Banking & Financial Services Law Association
30th Annual Conference
29 – 31 August 2013
Gold Coast, Australia

Managed investment schemes and other commercial trusts: the risks creditors run

Dr Nuncio D'Angelo

Norton Rose Fulbright
Level 18, Grosvenor Place,
225 George Street,
Sydney NSW 2000
Australia
nuncio.dangelo@nortonrosefulbright.com

TABLE OF CONTENTS

Banking & Financial Services Law Association
30th Annual Conference
29 – 31 August 2013
Gold Coast, Australia

Managed investment schemes and other commercial trusts: the risks creditors run

Dr Nuncio D'Angelo*

Synopsis [1]

In many ways, the modern Australian commercial trust is an accident of history. Anomalous and enigmatic, if it did not exist it almost certainly would not be invented today in its current form.

Although they may resemble limited liability companies in form and, like companies, may borrow, raise equity and engage in risk-taking business activities (often on a large scale), many managed investment schemes and all private trading trusts are still trusts in legal form. Thus, the law continues to view them through the lens of trust law which, traditionally, is hostile to risk-taking behaviour, is highly protective of beneficiaries and was not designed to facilitate commerce. The regulatory framework that governs Australian companies is constructed around a policy premise that contemplates entrepreneurial endeavour and is highly evolved in that context, with inbuilt protections for investors and creditors. By contrast, Australian trust law is not and so suffers some quite fundamental structural weaknesses as a system for regulating large and complex enterprise entities. The defects are many but perhaps the greatest defect of all is the absence of a coherent insolvency regime.

As a result, stakeholders are exposed to material legal risks and uncertainties, both pre- and post-insolvency, that do not exist for their counterparts in companies. Attempts to mitigate these defects through private means are only, and can only ever be, partially successful. The issues are particularly acute for creditors.[2]

---

* Partner and Head of Banking & Finance (Australia), Norton Rose Fulbright. Some of the arguments and analyses in this paper have appeared in published articles (see Appendix 1) and my PhD thesis, entitled *The Trust: from Guardian to Entrepreneur. Why the changing role of the trust demands a better legal framework for allocating stakeholder risk* (in respect of which I acknowledge the support of my PhD supervisors, Professor Sheelagh McCracken, Professor of Finance Law at the Sydney Law School, and Professor Joellen Riley, Dean of the Sydney Law School). The views expressed are my own and do not necessarily reflect the views of my firm or the experiences of any particular client. Nothing in this paper should be taken as legal or financial product advice.

1 This paper does not deal with all trusts that engage in commercial activities. The 'commercial trust' which is the focus of this paper is limited to managed investment schemes and trading trusts which bear the characteristics described in paragraph 1.4 below. Other expressions and concepts used in this paper are also defined in paragraph 1.4.

2 The primary focus of this discussion is *unsecured* trust creditors, but some of the issues will apply also to those which are secured. The position of trust creditors who hold proprietary security over trust assets is materially superior to that of their unsecured counterparts and they are less exposed to (although not immune from) anomalous outcomes under trust law. Further, as indicated in the definition of 'commercial trust' below, the discussion is limited to voluntary creditors of the trustee; additional considerations apply in relation to tort and other involuntary creditors.

Those responsible for regulating the activities of business associations in Australia have unwittingly allowed a situation to arise that is a disturbing echo of pre-companies law England. Australian commercial trusts are lineal descendants of the English trust-based unincorporated joint stock companies that were commonly used to raise public subscriptions for large business enterprises in England, particularly during and following the Industrial Revolution, in an environment where securing a Royal or Parliamentary charter of incorporation was difficult. Those entities were almost entirely unregulated and were highly vulnerable to fraud and insolvency. For these reasons, eventually they were outlawed by the first 'incorporation by registration' legislation in 1844. Thereafter in England trusts receded to their traditional role of risk-averse guardian of family assets and so there was no compulsion to develop a dedicated body of commercial and insolvency law for trusts.

Despite this, after WWII there evolved a species of trust in Australia that once again engaged in risk-taking business activities. However, the law of trusts did not evolve with it. Even today, commercial trusts are only partially regulated, through the managed investments regime in the Corporations Act but, as this paper seeks to demonstrate, that is a seriously inadequate framework. Well-advised parties in 21st century Australia are aware that there are legal risks in using the trust vehicle in this way and seek to deal with them through structuring and documentation techniques. The result is an entity that is in essence a company in all but legal form and may be perceived by non-expert investors and creditors as providing them with the same or a similar legal risk profile as if they had participated in a company. However, not all of the trust-specific legal risks can be eliminated by private means.

The issues are now crystallising in the aftermath of GFC collapses of substantial commercial trusts and litigation, and official enquiries, continue. While the current reform agenda in New Zealand appears to be directed at the broader use of trading trusts,[3] *in Australia the focus seems to be limited to managed investment schemes. It is acknowledged that substantial value is bound up in trusts that are of this type but they do not comprise the entire universe of commercial trusts in Australia. Calls for broader reform in this area have been made since at least the 1980s but the process overall has been disappointing, with a low rate of adoption of recommendations. The latest Australian contribution to the reform debate, the CAMAC Report of 2012, seems destined to suffer a similar fate.*

The message, for the time being, is clear: caveat creditor.

The law stated is as available and known to me on 12 August 2013.

[3] See http://www.lawcom.govt.nz/project/review-law-trusts.

1. Introduction, historical background and definitions

It may convincingly be argued that Australian trust law does not properly accommodate the reasonable commercial expectations of creditors of commercial trusts, particularly those which are unsecured. Trust law offers them very little in the way of protection when dealing with a trustee. Moreover, trust law's protective predisposition towards beneficiaries and 'their' trust property can appear to punish creditors for misconduct of the trustee, even if they are innocent and ignorant of that conduct.

Canadian commentators have observed that:

> the law is not simply unfair from the creditor's perspective but is also quite at odds with the expectations of commercial parties generally. As business trusts proliferate, this is a matter of no small importance … the proposition that an unsecured creditor of a trustee of a business trust will only have recourse against the assets of the trust on the basis of a derivative claim through the trustee's indemnity is highly unsatisfactory from a commercial standpoint.[4]

That observation applies with equal force in Australia, but describes merely one of the challenges facing creditors of Australian commercial trusts.

In this paper, as in commerce, the commercial trust is often spoken of as an entity. This personification or reification is not surprising because commercial trusts do, in effect, operate as standalone economic entities that, in many ways, resemble companies. However, a strictly legal exposition would eschew expressions that speak of the trust as if it were a person; as is well known, under Australian law the trust has no legal personality separate from its trustee and beneficiaries and is not a juristic person.

As a corollary, legally speaking it is not correct to describe a trust creditor as being a creditor of 'the trust'. However, that notion is commonly expressed in commerce and, indeed, from a commercial perspective they are debt participants in the economic enterprise held within the trust. Unless familiar with the intricacies of trust law (and, importantly, the differences from company law), trust creditors may mistakenly believe that their position with respect to equity investors and the enterprise assets is similar to that of a creditor of an economically corresponding enterprise conducted under a corporate form. This misapprehension can lead to unfortunate consequences for an unwary trust creditor.

This paper identifies key anatomical elements of these risks, many of which have not been the subject of detailed treatment in the case law or the literature, and analyses them critically by reference to their sources in trust law.[5]

1.1. The issues

The principal issues the subject of this paper are these:

No 'innocent outsider' protection

Creditors of commercial trusts do not enjoy the benefit of 'innocent outsider' protections of the type provided to creditors and intending creditors of companies and so must take proactive steps by way of due diligence and documentary comfort to protect themselves.

An indirect derivative claim against trust assets

When it comes to enforcing their claim against enterprise assets, unsecured creditors suffer what may be described as a 'double equity risk' because they must navigate two equitable claims: the trustee's equitable indemnity with respect to those assets and the creditor's equitable remedy of subrogation to that indemnity. Being sourced in equity, both are discretionary and thus subject to a range of disentitling events, not all of which are in the control of the creditor. A specific trust creditor's claim to the indemnity may be impaired by breaches of trust by the trustee, whether they are related or

---

4 DA Steele and AG Spence, 'Enforcement Against the Assets of a Business Trust by an Unsecured Creditor' (1999) 31 *Canadian Business Law Journal* 72 at 81-82.

5 Among the many issues with which this paper does not deal but which have been identified and canvassed elsewhere are the dangers for a creditor in dealing with an undisclosed trustee, issues in seeking and taking security over trust assets, and problems for creditors arising from the rule in *Barnes v Addy* (1874) LR 9 Ch App 244 (that is, knowing assistance in a breach of trust and knowing receipt of trust property in breach of trust).

unrelated to that creditor's claim. This exposes the trust creditor to risks that do not exist for their counterparts who extend credit to companies.[6]

No insolvency regime

There is no insolvency regime for commercial trusts that gives unsecured creditors preferential status over equity investors.[7] Because they are not companies, commercial trusts (even those which are managed investment schemes) are in effect invisible to the insolvency framework in the *Corporations Act*. Even the regulatory regime for commercial trusts that are MIS, itself contained within the *Corporations Act,* fails to deal adequately with insolvency.[8] Yet there is no established alternative 'insolvency law' as such for commercial trusts. Issues of insolvency pertaining to a trust have been left to be analysed on a first principles basis, by reference to the financial state of the trustee. This statutory vacuum has left modern Australian courts to develop a common law of insolvency for commercial trusts in the traditional manner, via the resolution of fact-dependent private disputes between self-interested parties in an adversarial context, applying an uncomfortable amalgam of trust law, company law and contract law principles.

Matrix of defects = inversion of priorities

Among other things, this matrix of 'defects' may result in an inversion of priorities vis-à-vis equity investors when compared to that applicable to companies: in an insolvent winding up of a commercial trust, equity investors can be in a better position in respect of the enterprise assets, both legally and economically, than creditors. The controversy generated by the 2007 decision of the High Court of Australia in *Sons of Gwalia v Margaretic* demonstrated the depth of attachment to the fundamental commercial principle that, as far as arm's length creditors are concerned, the claims of equity investors should always be subordinate to their claims[9] (even if the attachment to that principle might be based on erroneous assumptions about the history of company law[10]).

Efforts to protect against those risks by structuring and documentation techniques involve transaction costs and delays but, in any case, complete prophylaxis is not possible. Due to the limitations of the Australian trust device and the law which governs it the results are necessarily imperfect and creditors' expectations are not always met. The inevitable result is uncertainty, disputes, litigation and unexpected losses, as has been evident in the post-GFC era.

---

6 Secured creditors do not suffer this risk. Their access to trust assets on enforcement is direct, via their security. Their primary concern is to ensure that the security is given properly by the trustee. They may, however, become subject to this 'double equity' risk if their security fails or if there is a shortfall in recovery against the secured assets.

7 For secured creditors, see previous footnote.

8 A point acknowledged in the *CAMAC Report* and by various commentators: see, for example, RI Barrett, 'Insolvency of Registered Managed Investment Schemes' (Paper presented at the Banking & Financial Services Law Association Annual Conference, Queenstown NZ, July 2008).

9 In *Sons of Gwalia v Margaretic* [2007] HCA 1 the Court held that shareholders who had a claim in damages against a company for misleading or deceptive conduct in connection with their shareholding ranked as creditors alongside ordinary unsecured creditors in corporate insolvencies. In 2010 the *Corporations Amendment (Sons of Gwalia) Act 2010* (Cth) amended the *Corporations Act* to reverse the effect of the decision, effectively by replacing the subordination provision at the heart of the decision, s563A, with a new provision having a much wider scope in relation to shareholder claims. A summary of investors' and creditors' concerns with the decision is set out in Corporations and Markets Advisory Committee, 'Shareholder Claims Against Insolvent Companies: Implications of the *Sons of Gwalia* decision' (December 2008) and Chapter 2 of the Explanatory Memorandum which accompanied the amending legislation.

10 *Sons of Gwalia v Margaretic* [2007] HCA 1 at [36]-[37] (Gummow J).

1.2. How and why has this happened? From guardian to entrepreneur[11]

> A salient aspect of the modern-day [Australian] trust has been its penetration into commercial life, becoming a popular vehicle for commerce. Whereas the 19th century use of trusts was principally for the retention and redistribution of wealth within the family, its 20th century expansion has been chiefly in the commercial arena.[12]

The core of the argument

Over the course of several centuries, the trust has evolved:

- from a 'guardian', ie an arrangement designed to protect and preserve, over time and generations, private landholdings transferred gratuitously to, and managed in a conservative risk-averse manner by, one or more human trustees acting gratuitously,
- to an 'entrepreneur', ie a business vehicle managed by a remunerated corporate trustee which raises equity funds from arm's length investors and incurs debts to arm's length external counterparties, for use in risk-taking, profit-maximising enterprise, similar in many respects to a trading corporation.

However, the law of trusts has not evolved with it.

In the beginning…

The trust device emerged in feudal England, several centuries before Australia was settled by Europeans. Its original purpose was to assist men to protect and preserve private landholdings.

Scholars disagree on the precise juridical genesis of the trust and its relationship, if any, with non-English progenitors.[13] Regardless, the trust is inherently bound up in the uniquely English development of an equity jurisdiction as a stream of jurisprudence separate and distinct from the common law. Thus, to understand the trust one must understand equity.

The development of the trust as a creation of equity and the Chancery courts is well documented. It certainly did not 'spring full-grown into being. There were centuries of growth and gestation before it took its place as the central feature of the system of equity'.[14] The trust owed much of its development to the willingness of Chancery to side with deserving claimants to circumvent the strictures of the common law and even of statutes (including measures intended to raise taxes or feudal imposts).[15] Chancery was particularly willing to facilitate the preservation and orderly distribution post mortem of a man's wealth for the benefit of his family at a time when it was not legally possible to bequeath land by will.[16] The trust allowed a man to circumvent harsh feudal rules[17] by conveying his land *inter vivos* to male friends for his own use while alive and after death for the benefit of his family or other selected beneficiaries.

---

11 The time frame and historical territory to be traversed in considering the evolution of the trust is vast, as is the primary and secondary material that relates to it. That demands a certain economy of coverage for a paper of this type and so this is a very high level summary only.

12 G Dal Pont and DRC Chalmers, *Equity and Trusts in Australia* (4th ed, Law Book Co, 2007) at [27.05].

13 Holmes and others believed that the origin of trusts (and, before them, uses) could be traced back to early Germanic law; indeed, the similarities between the Germanic *salman* and the English feoffee to uses was declared by Holmes 'to be enough, without more, to satisfy me that the latter was the former transplanted': OW Holmes Jr, 'Early English Equity' (1885) 1 *Law Review Quarterly* 162 at 164. See, too, OW Holmes Jr, *The Common Law* (Belknap Press of Harvard University Press, 1881) and JB Ames, *Lectures on Legal History and Miscellaneous Legal Essays* (Cambridge University Press, 1913); but cf JL Barton, 'The Medieval Use' (1965) *Law Quarterly Review* 562. Others have said its origins lie in the Roman law concept of *fidei commissa*: J Story, *Commentaries on Equity Jurisprudence as Administered in England and America* (13 ed, Melville M Bigelow, Little Brown & Company, 1886), Volume II at 268-269. Maitland acknowledged both: FW Maitland, *Equity - A Course of Lectures* (Cambridge University Press, 1936, reprinted 1969), Lecture III (*The Modern Trust*).

14 AW Scott, WF Fratcher and ML Ascher, *Scott and Ascher on Trusts* (5th ed, Aspen Publishers, 2006)at §1.3.

15 It has been argued that the changes wrought by Chancery were so dramatic that they required the entire legal profession and other vested interests to acquiesce in what was 'in essence a legal fiction, with all sides in agreement that one state of affairs would appear on the legal record … while a completely different state of affairs would be given effect in real life…': DJ Seipp, 'Trust and Fiduciary Duty in the Early Common Law' (2011) 91 *Boston University Law Review* 1011.

16 It was not until the *Statute of Wills* (32 Hen. 8, c. 1, 1540) that it was legally possible for a landholder to pass real property on by will.

17 Such as primogeniture (which could leave a widow, daughters and younger sons destitute), wardship (by which the feudal lord could take wardship of a widow's minor children and the rents and profits of a dead man's land until the heir reached majority) and escheat (by which land held by a man dying without natural heirs would revert to the feudal lord or the King): see P Matthews' essay on *Burgess v Wheate* (1759) 1 Wm Bl 123; 96 ER 67 in C Mitchell and P Mitchell (eds), *Landmark Cases in Equity* (Hart Publishing, 2012) at 115.

The arrangement was not only for the benefit of men. At a time when married women were legally incapable of owning land or other assets of value by the so-called doctrine of coverture,[18] a father wanting to provide for his married daughter separately and beyond the reach of her husband (and his creditors), or indeed a man wanting to provide independent means for his wife, could settle property on male trustees for her benefit.[19]

The trust meets commerce to create the first 'commercial trusts'

The trust originated as a device for the private ordering of interests in land but it was not in its origins or for centuries thereafter called in aid of commerce:

> Chancery never set out to provide general regulation of dealings in the market place [or to] correct the clear eyed and hard hearted perception of the common law that a loss suffered in trade or commerce 'is often no more than one of the ordinary consequences of participation in a market economy'.[20]

Despite that, certain essential characteristics of the trust, evident from the outset, appear eventually to have been identified by entrepreneurs and their advisers as useful for commercial purposes:

(1) an ability to circumvent legal obstacles and avoid unwanted outcomes otherwise mandated by the common law or statute;

(2) a proprietary element that permitted the creation, recognition, protection and enforcement of multiple separate economic interests in property;

(3) an essentially personal fiduciary framework that facilitated the separation of ownership and management of property and offered inbuilt protections for beneficiaries and contracting third parties through the imposition of personal obligations, liabilities and sanctions on trustees; and

(4) almost infinite flexibility, which allowed both the proprietary and personal elements to be fashioned to accommodate specific requirements and desired outcomes.[21]

Through the application and skilful manipulation of these elements, entrepreneurs and their lawyers were able to put trusts to commercial use, to support and enhance arrangements that, up to that point, had been constructed around the available but functionally primitive common law concepts of contract, partnership and agency. Enterprise assets were placed in the hands of trustees who conducted the business of the entity, eventually via a delegated management committee, on behalf of all the participants. This synthesis of legal and equitable concepts liberated entrepreneurs from the inherent constraints in contract and partnership based structures and allowed business enterprises to grow into entities of great size and complexity, including by the injection and pooling of 'passive' capital and the creation of tradeable 'equity' interests.

The apotheosis of this evolutionary process was the unincorporated joint stock company (sometimes called 'deed of settlement' company) that arose and became popular as a vehicle for large-scale enterprise as a more readily available alternative to incorporation under a Royal or Parliamentary charter, the securing of which was fraught with uncertainty, delay and costs in a process that was open to political machinations and corruption. These hybrid entities were configured in manner that would today be described as a unit trust and were called 'companies' despite not being incorporated. They were, in effect, common law companies and the first 'commercial trusts', and they existed for several centuries, largely unregulated, before they were finally outlawed in the mid-19th century by general

---

18 That is, before passage of the *Married Women's Property Acts* of 1882 and 1893.

19 Nor was the trust's ability to circumvent confined necessarily to family arrangements. As early as the 13th century the trust (or use) was used to hold land for the benefit and use of Franciscan friars and other mendicant orders, who were otherwise forbidden to own property. Land for their use was conveyed to men who were friends of the order or to the borough community who thus held title while possession and all of the agricultural benefits of the land were enjoyed by the friars.

20 PA Keane, 'The 2009 WA Lee Lecture in Equity: The conscience of equity' (2010) 84 *Australian Law Journal* 92 at 98 (quoting from *Perre v Apand Pty Ltd* (1999) 198 CLR 180).

21 These elements are, of course, inter-related: circumvention is a function of flexibility and is achieved by manipulating the proprietary and/or personal elements, which are themselves intertwined. Nevertheless, it is useful to consider them as separate limbs. Tax advantages might be described as another element, but they should be seen as a consequence of these four rather than as a fifth limb. A similar point may be made about the trust's ability to shelter assets from creditors on bankruptcy, whether of the settlor himself or herself or those of spendthrift offspring.

companies legislation, which created incorporation by registration.[22] The absence of effective regulation before this led to these entities featuring prominently in the frequent emergence and financially calamitous collapses of market 'bubbles'. This created a situation that the courts found difficult to resolve using available common law and equitable remedies. By the 19th century commerce had raced well ahead of the law, leaving a serious regulatory gap.

The challenge of insolvency

A consequence of particular relevance for the present discussion was the challenge of insolvency. Before general incorporation legislation, insolvent companies (some of them the notorious bubble companies) were dealt with in the Courts of Chancery by application of basic agency, partnership, contract, bankruptcy and trust law; there was no other choice in the absence of a legislative regime.[23] While those courts tended to apply fiduciary principles and rules applicable to the administration of estates, in which they were expert, when it came to allocating liability for losses they did not invariably do so.[24] The distribution of assets and losses when these entities collapsed became something of an *ad hoc* process with very little certainty around outcomes.

Harris noted that by the early 19th century Chancery became clogged with the volume of cases brought before it: 'there could be up to 20,000 pending cases, and a plaintiff could expect to wait as long as thirty years for a final judgment … the Court of Chancery [became] a place to be avoided if at all possible'.[25] The need for legislative action was recognized and finally, as part of the process of constructing a body of general companies legislation, Parliament enacted a series of *Joint Stock Companies Winding-up Acts* in the 1840s and the *Limited Liability Act* in 1855. To this day, there is no equivalent for commercial trusts (including those which are managed investment schemes).

The end of history for the commercial trust in England

The advent of general incorporation legislation marked the end of history for the commercial trust as a business and trading entity in England. The law applicable to unincorporated companies before the enactment of this legislation was suffused with trust law principles and, for a time after it, in the absence of any other option, the courts continued to draw guidance from trust law (among others) when dealing with companies incorporated under that legislation.[26] Soon enough, however, as the focus of commercial endeavour shifted to the incorporated form and the relationship between the trust and the company became more distant, company law took its own path and diverged from trust law. A distinct body of case law evolved, and companies legislation was regularly amended, to deal with new and emerging circumstances requiring regulation.

Trust law as a regime for regulating private conduct receded to its traditional role. The context in which disputes involving trusts came before the courts reverted to the historical one, ie the trust as guardian, with the Chancery courts acting in their customary role as stern and unforgiving supervisor of trustees and protector of beneficiaries. As those adjudicating company law disputes became

---

22 A process which began with the *Joint Stock Companies Act 1844* and, after almost two decades of amendments and replacements, culminated in the *Companies Act 1862*, which in effect rationalised and consolidated the preceding legislation. An earlier attempt at abolition, the so-called *Bubble Act* of 1720, was a failure and was repealed in 1825.

23 See generally J Getzler and M Macnair, 'The Firm as an Entity Before the Companies Acts' in P Brand, K Costello and Osborough (eds), Adventures of the Law: Proceedings of the Sixteenth British Legal History Conference, Dublin, 2003 (2005). Vestiges of Chancery's involvement remain evident throughout the *Corporations Act* but relevantly in this context is the 'just and equitable' ground for winding up a company: see s461(1)(k). Further, 'even today when the Federal Court or a Supreme Court … orders that a company be wound up it is the court that administers the winding up through the insolvency practitioner … whom it appoints as liquidator and whom it treats as an officer of the court': *Ford on Corporations Law* at [2.160]. See also AK Ehlers, 'The inherent equitable jurisdiction and the plenary power of the Supreme Court of New South Wales to order the winding up of companies' (2010) 18 *Insolvency Law Journal* 52.

24 M Lobban, 'Nineteenth century frauds in company formation: Derry v Peek in context' (1996) 112 *Law Quarterly Review* 287 at 304, citing (1850-1851) 16 *Law Times* 181.

25 R Harris, *Industrializing English Law - Entrepreneurship and Business Organization, 1720-1844* (Cambridge University Press, 2000) at 164.

26 See generally FW Maitland, *The Unincorporated Body* (Collected Papers, 1903) and Getzler and Macnair, n23. Given their relevance to the unincorporated association, the laws of partnership, agency and contract were also applied, and elements of them are apparent in modern company law. There is a rich literature around the historical relationship between directors and trustees, the most recent contribution to which is M Pearce, 'Company directors as "super-fiduciaries"' (2013) 87 *Australian Law Journal* 464.

focused on facilitating risk-taking entrepreneurial activity, the courts reasserted trust law's original conservative and protective bias. Of this period Justice Gummow observed that:

> the trust as a mechanism for the conduct of business enterprise went into decline. In addition to the statutory forces at work directing efforts into incorporated entities, what Ogus (op. cit.) describes as the 'intense fiduciary principles' developed in the nineteenth century for trustees of family settlements were unreasonably stringent for the entrepreneur. In particular, directors were given more flexibility in exercise of their powers than trustees. It has not always been readily appreciated how misleading it is to describe directors as trustees … [27]

Thus, after incorporation became readily available by the simple process of registration, entrepreneurs were shepherded away from the trust and towards the incorporated form. Trusts ceased to be used as vehicles for risk-taking enterprise and so the courts and the legislatures were not compelled to progress or expand the law of trusts to suit commerce. Trusts rarely 'collapsed' into insolvency and so there was no imperative to develop a specific body of 'insolvency law' to deal with them. As a matter of policy, there prevailed a view that commerce was for companies, not trusts.

Meanwhile, in Australia…

Although the Australian colonies adopted corresponding companies legislation soon after the *Companies Act 1862*, including a provision which proscribed unincorporated business associations,[28] the commercial trust emerged (or, it could legitimately be said, re-emerged) in the latter part of the 20th century to become a significant competitor to the company. The reasons for this metamorphosis are interesting.

The starting point is that the 'asset management' or 'investment' trust survived the prohibition thanks to the decision in *Smith v Anderson* (1880) 15 Ch D 247 (often called the *Submarine Cables' Trust case*) in which the Court of Appeal held that investing in and holding shares and other securities was not, in and of itself, the carrying on of business in the relevant sense. This permitted the creation and dramatic growth of the public unit trust in Australia in the early to mid 20th century.[29]

However, post-WWII Australian promoters realised that the prohibition could be circumvented even for active trading and business enterprises by using a corporate trustee with expansive powers to conduct business and a wide discretion to exercise those powers, and curtailing the beneficiaries' powers correspondingly so that they became passive investors. Provided the relationship among investors, and between them and the trustee, were configured appropriately and, most importantly, that the investors had no mutual rights and obligations *inter se*, it would be difficult to argue that together they comprised a partnership or 'association' in the relevant sense. This realization, fuelled by certain tax advantages and a less regulated environment than that applicable to companies, eventually led to the use of the trust (and later the managed investment scheme) for active entrepreneurial endeavour – resulting in a renaissance of the commercial trust as a competitor to the company.[30]

---

27 *Elders Trustee & Executor Co Ltd v EG Reeves Pty Ltd* [1987] FCA 332 at [152].

28 Originally they were the *Companies Act 1874* (NSW), *The Companies Statute 1864* (Vic), the *Companies Act 1863* (Qld), the *Companies Act 1864* (SA), and the *Companies Act 1869* (Tas). Before then Australia also had unincorporated joint stock companies, perhaps the most famous (and indeed the first) of which was the Bank of New South Wales (now Westpac Banking Corporation), formed in 1817. The proscription is currently embodied in *Corporations Act 2001* (Cth), s115, which provides that "[a] person must not participate in the formation of a partnership or association that: (a) has as an object gain for itself or for any of its members; and (b) has more than 20 members; unless the partnership or association is incorporated or formed under an Australian law".

29 A development which is well documented: see, for example, HAJ Ford, 'Unit Trusts' (1960) 23 *Modern Law Review* 129; GC Spavold, 'The Unit Trust - A Comparison with the Corporation' (1991) 3 *Bond Law Review* 249; RA Hughes, *The Law of Public Unit Trusts* (Longman Professional, 1992); Australian Law Reform Commission and Companies and Securities Advisory Committee, 'Collective Investments: Other People's Money' (Report No 65, 1993); Australian Government, 'Review of the Managed Investments Act 1998' (December 2001); BT Mees, MS Wehner and PF Hanrahan, 'Fifty Years of Managed Funds in Australia: Preliminary Research Report' (University of Melbourne Centre for Corporate Law and Securities Regulation, 2005); PF Hanrahan, 'ASIC and managed investments' (2011) 29 *Companies & Securities Law Journal* 287.

30 Tax matters are beyond the scope of this paper. It must be acknowledged, however, that taxation has been a significant factor in the history and evolution of the trust and trust law; that is clear from the abundant literature and authorities in Australia and elsewhere. A discussion of the relationship between trusts and taxes must also acknowledge an important distinction. On the one hand, Australian tax laws expressly contemplate trusts and as a matter of policy deliberately extend certain benefits to participants in them (eg pass-through status) if they are structured a certain way and conform to certain ongoing requirements; in this context, the trust is not used as an instrument of tax evasion or avoidance. On the other hand, there is a long history of the trust being used specifically as a device for evading, avoiding or minimising both direct and indirect taxes.

Despite this evolution, Australian trust law remained resolutely anchored in its origins. Although the trust competed with the company it was not, and even today is not, regulated in the way that companies are. Participants in commercial trusts do not enjoy the benefit of a dedicated regulatory regime to replicate the investor and creditor protections imposed by companies law. In 1980, Australian equity scholar and later judge of the Federal Court of Australia, the late John Lehane, observed that:

> In general terms, company law - both statutory and general - proceeds on the assumption that it is normal and appropriate for a trading concern to be organised as a company incorporated under the Companies Act [a predecessor of the *Corporations Act*]. It is not unfair to say that the whole of trust law - both statutory and general - proceeds on the contrary assumption about trusts.[31]

Although some other common law countries today have a business trust or trading trust concept,[32] in none of those places does the scale of use approach that in Australia.[33] The modern large-scale commercial trust is in some quarters regarded as an Australian idiosyncrasy.[34] An English commentator noted in 1995 that 'Australia has developed concepts of trading trusts in the last decade or so which appear to be responsible for the only major source of modern learning of the topic of trustee liabilities, even though to English readers the words trading trust look like a contradiction in terms'.[35] Another described the insolvent trading trust as a 'specifically Australian problem'.[36] Even in Australia, the trading trust has been described as an 'antipodean mutation'.[37] Slater observed that the trading trust 'has few parallels outside Australia'.[38]

1.3. Transformation of the role of the beneficiary, the trustee and the trust creditor

This evolution has fundamentally transformed the role and expectations of the three principal stakeholders:

The beneficiary

No longer 'widows and orphans' or members of the extended family of the settlor/testator, beneficiaries have become equity investors or equity participants in the commercial trust enterprise, at arm's length to the trustee and each other. They do not acquire their economic interest in the trust fund gratuitously; rather they 'buy' it, either by contribution (ie subscribing cash or other assets for units) or by transfer (ie acquiring an existing unit holding). Their expectations are very different from those of a beneficiary under a testamentary trust or family settlement; rather, they are akin to those of a shareholder in a trading corporation.

The trustee

Originally the trustee was a natural person (and very often several of them acting together), usually of high repute, and well-known to and trusted by the settlor or testator, acting gratuitously or for a relatively nominal stipend. It was not only their personal reputation that was at risk when managing the estate; their personal assets were available to support trust debts and to make good certain losses to the estate. By contrast, the modern commercial trustee is a corporation, often at arm's length to all

---

31 John Lehane, 'Trading Trusts in *The Companies Bill 1980 — The Revised Draft* (University of Sydney, 1980), cited in Companies and Securities Law Review Committee, 'Forms of Legal Organisation for Small Business Enterprises' (1984).

32 Including the United States, Canada, New Zealand and Singapore. Interestingly, it is not a feature of the English landscape. The unit trust is well-known in England and continues in use for mutual investment funds but not, it seems, for active profit-maximising business activities: see MW Lau, *The Economic Structure of Trusts* (Oxford University Press, 2011). It appears that, in England, 'the trust does not normally empower the trustee to trade': C McCall, 'Trustees - risks they never thought they ran' (1995) 6 *Private Client Business* 419 at 422. See also G Thomas and A Hudson, *The Law of Trusts* (2nd ed, Oxford University Press, 2010) at [55.15].

33 In relation to MIS, see the statistics in ASIC's *Regulatory Statement on Managed Investments: Constitutions* dated June 2013. The growth in 20th century Australia of the public unit trust and, since 1998, the managed investment scheme, is well documented: see, for example, Australian Government, 'Review of the Managed Investments Act 1998' (December 2001); Mees et al, n29; Hanrahan, n29.

34 See D Ipp, 'The diligent director' (1997) 18(6) *Company Lawyer* 162 at 167; McCall, n32, at 422-423; A Trukhtanov, 'The irreducible core of trust obligations' (2007) 123 *Law Quarterly Review* 342.

35 McCall, n32, at 423.

36 C Harpum, 'Book Review' (1986) 45 *Cambridge Law Journal* 347 in a review of PD Finn (ed), *Essays in Equity* (Law Book Co, 1984).

37 P Agardy, 'Aspects of Trading Trusts' (2006) 14 *Insolvency Law Journal* 7 at 7.

38 AH Slater, 'Amendment of Trust Instruments' (Paper presented at the Society of Trust and Estate Practitioners, Sydney NSW, 29 September 2009) at 2.

other participants, and it either insists on limiting its personal liability by contract or has no personal assets of value. Typically trustees of smaller commercial trusts are companies set up by the promoters and managers of the enterprise. In larger public commercial trusts they are subsidiaries of banks or financial institutions or wholly independent entities with a solid commercial reputation. Professional corporate trustees bring particular skills and expertise to the role and are remunerated at market rates out of the trust fund for managing the trust as a business enterprise. They are, in effect, professional service providers and act, and are expected by investors and creditors to act, in a manner not dissimilar to the boards of directors of trading corporations.

The trust creditor

Today financiers and other contractual commercial counterparties are prepared to extend credit to the trustees of commercial trusts on an unsecured basis, in circumstances where the trustee has limited its personal liability, and typically look to the creditworthiness of the underlying enterprise rather than of the trustee personally. They may contract on terms not dissimilar to those on which they engage with trading corporations of corresponding size and worth. Their expectations are very different from those of the small trade creditors who provide goods and services to the trustees of a family trust or executors of a testamentary trust, who are usually individuals, where the engagement is supported by their personal reputation and credit – and assets.

Expanded risk appetites and the risk of insolvency

Stakeholders' risk-reward expectations and overall tolerance for risk differ fundamentally from those of their counterparts in the traditional testamentary trust or family settlement. The commercial trust shifted the entire foundational premise of the trust. At the nucleus of the trust notion, as originally conceived, is a deep aversion to risk; this is evident in the law's uncompromising emphasis on trustees' duties and the protection of beneficiaries and the trust estate. However, in pursuing profits and other commercial returns in competitive market environments, trustees of modern commercial trusts are, and indeed are expected by investors to be, more risk-tolerant and entrepreneurial in their dealings with trust property - including by incurring substantial contract debts - than traditional trust law contemplated. This has exposed the trust to the real possibility of financial distress.

Consequences

Despite this, Australian law appears not yet to have fully acknowledged or accommodated this transformation. It has not properly adapted to provide a mature, sophisticated company-like regulatory regime for commercial trusts. Rather, the law continues to view them largely through the lens of traditional trust law, which is hostile to risk-taking behaviour, is overly protective of beneficiaries and is patently not designed to facilitate commerce. This exposes stakeholders to material legal risks and uncertainties, both pre- and post-insolvency, that do not exist for their counterparts in companies. Those who regard the trust as a useful business device are left to address inadequacies by other means, including 'contractualisation' techniques, with the objective of yielding risk profiles that approximate those which result under company law.

Put another way, participants must construct their governing framework privately, both within the entity and when engaging with external persons, filling in manually much of that which would be automatically imposed or implied by law if they were to adopt a corporate form; the 'default rules' which are implied by trust law are very different from those implied by companies law. This exercise necessarily involves a delicate balance of risk-taking and risk-shifting.

Despite these private measures, however, trust participants can be shown to be materially worse off than their counterparts in a company, both pre- and post-insolvency.

1.4. Definitions and abbreviations

The 'commercial trust'

The focus of this paper is the '**commercial trust**'. This expression is not a legal term of art and it is not a category of trust in the traditional taxonomy. It has been used in commerce and the literature to describe a wide range of trusts used in a commercial context, many of which are not the subject of this discussion (eg security trusts, securitisation trusts, superannuation funds, trusts for debenture holders, custodian arrangements). When used in this paper in the Australian context it means an arrangement by which a business enterprise is conducted by the trustee of an express trust:

- which is a unit trust that has been constructed so as to resemble a company in form and function;[39]
- where the trustee is a limited liability company;[40]
- where the beneficiaries are arm's length equity investors in the enterprise who either contribute capital directly by subscription and are issued a tradeable instrument called a 'unit', or acquire pre-existing units by transfer;
- which may be a closely held private arrangement in the form of a trading trust, or a managed investment scheme in the form of a public unit trust with thousands of members and billions of dollars of enterprise value, with units listed on the ASX;
- where arm's length third parties are prepared to provide financial accommodation (including via debt instrument issuances) or otherwise to extend credit to the trustee for the purposes of the enterprise, whether secured over trust assets or unsecured;
- where the trustee is authorised by the trust instrument to carry on, and does carry on, risk-taking business activities with the trust assets with a view to profit maximisation (whether those activities involve an active trading business or passive investment in securities or real property); and
- in the course of which business the trustee is authorised to incur, and does incur, debts.

This definition embraces a wide spectrum of Australian entities from the partially regulated public unit trust (or managed investment scheme) to the almost wholly unregulated private trading trust. Where the distinction is material it is noted, but otherwise the issues are equally applicable across the spectrum.

'Contractualisation'

In investigating the means by which a trust is made to resemble a company, the expression '**contractualisation**' is used. As a neologism in the context of Australian trust law it appears to have been coined by Professor Michael Bryan in 2003[41] albeit without specific definition. It is also much used in American law and economics literature. As used in this paper it describes the use of private bargaining techniques, and contractual and contract-like documentary devices derived from and operating in a manner analogous to contractual principles, to shape or reallocate the risks of any of the three principal participants in the commercial trust enterprise. Contractualisation is not a concept of the law of contract, despite the apparent etymological connection. Nor is the law of contract a part of the law of trusts (or vice versa). While a trust can be created by a contract, it is fundamentally incorrect to say that the trust is a creature of contract. This distinction does not, however, disqualify the trust from analysis through a contractualisation lens.

---

39 Many of the issues traversed in this paper apply equally to entities which are structured as discretionary trusts but they raise additional issues that are not considered here.

40 Similarly, many of the issues apply equally to trusts which have natural persons as their trustee but they raise additional issues that are not considered here.

41 M Bryan, 'Contractual modifications of the duties of a trustee' in Sarah Worthington (ed), *Commercial Law and Commercial Practice* (Hart Publishing, 2003).

Managed investment schemes and *responsible entities*

A commercial trust will be a '**managed investment scheme**' if it falls within the definition of that term in s9 of the *Corporations Act*. The expression does not describe a separate category or species of trust. Rather, the Act gives that name to any multiple-participant arrangement having certain characteristics, for the purpose of imposing an investor protection regulatory framework on it, contained mainly in Chapter 5C of the *Corporations Act*. The word 'scheme' is given a very broad meaning,[42] and can capture unit trusts. However, not every unit trust is a managed investment scheme, and not every managed investment scheme is a unit trust.[43] The trustee of a unit trust which is a managed investment scheme is described by the Act as a '**responsible entity'** and must be a public company holding an Australian financial services licence authorising it to operate a managed investment scheme.[44] The Act reinforces the fiduciary nature of the role by providing that the responsible entity is a trustee of the scheme's assets (ie whether or not the scheme is structured as a trust) and imposing fiduciary-like duties on them.[45]

Trading trusts

The expression '**trading trust'** is used in the Australasian literature. Again, this not a legal term of art but rather is used to describe an express trust in which the trustee is given the power to carry on business activities, either generally or of a particular type, with some or all of the trust assets at its disposal. It is a commercial trust within the definition above. It may be structured as a discretionary trust (the form most commonly used for smaller, private and familial arrangements) or a unit trust (for larger and more arm's length commercial arrangements). While it has been described as 'an example of the family trust gone commercial',[46] it has also been used more generically to describe a wider range of commercial trusts. However, the expression also has a narrower technical meaning under the *Income Tax Assessment Act 1936* (Cth), ie in effect a trust in which the trustee carries on an active trading business (as opposed to passive investment),[47] and so, to avoid confusion, the expression 'trading trust' is not used except where specific reference is warranted.

Trust debts and *trust creditors*

As mentioned, a 'trustee' is not a distinct legal person having a representative capacity separate from itself. Under Australian law all debts and liabilities of a trustee are personal, and this applies whether or not the trustee identifies itself as a trustee in contracts under which it incurs debts and liabilities. The issue of contracting capacity is important from creditors' point of view, however, because it assists the analysis of whether the gateway to trust assets is open to the trustee, and thus creditors who claim through it, and confusion can result where capacities are not properly spelt out in the documentation. The question of capacity is crucial if the trustee's personal resources are insufficient (or unavailable, due to a contractual liability limitation) to discharge a liability and the creditor seeks recourse to assets held by it on trust.[48]

Given that all debts and liabilities incurred by a company that is a trustee, whether on its personal account for non-trust activities or in its capacity as trustee, are personal to the company, the expression 'trust creditors' is, therefore, a shorthand expression to describe those creditors of the trustee whose

---

42 *ASIC v Sydney Investment House Equities Pty Ltd* [2008] NSWSC 1224 at [256].

43 A distinction is drawn between trust-based schemes (which are sometimes described as 'pooled schemes') and contract-based schemes (also called 'common enterprise schemes'); schemes may exhibit elements of both and may even comprise partnerships: see the *CAMAC Report* at [2.2.1].

44 Section 601FA of the *Corporations Act*. The responsible entity replaced and unified the roles of trustee and manager of public unit trusts under the 'prescribed interests' regime which was the predecessor of Chapter 5C. The splitting of roles in that way echoed the structure of unincorporated 'deed of settlement' companies in pre-1844 England: see K Lindgren, 'The Birth of the Trading Trust' (2011) 5 *Journal of Equity* 1.

45 Section 601FC of the *Corporations Act*. Though statutory, these duties have been held to be fiduciary or quasi-fiduciary in nature and are in addition to the normal fiduciary overlay: *Re Centro Retail Limited and Centro MCS Manager Ltd* [2011] NSWSC 1175. For a specific discussion of the duties of responsible entities see P Hanrahan, "The Responsible Entity as Trustee" in IM Ramsay (ed), *Key Developments in Corporate Law and Trusts Law* (LexisNexis Butterworths, 2002).

46 See *Jacobs on Trusts* at [316].

47 See s102N of the *Income Tax Assessment Act 1936* (Cth), which turns on the carrying on of a 'trading business', that is, a business that does not consist wholly of 'eligible investment business', being the investing and/or trading in certain financial instruments, or investing in land to derive rent.

48 See, for example, *Re Interwest Hotels Pty Ltd (in liq)* (1993) 12 ACSR 78 and *MacarthurCook Fund Management Limited v Zhaofeng Funds Limited* [2012] NSWSC 911.

debts are either secured by trust assets or, if unsecured, in respect of which the trustee is entitled to be indemnified out of the trust assets, subject to the conditions precedent regarding breaches of trust described in paragraph 4 below.[49]

Abbreviations and short-forms

ASIC means the Australian Securities and Investments Commission.

ASX means Australian Securities Exchange Limited and the securities exchange managed by it.

CAMAC means the Corporations and Markets Advisory Committee, a body established in 1989 (and originally called Companies and Securities Advisory Committee) whose purpose is to provide independent advice to the Australian Government on issues that arise in corporations and financial markets law and practice.[50]

CAMAC Report means Corporations and Markets Advisory Committee, 'Report on Managed Investment Schemes' (July 2012) (available on the CAMAC website www.camac.gov.au).

Corporations Act means the *Corporations Act 2001* (Cth).

Ford and Lee on Trusts means HAJ Ford and others, *The Law of Trusts* (Law Book Co, Subscription Service).

Ford on Corporations Law means RP Austin and IM Ramsay, *Ford's Principles of Corporations Law* (14th ed, LexisNexis Butterworths, 2010).

Jacobs on Trusts means JD Heydon and MJ Leeming, *Jacobs' Law of Trusts in Australia* (7th ed, LexisNexis Butterworths, 2006).

Meagher, Gummow & Lehane means RP Meagher, JD Heydon and MJ Leeming, *Meagher, Gummow & Lehane's Equity: Doctrines and Remedies* (4th ed, Butterworths LexisNexis, 2002).

trust includes a managed investment scheme that is structured as a trust, unless in any given case the context otherwise requires.

trustee includes, in the context of a managed investment scheme that is a trust, the responsible entity, unless the context otherwise requires.

2. The commercial expectations of the unsecured trust creditor

By parity of reasoning with the position of an unsecured creditor of a company, in extending credit to or otherwise contracting with someone it knows is acting as the trustee of a commercial trust but who is unwilling to accept unlimited personal liability or which has no personal assets of value, the intending unsecured commercial trust creditor may be prepared to rely on the creditworthiness and economic viability of the underlying enterprise. If that is satisfactory, then objectively a creditor would be largely indifferent as to the personal worth of the trustee (although it will want to be satisfied that the trustee is a competent and capable manager of the enterprise, much as it would the board of directors and senior management of a company).

Thus, the commercial expectations of a reasonable unsecured creditor in relation to any given commercial contract between it and a trustee who will not accept personal liability on that contract may be described as follows:

(1) it wants to be able to contract with the trustee with minimal due diligence and transaction costs (or at least no greater than when dealing with an economically equivalent company);

(2) it expects a claim in insolvency as against the value of unsecured enterprise assets to the extent of the debt;

(3) it expects that claim to have legal priority over the claims of equity investors and to rank equally with those of other unsecured trust creditors;

---

49 *Re Stacks Managed Investments Ltd* [2005] NSWSC 753 at [44].

50 See its home page at http://www.camac.gov.au.

(4) because it will have agreed to bargain without security, it will be indifferent as to whether its claim gives it a proprietary interest in the enterprise assets, provided the other expectations described in this list are met;

(5) it will be indifferent as to whether the trustee is personally liable on the contract, provided the other expectations described in this list are met;

(6) it expects its claim against the enterprise assets to be exercisable free and clear of consequences of trustee misconduct. If there is trustee misconduct, and the creditor has not known of or participated in it in any relevant sense,[51] the consequences should fall on the equity investors; and

(7) it expects the trustee to be personally liable if it suffers a shortfall in recovery against the enterprise assets if and to the extent that shortfall is attributable to relevant misconduct of the trustee.

For reasons described more fully below, Australian trust law suffers weaknesses from an unsecured creditor's point of view and yields outcomes which do not meet these expectations. Trust law is heavily biased towards beneficiary protection and against the trustee – and anyone claiming through it. With some limited exceptions, the law does not provide external counterparties with the benefit of legal assumptions regarding matters of indoor management within the trust of the type provided to those dealing with companies under ss128 and 129 of the *Corporations Act*. This means that well-advised parties dealing with trustees are obliged to take active steps to protect their interests.

An intending counterparty wishing to maximise transactional safety must, before entering into the engagement, investigate fundamental issues such as the trustee's power to transact in its trustee capacity by conducting detailed due diligence and, if possible in the circumstances, negotiating contractual protections.[52] Those steps involve costs, delays and other transactional inefficiencies. In a market environment where competitive tensions and the potential for loss of the transaction require rapid deal execution, intending counterparties will be inclined toward greater risk-taking and less protection. However, a failure to take protective measures, or to execute them properly, may result in a counterparty being exposed to trust breaches that may undermine its claim. The consequences of trustee misconduct can be borne by external counterparties rather than the beneficiaries. This may be seen as a vestige of the non-commercial origins of the trust as a device for protecting vulnerable beneficiaries and their economic interest in underlying property against trustee misconduct, which resulted in almost all legal and insolvency risk being imposed on trustees and those who dealt with them, including creditors.

Thus, circumstances may arise in which many of the expectations of an unsecured trust creditor listed above will be frustrated by the operation of trust law.

3. Equity's protection of the trustee: the proprietary indemnity against trust assets[53]

The starting point for any discussion of the legal position of an unsecured trust creditor is an investigation into the legal position of trustees in relation to trust debts, liabilities and expenses because, as discussed below, the unsecured creditor's position is entirely derivative of the trustee's (as opposed to that of a secured creditor, whose access is direct, via their security).

Not being legal entities, trusts may only engage with the outside world through their trustee. The established principle is that when a trustee enters into a contract with an external party, even if expressly in that capacity, it is personally liable for the debts and liabilities thereby incurred, without limitation by reference to the trust assets that might be available to support those debts and liabilities.[54]

---

51 That is, in the sense contemplated by the rule in *Barnes v Addy* (1874) LR 9 Ch App 244.

52 If feasible and available, an intending creditor might also seek security over trust assets, however security is not always available.

53 In some situations, a trustee may also enjoy a personal indemnity against the beneficiaries. Whether a personal indemnity exists in any given case where the trust instrument is silent on the question is not a straightforward matter. Further, there is an open question as to whether trust creditors would be subrogated to any such indemnity: see generally N D'Angelo, 'Shares and units: The parity myth and the truth about limited liability' (2011) 29 *Companies & Securities Law Journal* 477. These issues are discussed no further in this paper.

54 'In respect of debts incurred by him [ie the trustee] in so carrying on the business [of the trust] he is personally liable to the trading creditors – the debts are his debts': *Vacuum Oil Co Pty Ltd v Wiltshire* (1945) 72 CLR 319 at 324 (Latham CJ).

Except in very particular circumstances, the trustee contracts as principal and not as agent of the beneficiaries.[55]

If this personal liability of trustees for trust debts and liabilities was immutable and unqualified, one could safely surmise that the circumstances in which any person would agree to accept the office of trustee in a commercial context might be very limited indeed. It would also change fundamentally the attitude of an intending unsecured trust creditor, since it would be relying on the personal credit of the trustee alone, without regard to the trust assets; there would be no competition between creditors and equity investors over those assets.

In recognition of this, equity intervenes by implying a right to be indemnified out of the trust assets, subject to the satisfaction of certain conditions precedent.[56] While equity's primary objective in supervising trusts is the protection of beneficiaries against trustee misconduct, this indemnity may be regarded as an instance where equity acts to protect the trustee and, though it, trust creditors.

This right is not something that must be contracted for or otherwise expressly provided for in the trust instrument, though it may be modified by the instrument or beneficiary consent. It derives from three sources: (1) decisions of the courts of equity; (2) legislation;[57] and (3) the instrument creating the trust.[58] It is said to be integral to the institution of the trust and incidental to the office of a trustee.[59] It operates for the benefit of the trustee and, through it, trust creditors.[60] The indemnity is, in essence, a right or privilege of the trustee, enforceable in equity, to have resort to the trust fund to protect and preserve its personal assets against debts, liabilities and expenditures that it incurs in the proper performance of the trust.[61]

The language used in the older authorities evidences the trust's traditional role in the management of family assets and deceased estates, where the trustee or executor typically was a gentleman of stature or a trusted friend or relative who agreed to act gratuitously as a matter of honour, affection or moral obligation.[62] Thus, the indemnity was described as 'the price paid by *cestuis que trust* for the

---

55 See the discussion in D'Angelo, n53.

56 *Vacuum Oil Co Pty Ltd v Wiltshire* (1945) 72 CLR 319; *RWG Management Ltd v Commissioner for Corporate Affairs* [1985] VR 385.

57 See s59(4) of the *Trustee Act 1925* (NSW), s36(2) of the *Trustee Act 1958* (Vic); s71 of the *Trusts Act 1973* (Qld); s71 of the *Trustees Act 1962* (WA); s27(1) of the *Trustee Act 1898* (Tas); s26 of the *Trustee Act* (NT); s59(4) of the *Trustee Act 1925* (ACT).

58 *RWG Management Ltd v Commissioner for Corporate Affairs* [1985] VR 385 at 394. To similar effect, see *Re Suco Gold Pty Ltd (in liq)* (1983) 33 SASR 99 at 102 (King CJ). The trust instrument has been described as the 'third source of law' in relation to a trust, after the general law and applicable statutes; 'the trust instrument has primacy': *Jacobs on Trusts* at [1617]. The indemnity in the trust instrument may expand or enlarge the rights given the trustee by the equitable rule or reduce them: K Lindgren, 'A superannuation trustee's right of indemnity' (2010) 4 *Journal of Equity* 85 at 89. However, the position regarding attempts to insulate trust assets for the benefit of beneficiaries by excluding the trustee's proprietary indemnity is the subject of some controversy: see the differing positions expressed in *Jacobs on Trusts* at [2106]; Lindgren, above, at 94-96; BH McPherson, 'The Insolvent Trading Trust' in Finn (ed), Essays in Equity (1985); *Clark v Commissioner of Taxation* [2009] FCA 1401 at [119]; *Moyes v J & L Developments Pty Ltd (No 2)* [2007] SASC 261 at [37]-[41]; *Jessup v Queensland Housing Commission* [2001] QCA Q12; *JA Pty Ltd v Jonco Holdings Pty Ltd* [2000] NSWSC 147 at [87]; *Rothmore Farms Pty Ltd v Belgravia Pty Ltd* [2005] SASC 117 at [37]-[42]; *Kemtron Industries Pty Ltd v Commissioner of Stamp Duties* (1984) 15 ATR 627, and the discussion in J Cooper, 'Piercing the "veil of obscurity" – the decision in Hanel v O'Neill' (2004) 22 *Companies & Securities Law Journal* 313 at 320-322; New Zealand Law Commission, 'Court Jurisdiction, Trading Trusts and Other Issues. Review of the Law of Trusts. Fifth Issues Paper' (No 28, 2011) at [7.27]-[7.36]. Section 601FH of the *Corporations Act* invalidates such provisions with respect to liquidations of managed investment schemes.

59 *Worrall v Harford* (1802) 32 ER 250; *National Trustee's Executors & Agency Co of Australasia Ltd v Barnes* (1941) 64 CLR 268.

60 As discussed below, under Australian trust law the unsecured trust creditors' claims against the trust assets on enforcement is through the trustee, via the equitable remedy of subrogation. Thus, the unsecured trust creditor has a fundamental interest in the nature and enforceability of the trustee's rights with respect to the trust fund.

61 *Re Suco Gold Pty Ltd (in liq)* (1983) 33 SASR 99 at 104-105 (King CJ).

62 Traditionally equity has regarded the role of trustee as gratuitous and has not permitted trustees to take anything for themselves out of the trust estate: *Robinson v Pett* (1734) 40 ER 1049; *Jennings v Mather* [1902] 1 KB 1; *Wickham v King* (1879) 1 QLJ (Supp) 13, pp 14-15; confirmed *Southern Wines Corp Pty Ltd (in liq) v Frankland River Olive Co Ltd* (2005) 31 WAR 162 at [62]. The rule continues to apply in Australia today. The High Court recently confirmed that it is 'an inflexible rule of a Court of Equity that a person in a fiduciary position ... is not, unless otherwise expressly provided, entitled to make a profit': *Macedonian Orthodox Community Church St Petka Inc v The Diocesan Bishop of Macedonian Orthodox Diocese of Australia and New Zealand* (2008) 237 CLR 66 at 93.

gratuitous and onerous services of trustees',[63] and was said to arise because liabilities are incurred by the trustee in acting for the benefit of the beneficiaries and the trust estate.[64]

Framed this way, it may be seen as an exception to the no profit rule. Despite this, the indemnity entitlement has survived the transformation of the trust into a commercial vehicle. It exists whether or not the services are provided gratuitously or are particularly onerous.

This right of indemnity in respect of trust property is not a single right. It is more appropriately described as a bundle of rights. First, the indemnity itself comprises two limbs:

- a right of reimbursement or recoupment in respect of trust debts, liabilities and expenditures that the trustee has satisfied using its own assets (the '**reimbursement limb**'); and
- the benefit of exoneration in respect of trust debts and liabilities properly incurred but not yet discharged (the '**exoneration limb**').[65]

The reimbursement limb may be seen as a right to take trust assets to replenish a trustee's own assets and so is a personal benefit to the trustee. By contrast, the exoneration limb is merely a power to apply trust assets in direct discharge of a debt or liability and so operates to the benefit of creditors (albeit not in a fiduciary sense) and may be regarded as an acknowledgement that in equity there is no need for the trustee to pay a debt or liability before claiming its indemnity.[66]

Because the right to indemnification arises, if it arises at all, concurrently with the incurring of the debt or liability, typically the exoneration limb will be engaged first, at the moment the debt or liability is incurred. If the trustee chooses to discharge that debt or liability out of its own assets, then the exoneration limb lapses and the reimbursement limb is engaged. It follows that the right of indemnity in relation to trust expenditures disbursed by the trustee out of its own funds also arises immediately and automatically the expenditure is made. Thus, the nature of the trustee's indemnity right against the trust fund in respect of a given liability at a given time depends on how the trustee has responded to that liability.[67]

Secondly, these rights are afforded a priority in respect of trust assets as against the beneficiaries; ie the beneficiaries are not entitled to call for a distribution of trust assets for so long as the trustee is owed money under the indemnity. [68]

Finally, this priority is reinforced by an equitable lien or charge over all of the trust assets for the purpose of enforcing the indemnity.[69] This gives the trustee a claim in respect of the trust assets to enable it to discharge properly incurred debts, which claim ranks in priority to the interests of the beneficiaries in those assets.[70]

---

63 *Re Beddoe* [1893] 1 Ch 547 at 558 (Lindley LJ).

64 *Jennings v Mather* [1902] 1 KB 1 at 6-7 (Stirling LJ). See also *Macedonian Orthodox Community Church St Petka Inc v The Diocesan Bishop of Macedonian Orthodox Diocese of Australia and New Zealand* (2008) 237 CLR 66 at 93.

65 *Worrall v Harford* (1802) 32 ER 250; *Chief Commissioner of Stamp Duties (NSW) v Buckle* (1998) 192 CLR 226; *Federal Commissioner of Taxation v Bruton Holdings Pty Ltd (in liq)* (2008) 173 FCR 472.

66 *Re Blundell* (1888) 40 Ch D 370 at 376; *Re Richardson; ex parte Governors of St Thomas Hospital* [1911] 2 KB 705 at 709-710 (Cozens-Hardy MR). By comparison, the common law requires a loss to be actually incurred before a claim could be made under a contractual indemnity: see the discussion of the difference between the common law's and equity's position on indemnities in *Firma C-Trade SA v Newcastle Protection and Indemnity Association (The Fanti)* [1991] 2 AC 1; *Paterson v Pongrass Group Operations Pty Ltd* [2011] NSWSC 1588.

67 *Re Dalewon Pty Ltd (in liquidation)* [2010] QSC 311; *Zen Ridgeway Pty Ltd v Adams* [2009] QSC 117; *Xebec Pty Ltd (in liq) v Enthe Pty Ltd* (1987) 18 ATR 893); *Trim Perfect Australia v Albrook Constructions* [2006] NSWSC 153.

68 *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 at 367 (Stephen, Mason, Aickin and Wilson JJ); *CPT Custodian Pty Ltd v Commissioner of State Revenue* [2005] HCA 53; *Commissioner of Stamp Duties v Buckle* [1998] HCA 4; *Chief Commissioner of Stamp Duties v ISPT Pty Ltd* (1998) 45 NSWLR 639.

69 Although some insist that liens and charges are quite distinct creatures, the courts have tended not to distinguish between 'lien' and 'charge' in describing the trustee's equitable right in respect of the trust property. In some of the cases the expressions lien and charge are used interchangeably, in some only one or the other expression is used, while some others simply skip over the distinction by describing the right as a 'lien or charge' or 'lien and charge'. This is so even the High Court: see *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 at 367 (Stephen, Mason, Aickin and Wilson JJ); *Chief Commissioner of Stamp Duties (NSW) v Buckle* (1998) 192 CLR 226 at 230.

70 The aggregate effect of this bundle of rights as against the beneficiaries and the trust estate was described by the High Court as not being in the nature of an encumbrance on the beneficiaries' interests in the trust property but rather a right which 'takes priority over the rights in or in reference to the assets of beneficiaries or others who stand in that situation', in effect a first

The aggregate effect of this bundle of rights as against the beneficiaries and the trust estate was described by the High Court as not being in the nature of an encumbrance on the beneficiaries' interests in the trust property but rather a right which 'takes priority over the rights in or in reference to the assets of beneficiaries or others who stand in that situation', in effect a first ranking claim leaving the beneficiaries with a residual interest.

This priority is critical in that it supports the enforcing unsecured creditor's priority over equity investors when subrogating to the trustee's rights. In that sense, it reflects the commercial outcomes applicable to investors in companies, that is that creditors rank ahead of equity investors (ie shareholders). However, as discussed below, this indirect route of access makes unsecured trust creditors vulnerable to trustee misconduct and outcomes that have no analogue in company law.

4. 'Impairment' of the proprietary indemnity

The trustee's indemnity with respect to trust assets is in the nature of relief or concession bestowed by the court of equity. It is often described as a 'right', but as with all equitable relief, there is an element of discretion in its availability.[71] The indemnity is always subject to the equities as between the trustee and beneficiaries.[72] The authorities are clear that (subject to any additional conditions in the trust instrument) a trustee is only entitled to enjoy indemnification out of the trust estate if two conditions are satisfied:

- first, the debt, liability or expense in question was incurred properly and *intra vires* with respect to the trust; and
- secondly, the accounts as between trustee and beneficiaries are 'clear'.

4.1. 'Related breaches' and the unavailable indemnity

The first condition is that any given personal debt, liability or expense sought to be indemnified must have been incurred by the trustee in the proper performance of the trust and not beyond authority.[73] The precise language used by the authorities to describe the qualifying threshold (or, to put it another way, the limits to be placed on the right of indemnity) differs. The language of connection between the trustee's acts and the trust in this context varies in the authorities.[74] Most refer to liabilities incurred 'properly',[75] but this expression has generated controversy.[76] The expression used in the statutory recognition of the indemnity in s 59(4) of the *Trustee Act 1925* (NSW) and equivalents is 'expenses incurred in or about execution of the trustee's trusts or powers'.[77] In the case of a managed investment scheme, the indemnity is unavailable to the responsible entity if the liability is incurred

---

ranking claim leaving the beneficiaries with a residual interest: *Chief Commissioner of Stamp Duties (NSW) v Buckle* (1998) 192 CLR 226 at 247.

71 On the other hand, 'a Court of Equity will never take trust property out of the hands of a trustee without seeing that [properly incurred] costs and expenses are reimbursed to him, and that he is relieved from personal liability in respect of them ... It is most important that this right should be maintained' *Jennings v Mather* [1902] 1 KB 1 at 6 (Stirling LJ). Thus, it has been said that denying a trustee its rights of indemnification is 'a violent exercise of the Court's discretion': *Re Chennell; Jones v Chennell* (1878) 8 Ch 492 at 502 (Sir George Jessel MR).

72 *Re Johnson; Sherman v Robinson* (1880) 15 Ch D 548 at 552; *Re Anderson; Ex parte Alexander* (1927) 27 SR (NSW) 296 at 299; *Re Staff Benefits Pty Ltd* [1979] 1 NSWLR 207 at 214.

73 *Vacuum Oil Co Pty Ltd v Wiltshire* (1945) 72 CLR 319; *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360.

74 See the conspectus in Lindgren, n58, at 89 and following.

75 *Dowse v Gorton* (1891) AC 190 at 203 (Lord Macnaghton); *Savage v The Union Bank of Australia Ltd* (1906) 3 CLR 1170; *National Trustee's Executors & Agency Co of Australasia Ltd v Barnes* (1941) 64 CLR 268; *Chief Commissioner of Stamp Duties (NSW) v Buckle* (1998) 192 CLR 226 at [47]. 'Such expressions as acting 'for the benefit of' 'with reference to' or 'on behalf of' the trust estate or in the discharge of his duty as a trustee are used indiscriminately in the judgments, but they all mean the same thing, namely, that the question is whether the costs, charges and expenses are properly incurred by the trustee as an incident of his administration of the estate': *National Trustee's Executors & Agency Co of Australasia Ltd v Barnes* (1941) 64 CLR 268 at 279 (Williams J).

76 Meagher JA condemned the expression 'properly' as 'almost meaningless': *Gatsios Holdings Pty Ltd v Nick Kritharas Holdings Pty Ltd (in liq)* [2002] NSWCA 29 at [47], but see the powerful rebuttal in *Nolan v Collie & Merlaw Nominees Pty Ltd (in liq)* [2003] VSCA 39, per Ormiston JA said (Batt and Vincent JJA concurring). A useful summary of the debate is contained in *Saker, in the matter of Great Southern Managers Australia Ltd (rec and mgrs apptd) (in liq) (No 2)* [2011] FCA 958 at [45] – [49]. The issue, and the differences between the Courts, are explored at further length in L Aitken, 'A liability 'properly incurred'? The trustee's right to indemnity, and exemption from liability for breach of trust' (2011) 35 *Australian Bar Review* 53.

77 An expression described, with some justification, as 'imprecise': Lindgren, n58, at 89. See also s36(2) of the *Trustee Act 1958* (Vic); s71 of the *Trusts Act 1973* (Qld); s71 of the *Trustees Act 1962* (WA); s27(1) of the *Trustee Act 1898* (Tas); s26 of the *Trustee Act* (NT); s59(4) of the *Trustee Act 1925* (ACT).

otherwise than in 'the proper performance of [its] duties'.[78] The conventional position has been stated thus:

> To my way of thinking the conventionally stated test as to expenses 'properly incurred' is merely a convenient shorthand to describe those restraints applicable to trustees who would seek to look to trust funds for the payment of their expenses and other trust liabilities. It also has the advantage of succinctly expressing the notion of propriety as underpinning a trustee's relationship with the trust estate and the beneficiaries.[79]

Perhaps these differences are semantic;[80] it is at least clear from the authorities that the indemnity is not available if the activity that generated the liability in question involved a breach of trust, was beyond the powers given to the trustee, or was criminal or fraudulent in nature.[81]

Therefore either of two different categories of event may constitute a breach in relation to a given debt, liability or expense and thus compromise the trustee's ability to indemnify itself out of trust property in respect of it:

(1) the trustee had no power as trustee to undertake the relevant dealing, whether in the trust instrument or otherwise (eg implied by law). When this happens, the trustee is said to have acted beyond its power or authority, or *ultra vires*, with respect to the trust; or

(2) the trustee had the power to undertake relevant dealing but in doing so it breached or failed to discharge a fiduciary or other duty[82] which has not been attenuated or waived (where that is legally possible). When this happens, the trustee is said to have acted improperly with respect to the trust.

For convenience, breaches in this category are described in this paper (as they are in commercial practice in Australia) as '**related breaches**' since they are relative to a particular debt, liability or expense incurred by the trustee. The sanction for misconduct of this type is very clear, direct and strict; absent exceptional relief granted by the court, the trustee has no right to indemnify itself out of the trust assets and so carries the debt, liability or expense personally.

The precise juridical effect of a related breach may be analysed in either of two ways. Often it is said in respect of a related breach that the indemnity is 'lost'. This assumes that the right exists in a contingent sense in the first place and the absence of related breach is a condition precedent to exercise or enforcement by the trustee; in other words, the right exists but becomes unenforceable if the condition is not satisfied. An alternative view, based on the fact that the indemnity is not an absolute legal right but is in the nature of a discretionary equitable benefit, is that the indemnity simply never arises (ie equity will not assist the trustee) because a condition precedent to its *existence* is not satisfied. In either case, however, the result is the same: the trustee bears the debt, liability or expense so incurred on its personal account in the normal way, but without a right of recourse to the trust estate in respect of it.

4.2. 'Unrelated breaches' and the clear accounts rule

The second condition is that, even if all debts, liabilities and expenses in respect of which the trustee seeks indemnity were properly incurred within power, the right of indemnity is always subject to, and diminished by, the claims of the beneficiaries against the trustee in connection with any breaches not connected to specific debts, liabilities or expenses. This sanction addresses misconduct of a different type, ie misconduct which occasions loss to the trust estate, such as misappropriation of trust money or neglect of trust assets. For convenience, breaches of this type are described in this paper (and

---

78 Sections 601GA(2) and 601FH of the *Corporations Act.*

79 *Nolan v Collie & Merlaw Nominees Pty Ltd (in liq)* [2003] VSCA 39 at [44] (Ormiston JA, with Batt and Vincent JJA concurring).

80 In *Re Beddoe* [1893] 1 Ch 547 the court held that the expression 'properly incurred' means 'not improperly incurred'. This was supported by the Court in *Nolan v Collie & Merlaw Nominees Pty Ltd (in liq)* [2003] VSCA 39.

81 *Gatsios Holdings Pty Ltd v Nick Kritharas Holdings Pty Ltd (in liq)* [2002] NSWCA 29.

82 Not all obligations borne by trustees are fiduciary in nature: see M Conaglen, *Fiduciary Loyalty* (Hart Publishing, 2010), Chapter 3 (*Peculiarly Fiduciary Duties*).

sometimes in commercial practice) as '**unrelated breaches**' because they need not necessarily relate to a particular debt, liability or expense incurred by the trustee. [83]

Note that the responsible entity of a registered managed investment scheme suffers what might be described as an 'extended' unrelated breach risk if it appoints an agent, or otherwise engages a person, to do anything that it is authorised to do in connection with the scheme. Under s601FB(2) of the Act, for the purpose of determining whether there is a liability to the members or if the responsible entity has properly performed its duties, the responsible entity is taken to have done (or failed to do) anything that the agent or other engaged person has done (or failed to do) because of the appointment or engagement, even if they were acting fraudulently or outside the scope of their authority or engagement. Further, by sub-section (3) this extends to sub-agents and sub-appointees engaged by any such agent or person.

The consequences for the trustee of an unrelated breach are quite different to those for related breaches because they do not involve a particular external liability in respect of which the trustee might otherwise seek indemnity. The trustee is obliged to make restitution to the trust estate and cannot avail itself of the proprietary indemnity until it discharges that obligation. The sanction is partially self-executing in the sense that the trustee's legitimate right to indemnification in respect of debts, liabilities and expenses properly incurred becomes subject to a condition precedent, ie it must first make good the loss to the estate. Thus, before the trustee is entitled to make a claim:

> a balance is to be struck between what is due [by the trustee] by way of compensation and what is due [to the trustee] by way of indemnity and … if the balance is in favour of the trustee he may recover from the estate to that extent.[84]

For this reason, the concept is often described as the '**clear accounts rule'**, a reference to the state of accounts as between trustee and beneficiaries with respect to the trust estate. The jurisprudential basis for the rule is the ancient principle in *Cherry v Boultbee*,[85] which may be stated thus: where a person entitled to participate in a fund is also obliged to make a contribution to that fund, they may not so participate unless and until they have fulfilled their obligation to contribute. The variation in its application to trusts is that, under the clear accounts rule, the process is an accounting exercise and the trustee need not actually pay its contribution first.[86]

Once again, the indemnity is not 'lost' for an unrelated breach; rather, its exercise is subject to the condition precedent of a taking of accounts and there being a positive balance in the trustee's favour. If the mathematical result of that exercise is that the value of the indemnity claim is exceeded by the value of the trustee's restitution obligation, then the indemnity is rendered worthless and the economic effect is as if the indemnity was 'lost'.

---

83 The learned authors of *Jacobs on Trusts* state that 'the better view is that the right [of indemnity] is not lost by any such breach of trust for so to deprive the trustee, is, as Sir George Jessel MR put it, 'a violent exercise' [in *Re Chennell* (1878) 8 Ch D 492]': *Jacobs on Trusts* at [2104]. Strictly, that is correct; the indemnity does not 'lost' in the sense applicable to related breaches but its exercise is conditional, as discussed below. There is *obiter* dictum of Needham J in *Re Staff Benefits Pty Ltd* [1979] 1 NSWLR 207 at 215, which seems to imply that the breach must be shown to relate to 'the subject matter of the indemnity', but the passage is ambiguous. However, this proposition is not otherwise supported by the authorities and is difficult to understand, given that the clear accounts rule applies on a whole-of-estate basis rather than a creditor-by-creditor or debt-by-debt basis. The Trust Law Committee Report dismissed *Re Staff Benefits* on this basis: Trust Law Committee, 'Rights of Creditors Against Trustees and Trust Funds - Consultation Paper' (Tolley Publishing Co, 1997), footnote 33 at 6. Perhaps Needham J's statement was intended to be confined to related breaches, in respect of which it is undoubtedly correct.

84 *RWG Management Ltd v Commissioner for Corporate Affairs* [1985] VR 385 at 397. The balance is to be struck at the time of judgment: *Target Holdings Ltd v Redferns* [1996] 1 AC 421 at 437 (Lord Browne-Wilkinson). For an example of how this is done, see *CB Darvall & Darvall v Moloney (No 2)* [2007] QSC 337.

85 *Cherry v Boultbee* (1839) 41 All ER 171.

86 *RWG Management Ltd v Commissioner for Corporate Affairs* [1985] VR 385. Putting it another way, when assessing the extent of the trustee's indemnity, 'it is good practice to assume that the trustee (whether bare or active) has a prima facie right of indemnity, but to order accounts if there is doubt about the entitlement of the trustee because of a default, and suspend the right of the claimant while those accounts are taken': *Warne v GDK Financial Solutions Pty Ltd* [2006] NSWSC 259 at [194] (Young CJ in Eq). See also the discussion in *ASIC v Letten (No 17)* [2011] FCA 1420 at [20]-[22] and *Fitzwood Pty Ltd v Unique Goal Pty Ltd (in liq)* [2002] FCAFC 285 at [138].

4.3. Relevance of the trustee's intentions and motivations

The effect on the indemnity of breaches is strict and applies regardless of the trustee's state of mind;[87] the conduct which constitutes the breach need not involve fraud, dishonesty or bad faith; it may be deliberate or inadvertent and may have been innocent;[88] it may even have been 'reasonable'.[89]

However, the court has a discretion to excuse a breach of trust in circumstances where the trustee has acted 'honestly and reasonably'.[90] Further, there are common law exceptions relating to expenses and liabilities incurred to preserve trust property, and where the trustee, though in breach, acted in good faith and benefited the trust estate,[91] or where the beneficiary has acquiesced in the conduct in a manner that raises an estoppel against it.[92]

As discussed below, the courts will recognise exculpatory provisions that excuse trust breaches, and thus allow the trustee to indemnify itself out of the trust estate despite them, but those clauses are subject to an irreducible core of obligation and, in any case, are carefully scrutinised by the courts.[93]

4.4. Effect of breaches on the proprietary indemnity: a summary

Thus, although the right of indemnity is sometimes described simplistically as being 'lost' if the trustee acts in breach of trust, that description is imprecise and in some senses incorrect. The indemnity is not automatically forfeited *ipso facto* because there is a breach of trust. The effect of a breach on the indemnity in relation to a given debt, liability or expense incurred by the trustee will depend on whether it is a related breach or an unrelated breach and, if the latter, the extent of the loss caused to the trust fund.[94] For simplicity and convenience, in this paper the neutral expression '**impaired**' is used to describe the effect of a breach on the trustee's proprietary indemnity.

The sensitivity of the indemnity right to a trustee's conduct, and the apparent readiness of the courts to hold the trustee personally to account by denial or diminution of the indemnity, bear all the hallmarks of equity's solicitous protection of vulnerable beneficiaries in a non-commercial context. Equity's protection of the trustee's personal position is very much conditioned upon scrupulous discharge by it of its duties towards the beneficiaries. The critical question in any given case thus is the scope and extent of the burden of those duties. The heavier the burden, the greater the risk of breach and consequent impairment of indemnity; the lighter the burden, the lower that risk. To a very large extent, that burden (and therefore that risk) may be enlarged or constrained though documentation.

5. Subrogation: the unsecured creditor's indirect (and only) route to trust assets

Under Australian corporations law, unsecured creditors of a company are able to participate in a statutorily mandated collective process which ultimately results in a distribution to them, rateably and *pari passu,* of the value of the company's assets (if any) in priority to the equity investors.[95] Provided a creditor is able to prove its claim, misconduct on the part of the company or its officers will not

---

87 *Boardman v Phipps* [1967] 2 AC 46. See also the discussion in D Hayton, 'Unique Rules for the Unique Institution, the Trust' in S Degeling and J Edelman (eds), *Equity in Commercial Law* (2005).

88 *Target Holdings Ltd v Redferns* [1996] 1 AC 421. See also *Armitage v Nurse* [1998] Ch 241 at 251 (Millett LJ).

89 *Nolan v Collie & Merlaw Nominees Pty Ltd (in liq)* [2003] VSCA 39. While some duties of a trustee are strict, the more day-to-day functions of a trustee in the management of a trading trust require only that the trustee 'exercise the same care as an ordinary, prudent person of business will exercise in the conduct of that business were it his or her own': *Breen v Williams* (1996) 186 CLR 71 at [70] (Gummow J). For further discussion, see *Meagher, Gummow & Lehane* at [5-110].

90 See ss85 and 86 of the *Trustee Act* 1925 (NSW), ss67 and 68 of the *Trustee Act 1958* (Vic); ss76 and 77 of the *Trusts Act 1973* (Qld); ss75 and 76 of the *Trustees Act 1962* (WA); ss56 and 57 of the *Trustee Act 1936* (SA); ss50 and 53 of the *Trustee Act 1898* (Tas); ss49A and 50 of the *Trustee Act* (NT); ss85 and 86 of the *Trustee Act 1925* (ACT).

91 *Daly v The Union Trustee of Australia Ltd* (1898) 24 VLR 460; *RWG Management Ltd v Commissioner for Corporate Affairs* [1985] VR 385); *Target Holdings Ltd v Redferns* [1996] 1 AC 421, Lord Browne-Wilkinson at 433.

92 *Re Pauling's Settlement Trusts* [1964] Ch 303.

93 While non-statutory fiduciary duties, even in a trust context, are almost infinitely malleable, for a trustee there is an "irreducible core" of obligation which may be described as a duty to act honestly and in good faith for the benefit of the beneficiaries, which is essential and fundamental to the concept of the trust: *Armitage v Nurse* [1998] Ch 241; *Alexander (t/as Minter Ellison) v Perpetual Trustees WA Ltd* [2001] NSWCA 240; *Wilden Pty Ltd v Green* [2009] WASCA 38.

94 Therefore, as is evident from the above, it is possible for there to be 'unrelated' breaches of trust that have no material effect on the right of indemnity because they do not cause or result in a loss to the trust estate: *Re Staff Benefits Pty Ltd* [1979] 1 NSWLR 207, and its analysis in *Ford and Lee on Trusts* at [1407]. See also *Target Holdings Ltd v Redferns* [1996] 1 AC 421 at 433 (Lord Browne-Wilkinson).

95 Subject to the prior claims of any secured creditors with respect to secured assets and certain preferential unsecured creditors. Sources which discuss this process are too numerous to list, but for a useful summary see *Ford on Company Law*, Part VII (*External Administration*).

impeach it, subject to certain qualifications based on the creditor's knowledge of or participation in some types of director misconduct.

Unsecured trust creditors enjoy no such certainty. Their *only* means of access to the value of trust assets on enforcement is by subrogation to the trustee's right of indemnity.[96] If that means of access fails, they are left with an unsecured personal claim against the trustee. The trust creditor's claim through subrogation is subject to legal risks arising from a range of procedural and substantive hurdles placed by equity between the creditor and the trust's assets, none of which exist for creditors of a *Corporations Act* company under the statutory regime.

The unsuitability of the subrogation route for modern commercial trust creditors is exposed by considering its origins. Subrogation exists because of the fundamental premise that, because the trust has no separate legal personality, trust debts are personal to the trustee, being the person with whom the creditor contracts. If available, it is said to be a remedy that gives unsecured trust creditors an 'advantage' over general creditors of the trustee in insolvency: see *Ford and Lee on Trusts* at [14.60.30]. Indeed, it has been said that the unsecured creditors of a trustee are in a privileged position over its general creditors because of the 'lucky accident' of being able to access trust assets via subrogation: see *Re Johnson; Sherman v Robinson* (1880) LR 15 Ch D 548 at 552. This notion is faithful to the doctrinal premise in characterising trust creditors and general creditors of a trustee as being prima facie in competition with each other, since all trust debts are personal to the trustee, but denies the economic reality that the trust is a distinct *economic* entity separate from its trustee.

One of the mysteries surrounding this issue is how and why subrogation has, in Australian trust law, become the sole means by which trust creditors may gain access to trust assets. This conclusion seems to have resulted as a leap in logic from the otherwise uncontroversial position that unsecured trust creditors have no proprietary interest in trust assets.[97] Yet none of the older Chancery and House of Lords authorities in relation to limitation of trustees' liability held that this was so, and all of them contemplated other means of access where a trustee had properly limited or excluded its personal liability.[98] Sackville posits that it may have resulted from a 'hardening' of general principles, originally designed to serve sensible policy objectives built on notions of fairness and commercial morality, into a settled and inflexible rule.[99] Others have argued that the cases that appeared to disallow creditors access to trust assets other than by subrogation may merely have been making a procedural rather than a substantive point.[100]

Subrogation is an ancient remedy and is not unique to the law of trusts.[101] It is a creation of the English courts of equity. While equity's main objective in supervising trusts is the protection of beneficiaries, this may be regarded as an instance where equity acts to protect the trust creditor, albeit in a heavily qualified manner. Equity's assistance of trust creditors is manifested quite differently in the United States. American equity gives unsecured creditors a direct right of access to a trust's assets,[102] while Australian equity gives them rights that are entirely derivative. Adopting the commonly used vernacular, Australian trust creditors step into the shoes of the trustee with respect to its rights of indemnity as against the trust assets. Thus, to the extent that the indemnity has been impaired in any of the ways described above, including as a result of trustee misconduct of which the

---

96 *RWG Management Ltd v Commissioner for Corporate Affairs* [1985] VR 385 at 401. The discussion in this paper is limited to the creditor's ability to subrogate to the trustee's *in rem* indemnity with respect to trust assets and not to any *in personam* indemnity it may have against the beneficiaries.

97 See the discussion in *Savage v The Union Bank of Australia Ltd* (1906) 3 CLR 1170 at 1186-1188 (Griffith CJ) and *Vacuum Oil Co Pty Ltd v Wiltshire* (1945) 72 CLR 319 at 327-328 (Latham CJ).

98 *Watling v Lewis* [1911] 1 Ch 414; *Gordon v Campbell* (1842) 1 Bell's App 428; *Parsons v Spooner* (1846) 67 ER 845; *Lumsden v Buchanan* (1865) 4 Macq 950; *Williams v Hathaway* (1877) LR 6 Ch D 544; *Muir v City of Glasgow Bank* (1879) 4 App Cas 337; *Re Robinson's Settlement; Gant v Hobbs* [1912] 1 Ch 717.

99 R Sackville, 'The trustee's right of indemnity and the creditor's right of subrogation: the hardening of equity' (2013) 7 *Journal of Equity* 34.

100 Y Grbich and others, *Winding up Trusts* (CCH Australia Ltd, 1984) at 188.

101 See the discussion in *Meagher, Gummow & Lehane* at [9-005]-[9-020].

102 See N D'Angelo, 'The unsecured creditor's perilous path to a trust's assets: is a safer, more direct United States-style route available?' (2010) 84 *Australian Law Journal* 833.

creditor is ignorant and innocent, the creditor seeking subrogation is correspondingly affected; the subrogating creditor can have no better claim on the trust assets than the trustee itself.[103]

Subrogation is often referred to, including in the authorities, as a 'right'. Strictly, it is not a right or cause of action, but rather an equitable remedy. Thus, it is subject to all the usual rules for engaging equitable remedies. In particular, it is 'discretionary'. This does not mean that the courts have an absolute discretion whether to grant the remedy or not; rather, it is 'discretionary ... to the extent that courts of equity reserve to themselves a right to refuse to make equitable orders if the party seeking them has acted unconscientiously or is otherwise disqualified by reason of any other rule of equity'.[104] This means that an enforcing unsecured trust creditor may be denied subrogation by application of disentitling equitable defences such as unconscionability, acquiescence or delay,[105] clean hands,[106] laches,[107] or who comes to equity must do equity.[108] Again, there is no analogue in company law. Potentially, parties in competition with a given trust creditor (such as the beneficiaries or even other trust creditors) could use this rule to seek to deny an unsecured trust creditor its claim to subrogation and, therefore access to the trust assets, by proving disentitling conduct, thus leaving the creditor to its rights against the trustee personally and a share out of the trustee's personal assets (if any) in liquidation. In the result, an unsecured trust creditor could be left without a remedy of value in circumstances that would not usually have that result if it were an unsecured creditor of a *Corporations Act* company, where contract debt claims exercisable in liquidation are not a matter of equitable principle.[109]

It is clear that subrogation does not mean that trust creditors enjoy direct proprietary security in the trust fund or are in any sense 'secured'.[110] Unless and until the remedy is granted, the creditor has no equitable interest in the trust assets, or other equity that has priority over those of other creditors of the trustee.[111] Further, while the order will give the creditor an equitable interest in the trust assets corresponding to that held by the trustee, it does not prevail over secured creditors; it merely gives the subrogating creditor the same priority the trustee enjoyed, that is, over the beneficiaries only.[112]

Finally, there is an important distinction to be made in this regard by reference to the difference between 'related breaches' and 'unrelated breaches' by the trustee. The former will only affect a specific creditor, ie the creditor whose engagement with the trustee is tainted by the related breach. That creditor will have no ability to subrogate in connection with its debt because the trustee will have no right of indemnity against the trust estate in respect of that debt. On the other hand, unrelated breaches affect all unsecured trust creditors since the loss occasioned to the trust estate by such a breach is, in effect, deducted from the aggregate claim the trustee has in respect of all debts which are properly incurred and in respect of which the trustee otherwise has a prima facie claim under its indemnity. Because subrogation is a collective process for the benefit of all creditors and not just

---

103 *General Credits Ltd v Tawilla Pty Ltd* [1984] 1 Qd R 388 at 389-390. In a sense, this may be seen as a manifestation of the rule applicable to subrogation generally, that the person against whom it is claimed may raise against the subrogator any defences otherwise available against the subrogatee: *Kerry Jane Fraser v Kirsty Power* [2000] NSWSC 257

104 *Nolan v Collie & Merlaw Nominees Pty Ltd (in liq)* [2003] VSCA 39 at [65] (Ormiston JA).

105 *Lerinda Pty Ltd v Laertes Investment Pty Ltd* [2009] QSC 251 at [8].

106 *Bridgewater v Leahy* (1998) 194 CLR 457 at 494. The offending conduct must be sufficiently proximate to the claim: see *Kation Pty Ltd v Lamru Pty Ltd* [2009] NSWCA 145.

107 *McLean v Burns Philp Trustee Co Pty Ltd* (1985) 2 NSWLR 623.

108 *Langman v Handover* (1929) 43 CLR 334 at 353-354 (Dixon and Rich JJ); *Bofinger v Kingsway Group Ltd* (2009) 239 CLR 269 at [67].

109 Which is not to say that a company creditor is never subject to the application of equitable principles that could defeat its claim: see, for example, *Bell Group (in liq) v Westpac Banking Corp (No 9)* (2008) 225 FLR 1. Rather, the point is that a creditor of a company need not resort to equity to make its claim against the company's assets.

110 *Aluma-Lite Products Pty Ltd v Simpson* [1999] FCA 1105; cf Williams' statement that '[t]he trust creditor is, by virtue of the right to be subrogated to the trustee's right of indemnity, in effect a secured creditor of the trustee. He has priority over the beneficiaries to the same extent as the trustee': Darryl R Williams, 'Winding Up Trading Trusts: Rights of Creditors and Beneficiaries' (1983) 57 *Australian Law Journal* 273. This statement can only be correct in the most general and non-technical sense. As confirmed later by the High Court, the trustee's priority rights with respect to the trust assets is not in the nature of an encumbrance: *Chief Commissioner of Stamp Duties (NSW) v Buckle* (1998) 192 CLR 226.

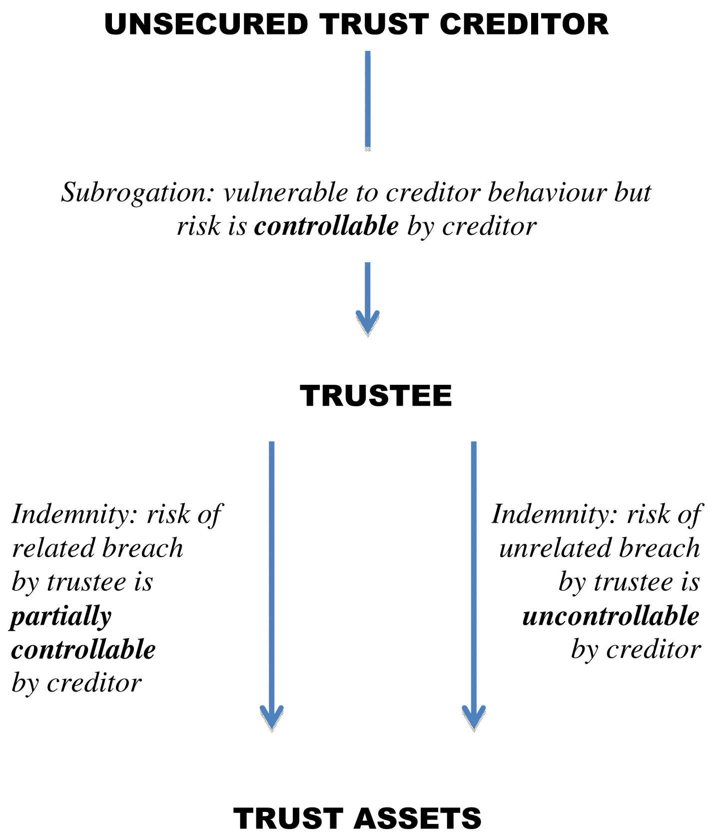
111 *Savage v The Union Bank of Australia Ltd* (1906) 3 CLR 1170 at 1187-1188 (Griffith CJ); *Lerinda Pty Ltd v Laertes Investment Pty Ltd* [2009] QSC 251 at [8].

112 *Nolan v Collie & Merlaw Nominees Pty Ltd (in liq)* [2003] VSCA 39.

those who seek it,[113] the loss is, in effect, shared among all creditors not otherwise affected by a ‘related breach’.

The ‘double equity risk’

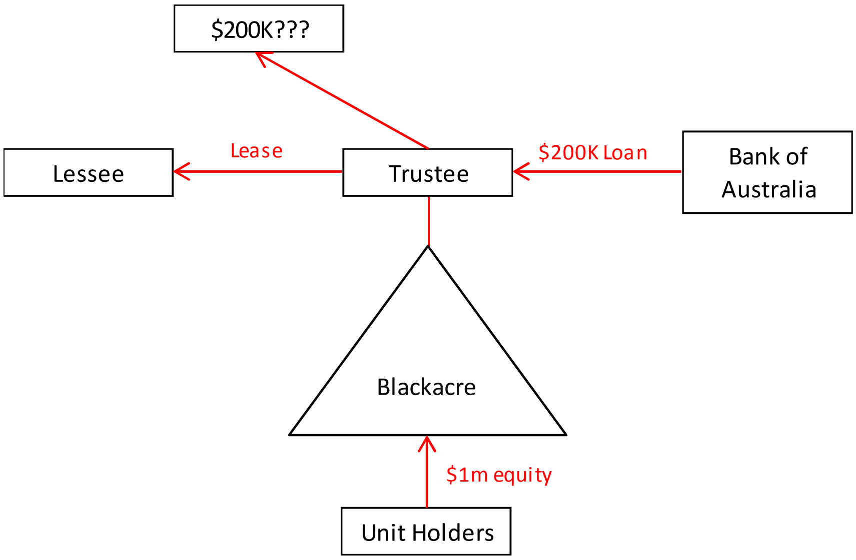
The uncertainty attending the subrogation remedy, when combined with the fragility of the trustee’s indemnity, exposes unsecured trust creditors to what may be described as a ‘double equity risk’. While the subrogation risk is to a large extent controllable if the creditor conducts itself in a manner that does not arouse the disapproval of equity, and the potential for indemnity impairment through related breaches can be managed in the ways described below, the risk that the trustee’s indemnity might be impaired by an unrelated breach is almost entirely uncontrollable.



The double equity risk exists because of equity’s insistence that unsecured trust creditors’ only route of access to trust assets is via subrogation to the trustee’s indemnity. The elements of the double equity risk and its consequences are highlighted in the Blackacre Trust hypothetical set out in Appendix 2.

113 *Lerinda Pty Ltd v Laertes Investment Pty Ltd* [2009] QSC 251; *Nolan v Collie & Merlaw Nominees Pty Ltd (in liq)* [2003] VSCA 39.

6. Analysis of the Blackacre Trust hypothetical



In the Blackacre Trust hypothetical, assuming that (1) the Trustee is irredeemably insolvent,[114] (2) the directors are either impecunious or unable to be located,[115] and (3) none of the grounds for lifting the trust veil could be made out to fix personal liability for the loan on the Unit Holders,[116] Bank of Australia would suffer a total loss of its debt investment. As an unsecured trust creditor, it may only reach trust property via subrogation and thus can have no greater claim than the Trustee. This is so even though it had acted with reasonable diligence when providing the loan, and was both innocent and ignorant of the breaches.

Meanwhile, the Unit Holders would remain beneficially entitled to the value of an unencumbered Blackacre, free and clear of any claims by the former Trustee, and enjoy the benefit of not having to repay Bank of Australia's loan of $200,000; they suffer a net zero loss in respect of the misappropriated $200,000.[117] Assuming they are not guilty of any relevant disentitling conduct, the Unit Holders enjoy what appears to be a windfall or, put another way, the benefit of an external party in effect 'insuring' them against the Trustee's default. This scenario has been described as 'shocking' and 'the one authentic instance in the law where one may pay his debts with his losses'.[118] It self-evidently is not the result of a well-considered, commercially focussed and statutorily mandated allocation of risks consistent with articulated policy objectives, such as applies in the case of a corporate insolvency.[119]

---

114 Although the trustee limitation of liability clause in the Loan Agreement would have been disengaged due to the breaches of trust, the Bank's personal claim against an insolvent Trustee was effectively worthless.

115 The Bank may have claims against the Trustee's directors under s197 and a number of other provisions of the *Corporations Act*.

116 As to which, see D'Angelo, n53.

117 Bank of Australia may have a claim based on ancient authority giving a creditor rights to trust property if it has benefited the estate, but that remedy is discretionary and poorly developed: see *Ford and Lee on Trusts* at [14.6070]. The remedy is more established in the United States: see §269 of the *Restatement (Second) of Trusts*.

118 HF Stone, 'A Theory of Liability of Trust Estates for the Contracts and Torts of the Trustee' (1922) 22 *Columbia Law Review* 527 at 528-529.

119 As a final point in this regard, and to highlight further the anomalous position of the trust creditor, it is appropriate to consider briefly the issue of accessory liability. If the defaulting Trustee had applied trust funds to pay Bank of Australia without 'clearing the accounts', such that the taking of trust funds was itself a breach of trust, and Bank of Australia was aware of this in the relevant sense, Bank of Australia may have been forced to disgorge the payment (and possibly pay other equitable compensation) on the principles in *Barnes v Addy* (1874) LR 9 Ch App 244, as discussed in *Bell Group (in liq) v Westpac Banking Corp (No 9)* (2008) 225 FLR 1; see also *Farah Constructions Pty Ltd v Say-Dee Pty Ltd* [2007] HCA 22. A claim of this nature was made in *Re Blundell* (1888) 40 Ch D 370 but failed because the payee did not have the requisite knowledge of breach.

It might be argued that this is a risk that unsecured creditors take in dealing with a trustee and not bargaining for security, as was suggested by Sir George Jessel MR in *Re Johnson; Sherman v Robinson*.[120] But that view is naïve in the modern commercial context and assumes that security is in all instances realistically available. It does not take into account variable bargaining strength and market conditions. In buoyant economic times, with heavy competition among financiers and a commercial trust that appears to be financially viable, a request for security may result in the loss of the transaction to a competitor financier who is prepared to engage on an unsecured basis. In any case, security is not generally available for non-financier unsecured contract creditors such as trade creditors and employees. In some instances, the trustee may have no power in the terms of the trust to grant security over trust assets.

It is instructive to consider the broader import of the outcome in the Blackacre Trust hypothetical: a person selected by, and acting for the benefit of, the equity investors has misbehaved, possibly fraudulently, but the financial consequences of that misbehaviour are borne by an innocent external party who advanced credit in good faith for the benefit of the enterprise and, while unsecured, did so on a not unreasonable commercial expectation that, if it became necessary, the assets of the enterprise would be available to discharge the debt. Undoubtedly, as between the Trustee and the Unit Holders in a situation like the Blackacre Trust hypothetical, the Unit Holders ought to be preferred, but it is an extraordinary commercial result that the Unit Holders should prevail in the competition between them and the Bank of Australia as an innocent arm's length external creditor without notice of the misconduct.

Commercially speaking, the result in the Blackacre Trust hypothetical means that, in a competition in equity between two classes of stakeholder, where both are innocent of any applicable disentitling conduct, equity investors are preferred over creditors. It is difficult to conceive of a result like this in relation to a company. If a counterfactual is assumed, where the parties had instead chosen to structure their venture as a company under the *Corporations Act*, with the equity investors becoming shareholders and the misappropriation of rental moneys being committed by the board of directors, an entirely different result is generated. By dint of statutory mandate, the Bank and other creditors would be preferred over the equity investors in the liquidation of Blackacre Limited; the equity investors would only receive a distribution if all creditors, including Bank of Australia, are paid in full. The result under company law is that the equity investors rather than the creditors suffer the first layer of loss for misconduct by those who manage the enterprise.

It is appropriate at this stage to analyse the reasons for the Blackacre Trust outcome. The loss suffered by Bank of Australia (and indeed any unsecured creditor of a commercial trust placed in a similar position) is the result of double equity risk with respect to unrelated breaches. That risk exists because of the following jurisprudential peculiarities in the Australian law of trusts (some of which are related or overlap, but they are discussed separately to highlight the issues).

6.1. The asymmetry of the trustee's indemnity

First, although traditionally the language of indemnity, lien and charge has been used to describe the trustee's prior rights with respect to trust assets, the indemnity with respect to trust assets is asymmetrical. Those 'rights' are not granted by the beneficiaries and there is no person with a reciprocating duty or obligation, including the beneficiaries.[121] The benefit of the lien and/or charge is held by the person who legally owns and controls the property so affected, and who is primarily responsible for performance. In fact, as with subrogation, these are not rights at all but remedies or concessions available to the trustee in equity. There is no person on the other side of any of them who might otherwise be held responsible if the trustee defaults; the 'rights' simply disappear, leaving the creditor who seeks subrogation with no recourse against the trust assets. In this sense, the language of indemnity, lien and charge is, arguably, inappropriate; in essence, all equity has given the trustee is permission to do something which would otherwise be a breach of trust, ie to reach into the trust estate

120 *Re Johnson; Sherman v Robinson* (1880) 15 Ch D 548 at 552-553.

121 Assuming that the personal indemnity against beneficiaries has been expressly negatived, as is usual for commercial trusts, or is unavailable. The proprietary indemnity may in one sense be described as a right exercisable as against the beneficiaries, but limited always in recourse to the trust assets.

and take assets to satisfy a personal liability, albeit one incurred in pursuance of trust objectives. From an economic viewpoint, there is an apparent asymmetry in the persons enjoying the benefit of a bargain (the beneficiaries), being free of any corresponding personal obligation in relation to it.

6.2. Asymmetry resulting from the separation of ownership

The way in which trust assets are held creates another apparent incongruity. An essential feature of the trust, and a consequence of holding property through it, is that 'ownership' is divided between the trustee and beneficiaries; this is a facet of the 'proprietary element' described in paragraph 1.2 above. One consequence of 'ownership' of any given asset is that it is available to a person's creditors on bankruptcy or insolvency.[122] The debtor under trust law is the trustee. Trust assets are not 'owned' by the trustee in the relevant (economic) sense and so are not available to the trustee's *personal creditors*; but neither are they available to the trustee's *trust creditors* in the circumstances described in the Blackacre Trust hypothetical where the trust creditors' route of access otherwise fails. Because the trust creditor is not a creditor of the beneficiaries, and despite the beneficiaries enjoying the benefit of the credit bargain, the beneficiaries' ownership interest in the trust assets is not available to the trust creditor. The creditor has, in effect, fallen between two stools.[123]

6.3. The interplay of law and equity

The enforcement of debts is a matter primarily of common law. The trust is not an entity recognised by the common law in any relevant sense. Except in very particular circumstances, the trustee does not contract as agent of the beneficiary. Thus, at law, the debt is always that of the trustee personally, as principal. Equity's intervention to protect the trustee through the implication of an indemnity for debts properly incurred, and to protect creditors through the benefit of subrogation to that indemnity, is evidence of recognition that the 'trust estate' should properly bear those debts and liabilities. American equity's recognition of this economic imperative resulted in it permitting the trustee to exclude entirely its personal liability and giving unsecured creditors direct access to the estate, thus bypassing the trustee's indemnity altogether.[124] Australian equity does not go so far as to relieve the trustee of its personal burden, nor does it give the unsecured creditor direct access to the trust estate. Australian equity's two-step solution is an imperfect one for those creditors.

6.4. The unrelated breach problem and the clear accounts rule

Another peculiarity is the fact that unrelated breaches are permitted to operate as against an innocent creditor via the clear accounts rule. In the Blackacre Trust hypothetical, the breaches of trust committed by the Trustee were in no meaningful way related to the transaction with Bank of Australia. Indeed, the Bank took all reasonable steps available to it to ensure that nothing in the loan transaction with them would constitute a breach of trust. The clear accounts rule self-evidently goes to the equities as between trustee and beneficiary. The unrelated breach problem means that, even if an intending creditor does all it reasonably can to protect its position against a related breach, it remains vulnerable to prior or later misconduct by the trustee of which the creditor may have no knowledge and no way of obtaining knowledge. The clear accounts rule results in unrelated breaches operating to the detriment of innocent creditors.

6.5. The effect of the clear accounts rule on the exoneration power

As a corollary to the preceding point, a further peculiarity is the fact that the clear accounts rule operates with respect to the exoneration power. Because the reimbursement right is unambiguously to

---

122 The expressions 'ownership' and 'owned' are used in a non-technical sense. The nature of a beneficiary's interest in the trust *res* is vague and contentious: see B McFarlane and R Stevens, 'The nature of equitable property' (2010) 4 *Journal of Equity* 1. In any case, this paper is limited to the *commercial trust* as defined in the Introduction, which is a unit trust. There is no doubt under Australian law that a unit holder in a commercial trust can give a security interest over its unit holding (assuming no restriction in the trust instrument or elsewhere) and that unit holding is an asset in its estate for bankruptcy or insolvency purposes.

123 As an interesting corollary to this anomaly, a beneficiary's interest in the trust fund (that is, each Unit Holder's unit holding in the Blackacre Trust), being a personal asset, would be available to personal creditors of that beneficiary in its bankruptcy or liquidation. The trust creditor, therefore, is in a potentially subordinate position to personal creditors of the beneficiaries with respect to trust assets against which it has extended credit.

124 See n102.

the personal benefit of the trustee,[125] it is logical that the clear accounts rule should operate against it. With the rule in *Cherry v Boultbee* as its jurisprudential foundation, the clear accounts rule self-evidently goes to the equities as between a trustee and its beneficiaries. But it is doctrinally troubling that it derogates from the exoneration right. While it may be seen as a personal right of the trustee in that it protects it against a liability, the exoneration right can also be seen as a power to apply trust assets for trust purposes, to pay liabilities incurred for trust purposes, and thus to the benefit of creditors (albeit not in a fiduciary sense).[126] Trust assets applied in so doing so are not paid to the trustee for its own account, and remain trust assets until paid to the creditor.[127] In the result, the economic consequences of the trustee's misconduct can be borne by innocent creditors rather than the beneficiaries – the wrong persons are punished for the sins of the trustee. This outcome results from a failure to respect the fundamental differences between the reimbursement and exoneration rights and their conflation into a single 'indemnity'.[128]

6.6. Evolutionary mismatch and the 'lag effect'

The final peculiarity can be described as a structural outcome of the evolutionary process. The majority of Australian trust law relating to the rights of trust creditors was formulated in the 19th and early 20th centuries, in England and Australia, in the context mainly of disputes to do with deceased estates and family trusts, where the intervention of equity was aroused by a need to protect the vulnerable in the absence of adequate remedies at common law. Commercial trusts and the concept of the beneficiary as an equity investor were not, until relatively recently, a significant feature of the Australian commercial landscape. The reasoning behind the result in the Blackacre Trust hypothetical can be traced at least as far back as the 1880 decision of the court of Chancery in *Re Johnson; Sherman v Robinson* (1880) 15 Ch D 548 which involved a testamentary trust where the beneficiaries were family members of the deceased, including children, and a misbehaving executor. In finding that the creditors could not subrogate, the dicta of Sir George Jessel MR evidenced a clear protective bias towards the beneficiaries, and an implication that the creditor should bear the risk, and suffer the consequences, of the trustee's default because they bargained for personal liability of the trustee when they were in a position to protect themselves (for example, by demanding security).

7. 'Related breaches': contractualised creditor protection

In 1979 the late Roddy Meagher QC (as he then was) said:

> any person proposing to deal with the trustee of a trading trust, if he is on notice of the existence of the trust, ought to satisfy himself that the transaction is authorised by the terms of the trust, if he anticipates having to rely on being subrogated to the trustee's right to indemnity out of the trust assets.[129]

Related breaches are a concern to intending creditors who are properly advised. To ameliorate their risk, they will seek to ensure that the engagement they are contemplating entering into with the trustee is not itself in breach of trust either for acting beyond power or for an improper exercise of power. In the absence of legally mandated indoor management style protections of the type available in respect of companies, this risk is controllable if the intending unsecured creditor is in a position to take a

---

125 *Federal Commissioner of Taxation v Bruton Holdings Pty Ltd (in liq)* (2008) 173 FCR 472; *Re Suco Gold Pty Ltd (in liq)* (1983) 33 SASR 99; *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360.

126 See *In re Richardson; Ex parte Governors of St Thomas' Hospital* [1911] 2 KB 705.

127 Assume the following example. A trust debt is due. Not wishing to use its own money to pay it, the trustee decides to discharge it by drawing a cheque on the trust bank account which is payable to the creditor directly. Until that money is received by the creditor, it remains trust money, and is never beneficially the property of the trustee; ownership of it does not pass first to the trustee en route to the creditor. Even if the trustee, for whatever reason, drew the cheque as payable to itself first and banked it in its personal account pending payment to the creditors, it would retain its character as trust property in its bank account: *Re Matheson; Ex parte Worrell v Matheson* (1994) 49 FCR 454; *Re French Caledonia Travel* [2003] NSWSC 1008. Thus, in relation to the right of exoneration, the trustee is little more than a conduit.

128 A particularly egregious example of this doctrinal fallacy is *Re Enhill Pty Ltd* [1983] 1 VR 561, a decision of the Full Court of the Supreme Court of Victoria. The decision has been described extracurially by the former Chief Justice Sir Anthony Mason, as 'distinctly fragile' (in 'Themes and Prospects' in PD Finn (ed), *Essays in Equity* (Law Book Co, 1985)) and by others as 'obviously wrong': *Jacobs on Trusts* at [2114]. See also *Lerinda Pty Ltd v Laertes Investment Pty Ltd* [2009] QSC 251 at [13]-[14]; Barrett, n8 at 13; and B Horrigan, 'Trust Asset Wars - The Liquidator Strikes Back' (1988) 15 *University of Queensland Law Journal* 69. In *CB Darvall & Darvall v Moloney (No 2)* [2007] QSC 337, Muir J mentions several authorities that suggested that *Enhill* was wrong. The debate is discussed in *Federal Commissioner of Taxation v Bruton Holdings Pty Ltd (in liq)* (2008) 173 FCR 472 at [47]-[58]. The *CAMAC Report* describes the *Re Enhill* decision as one of two 'lines of trust law authority' on this issue, at [2.3.3]; with respect, this accords the decision too high a status.

129 RP Meagher, 'Insolvency of Trustees' (1979) 53 *Australian Law Journal* 648 at 653.

series of practical pre-contractual steps, including (1) conducting due diligence investigations with respect to the trustee, the trust and the trust documents, and (2) negotiating for specific contractual comfort from the trustee.[130]

Not all unsecured creditors are in a position to take these protective steps before contracting with a trustee, but one class of creditor is: the well-advised financier creditor with negotiating leverage against a trustee borrower seeking a commercial loan or other financing facility.

7.1. Due diligence

In addition to the usual enquiries regarding the trustee as a company in its own right (detailed discussion of which is outside the scope of this paper), a well-advised intending creditor will, before entering into a transaction with a trustee, obtain and review the trust's constituent documents to ensure that a number of critical matters are in order. These include:

- that the person with which they are dealing is the trustee of the relevant trust;
- that the trust has been properly established and exists, according to trust law principles;
- that the trust instrument is valid, binding and enforceable according to trust law and (if applicable) contract law principles;
- that the trustee has express power to do all relevant things for the purpose of the intended transaction (for example, to borrow money);
- that nothing in the trust instrument derogates from or limits or imposes conditions on the trustee's indemnity out of the trust property in respect of liabilities incurred as part of the intended transaction; and
- that there are no restrictions on the trustee's ability to exercise its powers contained in the trust instrument either generally or in respect of the intended transaction.[131]

In addition, other matters require attention that will not necessarily be addressed by a review of the trust instrument which involve the fiduciary duties of the trustee, such as whether the intended transaction is for the benefit the trust estate and for the legitimate purposes of the trust, and whether the trustee is under any conflict of interest and duty in entering into the intended transaction. These are usually addressed by contractual assurances from the trustee.

7.2. Contractual protections

In addition to those due diligence enquiries, well-advised financiers and other intending creditors with sufficient bargaining leverage will usually seek contractual comfort from the trustee by way of:

- representations: these provide assurances in relation to past conduct and confirmations in relation to key information about, among other things, the status of the borrower as a trustee and the trust itself. These are made on the date of the financing agreement and are deemed to be repeated periodically; and
- covenants or undertakings: these impose ongoing positive or negative obligations on the trustee in relation to its conduct and the status of the trust during the term of the financing arrangement.

The reasons financiers providing credit to trustees seek these assurances, and the matters in respect of which they provide comfort, are evident from their contents. While addressing different matters of detail, as a whole they are designed to maximise the prospects that the trustee will have a valid claim of indemnification against the trust assets in respect of the indebtedness incurred under the loan agreement, to which the financier may subrogate if it becomes necessary.

In the absence of supporting security over the trust assets, however, any claim for damages for a breach of contractual comfort would still be an unsecured claim against the trustee (and, moreover, one in respect of which the trustee may have no indemnity as against trust assets). Still, these assurances provide a range of benefits beyond that:

---

130 When dealing with smaller closely-held trusts, it is sometimes possible for a creditor to obtain supporting contractual comfort from the beneficiaries.

131 Strictly speaking, not all of these matters address directly the related breach problem; the first two points are more fundamental and go to assuring the intending creditor that it is indeed engaging with the trust enterprise.

- first, under conventional drafting of financing agreements, a breach results in an 'event of default' which will give the financier the right to bring forward the tenor of the loan (a process described as 'acceleration') and cancel any further obligation to advance credit. In some circumstances, this in itself could undermine the financial viability of the trustee and/or the trust enterprise itself and so is potentially a serious matter for the trustee, its directors and the beneficiaries;[132]
- secondly, they provide an inbuilt incentive for the reasonably diligent trustee to ensure that all is in order, at the outset and on an ongoing basis, so that it may give these contractual assurances safely and without incurring an unindemnified personal liability;
- thirdly, a breach of a representation may ground a claim for misleading and deceptive conduct under relevant statutes,[133] both against the trustee personally[134] and its directors.[135]

While these practical steps may be described as a contractualised solution, they are time consuming, costly and only partially effective. They demonstrate the inherent inefficiencies in trust law as a regime for regulating the trust as an enterprise entity and the legal risks of those who participate in them.

8. 'Unrelated breaches': contractualised creditor protection

The unrelated breach problem facing creditors is a direct result of the fiduciary overlay, since the clear accounts rule engaged by such breaches goes to the equities as between the beneficiaries and their trustee. Despite the undoubted logic of this as between trustee and beneficiaries the rule yields adverse consequences for innocent external counterparties.

While, as described above, an intending creditor may take a series of steps to protect itself against related breaches, unrelated breaches can be the source of a different type of anxiety among a trustee's creditors. Each creditor is concerned that the trustee may in the future commit, or may in the past have committed, breaches that are unrelated to its engagement with the creditor but which may arouse the operation of the clear accounts rule. Even after taking steps of the type described above, there will always be an uncovered risk that the trustee's right of indemnity may be impaired due to unrelated breaches. There are limits to what any given unsecured creditor can do, practically speaking, to prevent this or protect itself against its consequences, short of taking security (which, as discussed above, is not always available). Contractualised protections of the type discussed above provide a limited degree of protection against unrelated breaches and, in any case, they are merely unsecured promises and may provide little recourse of worth in insolvency.

In the result, creditors who engage with a trustee on an unsecured basis are, whether consciously or otherwise, placing a high degree of trust in the good faith and competence of its directors and management. It may be argued this is no different from the trust that unsecured creditors place in the directors and senior management of a corporation when dealing with it on unsecured terms. Yet the consequences if that trust proves to be misplaced differ materially as between companies and trusts, as the discussion of the Blackacre Limited counterfactual shows.

It would be preferable if the problem could be dealt with at its source. As discussed above, clauses in trust instruments which purport to exempt trustees from liability for breaches of trust beyond an 'irreducible core' have been held to be valid. While at one level, removing the unrelated breach

---

132 Wood makes the practical point that the actual exercise of these rights is a last resort since that may crystallise an undesirable position for the financier; thus, provided the trust is not hopelessly unviable the default is often used as negotiating leverage to give the financier a degree of control and the right to force a renegotiation of the terms of the financing arrangement: PR Wood, *Project Finance, Securitisations, Subordinated Debt* (2nd ed, Sweet & Maxwell, 2007) at 4-014.

133 Section 12DA of the *Australian Securities and Investments Commission Act 1989* (Cth) and s1041H of the *Corporations Act* in relation to the provision of financial products and services; generally, see s18 of the *Australian Consumer Law* comprised in Schedule 2 of the *Competition & Consumer Act 2010* (Cth), s42 of the *Fair Trading Act 1987* (NSW) and corresponding legislation in other states. A breach of contract may ground an action under the misleading and deceptive conduct statute: *Demagogue Pty Ltd v Ramensky* (1992) 39 FCR 31. The giving of a contractual warranty can be 'conduct' for the purposes of the misleading and deceptive conduct statute: *Accounting Systems 2000 (Developments) Pty Ltd v CCH Australia Ltd* (1993) 42 FCR 470.

134 Misleading and deceptive conduct damages are not excluded per se from the benefit of the trustee's indemnity: *Gatsios Holdings Pty Ltd v Nick Kritharas Holdings Pty Ltd (in liq)* [2002] NSWCA 29.

135 See the discussion in *Keller v LED Technologies Pty Ltd* [2010] FCAFC 55.

problem has the potential to erode the equity of the beneficiaries, it may equally be argued that it is in the interests of all investors in commercial trusts that the problem is ameliorated to the extent possible, to encourage external parties to engage with the trustee in carrying on its activities and achieving its legitimate business objectives. Promoters who recognise the issue may seek to overcome it by including in the constitution of commercial trusts a provision along the following lines:

> If the Trustee incurs a liability in a proper exercise of its powers as trustee, it may satisfy that liability out of the Trust Fund, despite any obligation to make good any loss to or any diminution in the value of the Trust Fund as a consequence of any act or omission by it (or by any person or entity acting on its behalf) which is unrelated to that liability or the person to whom it is owed.[136]

The efficacy of such clauses is yet to be tested before the courts.[137] However, if valid the net effect would be to shift the economic consequences of trustee misbehaviour in the nature of an unrelated breach from the creditors to the beneficiaries. The creditors' interest in the trust assets is unaffected and the equity investors rather than the creditors are burdened with the risk of the trustee's personal creditworthiness, leaving them to resolve the matter bilaterally with the trustee (in respect of which established laws of equity in relation to trustee breaches provide them with ample remedies).

However, despite the breadth of language it seems clear that the authorities would apply to a read down a provision like this, so that it could not operate if the unrelated breach was of the 'irreducible core' of the trustee's duty, ie to act honestly and in good faith for the benefit of the beneficiaries. This seems reasonable enough with respect to the trustee – after all, it can hardly be permitted to benefit from its own dishonesty – but again it is noted that the contractualised solution is imperfect because it fails to protect properly the unsecured creditor. Thus, if the unrelated breach is grounded in dishonesty or bad faith, this clause would not protect the indemnity and so even a creditor who is innocent of the relevant conduct, and has no notice of it, will have no ability to access the trust assets. The risk shifting from creditors to equity investors is incomplete.

9. What happens to creditors when a commercial trust is affected by insolvency?

> The differences between trading trusts and registered companies are highly technical and outside the understanding of not only most lay investors but also most professional investment advisers. Only when liquidation in insolvency supervenes will minds be concentrated enough to appreciate the technicalities.[138]

The remainder of this paper completes the substantive discussion of creditor risks by considering the situation when a commercial trust is affected by insolvency. It considers the structural weaknesses in current laws that render the position of all stakeholders uncertain and prone to unexpected outcomes. It investigates in particular the critical threshold issues of whether and when a commercial trust, as an economic entity, can be said to be 'insolvent', matters that have received relatively little attention, mainly because the cases that have come before the courts have involved trustees that were already insolvent and commercial trusts that had collapsed.[139]

The process that saw the trust evolve into a company-like commercial entity liberated trustees from their traditional constraints. When combined with normal commercial pressures from arm's length

---

136 A clause to similar effect appears in MIS constitutions commonly prepared by large commercial law firms in the Australian market. Note that by its opening language, it presupposes that liabilities are properly incurred - this clause is not designed to protect against related breaches.

137 The argument in favour of efficacy would be that the beneficiaries, by agreeing the inclusion of such a clause in the trust instrument (or acquiring their interest subject to it) and allowing the trustee to engage with creditors and other third parties on the basis of it, are precluded from asserting the clear accounts rule to the detriment of a third party claimant if and when that claimant subrogates to the trustee's indemnity claim. The rule, as with the trustee's indemnity itself, is a creation of equity and, like the indemnity, ought to be susceptible to modification by the terms of trust. As between beneficiary and creditor this provision would not and could not rest on contact (absent a bilateral engagement between them either directly or via agency), but could readily support an argument based on estoppel or, alternatively, an argument that the clause in effect circumscribes the nature of the beneficiaries' interest, which is residual in nature, in the sense contemplated by the High Court in *Chief Commissioner of Stamp Duties (NSW) v Buckle* (1998) 192 CLR 226.

138 HAJ Ford and IJ Hardingham, 'Trading Trusts: Rights and Liabilities of Beneficiaries' in Finn (ed), Equity and Commercial Relationships (1987) at 84.

139 There is a useful comparative discussion in the way in which United States law extends the benefits and protections of the orderly statutory insolvency regime in the *Bankruptcy Code* to stakeholders in 'business trusts' by aligning them with corporations and treating them as separate entities (see Title 11, §§101(41) and 101(9)(A)(v) of the *United States Code*), but that is for another time.

equity investors to maximise returns on their investment, trustees of commercial trusts are permitted to be (and indeed are usually expected to be) risk-tolerant and entrepreneurial in their dealings with trust property in the pursuit of profits. This includes taking on financing debt to leverage the balance sheet of the trust. A more risk-tolerant and entrepreneurial trustee and substantial trust indebtedness expose a trust and its stakeholders to a greater risk of financial distress and insolvency. It may be argued that economically this has merely resulted in equity and debt investors in commercial trusts facing the same risk profile as corresponding investors in trading companies. However, as has been demonstrated, creditors' *legal* risks are not identical to those faced by their counterparts in a company. The framework for allocating legal risks and liabilities under trust law differs from that which governs companies; major components of the latter are entirely missing from the former. The focus of this paper from here on is on that which may be regarded as the most serious omission of all: the absence of a sophisticated, policy-based insolvency regime.

The relationship between the Australian commercial trust and current insolvency laws is an awkward one. The commercial trust is not a legal entity in its own right, but will have a *Corporations Act* limited liability company as its trustee – a combination which Professor Ford famously described as a 'commercial monstrosity'.[140] It is clear from the context in which that rather striking description appears that he intended it to mean a creature 'made up of incongruous elements'.[141] Much of the content of the preceding discussion supports the sentiment in that description, but it is in insolvency that the 'monstrous' nature of the commercial trust is fully exposed. Because it is not a company, the commercial trust is in effect invisible to the insolvency regime in the *Corporations Act.* Even the regulatory regime for commercial trusts that are managed investment schemes, itself contained within the *Corporations Act,* fails to deal adequately with insolvency.[142]

Yet there is no established alternative 'insolvency law' as such for commercial trusts. Issues of insolvency pertaining to a trust are left to be analysed on a first principles basis, by reference to the financial state of the trustee. This is the point at which the trust's economic existence as an enterprise entity must yield to its legal nature as a cluster of relationships between the stakeholders and a fund of assets. This statutory vacuum has left modern Australian courts to develop a common law of insolvency for commercial trusts in the traditional manner, via the resolution of private disputes between self-interested actors in an adversarial context, applying an amalgam of trust law, company law and contract law principles.

10. The many issues attending commercial trusts affected by insolvency[143]

The absence of a structured statutory regime for dealing with insolvent commercial trusts creates uncertainties and legal lacunae that affect all stakeholders. Some of the issues are quite complex and have begun challenging the creative potential of the courts. By way of brief summary, they include (but are by no means limited to) the following:

- generally, the extent to which corporate insolvency law principles can and should apply when dealing with commercial trusts, and how trust law interacts or should interact with corporate insolvency law;[144]
- issues that arise when a trustee is in voluntary administration,[145] including specifically whether the affairs of a corporate trustee in voluntary administration should include the affairs of a trust of which it is trustee;[146]

---

140 HAJ Ford, 'Trading Trusts and Creditors' Rights' (1981) 13 *Melbourne University Law Review* 1 at 1.

141 *Shorter Oxford English Dictionary* (6th ed, Oxford University Press, 2007), definition of 'monster', item 3.

142 A point acknowledged in the *CAMAC Report*.

143 This paper is not a comprehensive conspectus of the ways in which the law deals with (or fails adequately to deal with) commercial trusts affected by insolvency. Many of the issues have been identified and some have been the subject of detailed treatment in official reports, case law and academic commentary. The literature is growing rapidly in the aftermath of the global financial crisis. Most recently, some of the key issues have been canvassed by CAMAC in relation to trust-based registered managed investment schemes in the *CAMAC Report*, and by the New Zealand Law Commission in New Zealand Law Commission, 'Court Jurisdiction, Trading Trusts and Other Issues. Review of the Law of Trusts. Fifth Issues Paper' (No 28, 2011).

144 See *ASIC v Tasman Investment Management Ltd* [2006] NSWSC 943 and *Re Stacks Managed Investments Ltd* [2005] NSWSC 753.

- issues that arise specifically in the winding up of insolvent (or unviable) trusts and trustees;[147]
- how and the extent to which laws relating to voidable transactions are applicable to commercial trusts;[148]
- how trust property is to be distributed among trust creditors, in the absence of a statutorily mandated *pari passu* rule, where the value of trust assets is insufficient to discharge all trust debts fully;[149]
- if and the extent to which a corporate trustee's administrator or liquidator is entitled to be remunerated, and to have its expenses indemnified, out of trust assets;[150]
- the conflicts and other challenges that arise when an administrator or a liquidator is appointed to a corporate trustee and is required to administer trust property, particularly as between his or her duties to general or personal creditors of the corporate trustee, his or her duties as an officer of the trustee as a company and the duties the trustee owes to beneficiaries, as well as his or her own personal interest in protecting their personal liability position and being remunerated out of the trust property;[151]
- whether an insolvent corporate trustee should be removed as trustee and legal and practical impediments in effecting that;[152]
- what happens if a trust instrument has a clause automatically removing the trustee or vacating its office upon insolvency or the appointment of an insolvency official;[153] and
- how these issues are dealt with in situations where the same company is trustee of multiple trusts or schemes, all of which are affected by financial distress, and the rights of creditors and equity investors if the trustee has failed to properly segregate the assets and liabilities of a trust from its personal assets and liabilities (or, indeed, those of other trusts of which it is trustee).[154]

---

145 Which have emerged in the voluminous (and growing) litigation regarding the voluntary administration of managed investment schemes formerly managed by the Allco Group, Austcorp, Babcock & Brown, Environinvest, Forest Enterprises Australia, Great Southern Group, Record Funds Management, Rewards Group, Rubicon Funds Management, Timbercorp Securities, Trio Capital, Willmott Forests and others. Some of the issues and cases in relation to trust-based registered managed investment schemes are discussed in Chapter 6 of the *CAMAC Report*. The Report points out, in particular, complexities arising due to the distinctions between situations where creditors have full recourse against the responsible entity personally and where their recourse is limited to scheme assets, and between dedicated sole-function (that is, single scheme) responsible entities and multi-function (that is, multiple scheme) responsible entities.

146 In respect of which there is conflicting authority: see *Silvia, in the matter of FEA Plantations Ltd (admin apptd)* [2010] FCA 468 (yes); *Owen, in the matter of RiverCity Motorway Pty Limited (admin and rec apptd) v Madden (No 3)* [2012] FCA 313 (no).

147 See *Caterpillar Financial Australia Ltd v Ovens Nominees Pty Ltd* [2011] FCA 677. Some of the issues in relation to trust-based registered managed investment schemes are discussed in Chapter 7 of the *CAMAC Report*.

148 *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360; *Tolcher v John Danks & Son Pty Ltd* [2007] NSWSC 1207; *Jacobs on Trusts* at [2116]. The *CAMAC Report* made a policy recommendation at [7.5.6] that '[t]here should be voidable transaction provisions applicable in the winding up of an insolvent [registered managed investment] scheme, based on the exiting [sic] provisions applicable to companies', but without suggesting specific language or addressing the various issues and complexities, including those raised in submissions.

149 See *ASIC v Commercial Nominees* [2002] NSWSC 576; *Lerinda Pty Ltd v Laertes Investment Pty Ltd* [2009] QSC 251; *Adams v Zen 28 Pty Ltd* [2010] QSC 36. See also McPherson, n58. In *Spies v The Queen* (2000) 201 CLR 603 the High Court of Australia said (but not in relation to trusts specifically) '[t]o give some unsecured creditors remedies in insolvency which are denied to others would undermine the basic principle of *pari passu* participation by creditors' at 636; cf Williams, n110, in which the author suggested that the appropriate method for allocation among creditors was the equitable 'first in time' principle, at 277.

150 In respect of which there is conflicting authority: see *JGM Nominees Pty Ltd v Australvic Pty Ltd (No 2)* (2010) 28 ACLC 383; *Re Dalewon Pty Ltd (in liquidation)* [2010] QSC 311; *Re Byrne Australia Pty Ltd (No 2)* [1981] 2 NSWLR 364; *Re Enhill Pty Ltd* [1983] 1 VR 561; *Re Suco Gold Pty Ltd (in liq)* (1983) 33 SASR 99. In relation to the complex situation where a company in administration is trustee of several trusts, some of which are insolvent and other which are not, see *Trio Capital Ltd (admin apptd) v ACT Superannuation Management Pty Ltd* [2010] NSWSC 941.

151 *Dreiberg v Bettles & Carter as liquidators of Corindi Beach Developments Pty Ltd* [2007] NSWSC 1204; *Timbercorp Securities Ltd (in liq) v WA Chip & Pulp Co Pty Ltd* [2009] FCA 901 In relation to liquidators and conflicts generally, see *Public Trustee (Qld) v Octaviar Ltd (in prov liq) (recs & mgrs appt)* [2009] QSC 283 at [23].

152 *Wells v Wiley* (2004) 183 FLR 284; *Re French Caledonia Travel Service Pty Ltd (in liq)* [2002] NSWSC 641; *Re Matheson; Ex parte Worrell v Matheson* (1994) 49 FCR 454. See also Chapter 5 of the *CAMAC Report*.

153 *Pleash, in the matter of Suncoast Restoration Pty Ltd (in liq)* [2013] FCA 355 and *Neeeat Holdings (in liq)* [2013] FCA 61. See also A Kawalsky, 'Lessons from Apostolou v VA Corporation Aust Pty Ltd [2010] FCA 64' (2012) Jan-Mar *Australian Insolvency Journal* 32.

154 See, for example, *ASIC v Letten (No 7)* [2010] FCA 1231. Some of the issues are discussed in relation to trust-based registered managed investment schemes in the *CAMAC Report*.

The fact that there is no statutory guidance on these fundamental issues demonstrates that the law which applies when a commercial trust faces insolvency is, in commercial terms, highly inefficient, and in any given case has the potential to frustrate the commercial expectations of stakeholders.[155] In its submission to CAMAC following release of the *CAMAC Discussion Paper*, the Insolvency Practitioners Association stated that 'trusts make the insolvency process overly complicated with an outcome not necessarily in line with what would be an expected outcome in the insolvency of a company'.[156] To similar effect, the learned authors of *Jacobs on Trusts* note that 'conceptually [the trading trust] presents no problem, but it can give rise to practical problems of some magnitude, particularly on insolvency', at [316].

11. The commercial trust and insolvency law: an awkward relationship

There is abundant case law on the meaning of 'insolvency' in relation to companies, and this is touched on briefly below. However, while a trust or managed investment scheme may be described as 'insolvent' in certain contexts, it cannot be an insolvent *person* under the *Corporations Act* because it is not a person in the relevant sense and so it cannot be subject to (and its stakeholders cannot enjoy the benefit of) the insolvency regime provided under the Act. While it is certainly possible for a corporate trustee, as a company, to become insolvent,[157] it is a legal nonsense to speak of a trust or managed investment scheme as being 'insolvent' in the sense contemplated by the Act. The analysis for the purposes of the Act must be conducted at the level of the trustee, although the financial viability of the trust fund is relevant in that analysis. Financially speaking, in one (highly simplified, non-technical) sense, to a corporate trustee a trust can be said merely to represent a set of liabilities (ie those incurred in its trustee role) and a corresponding asset (ie its right of indemnity out of the assets it holds as trustee). Beyond that, however, the matter becomes quite complicated, due to the arcane nature of trusts and the resultant complexities when they are used as business vehicles.

Consistent with the overall investor and creditor protection policy setting of companies law, the insolvency regime which operates when a *Corporations Act* company becomes or is near insolvent is detailed, sophisticated, policy-based and highly evolved. The expression 'insolvency law' does not describe a doctrinal category, like contract or tort law,[158] but it is a convenient collective label often used to describe the body of law that applies when a company is insolvent or approaches insolvency. Its objective is to ensure orderly dealing with the company and its property, and an appropriate allocation of assets and losses among stakeholders, consistent with policy objectives that are imposed through legislation. The architecture of this body of law is contained mostly in the *Corporations Act*, but that is not a code; there is significant common law overlay. The history and development of insolvency law has been well documented; trusts feature only peripherally.

Solvency, or its absence, is at the heart of this regime. It is the gateway for the principal insolvency administration regimes available in respect of companies, being voluntary administration[159] and insolvent liquidation or winding up.[160] It engages the laws of voidable transactions.[161] It arouses the

---

155 It is also disappointing to observe that many of these very same issues were noted over two decades ago by the Australian Law Reform Commission: Australian Law Reform Commission, 'General Insolvency Inquiry' (Report No 45, 1988), Chapter 6 (*Corporate Trading Trusts*).

156 Submission by Dennis North, Chief Executive, Insolvency Practitioners Association dated 7 October 2011 (available at http://www.camac.gov.au/camac/camac.nsf/byHeadline/SubmissionsMIS?openDocument) at page 4. In the *CAMAC Report*, it was acknowledged that '[w]here a scheme or its RE [responsible entity] suffers financial stress, the process of attempting their rehabilitation or orderly winding up can be complicated by the entangling of the affairs of the scheme and of the RE', at 46.

157 ASIC seeks to provide for a solvency buffer for companies acting as responsible entities of registered managed investment schemes by imposing minimum net tangible assets requirements on them as conditions to their holding an Australian financial services license (or 'AFSL'). ASIC has power to do this under s914A of the *Corporations Act*. A responsible entity of a registered scheme must be a public company that holds an AFSL: s601FA.

158 Although it has been described as having evolved into a 'discrete discipline': M Murray, *Keay's Insolvency, Personal and Corporate Law and Practice* (6th ed, Law Book Co, 2008) at [1.10].

159 Part 5.3A of the *Corporations Act*.

160 Parts 5.4 and 5.4B of the *Corporations Act*. Receivership is also commonly included in the category of insolvency administration regimes in respect of companies, but receivership is a private arrangement initiated out of court by a secured creditor in connection with enforcement of its security (although the courts have an inherent jurisdiction to appoint receivers in other circumstances for limited purposes in specific cases: see Part 26 *Uniform Civil Procedure Rules*). In any case, it is not a prerequisite for receivership that the company be insolvent; it merely needs to be in default under its security. A company may survive receivership if the secured debt can be repaid (or compromised) and the company left with sufficient assets to be viable.

161 Part 5.7B Division 2 of the *Corporations Act*.

potential for personal liability of directors for insolvent trading (and thus motivates consideration of whether they should place a company into voluntary administration to protect against that liability).[162]

By contrast, there is no specific statutory regime for dealing with insolvency in the case of commercial trusts. In relation to managed investment schemes, although Chapter 5C, when introduced into the Act in 1998, effected real and substantial change to the regulation of the use of trusts as collective investment vehicles, it has one very obvious deficiency – it does not comprehensively deal with insolvency and the insolvent administration of schemes.[163] This is, indeed, a most curious omission.[164]

Thus, while the expressions 'insolvent trust' and 'insolvent managed investment scheme' are used in commerce, and their use has even been accepted in the courts in some contexts,[165] these should be understood to be colloquialisms or conveniences of expression rather than legally correct expressions.[166]

When a company becomes insolvent, the legal options available to stakeholders are clear (if not always simple to apply in complex factual matrices). Unsecured creditors have means available to them to press the company into liquidation and force a break-up of the enterprise in an effort to recoup their debt out of the assets. The directors may place the company into the hands of a voluntary administrator in an effort to salvage the enterprise or, if not, then at least to manage the process in an orderly fashion. There is no such clarity when a trust becomes 'insolvent'. The interplay between the state of solvency of the trustee as a company and the financial viability of the trust fund as an economic entity creates a degree of complexity that requires careful analysis to divine the rights and obligations of stakeholders. This has an aggravating effect on the already difficult issue, for trust stakeholders, of assessing solvency. The questions of whether a company has become insolvent, the precise point in time at which it became so and who knew or suspected relevant matters at relevant times (or ought to have done so) can be critical to the position of key stakeholders like directors and creditors.

In 2006, Austin J warned that '[c]are must be taken to avoid any unreflective application of company law ideas to enterprises organised as managed investment schemes', even in the face of the managed investment scheme provisions in the *Corporations Act*, and that 'the winding up of a trust is quite a different thing from the winding up of a company, in terms of such matters as the rights of 'scheme creditors' and investors'.[167] Where a corporate trustee is wound up, including in insolvency, there is a point at which company law ends and trust law takes over.[168]

The result is that when the shadow of insolvency descends over a trust with a company as trustee (as is the case with commercial trusts), the matter must be dealt with by reference to the trustee, and the question of how its solvency is affected by the financial viability of the trust fund must be considered on a first principles basis. Stakeholders, and those who advise them, are forced to consider an unsettled melange of company law, trust law and contract law. Unfortunately, the courts have not yet been given the opportunity to explore and clarify these issues comprehensively.

---

162 Part 5.7B Division 3, and s588H(5) and (6) of the *Corporations Act*. See N D'Angelo, 'What directors need to consider before calling in an administrator – and it's not just solvency…' (2006) 24 *Companies & Securities Law Journal* 7.

163 Chapter 5C has been described by Justice Barrett of the NSW Supreme Court, speaking extracurially, as the *Corporations Act* 'flirting' with a concept of insolvency of managed investment schemes; he went on to say that the provisions 'do not attempt to deal in any comprehensive way with insolvency': Barrett, n8.

164 Curious because Chapter 5C was the final output of a lengthy consultative process, which resulted in recommendations made in Australian Law Reform Commission and Companies and Securities Advisory Committee, 'Collective Investments: Other People's Money' (Report No 65, 1993) and Financial System Inquiry Committee, 'Financial System Inquiry: Final Report' (AGPS, 1997). One suggestion was the inclusion of administration and winding up regimes for insolvent schemes.

165 See, for example, *Capelli v Shepard* [2010] VSCA 2; *Basecove Pty Ltd v Dolores Lavin Management Pty Ltd* [2009] NSWSC 1315 at [9]; *Lerinda Pty Ltd v Laertes Investment Pty Ltd* [2009] QSC 251 at [9]; *Adams v Zen 28 Pty Ltd* [2010] QSC 36 at [23]; *Rubicon Asset Management Ltd* [2009] NSWSC 1068 at [42] and [55]; *Re Environinvest Ltd* [2009] VSC 33 at [103]-[105]; *Ex parte PWL Ltd (formerly Palandri Wines Ltd) (admin apptd) (No 2)* [2008] WASC 232; *Re Orchard Aginvest Ltd* [2008] QSC 2. This is not an exhaustive list.

166 An alternative and more neutral terminology has been coined: a trust fund may be 'financially viable' or have ceased to be so: see Barrett, n8. The meaning of viability in this context is discussed in paragraph 16 below.

167 *ASIC v Tasman Investment Management Ltd* [2006] NSWSC 943 at [18].

168 See *Re Stacks Managed Investments Ltd* [2005] NSWSC 753. The Australian Law Reform Commission noted in 1988 that 'in theory a direct though archaic method was available to wind up a[n insolvent] trust through an administration action, [and that] it was possible for an imaginative judge to appoint a receiver who would have similar powers to a liquidator': Australian Law Reform Commission, 'General Insolvency Inquiry' (Report No 45, 1988), Chapter 6 (*Corporate Trading Trusts*) at 109.

12. What is 'insolvency' under Australian law?

To position the analysis concerning whether and when a commercial trust can be said to be insolvent, a brief discussion is required of what is meant by 'solvency' and insolvency' in relation to a company. This is a summary only; the canon is well served in this regard,[169] and the concepts are being tested and applied regularly as cases are taken up to the courts in the aftermath of the global financial crisis. Rather than a review of the entire body of law on the meaning of those terms, the focus is on those aspects that are relevant to the issues in this paper.

The assessment of solvency or otherwise of a company is the same whether it has incurred some or all of its debts in a trustee capacity, or none at all. The relevance of trust debts to the assessment of a company's solvency is discussed below.

Sections 9 and 95A of the *Corporations Act* in effect define 'insolvency' as the inability of a person to pay all of their debts as and when they become due and payable. The definition implies a cash flow test, as opposed to a balance sheet or assets deficiency test. However, the state of a company's balance sheet is relevant in the sense that the relationship of assets (particularly income earning and liquid assets) to liabilities (particularly current liabilities) will be a relevant indicator of the company's ability to generate future income and/or sell assets quickly and/or raise funds through borrowing.[170] A company may have an excess of liabilities over assets but still be solvent if it can pay its debts in a timely fashion; conversely it may be 'asset rich but cash poor' in that it may have assets of sufficient value to cover the principal value of debts but that value is comprised mostly of highly illiquid assets (eg commercial or industrial real estate during a severe economic downturn).[171]

The courts have said that '[i]nsolvency is a state of affairs, not an event at a single point of time, and the question of solvency cannot be addressed in a narrow timeframe'.[172] In determining the ability of a company to pay debts as and when they become due and payable, the future must be considered.[173] Regard should be had to the expected cash flow of the business[174] and to anticipated debts.[175] Thus analysis is not limited to the resources immediately available to the company, but includes funds that the company could obtain by realising the value of its assets by sale or encumbrance, or by way of loans or subscription of share capital, to meet recurrent and future liabilities as they fall due. However, short-term loans or loans payable on demand will not enhance solvency.

There is a difference between a 'surmountable temporary lack of liquidity' (which is not insolvency) and an 'insurmountable endemic illiquidity'[176] or 'endemic shortage of working capital'[177] (which is insolvency).[178] Thus, just as the availability of assets is not conclusive of solvency, lack of liquidity is not conclusive of insolvency.[179] From the discussion in the cases, 'temporary' illiquidity appears to mean that, even though a company may not be able to pay all of its due debts at a given point in time, there is a reasonable prospect that it will be in a position to pay those debts within a short timeframe

---

169 In *McLellan, in the matter of The Stake Man Pty Ltd v Carroll* [2009] FCA 1415, Goldberg J of the Federal Court set out a comprehensive conspectus of the authorities in relation to determining whether a company is insolvent at [106] and [107]. See also J Duns, 'Insolvency: Problems of Concept, Definition and Proof' (2000) 28 *Australian Business Law Review* 22; Murray, n158, at [1.45] – [1.85].

170 *Cooper v Commissioner of Taxation* [2009] NSWSC 880; *Bell Group (in liq) v Westpac Banking Corp (No 9)* (2008) 225 FLR 1 at [1064] and following.

171 '…it is possible that a company might be cash flow insolvent but show a positive balance sheet where assets exceed liabilities. A company may be, at the same time, insolvent and wealthy. It may have wealth locked up in investments that are not easy to realise. Regardless of its wealth (in this sense), unless it has assets available to meet its current liabilities, it is commercially insolvent and therefore liable to be wound up': *Bell Group (in liq) v Westpac Banking Corp (No 9)* (2008) 225 FLR 1 at [1070].

172 *Box Valley Pty Ltd v Kidd* [2006] NSWCA 26 at [9].

173 *Bank of Australasia v Hall* (1907) 4 CLR 1514 at 1528. See also *Expo International v Chant* [1979] 2 NSWLR 820; *Leslie v Howship Holdings Pty Ltd* (1997) 15 ACLC 459.

174 *Quick v Stoland Pty Ltd* (1998) 87 FCR 371 at 379.

175 *Tru Floor Service Pty Ltd v Jenkins (No 2)* (2006) 232 ALR 532 at 544. In *Melbase Corp Pty Ltd v Segenhoe Ltd* (1995) 17 ACSR 187, Lindgren J stated at 198, that '[t]he words 'as and when they become due and payable' make it clear that although the issue of prima facie insolvency must be determined at a particular time, the determination calls for a degree of 'forward looking'.' Similarly, in *Re United Medical Protection Ltd* (2003) 47 ACSR 705, Austin J commented at 719, that assessment of solvency may 'call for a degree of forward analysis'.

176 *Southern Cross Interiors Pty Ltd (in liq) v DCT* (2001) 53 NSWLR 213 at [54].

177 *Hymix Concrete Pty Ltd v Garrity* (1977) 2 ACLR 559 at 566.

178 *Sandell v Porter* (1966) 115 CLR 666; *Re Timbatec Pty Ltd* [1974] 1 NSWLR 613; *Bell Group (in liq) v Westpac Banking Corp (No 9)* (2008) 225 FLR 1 at [1064] and following.

179 *Hall v Poolman* [2007] NSWSC 1330 at [266], citing *Expo International Pty Ltd (in liq) v Chant* [1979] 2 NSWLR 820 at 837.

by taking steps available to it, such as selling readily realisable assets, raising further credit on security, more rapid turnover of stock, better collection of outstanding receivables or a capital raising.[180]

These issues are of crucial importance to directors. Determining whether a company is insolvent, and when precisely it became so, can be a difficult exercise even in the absence of a trust. Despite (or, perhaps, because of) the quite detailed guidance in the authorities and the literature on the meaning of 'insolvency', it is not always easy for directors to assess, in real-time, the solvency of a company that is under financial pressure.[181] To assist in applying the above in a practical context, ASIC provides, on its website, a series of guidance notes and 'information sheets' for various stakeholders, including directors and creditors.[182] Somewhat surprisingly, none of this material contains any discussion on the trust-specific issues facing the directors of companies which are trustees or responsible entities, whether with respect to the trustee/responsible entity itself, or the trust or scheme it manages.

13. The 'insolvent trust': legal nonsense v commercial reality

There is surprisingly little discussion in the authorities of how and when a company that has incurred some or all of its debts in a trustee capacity may be considered to be insolvent. While the collapse of numerous managed investment schemes in recent times has generated a growing body of case law, the cases to date have tended to involve responsible entities that were acknowledged as being insolvent, 'almost certainly insolvent', 'hopelessly insolvent' or 'plainly insolvent'.[183] The discussion has focused on the financial viability of the fund or scheme, for the purposes of assessing whether it should be wound up on just and equitable grounds, pursuant to s601ND(1)(a) of the *Corporations Act*. There is very little consideration, however, of how the viability of a fund or scheme is to be taken into account in assessing the solvency of the responsible entity.

As mentioned, the concept of 'insolvency' as contemplated by the *Corporations Act* relates only to 'persons' and so can only be relevant, in the context of the present discussion, in relation to the trustee as a company. No distinction is made in the statutory definition by reference to the capacity or context in which debts are incurred by a person and so there are no statutory rules or other guidance in the legislation addressing the complexities that arise with respect to a company acting as a trustee. A corporation that acts as a trustee may have both personal debts and trust debts, but it cannot be insolvent 'in its capacity as' a trustee while being solvent in its personal capacity, or vice versa.[184] A 'trustee' (or a 'responsible entity') is not a distinct legal person having a representative capacity separate from its personal capacity.[185] The law looks at the entire legal person to assess whether it is solvent.

---

180 See *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266; *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* [2010] NSWSC 233 at [202] - [205]. Put another way, '[i]n some cases a reasonable time must be allowed to a director to assess whether the company's difficulty is temporary and remediable or endemic and fatal. The commercial reality is that creditors will usually allow some time for payment beyond normal trading terms, if there are worthwhile prospects of an improvement in the company's position': *Hall v Poolman* [2007] NSWSC 1330 at [331].

181 Indeed, it has been noted that, even after the fact, 'establishing when a company became insolvent is one of the most difficult tasks that confronts an insolvency practitioner': see Parliamentary Joint Committee on Corporations and Financial Services, '*Improving Australia's Corporate Insolvency Laws: Issues Paper*' (2003) at [1.47]. The complexities in ascertaining precisely when a company became insolvent are discussed in Murray, n158, at [1.50]-[1.55].

182 See www.asic.gov.au, under drop-down tab 'Insolvency'.

183 See, for example, *Trio Capital Ltd (admin apptd) v ACT Superannuation Management Pty Ltd* [2010] NSWSC 941; *Great Southern Managers Australia Ltd (in liq) v Thackray* [2010] WASC 138; *Capelli v Shepard* [2010] VSCA 2; *Rubicon Asset Management Ltd* [2009] NSWSC 1068; *Re Great Southern Managers Australia Ltd (ACN 083 825 405) (rec and mgr apptd) (in liq)* [2009] VSC 557; *Re Timbercorp Securities Ltd (in liq)* [2009] VSC 510.

184 Nor can it be solvent or insolvent in different trustee capacities, a matter that would be of concern for a company which acts as trustee of several trusts. If financial difficulties in one trust force the trustee into insolvency, that will have serious consequences for the stakeholders of other trusts of which it is trustee, even if those trusts are viable.

185 *MacarthurCook Fund Management Limited v Zhaofeng Funds Limited* [2012] NSWSC 911 at [117]. See also the discussion in *Glennon v Commissioner of Taxation (Cth)* (1972) 127 CLR 503 at 511-513. That does not mean that the expression 'in its capacity as trustee' is legally meaningless. Contracting capacity is important in relation to whether a creditor is able to have some form of access trust assets, and confusion can result where capacities are not properly spelt out in the documentation: see *Re Interwest Hotels Pty Ltd (in liq)* (1993) 12 ACSR 78. The issue is somewhat confused in the case of a responsible entity of a scheme by the reference in *s*601ND(1)(b) of the *Corporations Act* to orders obtained by a creditor against 'the responsible entity in its capacity as the scheme's responsible entity'. As a general rule, a person cannot be sued in a representative capacity, at least in Australia.

Thus, while it is possible for a trustee to become insolvent, it is not possible for a trust or managed investment scheme, as such, to be 'insolvent' in the sense contemplated by, or therefore for the purposes of, the *Corporations Act*. Unlike a company, a trust cannot, as such, be placed into voluntary administration or liquidation in the sense contemplated in the Act. What legislative and judicial guidance there is to date in relation to commercial trusts is confined to situations involving managed investment schemes and that is the focus of the following discussion.

In contrast to the detailed regime for dealing with insolvency and the winding up of companies under the *Corporations Act*, Chapter 5C leaves almost all matters to do with insolvency and the winding up of managed investment schemes to the discretion of the courts.[186] There is no prescriptive regime for ordering priorities and regulating the conduct of the process generally; the legislation leaves those matters to the courts.

The Act neither provides guidance as to when a scheme is to be regarded as insolvent or financially unviable, nor does it expressly provide that a scheme that has ceased to be viable may or must be wound up. However, in relation to a registered scheme, s601ND(1)(a) gives the court the power, on application by the responsible entity, its directors, members of the scheme or ASIC, to direct the responsible entity to wind up the scheme if it 'thinks it is just and equitable' to do so.[187] The power to wind up a scheme on the just and equitable ground is a general power given the courts to aid them in protecting investors and other stakeholders. [188]

Despite reservations expressed extracurially by Justice Barrett in 2008,[189] and some uncertainty following a finding in one of the early cases that was unsupported by authority,[190] it now appears settled that a winding up order may be given under the just and equitable provision if a scheme is 'insolvent'.[191] In this context, however, 'insolvency' appears to mean something different from the statutory definition in the *Corporations Act*, even after allowing for trusts and schemes not being 'persons'. The courts have not applied a consistent approach or, therefore, developed an alternative definition or formula for trusts and schemes. In *Reynolds Wines v Huntley Management*, Austin J applied a cashflow test echoing the statutory definition. [192]

To similar effect, in *Capelli v Shepard*, after acknowledging the threshold issue that a trust or scheme is not a legal entity, the court favoured a cashflow test in saying that:

> [n]evertheless, a scheme may *colloquially* be characterised as insolvent in the sense that, as in Re Orchard, the liabilities referable to it cannot be satisfied as they fall due from its income or readily realisable assets.[193]

---

186 For unregistered schemes, see s601EE and for registered schemes, see s601NF of the *Corporations Act*. There are differences in the statutory regime for the winding up of registered and unregistered schemes; these are discussed in *Re Stacks Managed Investments Ltd* [2005] NSWSC 753. The Act is silent with respect to commercial trusts which are not managed investment schemes.

187 A creditor does not have standing to apply for the winding up of a scheme on the just and equitable ground, but may do so on the basis of an unsatisfied execution or other process against the responsible entity in that capacity: see s601ND(1)(b) and (3).

188 *Trio Capital Ltd (admin apptd) v ACT Superannuation Management Pty Ltd* [2010] NSWSC 941. The body of law relating to the just and equitable ground as applicable to the winding up of companies (in its current emanation, s461(1)(k) of the Act) informs the application of s601ND(1)(a): *Capelli v Shepard* [2010] VSCA 2 at [104]. See also *ASIC v Knightsbridge Managed Funds Ltd* [2001] WASC 339 and *ASIC v West* [2008] SASC 111 at [139].

189 'An order was made in … *Re Orchard Aginvest Ltd* [2008] QSC 2. Interestingly, I think, the view that winding up of the scheme was just and equitable was based on what the judge unambiguously described as the insolvency of the scheme. Despite this, it is too early to say that a concept of insolvency of a managed investment scheme is meaningful or to see the alternative ground in s601ND as allowing some form of winding up in insolvency': Barrett, n8, at p4.

190 'There is no direct authority cited to me to establish that a mere insolvency makes the winding up one which would be just and equitable but in the absence of any submission to the contrary I am prepared to proceed on the basis that the terms of the section are satisfied by that condition of insolvency': *Re Orchard Aginvest Ltd* [2008] QSC 2.

191 *Capelli v Shepard* [2010] VSCA 2; *Rubicon Asset Management Ltd* [2009] NSWSC 1068; *Re Orchard Aginvest Ltd* [2008] QSC 2; *Re PWL ACN 084 252 488 Ltd Ex parte PWL Ltd (formerly Palandri Wines Ltd) (admin apptd) (No 2)* [2008] WASC 232; *Re Traditional Values Management Limited (in liq)* [2010] VSC 339.

192 *Cumulus Wines v Huntley Management; Reynolds Wines v Huntley Management* [2004] NSWSC 609 at [21].

193 *Capelli v Shepard* [2010] VSCA 2 at [93] (emphasis added). The court went on to say that 'his Honour's statement that the schemes were insolvent may be read as a short-hand expression of a number of interrelated factors, including the non-viability of the schemes, the related insolvency of the responsible entity, its inability to fund the continued operation of the schemes, the unavailability of any replacement entity and the consequent breakdown of the original scheme arrangements set out in the prospectuses' at [95].

However, in *Rubicon Asset Management*, the court did not decide whether the test was a cashflow test or assets test, because it did not need to:

> it is clear that each of the schemes is insolvent … in each case the conclusion of insolvency is irresistible; and this is so whether insolvency is assessed on a net asset basis or on a cash flow basis.[194]

In the *Palandri Wines* case, in assessing whether any of several schemes was insolvent or unviable for the purposes of the just and equitable grounds, the court adopted a 'first principles' approach and considered evidence (in the absence of properly kept accounts) from viticultural experts and the administrators of the responsible entity going to various factors including operating expenses, operating losses, future income, capital expenditure requirements to make the scheme commercially viable, the prospects of the scheme being able to trade profitably in the future, and the ability of the responsible entity to fund necessary capital requirements from existing or new members or creditors. This was in contrast to the court's swift dispatch of the issue with respect to the responsible entity, applying the statutory definition: 'The plaintiff is unable to pay its debts as and when they fall due for payment and is, therefore, insolvent'.[195]

In *Environinvest*, the court took a broad view and made the following observations:

> Insofar as the scheme is characterised as no more than a trust fund or 'scheme property' held on trust for scheme members by the responsible entity, the condition of insolvency may not easily attach. But in my view the scheme is something more than trust assets or scheme property … By adopting *a more generous definition of a scheme, by reference to the scheme documents, relationships, objectives, inputs and outcomes,* the concept of insolvency may be applied without much difficulty if the scheme has broken down because the responsible entity has no funds to continue the management and administration of the scheme and no reasonable prospect of getting in those funds. The scheme is, in my view, insolvent; it has failed and it is just and equitable that it should be wound up.[196]

Despite the inherent tension with the statutory definition of 'insolvency', the courts appear to have taken a somewhat pragmatic approach and, in effect, deemed it possible for a scheme, separately from the responsible entity, to be regarded as insolvent, at least for the purposes of the just and equitable ground in s601ND(1)(a) of the Act. In *Capelli v Shepard*, the Victorian Court of Appeal supported the conclusion of the judge at first instance that:

> the insolvency of a managed investment scheme was possible, in a limited sense at least, if a sufficiently broad concept of a scheme and a common sense approach were adopted.[197]

While the courts in these cases appeared to favour the application of a cashflow analysis, they did not base their analyses on the many cases on corporate insolvency, confirming that the statutory definition of insolvency is not applicable or relevant.

14. The 'insolvent trust': a proposed definition

Although it is legally inaccurate to describe a trust or scheme as being insolvent, the concept has utility in analysing the solvency of the trustee. It might also be relevant if ever Parliament was to seek to tackle the issues directly with legislation. Thus, it is useful to investigate the componentry of a trust that may be said to have become insolvent with a view to proposing a definition.

As mentioned above, those of a more strictly doctrinal disposition eschew the expressions 'solvent' or 'insolvent' in relation to a trust or fund, noting, correctly, that those terms, as used in a legal context, can only apply to persons. Those people tend to use the more neutral expression 'financially viable' and 'financially unviable'.

What does 'viability' mean in this context? Is it the same as solvency or does it mean something else?

It is useful to bear in mind that these questions can be asked in two separate and quite different contexts:

---

194 *Rubicon Asset Management Ltd* [2009] NSWSC 1068 at [22].
195 *Ex parte PWL Ltd (formerly Palandri Wines Ltd) (admin apptd) (No 2)* [2008] WASC 232 at [86].
196 *Re Environinvest Ltd* [2009] VSC 33 at [104]-[105] (emphasis added).
197 *Capelli v Shepard* [2010] VSCA 2 at [76].

- the first is whether a registered managed investment scheme ought to be wound up under the *Corporations Act* on just and equitable grounds;
- the second is in considering the effect on the solvency of a trustee (whether or not the responsible entity of a managed investment scheme), ie the ability of the fund to support payment by the trustee of trust debts as and when they fall due.

In this respect one would, naturally, consider the cases described above, but it is important to note that those cases were decided in the first context, while the second context appears not to have been discussed by the courts in any detail.

One consequence of this absence of guidance is that there is little more than oblique reference in the discussion to the difference between 'balance sheet solvency' and 'cash flow solvency'. Certainly, as was the case in *Rubicon Asset Management*, a conclusion of insolvency is 'irresistible' if a trust or scheme suffers both an assets deficiency and endemic negative cashflow. However, it is possible for a trust or scheme as an economic entity to enjoy an excess of assets over liabilities but still be unviable in a way that is relevant to the solvency of the trustee. As noted above, a trustee is not obliged to pay trust debts out of its own pocket first then seek reimbursement, but it may have no other option where the trust fund is asset rich but cash poor. In these circumstances, absent a robust limitation of liability across all debts, the trustee is left to pay due debts out of its own money and seek to recoup those payments out of the trust fund at a later time, as and when trust assets can be liquidated. If it cannot do this, or otherwise hold off trust creditors, the trustee may find itself facing 'insurmountable endemic illiquidity' and, thus, insolvency in the *Corporations Act* sense.

Therefore, whatever viability and/or insolvency may mean for the purposes of winding up a registered scheme under the just and equitable ground, the ultimate question in assessing the solvency of a trustee is whether and how the financial state of the fund affects the ability of the trustee to pay all of its debts, including trust debts, as and when they become due and payable. It is therefore argued that, when it comes to assessing this question, 'viability' must mean *liquidity*. That, in turn, must lead to consideration of whether the effect on the trustee of illiquidity in the fund is a 'surmountable temporary lack of liquidity' (which is not insolvency) or an 'insurmountable endemic illiquidity' (which is).

Taking a lead from the authorities, the following definition is proposed to support the discussion and analyses which follow:

A trust ('relevant trust') is solvent if, and only if, the trustee is able to pay all trust debts as and when they become due and payable out of:

(a) its own assets (where it is obliged to do so); and

(b) trust assets.

A debt of a trustee is a 'trust debt' of the relevant trust if the trustee is entitled to apply trust assets of that trust to pay it (even if it is also obliged to pay it out of its own assets), disregarding for the purposes of this definition any application of the clear accounts rule.

'Trust assets' of a relevant trust means:

(a) all assets held by a person (directly or through nominee or custodian arrangements) as trustee of the relevant trust; and

(b) the benefit of any obligation of the trustee or a former trustee to make good the trust fund in respect of breaches of trust.

A trust which is not solvent is insolvent.

Note, in particular:

- the test correlates to the definition in s95A of the *Corporations Act* and reflects elements of the cashflow test for corporate insolvency, which includes the common law gloss regarding 'liquidity';
- the test requires consideration of the personal obligation of the trustee in relation to trust debts. In relation to any given trust debt, that personal liability is unlimited if the trustee has not negotiated for itself, as a matter of contract, a robust limitation of liability clause, or any such limitation has fallen away for relevant misconduct.[198] Where a trustee has unlimited personal liability for any trust debts, assessment of the solvency of 'the trust' must include consideration of the trustee's ability to pay those trust debts out of its personal assets if the trust assets are inadequate. Where the trustee has properly limited its liability for any trust debts so that its obligation to pay is limited in recourse to the trust assets, then the test in relation to those debts is limited to the trust assets;
- the definition of 'trust debt' for these purposes includes all debts properly incurred by the trustee within power (even if it has not limited its personal liability), but disregards the operation of the clear accounts rule. This is because that rule operates to diminish the trustee's aggregate claim against trust assets in relation to all trust debts rather than any specific trust debt; and
- the definition of 'trust assets' includes the value of any claim the beneficiaries may have against the trustee or a former trustee to make good losses to the trust estate arising out of any breach. This claim is as much a part of the estate as any other asset and should be taken into account (even if it is of limited value, eg against a present or former trustee which is insolvent).

15. The four possible scenarios

The defects in trust law identified above do not mean that the law is unable to cope with a trust affected by insolvency. The primary focus is on the legal entity (the trustee), rather than the economic entity (the trust or scheme), but the analysis takes into account the effect of trust debts and assets on the trustee's financial position and this, in turn, necessitates a consideration of the viability or 'solvency' of the trust fund. Thus, both economic entities are to be analysed. If, after conducting the analysis, the trustee is insolvent according to the statutory definition, then the entire body of insolvency law is engaged to deal with the trustee as a company (although some of the issues described in paragraph 10 may arise and must be dealt with). However, the fact that the trust is 'insolvent' may or may not impact the solvency of the trustee (although, in the case of a registered managed investment scheme, may result in the court ordering a winding up of the scheme on just and equitable grounds).

[198] As to which, see generally D Loxton and N D'Angelo, 'Trustees' limitation of liability: Myths, mysteries and a model clause' (2013) 41 *Australian Business Law Review* 142

The analysis will, therefore, yield one of 4 outcomes, as shown in the following table:

	Trustee is solvent	**Trustee is insolvent**
Trust is 'solvent' (adopting the definition proposed in para 14 above)	The trustee is solvent and the trust is solvent in that the trustee is able to discharge trust debts as and when they fall due.	The trustee is insolvent but the trust is solvent in that the trustee is able to discharge trust debts as and when they fall due out of trust assets.[199]
Trust is 'insolvent' (ditto)	The trust is insolvent, however this has not resulted in the trustee becoming insolvent because effective liability limitations have been put in place. The trustee is otherwise able to pay all of its other debts as and when they fall due.	Both the trustee and the trust are insolvent. The trustee's insolvency may be due to matters unrelated to the trust. Alternatively, its insolvency may be related to the insolvency of the trust, due to the absence (or loss of) liability limitations and/or impairment of the trustee's indemnity out of trust assets, which has left the trustee with personal liability for trust debts.

16. Elements of the analysis

In seeking to ascertain which of these outcomes may be applicable in any given circumstances, layers of complexity arise. The following factors must be taken into account.[200]

The solvency of the trustee in its own right

The starting point is the solvency of the trustee as a company in its own right, applying the usual tests and guidance. In the first instance, this assessment would be made without taking into account trust debts and assets.[201] This initial test is necessarily a theoretical or notional analysis because, as discussed above, solvency of the trustee must include consideration of its relationship with trust debts and assets; the effect of these on the trustee's solvency, if any, will depend on the matters that follow.

The solvency of the trust fund

Next, one must consider the solvency or 'viability' of the trust. For this purpose the analysis in paragraph 14 is applied.

The trustee's proprietary indemnity

Next, one must consider the state of the trustee's indemnity with respect to the trust fund. The mere fact that the trust fund is viable or solvent does not, in and of itself, mean the trustee is entitled to access it to pay trust debts; its indemnity with respect to those debts must be intact. Therefore, the question of a trustee's solvency must take into account whether its indemnity is affected by:

- *related breaches* in respect of any given debts, which will leave the trustee to carry those debts on its personal account, or
- *unrelated breaches*, which, via the clear accounts rule, will affect the trustee's aggregate claim against the trust fund, possibly leaving it personally liable for all or some proportion of the aggregate trust indebtedness.

---

199 In this regard, it is interesting to note that in its submission to CAMAC following release of its *Discussion Paper on Managed Investment Schemes* in 2011, ASIC stated that it 'has not experienced any situations where an incapacitated responsible entity is operating a clearly viable enterprise scheme, and for this reason does not propose any significant reforms in this situation' at paragraph 23. Chapter 5 of the *CAMAC Report* deals with changing the responsible entity of a viable scheme.

200 In discussing these factors it is assumed that any personal indemnity against the beneficiaries has been negatived, as is usual for commercial trusts.

201 Including the trustee's right of indemnity against trust property, its most important asset as a trustee.

Limitation of the trustee's personal liability

Finally, one must consider the extent to which the trustee has limited its personal liability to trust creditors. Limitations are a matter of contract and not trust law, and so must be negotiated on a transaction-by-transaction basis. A trustee which has limited its personal liability in respect of a trust debt has no need of a right of reimbursement or recoupment; the whole point of the limitation should be that the trustee wishes to avoid being in the position of having to pay the creditor out of its personal assets and then have to seek reimbursement out of the trust fund. Critically, if well drafted, they limit the creditor's recourse against the trustee to the extent of the trustee's ability to discharge the debt out of the trust fund, effectively insulating the trustee against potential insolvency that might otherwise arise due to trust debts. Equally importantly, however, the limitation is typically stated to fall away if there has been conduct that impairs the indemnity, leaving the trustee exposed personally for the debt.[202]

17. The sequence of investigation

How do these elements interrelate? Bringing them all together, an analysis in relation to a given trust at any given time may be conducted by testing against the following sequence of questions:

Question 1: Is the trustee solvent in its own right?

If the trustee is solvent in its own right (ie before taking into account trust debts and assets), the analysis proceeds to Questions 2 to 5.

However, if the trustee is insolvent even before taking into account trust debts and assets (or indeed has become so because the circumstances described below under Questions 3 to 5 have arisen and made it personally liable for trust debts), this does not, in and of itself, mean that the trust is insolvent. The directors would be advised to place the trustee into some form of insolvent administration. The beneficiaries may be able to replace the trustee under the terms of the trust or with the assistance of the court,[203] so as to enable the business of the trust to carry on; if the trust is solvent, there should be little difficulty in doing this.[204]

Question 2: Is the trust solvent?

If the answer is yes and the trustee's indemnity is intact (see Question 3), the trustee need not use its own money to discharge trust debts; it may choose to exercise the exoneration power to apply liquid trust assets directly in discharge of trust debts as and when they fall due. However, if the trustee's exoneration power has been impaired, that could affect its solvency: in this case the enquiry proceeds to Question 3.

If the answer is no then the effect on the trustee's solvency will depend on whether the trustee has properly limited its personal liability in respect of sufficient trust debts: in this case the enquiry proceeds to Questions 4 and 5.

Question 3: Has the trustee committed acts which impair its indemnity?

If the answer is yes and they are *related breaches* of the inexcusable type, then the debts so affected are personal debts of the trustee and cannot be paid or indemnified out of trust assets, regardless of state of solvency of the trust. Being personal debts, they must be taken into account in assessing the solvency of the trustee.

If the answer is yes and they are *unrelated breaches*, then the aggregate claim of the trustee against the trust assets in relation to all properly incurred trust debts is reduced by the value of the claim of the

---

202 See Loxton and N D'Angelo, n198.

203 See s70 of the *Trustee Act 1925* (ACT); s41 of the *Trustee Act 1958* (Vic); s80 of the *Trusts Act 1973* (Qld); s77 of the *Trustees Act 1962* (WA); s36 of the *Trustee Act 1936* (SA); s32 of the *Trustee Act 1898* (Tas); s27 of the *Trustee Act* (NT); s70 of the *Trustee Act 1925* (ACT). In relation to court-assisted replacement of trustees, see *Northwest Capital Management v Westate Capital Ltd* [2012] WASC 121. For managed investment schemes, s601FL of the *Corporations Act* provides a mechanism for members to remove and replace a responsible entity and s601FP allows the court, on application of the outgoing responsible entity, a member or ASIC, to appoint a temporary responsible entity if the scheme does not have one that meets the statutory requirements. The *CAMAC Report* discusses the replacement of responsible entities of viable registered managed investment schemes in Chapter 5.

204 See Barrett, n8, and *Capelli v Shepard* [2010] VSCA 2.

beneficiaries against the trustee for those breaches. By application of the clear accounts rule, the trustee must bear the difference as a personal liability, with no right of recourse to the trust assets. As such, the amount of that difference must be taken into account in assessing the solvency of the trustee.

If the answer is no and the indemnity is intact, then the effect of the trust debts on the trustee's solvency will depend, first, on whether the trust is solvent. If it is, all is well. If it is not, then the effect will depend on whether the trustee has limited its personal liability in respect of sufficient trust debts: in this case the enquiry proceeds to Questions 4 and 5.

Question 4: ***Has the trustee limited its personal liability in relation to sufficient value of trust debts so that trust debts do not materially and adversely affect its personal financial position?***[205]

If the answer is no, the trustee is personally liable for the full amount of trust debts in respect of which it has not limited its liability. If the trust is solvent and the trustee has not impaired its indemnity, it may discharge those debts directly out of trust assets. If the trust is insolvent, the trustee must nevertheless discharge those debts out of its own money and is left to seek reimbursement against the trust assets if and when possible. If there is a shortfall in the trust assets, it bears that shortfall personally. If the trustee is unable to discharge trust debts, or any shortfall, out of its own money, the trustee may be insolvent.

If the answer is yes, and the trustee is otherwise solvent, and the answer to Question 5 is no, the trustee cannot be made insolvent by the trust debts.

Question 5: ***If the trustee has the benefit of a limitation of liability clause which prima facie protects it from insolvency, has the trustee done anything that would trigger the exclusions in that clause?***

If the answer is yes, then the protection of the limitation fails as a matter of contract vis-à-vis the relevant creditor(s), making the trustee personally liable in respect of the relevant debts regardless of the state of solvency of the trust fund. The conduct that triggered the failure may also have impaired the trustee's indemnity (see the analysis in Question 3), in which case the trustee will have no recourse to trust assets in respect of those debts. If the trustee is unable to discharge those debts when due out of its own money, it may be insolvent.

If the answer is no, then the trustee cannot be made insolvent by the trust debts.

18. Indicators of insolvency of a commercial trust

The above demonstrates the complexity involved in dealing with a commercial trust that has come under the shadow of insolvency. It is acknowledged that this analysis suffers an inherent limitation in its practical application: there is likely to be a material information gap with respect to some stakeholders. Even after allowing for the difficulties in assessing solvency generally, the person making the analysis may not have at hand all the information necessary to answer these questions, at least not in real time. For example, conduct of the trustee which may have impaired its indemnity and/or negated limitation of liability protections is not always apparent on the face of the record and may only be discovered *ex post facto* under due diligence, in litigation or under external investigation.[206]

This is problematic enough for directors, but can be a daunting challenge for outsiders such as creditors. Still, the cases have highlighted some factors that might serve as early warning indicators of potential trouble and which might encourage concerned stakeholders to initiate pre-emptive investigations. For example, recent collapses the subject of reported litigation have not involved established 'professional' external trustees or responsible entities, but rather entities which have been

[205] The assumption in the use of 'robust' is that the limitation clause is drafted so as to protect against both balance sheet and cash flow insolvency.

[206] Liquidators of Australian companies have extensive powers under the *Corporations Act* to inspect a company's books and records and to examine a company's officers and any other person 'concerned in the examinable affairs of the corporation': see Parts 5.6 and 5.9 of the Act. It has been argued that these powers could be and should be used more vigorously in relation to trading trusts: KJ Crossland, 'Unsecured Creditors and the "Uncorporation": Issues with Trading Trusts Post Global Financial Crisis' (2011) 17 *Trusts & Trustees* 183 at 202–209.

managed and controlled by scheme promoters, and which have limited material assets or inherent value beyond the minimum statutory requirements. The risks in those circumstances are exacerbated if the same company operates as responsible entity of several schemes, where a failure to respect separation and segregation has led, among other things, to commingling of invested funds and scheme assets.[207]

Further, in a great many of the cases the financial records and accounts of the schemes have been in a poor state, and have had to be reconstructed by administrators, investigative accountants or other external experts. In extreme cases, there has been doubt as to whether given assets and/or income are part of the trust fund,[208] and in one case it was successfully argued that the only way the final position and the assets and liabilities of the responsible entity could be ascertained was through the winding up of its schemes.[209]

In some cases, the matrix of contracts, relationships and arrangements entered into by the responsible entity with invested funds, often designed to achieve certain tax objectives, was complex and evidently not well-understood or respected by the responsible entity and the individuals who managed the scheme.[210] The direction of the cause-and-effect relationship between this indicator and the poor record- and account-keeping described above is not always obvious, but they are often found together.[211] In other cases losses arose from a failure by those who managed the funds to understand and/or to appropriately deal with conflicts of interest and other failures of governance, risk management and compliance protocols.[212]

19. Reform: a story of disappointment and missed opportunities[213]

It is not an objective of this paper to conclude with a neat set of suggestions for reform, wrapped up in a carefully crafted model Bill. Greater minds than mine have applied their expertise to that challenge. The issue I want to expose is one of failure of execution.

The path to reform in Australia has been a deeply disappointing one. The fact that there are issues for creditors of trusts is notorious. Numerous law reform papers have been published in Australia and elsewhere, some going back to the 1980s, that raise many of the issues and contain suggestions for reform.[214] There is also a substantial canon of scholarly and practitioner literature. Less well understood are the reasons why so little legislative action has followed and why the few attempts that have been made have misfired, miscarried or fallen short, leaving gaps; many suggestions for

---

207 In an extreme example, the subject of the decision in *ASIC v Letten (No 7)* [2010] FCA 1231, poor management of 21 separate unregistered managed investment schemes led to the Court to say that ‘distribution of Scheme property in a particular Scheme to those entitled to the property in proportion to their entitlements is practically impossible at a number of levels. Given the manner in which these Schemes were operated and the difficulties identified in unscrambling the affairs of the Schemes, no rational person would undertake or engage in that task’ at [335]. Instead, on the basis of ‘pragmatism’, the Court ordered the pooling of surplus assets and rateable distribution among the various claimants. The *CAMAC Report* notes, at [4.1.2], that 61% of all responsible entities of registered managed investment schemes operate multiple schemes. The *Corporations Act* contemplates that the assets and liabilities of two or more companies may be ‘pooled’ in certain circumstances: see Part 5.6 Division 8.

208 See, for example, *ASIC v Letten (No 7)* [2010] FCA 1231; *Trio Capital Ltd (admin apptd) v ACT Superannuation Management Pty Ltd* [2010] NSWSC 941; *Ex parte PWL Ltd (formerly Palandri Wines Ltd) (admin apptd) (No 2)* [2008] WASC 232; *Re Orchard Aginvest Ltd* [2008] QSC 2.

209 *Re Environinvest Ltd* [2009] VSC 33. By s588E(4) of the Act, if it is proved that a company has failed to keep or retain proper financial records in accordance with s286 (including in a capacity as responsible entity of a registered scheme), the company is presumed to have been insolvent throughout the period of its failure to do so.

210 This was the case, for example, in *Re Timbercorp Securities Ltd (in liq)* [2009] VSC 510 and [2010] VSC 50 *Re Timbercorp Securities Ltd (in liq)* [2010] VSC 50; *Ex parte PWL Ltd (formerly Palandri Wines Ltd) (admin apptd) (No 2)* [2008] WASC 232; *Re Orchard Aginvest Ltd* [2008] QSC 2.

211 A useful summary of factors, behaviours and practices which led to the collapse of many managed investment schemes in the agribusiness sector is contained in the Parliamentary Joint Committee on Corporations and Financial Services, 'Inquiry on Aspects of Agribusiness Managed Investment Schemes' (2009). See also C Brown, C Trusler and K Davis, 'Managed Investment Scheme regulation: lessons from the Great Southern failure' (2010) 2 *FINSIA Journal of Applied Finance* 20, where the authors identify a number of inadequacies in current investor protection arrangements. In January 2012 ASIC released a Regulatory Impact Statement entitled *Agribusiness Managed Investment Schemes: Improved Disclosure for Retail Investors*.

212 See Parliamentary Joint Committee on Corporations and Financial Services, 'Inquiry into the collapse of Trio Capital' (2012), particularly at paragraph 5.36. The *CAMAC Report* noted these issues in relation to registered managed investment schemes (both trust-based and common enterprise structures) and suggested reforms to deal with them, including a definitive scheme agreements register and scheme property register to force greater discipline and transparency around identification and segregation of scheme property and affairs: see [4.3.4] and [4.4.3].

213 Much of the argument in this paragraph is drawn directly from N D'Angelo, 'The CAMAC Report on managed investment schemes: Another opportunity missed?' (2012) 23 *Journal of Banking & Finance Law & Practice* 253

214 See the Annexure in D’Angelo, ibid, for a listing of the more important ones.

improvement have been ignored. If one were to speculate, one might argue that this is due to a lack of understanding of the complexities of the issues, a want of political will to confront them and an inability of legislators to reconcile the competing interests of various stakeholders.

For example, in 1984 the *Companies and Securities Legislation (Miscellaneous Amendments) Bill (No 2) 1984* (Cth) was exposed for comment. It contained a series of reforms designed to protect external counterparties dealing with companies acting as trustees, including mandatory noting of the fact that a company was acting as trustee in all business documents in which it was so acting; a provision that persons dealing with a corporate trustee would not be deemed to have notice of the terms of the trust; and personal liability for directors of a corporate trustee in certain circumstances. Only the third of these survived and is now reflected in s197 of the *Corporations Act*.[215]

In 1988 the Australian Law Reform Commission produced a report that made several specific recommendations for legislative change to improve the way in which the law deals with insolvent trading trusts.[216] Almost none of them have been enacted.

In response to the perceived excesses of corporate Australia in the late 1980s, the stock market crash of October 1987, the property sector collapse of the late 1980s and the recession that followed in the early 1990s, statute law in relation to the insolvency of Australian corporations underwent significant change in 1993, with major amendments to the *Corporations Law* (the predecessor of the *Corporations Act*). These included the introduction of the voluntary administration regime. There was also a wholesale rewriting of the laws relating to voidable transactions, as applicable to companies, cutting the increasingly uncomfortable umbilical cord that tied those laws back to ss 120-122 of the *Bankruptcy Act 1966* (Cth).[217] However, the legislature did not see fit to effect corresponding changes in relation to insolvent commercial trusts. This was despite the issues having been raised in the ALRC 1988 Report, the evidence at that time of growth in use of the commercial trust, including in public fund raising,[218] and the fact that one of the catalysts for these changes was a series of collapses in the property trust sector.[219]

The 1993 joint report of the Australian Law Reform Commission and the Companies and Securities Advisory Committee entitled *Collective Investments: Other People's Money* contained draft legislation that would have applied many of the provisions applicable to the winding up and voluntary administration of companies to collective investment schemes.[220] These recommendations were not enacted and neither the second reading speech for the *Managed Investments Bill 1997* (Cth), which emanated from that report, nor the Explanatory Memorandum for that Bill explain the reasons for this omission. The result was that the regime for regulating managed investment schemes was introduced into the *Corporations Act* with almost no machinery for dealing with insolvent managed investment schemes. It in effect delegates almost all matters to do with insolvency and the winding up of managed investment schemes to the discretion of the courts,[221] leaving them to find their own way and build a body of common law around the issues in the traditional manner – just as was the case with unincorporated joint stock companies in pre-1844 England.

---

215 Even that was flawed in its original formulation and required amendment after the South Australian decision *Hanel v O'Neill* (2003) 180 FLR 360: see the discussion in Cooper J, 'Piercing the "Veil of Obscurity" – the Decision in Hanel v O'Neill' (2004) 22 *Companies & Securities Law Journal* 313.

216 Australian Law Reform Commission, "General Insolvency Inquiry" (Report No 45, 1988) Ch 6 – "Corporate Trading Trusts".

217 See *Corporations Act* Part 5.7B, Division 2. Vestiges of the relationship remain: see s553E.

218 See the statistical information in RA Hughes, *The Law of Public Unit Trusts* (Longman Professional, 1992) at 34; Mees et al, n29.

219 Early signs of which came by mid-1991 when "the unlisted property trust sector had failed comprehensively, and urgent amendments to the *Corporations Law* suspended withdrawals and provided for the restructuring of the (direct and indirect) property component of the industry": Mees et al, n15, p 7. See also the Explanatory Memorandum for the *Corporations (Unlisted Property Trusts) Amendment Bill 1991* (Cth).

220 See Australian Law Reform Commission and Companies and Securities Advisory Committee, *Collective Investments: Other People's Money* (1993) Vol 1 at [8.11]-[8.14], the draft Explanatory Memorandum in Vol 2 at [14.7]-[14.14], and Part 5.3B of the proposed *Collective Investments Scheme Bill* at p70 *et seq* of Vol 2. In a newspaper report, the Commissioner leading the enquiry, Mr Ron Harmer, was quoted as saying to a public meeting that 'it is probably remarkable that we put up with [trading trusts]… we should fit [them] into the same law that would be expected to apply in most cases upon the insolvency of a straight company': A Flahvin, 'Law Body Attacks Trading Trusts Control', *Sydney Morning Herald* (18 April 1986).

221 See *Corporations Act* s601EE for unregistered schemes and ss601NE and 601NF for registered schemes.

The CAMAC Report of 2012

The Report of the Corporations and Markets Advisory Committee (CAMAC) on Managed Investment Schemes, published in July 2012, is the latest Australian review of issues arising out of the use of trusts (being those that are managed investment schemes) as business vehicles. Commissioned in November 2010 in the wake of numerous GFC scheme collapses and burgeoning litigation, it presented an opportunity to catalyse real change in an area where the history of reform is decidedly chequered.

The *CAMAC Report* disappoints in several key respects. Its central and most radical proposal is the abolition of the unincorporated registered scheme and its replacement with a passive separate legal entity acting through a responsible entity as its agent (described as the 'SLE Proposal'). While it undoubtedly has attractions as a conceptual solution, the proposal is inchoate at best, is puzzling in some aspects and in any case, if history is any guide, is unlikely to gain the necessary traction for implementation in the short to medium term.

The SLE Proposal is theoretically workable and, if implemented, could be the answer to almost all of the issues. However, in my view it is over-ambitious and is unlikely to gain the necessary support in the short term; even if draft legislation could be produced quickly, it is inconceivable that structural change of this magnitude could be implemented quickly. The law has so badly lagged behind commerce, and the use of the trust as a surrogate company has become so entrenched, that this kind of paradigm-shifting reform at this stage of the process might be regarded as revolutionary rather than evolutionary and would inevitably spark ideological objection and lengthy debates. It would be exposed to the vicissitudes of the legislative and political process. It would become a battleground on which various stakeholder and interest groups with opposing or at least competing political and commercial agendas (such as investors, promoters, financiers and other creditor groups, unions, regulators, revenue authorities and others) would campaign to influence the process in their favour. In addition, there would be inevitable and unavoidable debates around State and federal taxation implications. The *CAMAC Report* briefly acknowledges that 'the tax treatment of schemes is an important factor in their use as a collective investment vehicle'[222] but this understates the issue; in reality, tax would be at the very heart of the debate.

For these reasons, it is a pity that CAMAC devoted so much of its valuable time and energy to it. As an idea, at this stage of the evolutionary process, it merited no more than a mention – something more than a footnote perhaps, but not much more than a signpost for later, more detailed consideration under a specific reference. It ought not have been the centrepiece of a long-awaited and much needed review and report intended to deal with urgent issues needing swift remediation. It is interesting and relevant to note that the SLE Proposal was not anticipated in either the Terms of Reference or CAMAC's *Discussion Paper* of June 2011, and appears to have emanated from a single submission: see footnote 5 of the *CAMAC Report*.

It is argued that the better, less controversial and more realistic alternative in the near term is to continue to permit the use of the trust as a business entity (including as a managed investment scheme) but to remedy the shortcomings with targeted incremental changes. This is offered as an alternative in the *CAMAC Report* but with much less enthusiasm than the SLE Proposal. Recommendations are stated as a series of aspirational statements of principle rather than black letter proposals with draft legislation; the coverage is not exhaustive. Some of the discussion and recommendations traverse terrain covered in previous reports (although this is less a criticism of the Report than it is evidence of the limited success of its predecessors). There remains a backward-looking adherence to Anglo-Australian trust law principles when guidance is to be had from elsewhere, including in particular the United States where trust law has evolved to better accommodate the business trust.

It is disappointing that the output of CAMAC's efforts did not include more detailed and comprehensive analysis and drafting, and perhaps even a suggested Bill of remedial measures. Surely the time has come to smooth the path for legislators to encourage them to take the next step promptly? If recent collapses and the ensuing litigation have shown us anything it is that current law imposes real

---

222 See the *CAMAC Report* at [2.1] and [3.8].

and often unexpected financial consequences on stakeholders. The market needs those responsible for regulating business entities to act now.

It is acknowledged that this remedial option also has its challenges – the issues are many and complex – however, most of them are now known and, in terms of maximising the chances of early adoption and implementation, this option would be seen as an evolutionary next step along a continuum rather than a revolutionary structural shift. Reform in this area is a work-in-progress, and this would represent the latest instalment.

In light of these reservations, one may fairly wonder whether the *CAMAC Report's* contribution to the debate will expedite reform. Regrettably, there is a risk it will suffer the same fate as the many reports that precede it.

Although not a focus of this paper (Dr Andrew Butler will be addressing this), the process of reforming trust law in New Zealand is quite advanced and has confronted the issues in a much more systematic and realistic fashion. It has published 6 papers and, at the time of writing, was due to publish a draft Bill.[223]

20. Conclusion

This paper has shown that creditors of commercial trusts, particularly those that are unsecured, are in a particularly vulnerable position under Australian trust law. That law does not accommodate their commercial expectations if those are that their position vis-à-vis the equity investors in, and the enterprise assets of, a commercial trust is similar to that of a creditor of a corresponding enterprise conducted under a corporate form. Trust creditors are exposed to legal risks that creditors of a company are not. This is the result of a number of jurisprudential peculiarities in the Australian law of trusts that hark back to the non-commercial origins of the trust and a failure of law to keep pace with commerce.

As a policy matter and as a matter of commercial efficiency, it is cause for concern that substantial business entities structured as commercial trusts are permitted, and indeed encouraged, to exist in 21st century Australia without a dedicated policy-based insolvency regime for managing stakeholders' risks and allocating losses. This is all the more surprising when one considers that these entities are permitted to raise funds from the public. Once again, a comparison with the pre-1844 unincorporated joint stock company is irresistible. While the *CAMAC Report* is the latest in a long history of reports that have considered the issues, it has its limitations and the process of reform in this area continues to disappoint.

The message, for the time being, is clear: *caveat creditor*.

* * * * *

223 See http://www.lawcom.govt.nz/project/review-law-trusts.

APPENDIX 1
Relevant articles

N D’Angelo, 'The trust: evolution from guardian to risk-taker, and how a lagging insolvency law framework has left financiers and other stakeholders in peril' (2009) 20 *Journal of Banking & Finance Law & Practice* 279.

N D’Angelo, 'The unsecured creditor’s perilous path to a trust’s assets: is a safer, more direct United States-style route available?' (2010) 84 *Australian Law Journal* 833.

N D’Angelo, 'When is a trustee or responsible entity insolvent? Can a trust or managed investment scheme be “insolvent’?' (2011) 39 *Australian Business Law Review* 95.

N D’Angelo, 'Shares and units: The parity myth and the truth about limited liability' (2011) 29 *Companies & Securities Law Journal* 477.

N D’Angelo & H Busljeta, 'The trustee’s lien or charge over trust assets: a PPSA security interest or not?' (2011) 22 *Journal of Banking & Finance Law & Practice* 251.

N D’Angelo, ‘The CAMAC Report on managed investment schemes: another opportunity missed?’ (2012) 23 *Journal of Banking & Finance Law & Practice* 253.

D Loxton & N D’Angelo, ‘Trustees’ limitation of liability: Myths, mysteries and a model clause’ (2013) 41 *Australian Business Law Review* 142.

N D’Angelo, ‘REs and other trustees: Beware when distributing assets *in specie* – universal powers are not enough’ (2013) 14 *Butterworths Corporation Law Bulletin* 6.

* * * * *

APPENDIX 2
The Blackacre Trust hypothetical*

Assume it is 2007, the peak of the 'long boom' that began in Australia in the mid 1990s. Conditions in the credit and capital markets are ideal for commercial borrowers, with deep liquidity on the supply side leading to heavy competition between banks and other financers and a relaxation of lending standards.

A unit trust (not being a managed investment scheme) is established by a small group of private investors under the name '**Blackacre Trust**', with the primary objective of acquiring and holding a particular commercial property comprising land and an office building known as Blackacre, and to carry on real estate investment and development business more generally. They chose the unit trust form because that offered the investors certain tax advantages and the flexibility to structure the equity interests of later entrants in terms of capital, income, ranking and other matters, while providing most of the features of a company for other purposes. The Trust Deed was drafted in quite usual terms, and gave the Trustee plenary powers to carry on the intended business.**

The Unit Holders appointed as the Trustee a company incorporated under the *Corporations Act* whose board of directors comprised a small subset of the founding investors. The initial investors subscribed for one million $1 units in aggregate, giving the Trustee total invested equity of $1,000,000.

The Trust Deed contained the usual provisions supporting the Trustee's rights of indemnity and related rights with respect to the Trust Assets but, as is usual for such arrangements, negated the Trustee's indemnity against the Unit Holders personally in respect of trust debts and liabilities

The Trustee, acting within its authority, sought and obtained an interest-only loan of $200,000 from Bank of Australia which, faced with aggressive competition, was prepared to proceed on an unsecured basis, given the more than adequate asset coverage in the Blackacre Trust. Mindful of the risks of dealing with trustees, the Bank took legal advice as a result of which it obtained and reviewed a certified copy of the Trust Deed and conducted comprehensive due diligence enquiries (of the type described in paragraph 7). Further, the Loan Agreement contained the usual suite of protective contractual representations, warranties and undertakings from the Trustee in favour of the Bank. For its part, the Trustee demanded and the Bank agreed to include in the Loan Agreement a limitation of liability clause in the usual terms.

With the pooled invested equity and bank debt, the Trustee purchased Blackacre for $1,200,000 which it held, as to both corpus and income, on the terms of the Blackacre Trust. The Trustee leased Blackacre to a thriving business tenant at market rent. At this stage the Blackacre Trust, as an accounting entity, had a balance sheet comprising $1,200,000 in assets, $200,000 in liabilities and $1,000,000 in unit holders' equity. The effect on the Trustee's personal balance sheet was the addition of a personal liability of $200,000 representing the borrowing, and a corresponding asset of the same value comprising its right of indemnity out of Trust Assets. Blackacre, being trust property, was not a personal asset of the Trustee and so did not appear as such on the Trustee's personal balance sheet.

Almost immediately, the Trustee began committing breaches of trust, completely unrelated to the loan transaction. Each month, when it received the rental on Blackacre, it serviced the interest due on the loan, but the directors then misappropriated the balance to their and the Trustee's personal use and spent it on current expenditures. Over time, the misappropriations accrued to $200,000 before the matter came to the attention of the Bank.

The misappropriations constituted an event of default under the Loan Agreement and Bank of Australia moved swiftly to accelerate and enforce repayment of its loan. The Trustee, which soon collapsed into insolvency due to mismanagement and fraud, was unable to respond to Bank of Australia's demands. The Bank ascertained that, despite the Trustee's insolvency, the Blackacre Trust as an economic entity was financially viable and took advice on accessing the value in Blackacre. The

---

* A version of this hypothetical appeared in D'Angelo, n102, at 845-846.

** For a discussion of the legal effect (and limitations) of universal or plenary powers clauses, see N D'Angelo, 'REs and other trustees: Beware when distributing assets *in specie* – universal powers are not enough' (2013) 14 *Butterworths Corporation Law Bulletin* 6.

Bank's legal counsel advised that, as an unsecured creditor, the Bank's only available course was to subrogate to the Trustee's indemnity with respect to the Trust's property. However, while the indemnity against the Trust Assets in relation to the loan was sound, there must first be a taking of accounts as between the Trustee and Unit Holders, as the Trustee was only entitled to the net residue, if any, after balancing off what it owed in respect of its breaches. The Bank appointed an investigative accountant to conduct the necessary enquiries and discovered that the balance was nil.

* * * * *