TRUSTEES IN FINANCIAL TRANSACTIONS - PITFALLS

Comment by

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Mr Chairman, ladies and gentlemen. I propose to confine myself to three points.

In dealing with the corporate trustee it is of the utmost importance to consider the transaction generally in relation to the trustee's powers.

It is important to consider not only whether the intended transaction is within the head or heads of power but also whether it is for the benefit, and I underline that word, of the trust.

In addition it is necessary to consider whether the exercise of that power could be vitiated by any conflict of interest and duty. This latter point arises from the principle that no one who has a fiduciary duty to perform shall place himself in a position where his interest and duty conflict. And where they do conflict then duty must prevail. That principle has been established, of course, by the old case with which you are doubtless all familiar of Bray v. Ford [1896] A.C. 44, which contains perhaps the most lucid exposition of the principle. See the speech of Lord Herschell at page 51.

Sometimes the trust instrument itself will properly address the question of conflicts of interest and will alleviate to some extent the strictness of the rule of equity to which I have referred; but quite frequently the problem is just not addressed. That is particularly so with the older trusts set up several years ago where many of the complexities which attend this subject were not fully comprehended.

The most common situation where principles need to be considered is where a corporate trustee furnishes a guarantee or indemnity and indeed sometimes goes even further and gives security to support it. Of what benefit is that transaction to the trust? Is the trust being used merely for someone else's convenience? Perhaps the whole of the shares in the borrowing company are held as trust assets so that a financial transaction with that company could be regarded as preserving or likely to enhance the value of

the trust investment. But more often than not it is impossible to find any clear basis for saying that the trust, as distinct from some of the individuals behind it, will benefit.

I suggest that where there has been a purported exercise by the trustee of the power contained in the trust deed and the transaction concerned is not for the benefit of the trust or alternatively the trustees or one or more of its directors has or have a conflict of interest in relation to the transaction, the exercise of the power is void. It is said to be in fraud of the power. As Lord Parker said in Vatcher v. Paull [1915] A.C. 372 at 378:

> "The term fraud in connection with frauds on a power does not necessarily denote any conduct on the part of the appointor amounting to fraud in the common law meaning of the term or any conduct which could be properly termed dishonest or immoral. It merely means that the power has been exercised for a purpose or with an intention beyond the scope of or not justified by the instrument creating the power."

That case, of course, concerned a power of appointment although I suggest that the principles enunciated in it are equally applicable to management powers: Kerr on Fraud and Mistake 7th Ed. 459, Howard Smith Ltd. v. Ampol Limited [1974] A.C. 821 at 834.

It is not uncommon for the transaction to involve an element of conflict of interest and duty so far as the trustee is concerned. A corporate trustee sometimes proposes to give a guarantee or indemnity in respect of a loan to a company or the trustee of some other trust in which the directors of the corporate trustee have a material interest.

Sometimes the trustee will seek to amend the trust deed to include a clause authorising it or members of its Board to enter into transactions withstanding those conflicts of interest. But one must remember that the power of variation and resettlement is itself a power and any exercise under it is liable to be struck down having regard to the considerations to which I have previously referred.

My second point deals with the question of the trustee's indemnity. In recent years there have been a number of cases where the courts have had to consider questions of priorities in relation to the debts of unsecured creditors where those debts have been incurred by a corporate trustee in the course of carrying on a trading business authorised by the trust instrument and where subsequently the trustee is wound up.

I propose to preface what I am going to say on this topic with a statement of a few very basic principles. A trustee who carries on business is personally liable for the debts incurred by him in the course of carrying on that business. He can be pursued by

the process of execution to his own assets. There is no direct way of getting to trust assets either by the process of execution or by way of winding up. In either event the whole thing must go through the trustee.

The trustee does have a valuable asset called a right of indemnity against the trust property in respect of debts incurred by him in administering the trust and in particular in conducting any business that he might lawfully carry on employing trust assets: Vacuum Oil Company Pty. Ltd. v. Wiltshire (1945) 72 C.L.R. 319 at 324 per Latham C.J. That right of indemnity is supported by an equitable lien over the assets arising by operation of law which in point of security ranks behind any security which the trustee himself creates for the benefit of a creditor but ranks ahead of the claims of the beneficiaries.

The equitable lien remains irrespective of whether or not the trustee continues in possession of the assets. If he is removed from office and the assets vested in a successor trustee, the former trustee will nevertheless be able to enforce his lien.

The trustee's right of indemnity and its related equitable lien are however limited in a number of important respects. First, if the trust instrument authorises the employment of part only of the trust assets in connection with the business conducted by the trustee, the lien is limited to those assets and to those assets alone: Re Johnson (1880) 15 Ch.D. 548. In the modern discretionary trust or unit trust the powers are generally couched in terms where the whole of the trust assets are capable of being committed to the business venture conducted by the trustee so that this limitation seldom arises in practice.

Secondly, if the trustee has committed a breach of trust and is liable to restore money to the trust fund, then the amount concerned will be set-off against his claim to indemnity thus reducing the claim or indeed quite probably eliminating it all together: Re Johnson (supra) and Re British Power Traction and Lighting Co. Ltd. (1910) 2 Ch. 470.

Thirdly, if the debt incurred by the trustee is a result of a transaction outside his powers or vitiated by reason of a conflict of interest, the trustee will have no right of indemnity and therefore no lien on trust assets in respect of it: Vacuum Oil Company Pty. Ltd. c. Wiltshire (supra).

These difficulties have been considered recently when a new section 229A of the Companies Code was enacted which provided in effect that where a corporate trustee incurs a liability and the corporation is for any reason not entitled to be fully indemnified out of the assets of the trust in respect of that liability, the corporate trustee and its directors in office at the time when the liability was incurred and who are not innocent directors are jointly and severally liable to discharge that liability.

An innocent director for this purpose is defined as one who, if he were a trustee, would be entitled to full indemnity from his co-trustees in respect of the liability concerned. I suppose if a director were out of the country when the decision was made or indeed actively opposed the making of the decision he might well bring himself within the definition of an innocent director.

An indemnity is only as good as the person giving it and in my view section 229A is of very limited value indeed. Despite the recent legislation creditors, and particularly unsecured creditors, of a trust suffer a serious disability from the limitation of the trustee's rights to which I have referred. No creditor can safely enter into a transaction with a trustee with any confidence of having resort to trust assets for the satisfaction of his debt without painstaking and time-consuming enquiry and professional assistance. And that is simply not possible in the overwhelming number of cases in a busy modern commercial environment.

I want to just make a few brief observations about the recent decision of Re Suco Gold Pty. Ltd. (1983) 1 ACLC 895. The trustee's right of indemnity is generally described as being of two kinds and the difference between them is important for what I am about to say. On one hand when the trustee has paid the debt, he has a right to recoup himself from the trust assets. The moneys recouped form part of his own assets and are available for his creditors irrespective of whether they are personal creditors or trust creditors.

On the other hand the trustee does not have to first pay the debt. He is permitted a right of exoneration - a right to discharge the debt directly from the trust assets and without having resort to his own assets at any stage: Re Suco Gold Pty. Ltd. (supra) at page 901. Co-extensively with that right of indemnity in the trustee is a right of subrogation in the creditor. The creditor is neither at law nor in equity an assignee of the trustee's rights of indemnity and lien, but he is nevertheless treated in equity as if he were so to the extent necessary to enable him to exercise the remedies which the trustee is entitled to exercise as against the trust assets: Orakpo v. Manson Investments Pty. Ltd. [1977] 1 All E.R. 666 at 676. To the extent that the trustee's right of indemnity is diminished or lapses then of course so does the right of subrogation.

In Re Byrne Australia Pty. Ltd. [1981] 1 NSWLR 394, Needham J. held that in the liquidation of a corporate trustee, trust assets could be applied only to satisfy the debts of trust creditors and no part could be used to pay the expenses of winding up including the remuneration of the liquidator.

This view was not adhered to by a decision of the Full Court of the Supreme Court of Victoria in Re Enhill Pty. Ltd. (1982) 7 ACLR 8, where that Court held in similar circumstances that the liquidator of a corporate trustee was entitled to have resort to

trust assets to satisfy any amount for which the trustee was entitled to claim under his indemnity and that such amount was liable to be distributed according to the code of priorities set out under section 292 of the former Uniform Companies Act to all creditors whether personal creditors or trust creditors. Accordingly the expenses of liquidation including the liquidator's own remuneration were to rank as a first priority.

In Re Suco Gold Pty. Ltd. (supra), the Full Court of the Supreme Court of South Australia had to consider the same question in similar circumstances except that in that case there was not one but two trusts involved in relation to the one trustee. As in the previous cases the liquidator sought clarification as to whether resort could be had to the moneys payable to the trustee of the trust funds in exercise of its right of indemnity for the purpose of paying the costs and expenses of winding up including the remuneration of the liquidator. King C.J. emphasised the distinction between a trustee who had discharged trust creditors' liabilities and one who had not. In the former case, if the trustee reimburses himself from the trust fund, he can deal with the moneys received as he pleases. In the latter he may apply the trust money directly to the payment of trust creditors or he may take it into his own possession for that purpose. If he does so, the property retains its character as trust property and may only be used to pay the trust creditors concerned. Any other application of the money, King C.J. thought, would be a breach of trust.

He went on to say:

> "The liquidator is bound by the provisions of section 292 (that is of the old Uniform Act) with respect to the payment of the company's debts. He must therefore endeavour to pay the debts in accordance with the order of priority set out in that section. To the extent that each priority debt has been incurred in the performance of a particular trust, he should have recourse to the property of that trust for the purpose of paying it. If there is a residue of assets of a particular trust after payment of the priority debts incurred in the performance of that trust, that residue should be applied to the payment of the other debts applicable to that trust. If there is a deficiency in the assets of a particular trust the non-priority debts applicable to that trust would have to rank pari passu. The unpaid balance would, of course, rank for dividend out of the general assets of the company but as there are no such assets that is an academic consideration."

As to the costs of winding up, his Honour thought that there were strong practical considerations in favour of allowing those as a priority and that such a course would be justified by reference to the obligations of the trustee company arising out of carrying on of the business authorised by the trusts. Accordingly the liquidator was entitled to have recourse to the trust property for the purpose of meeting the costs and expenses of winding up,

the costs of the petitioning creditor and the liquidator's remuneration, but only so far as they were incurred in relation to that particular trust. I emphasise that in the Suco Gold case there were two trusts and that an apportionment had to be made.

That approach now seems to have been followed by McLelland J. in the Supreme Court of New South Wales in Re A.D.M. Franchise Pty. Ltd. (1983) 1 ACLC 987, but as far as I am aware the subject has not been discussed by any other superior court in Australia or by any other Court of Appeal or Full Court.

I suggest that the reasoning set out in the judgment of King C.J. can be tested by speculating on what would have been the result if a creditor had secured the appointment of a receiver of the trust. The receiver's remuneration and the creditor's costs in appointing him would be paid out of the assets of the trust first. After paying off the secured creditors he would then pay the trustee the amount required to discharge his lien and indemnity. The creditors wouldn't allow that money to be paid directly to the trustee but rather would assert their rights of subrogation directly against the receiver, standing, as it were, in the trustee's shoes.

Bearing in mind that the creditors are still unsecured creditors, and I emphasise that, and as against the trustee have only a right of subrogation and no more, I cannot see why the code of priorities applicable to the trustee in the event of his or its bankruptcy or winding-up is not applicable. The creditors chose to deal with him and must therefore accept the code of priorities applicable to him.

Modern trading and investment trusts have brought in truck loads of bread and butter to the legal and accounting professions. They have given a healthy distortion to what would otherwise have been the effect of our revenue laws and they have shown and will continue to show that creditors should treat them with the utmost circumspection and respect.