of being controlled, managed and earning income during the Knights' absence, vested these estates in persons remaining in England. Jacobs' Law of Trusts in Australia attributes the development to not long after the Norman Conquest when it became common practice for land to be converted to the use of another.

Ultimately the enforcement of equitable obligations on persons who had the legal estate vested in them fell to the Chancellor, whereupon a separate body of law providing appropriate remedies to enforce those obligations developed. Thus the inherent inflexibility of the common law was overcome not by statutory intervention but by the growth of this "separate and independent" jurisdiction. As an aside, perhaps modern law reform agencies should take note of this historical precedent.

One area where I would like to expand on what we have already heard this afternoon but, from the practitioner's viewpoint, is in the area of fraud by or involving a corporate trustee in respect of which the financier is innocent as to complicity but perhaps not as to notice. This fraud may arise in one of two ways: either as a legal fraud which satisfies the technical elements at law, or as an equitable fraud arising out of the trustee's abuse of its powers under the trust instrument, an exercise of those powers mala fides by the trustee. In this context I believe four issues need to be considered: namely the most common structures which a financier is likely to face in in dealing with a trustee and the level in a particular structure at which the fraud occurs, the nature of the liability being assumed by the trustee (direct or third party), the securities (if any) being contemplated by the financier (whether legal or equitable) and the state of the financier's knowledge regarding the fact that the body corporate is acting as trustee (whether actual, constructive or imputed, or no knowledge). I would like to consider each of these aspects in turn.

1. Trust structure

There would seem to be three types of trust structures which would most commonly confront the financier. First where the trustee is trustee of a unit trust, the units in which are in turn held by trustees for discretionary trusts. Secondly where the trust is a unit trust and the units are held directly by those beneficially entitled, and thirdly where the trust is a discretionary trust. A mixture of any of these types is also common.

The question that needs to be asked here is what is the effect of fraud on the financial transaction where that fraud occurs at different levels; that is, is fraud by a discretionary trustee dealing directly with the financier (as in the third category above) to be treated differently from fraud by a discretionary trustee only dealing indirectly through a unit trustee with the financier (as in the first category above). In itself the question cannot be dealt with, as it is largely dependent on the factual position in each transaction. However, in the context of the balance of this commentary the issue impinges on each of the other elements which I shall now address.

2. Nature of the liability being assumed

This matter squarely raises the equitable obligations owed by a trustee to the beneficiaries of the trust in embarking on a course of action which potentially may diminish the value of the trust assets, at least in the short term. Clearly where the trustee is itself directly borrowing or raising funds in the transaction, the issues to be considered are narrower than where the trustee is providing a guarantee or third party security to support another party's involvement in the financial transaction. In the former case, if the trustee has the requisite power, this may of itself protect the financier (section 45 of the Queensland Trusts Act and equivalent provisions in other States may assist in this regard, providing for a statutory power to raise money by sale or mortgage). However in the latter case the financier is put on inquiry as to the propriety of the trustee's provision of the guarantee or third party security, even if there is express power in the trust instrument to provide such guarantee or security. The financier must be looking for something more, a commercial benefit flowing from the trustee's assumption of the obligation that is commercially justifiable for the relevant trust.

Underpinning this proposition is the principle that the trustee's primary purpose and role is to manage the affairs of the trust for the benefit of the beneficiaries. Accordingly, a clause in a trust deed entitling the trustee to act as it sees fit in the exercise of any power as it may consider appropriate would not save the financier. At best it could prop up in an ancillary fashion an exercise of power by the trustee specifically authorised by the trust instrument, in other words it would operate as an extension to the ambit of a specific power.

3. Securities being contemplated

The financier's worry when one turns to the contemplation of the securities proposed must inevitably focus on the quality of those securities should its right to proceed on them be questioned by the beneficiaries of the trust. Here our attention is drawn to the distinction between legal and equitable title, between say a Torrens title mortgage and a floating charge.

Upon registration of a Torrens title mortgage, in the absence of either fraud involving the financier or actual or constructive notice on the financier's part that the dealing would necessarily involve a breach of trust, i.e. equitable fraud (but see in this regard Templeton v. Leviathon Pty. Ltd. (1921-22) 30 C.L.R. 34), the financier will acquire indefeasible title to his security under section 44 of the Queensland Real Property Act 1861 and its equivalent provisions elsewhere. However, a floating charge gives the financier an equitable interest only.

Section 199(2) of the Companies Code eliminates any concern we may have previously had as to whether the property of a company includes property held by it as trustee, thus clarifying some earlier confusion on this point as to whether a charge over trust property is a registrable charge for the purposes of what is now section 200 of the Code - clearly it is. However, it is still necessary to draft the charge itself to make it clear that the property held by the company as trustee is being charged. In other words it must be manifest from the wording of the charge that that trust property is being charged under a power duly exercisable by the trustee. Accordingly it follows that trusts coming into existence later in time to the charge could not be the subject of the prior charge as at the time of creation of the charge, there was no such power capable of being so exercised.

Further, as the beneficiaries have an equitable interest in the trust fund (or perhaps only an equity in the case of a discretionary trust before the exercise of the trustee's discretion, a distinction the High Court raised in analogous circumstances in Latec Investments Ltd. v. Hotel Terrigal Pty. Ltd. (in liquidation) (1964-65) 113 C.L.R. 265), the equitable interests as "if the merits are equal, priority in time of creation is considered to give the better equity" (per Kitto J. in Latec Investments Ltd. above), unless the prior interests are susceptible to being postponed. This is assumed to be the case if there is a power to mortgage in the trust deed, or to give a guarantee and mortgage with a commercial benefit clearly flowing through to the beneficiaries. This merely demonstrates that a floating charge is an inferior security where dealing with competing equities.

In the end the matter becomes one of drafting of the charge itself; for example, to ensure that the trust assets are properly mortgaged, and to provide that the charge crystallizes in the event of a termination of the trust (so that any distribution to beneficiaries would be subject to a fixed charge to the financier) and so on.

4. State of the financier's knowledge

Where the financier has actual knowledge of the trustee's fraud, it is doubtful that registration of a Torrens title mortgage will save him, as mentioned earlier. There is some dicta in Templeton v. Leviathon Pty. Ltd. referred to earlier, which may be of use to a financier in this position - it is conceivable that the door is not completely closed. The question of constructive notice is one not so easily answered given the purported restriction on constructive and imputed notice arising for example under section 256 of the Queensland Property Law Act or section 164 of the New South Wales Conveyancing Act which provide that a financier is not prejudicially affected by notice unless the relevant matter would have come to its knowledge if such searches of registered instruments, inquiries and inspections had been made as ought reasonably to have been made by the financier or in the same transaction by its solicitor or other agent. The only real limitation on the position at law is that imputed notice is restricted to the particular transaction.

The protection conferred by section 46 of the Queensland Trusts Act which has its counterparts in most jurisdictions, namely that the mortgagee is not concerned to see that the money raised is wanted or that the trustee had such power, is also relevant. The efficacy of this provision is doubtful however where the mortgagee has actual or constructive knowledge of the fraud.

When one considers more difficult examples of "notice" the problem remains. For instance, what if a search of the corporate trustee conducted at the Corporate Affairs Office disclosed in the latest Annual Return for the company that the company's principal activity was acting as trustee for the XYZ trust, yet the financier was not aware of this fact, and failed to notice this statement amongst the myriad accounts and details appearing with the Return on the microfiche. Would this be constructive notice? Presumably yes under section 256 of the Property Law Act mentioned above but not under section 68C of the Companies Code. Where the financier has no notice, the question is then more likely to resolve itself by reference to the nature of the liability assumed and the quality of the underlying security covered previously.

I would like to conclude by considering what some of the financier's antecedent and subsequent options are in seeking to overcome the problems outlined above.

Before becoming involved in a financial transaction with a potential corporate trustee it would seem appropriate for the financier to:

(i) Make enquiry as to whether the body corporate is a trustee, and require execution by its directors of a statutory declaration that the company is not or is (as the case may be) a trustee, in the latter case annexing a certified copy of the trust instrument and variations. A certificate to this effect from the company's accountants should also be considered.

(ii) The search of the body corporate records at the Corporate Affairs Office should be done paying particular attention to any information disclosed in the Annual Returns regarding trusts.

(iii) Where a trustee is involved consideration should be given to both the nature of the liability to be assumed and the securities contemplated (for the reasons outlined previously). Investigation of the minute books for the trust, evidence regarding commercial benefit flowing through to the trust and appropriate drafting steps in documentation (warranties, crystallization clauses and so on) should be pursued. Guarantees and subordination agreements should be sought, if available, from sui juris beneficiaries.

(iv) A certificate should be sought from the trustee's solicitor as to the trustee's due execution which preferably should be by way of common seal attested to by a director and secretary to take advantage of the presumption of due execution of deeds by corporations arising under section 46 of the Property Law Act (Queensland) and equivalent provision elsewhere or section 68A(3)(e) of the Code.

Of course, whether the financier will want or be in a position to take all of the above steps will depend largely on the coupling of expediency and risk.

Once the milk has been spilt, and there is fraud, what may the financier then do? Effectively his fate is sealed by the course of action adopted prior to completion. Comfort would no doubt be felt where the security received Torrens indefeasibility, the benefit of the presumption of due execution or protection under the Trusts Act referred to previously. Where one or more beneficiaries were party to the fraud presumably their equitable entitlements to the trust fund would be postponed to the interests of the financier. This would seem to be implicitly recognised in section 77 of the Queensland Trusts Act under which the Court may enforce the trustee's indemnity against such beneficiary's interest in the trust. An alternative avenue open to the financier may be to pursue the fraudulent trustee directors under sections 229, 542, 556 and 557 of the Companies Code (and now also under section 229A).