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22ND ANNIVERSARY

# Flash Mob Discussion
## Are Trusts Monstrosities?

19 May 2017

Conference Suite, Level 9, 40 St George's Terrace, Perth

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**Flash Mob Discussion**
**Are Trusts Monstrosities?**
19 May 2017

# " Trusts are like those extraordinary drugs curing at the same time toothache, sprained ankles and baldness, sold by peddlers on the Paris boulevards; they solve equally well family troubles, business difficulties, religious and charitable problems."

P Lepaulle, 'Civil Law Substitutes for Trusts' (1927) 36 Yale LJ 1126 as recited in K Crossland, 'Unsecured creditors and the 'Uncorporation': issues with trading trusts post Global Financial Crisis' Trusts & Trustees, Vol. 17, No. 3, April 2011, pp. 185 - 213.

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## 1. Introduction

When assets held on trust are insufficient to cover the debts incurred by the trustee in relation to the trust, we tend to say the trust is insolvent. However, this implies a trust is an entity. It is not.

- A trust is not an entity.
- A trust does not have assets.
- A trust does not have debts.
- **A trust is not an entity.**

The fundamental fact that a trust is not an entity is not generally understood.

The confusion has been compounded by the judiciary's use of language inconsistent with that fundamental fact and this has resulted in conflicting judgments.

## 2. The basics – what is a trust?

A trust is a bundle of obligations whereby one party holds property for the benefit of another party.

There are three parties to this relationship:

- the settlor who creates the trust by transferring the property to the trustee,
- the trustee who holds the property for the benefit of the beneficiary or beneficiaries,
- the beneficiary or beneficiaries in whose best interests the trustee is obligated to act.

While the trustee is given legal title to the property, he/she/it is obligated to act in the best interests of the beneficiary or beneficiaries and not to place him or herself in a position of conflict.

These are the proscriptive fiduciary duties of a trustee.

The beneficiary is described as the beneficial owner of the property the subject of the trust.

## 3. What is a trust NOT?

A trust is not a separate legal entity.

However, some jurisdictions' tax departments treat trusts as if they are an entity and will issue them with their own tax number. This does not change the legal nature of the trust – only the way it is treated for tax purposes.

## 4. Trust characteristics – the Three Certainties

Case law has determined that there must be three certainties for a trust to exist:

- There must be a clear **intention** to create a trust.
- The **subject matter** of the trust, or trust property, must be clearly identified.
- The object, or **beneficiaries,** of the trust must be clearly identifiable, or easily ascertainable.

The requirement for these certainties usually means a trust will be evidenced by a deed.

However, where no deed exists, the courts may declare the existence of an implied trust by working out the intentions of the parties (a resulting trust), or to achieve justice as between the parties (a constructive trust).

## 5. Fiduciary duties

A fiduciary duty is a legal duty to act solely in the interests of another.

The primary duties are loyalty, prudence and impartiality. Trustees have a very high duty of care.

Secondary duties of trustees include comprehension of the relevant trust law and terms of the trust deed, openness and transparency, record keeping, accounting and disclosure.

The law of trusts comes from a branch of equity, which centres on fiduciary duties. However, trusts are also regulated by statute (Trustees Act 1962 for WA) and some tax legislation applies to trusts (see Part IVA Income Tax Assessment Act 1936).

## 6. Trustees

A trustee has a fiduciary duty to deal with the assets held on trust for the benefit of the beneficiaries.

**A trust is not a legal entity in its own right.** There can be no contract with a trust, and nor can there be a contract with the beneficiaries. Any contract must be with the trustee(s).

Trustees will sometimes try and limit their liability by adding "as trustee" but that has been found to be, on its own, insufficient. However, "as trustee and not otherwise" may be sufficient to exclude personal liability but all the circumstances will need to be assessed to ascertain liability.

Further protection for trustees comes in the form of a common law indemnity out of the assets held on trust. In some jurisdictions this is reinforced by statute.

There are three potential restraints on this right of indemnity:

- The trust deed may reduce or exclude the trustee's indemnity;
- Where the trustee is in default of the trustee's obligations to the trust;
- Where the trustee has incurred an obligation that is outside what the trust deed permits.

Some trust deeds include a provision terminating/replacing the position of the trustee upon bankruptcy or liquidation. However, the common law right to indemnity continues.

The trustee's right to indemnity constitutes an equitable lien. Therefore there is no reason in principle why it should not support a caveat. Beware though, that to the extent that the indemnity is in the nature of a security interest, failure to register, or respond to notices, could result in loss of priority or even in surrender of the security interest.

## 7. The Corporate Trustee – "a commercial monstrosity"

Professor H A J Ford of the University of Melbourne, and a leading authority on trust law, once described the ***"fruit of this union of the law of trusts and the law of limited liability companies [as] a commercial monstrosity".***

Notwithstanding the increasing popularity of trusts in recent years, creditors continue to assume they are dealing with a normal limited liability company which, upon incurring the debt, would have experienced a corresponding increase in its assets in the form of the goods or services supplied.

However, the only asset the trustee holds is the indemnity from the trust assets. The value of that indemnity is often less than the sum of the liabilities because of distributions, trading losses and asset depreciation. Its perceived or represented value may also be misleading because of uncertainty and improper conduct on the part of the trustee / director.

A corporate trustee's role as trustee of multiple trusts does not exempt it from its obligation to comply with the Corporations Act 2001. Therefore an inability to pay the due debts in respect of any one of the trusts may render the corporate trustee insolvent in the same way if the corporate trustee were the trustee of a single trust.

## 8. Not your normal balance sheet

The directors of corporate trustees are quite vulnerable to personal liability.

The balance sheet of the company consists of liabilities on the one side, and the right of indemnity on the other side. Directors must therefore carefully monitor the value and accessibility of the assets held on trust.

Directors of a corporate trustee may be in breach of their duties if they permit the company to take on the role of trustee where the trust deed has a provision excluding or limiting the trustee's right to indemnity. The same applies where there is a provision in the deed that allows it to be amended so that the trustee's right of indemnity may be excluded or limited.

## 9. The indemnity

The trustee is indemnified from the assets held on trust both for unpaid debts properly incurred in furthering the purposes of the trust and also for such debts that have been paid from the trustee's own resources (i.e. other than the assets held on trust). The latter is the trustee's right of reimbursement. The more common situation is the former, which is the right of exoneration.

This right of indemnity is in the nature of a proprietary interest.

Creditors have a right of subrogation into the position of the trustee in respect of their unpaid debt. Therefore, they can benefit from the trustee's indemnity. However, they do not have a direct right to deal with the assets.

The creditors are creditors of the trustee. Therefore they are interested in the value of the trustee's overall debts and assets, rather than in the value of debts relating only to the trust and the right of indemnity from the assets held on trust. Unless they have contracted otherwise, creditors are not restricted to assets held on trust when they are seeking to recover from the trustee.

If a trustee is replaced the right of indemnity remains.

## 10. Automatic displacement upon formal insolvency

Many trust deeds contain a provision removing the trustee upon liquidation or bankruptcy. Usually there is no replacement trustee, leaving the displaced trustee holding the assets as a bare trustee.

Recent decisions from the New South Wales and Victorian Supreme Courts have found that a liquidator of a corporate trustee holding assets as bare trustee cannot sell the assets without court approval on the basis that the assets are not "property of the company". This is contrary to earlier decisions, including one from the Western Australian Supreme Court, where the liquidator was found to have more than a mere legal title to the assets because of the indemnity supported by an equitable lien.

Until such time as a superior court clarifies this issue, it is risky for a liquidator to sell assets held as bare trustee unless court approval has been obtained. The courts will usually appoint the liquidator as receiver of the assets to facilitate their sale.

## 11. The pecking order

The recent New South Wales and Victorian Supreme Court decisions have caused some angst among all stakeholders as the courts have found that the net realisations from the assets held on trust should be distributed to creditors pro rata. This is at odds with the statutory insolvency regime set out in the Corporations Act 2001 and the Bankruptcy Act 1966. In these two acts, Parliament has legislated for the preferential treatment of certain creditors, such as employees.

Essentially this disparity is because, irrespective of the insolvency of the trustee, the assets are still held on trust. The trustee is obliged to deal with them in accordance with the trust legislation (Trustees Act 1962 for WA), which has not been updated to reflect Parliament's intent in the Corporations Act 2001 and the Bankruptcy Act 1966.

Although it does not yet appear to have been specifically addressed by the courts, any net realisations a corporate trustee recovers pursuant to a right of reimbursement rather than exoneration, would appear to be realisation of the trustee's asset, the indemnity. The Victorian Supreme Court has recently found that the right of indemnity is an equitable right that attaches upon the debt being incurred [the *Amerind* case]. Accordingly, the court found it is in the nature of a fixed charge. Therefore, priority creditors will benefit from such recoveries if there is no generally secured creditor first in time. In *Amerind* the indemnity appears to have been one of exoneration so the court did not need to address the distinction. Rather, the creditors all stood to share pari passu after the secured creditor and the statutory priority that elevated certain creditors above the secured creditor did not apply.

In addition, the courts have found that where a trustee has traded in its own right, as well as trustee of a trading trust, then an insolvency practitioner can only recover their fees and costs from assets held on trust for work done that is related to the trust.

## 12. Beneficiaries at risk?

If it is the case that the assets held on trust have been utilised with the beneficiary having meaningful input into the manner in which the trustee deals with those assets, it may be that the assets are traded through a partnership between the trustee and the beneficiary.

The substance of what has occurred may enable a creditor or liquidator to recharacterise the relationship as a partnership and chase the solvent partner(s).

## 13. Breach of directors' duties

The vulnerability of directors, who are totally reliant on the right of indemnity, could be explored by liquidators or creditors in three ways:

(i) If the trustee has breached the terms of the trust then the ability of the trustee to enforce the terms of the trust is compromised. The directors' conduct in allowing the trustee to act outside the terms of the trust renders them liable to a claim that they have breached their common law, statutory and fiduciary duties they owe to the trustee company.

(ii) As noted above, by permitting the trustee to undertake the role of trustee where the trust deed has a provision excluding the trustee's right to an indemnity, the directors expose themselves to a claim of insolvent trading.

(iii) Even if there is an agreement limiting the liability of the trustee a Court may allow a creditor to reach through the trust to the trustee where a breach of trust has resulted in the creditor being unable to obtain full satisfaction of the debt from the trust estate.

## 14. PPSR & trusts

The *Personal Property Securities Act 2009 ("PPSA")* concerns security interests in all forms of personal property (other than real estate). In order for a security interest to be "perfected" it must:

- have attached to the relevant secured property (known as collateral);
- be enforceable; and
- be correctly registered on the PPSR.

When registering a security interest on the PPSR, secured parties must identify the correct grantor. This is prescribed by the PPS Regulations. If a registration does not follow the PPS Regulations then the registration may not be effective.

Trusts add a layer of complexity for secured parties when registering their security interest on the PPSR. **If the trustee is a company without an ARSN and the trust has an ABN, the secured party is required to register their security interest over the trust's ABN and *not* the company's ACN.**

Once an external administrator is appointed, any security interest that is unregistered or unperfected will "vest" in the grantor pursuant to Section 267 of the PPSA (i.e. the secured party cannot recover the collateral). A registration against the ACN of the corporate trustee when the trust has an ABN (and the corporate trustee does not have an ARSN) will not perfect the security interest. It is therefore crucial for secured parties to identify the correct grantor to ensure that they are protected in the event of external administration of the grantor.

Section 588FM of the Corporations Act 2001 provides relief for secured parties with unperfected security interests. However, this is only available where the security interest has been perfected prior to the "critical time", which is usually the appointment of the external administrator (*In the matter of OneSteel Manufacturing Pty Ltd (administrators appointed) [2017] NSWSC 21).*

*PPSR = Personal Property Securities Register*
*ARSN = Australian Registered Scheme Number*

## 15. Case examples

**Commissioner of Inland Revenue v Newmarket Trustees Ltd [2012] NZCA 351**

Newmarket Trustees was a corporate trustee established by a firm of lawyers to serve their clients. It was a trustee of 118 trusts and held 145 properties. It is common practice in New Zealand for a law firm's trustee company to be the independent trustee jointly with a trustee representing the client's interests. One of those 118 trusts fell into arrears with Inland Revenue (New Zealand's ATO) who served a statutory demand on the trustees, including the corporate trustee.

The assets held on trust were insufficient to meet the statutory demand. The joint 'client' trustee similarly could not meet the demand. Inland Revenue chose to pursue Newmarket Trustees who defended the ensuing liquidation application and the appeal. The Court of Appeal agreed with the lower court and a liquidator was appointed.

The law firm then had the laborious task of appointing a replacement trustee for each of the other 117 trusts.

This case illustrates the dangers of relying on a joint trustee, and the risks associated with a trustee's activities not associated with the relevant trust.

**Independent Contractor Services (Aust) Pty Ltd (In Liq) (No.2) [2016] NSWSC 106**

The company was a corporate trustee which hired out IT and engineering staff. The company subsequently failed, and a liquidator was appointed. The NSW Supreme Court found:

*"… the company, as trustee, had, and its Liquidator now has, a right of indemnity from, and lien over, the trust assets, which has priority over the interest of the beneficiaries, for liabilities it incurred in acting as trustee. As all the company's liabilities were incurred in its trustee capacity, all its creditors … are entitled to be subrogated to the Liquidator's lien. The statutory priority referred to in s556 does not apply in respect of trust assets, and creditors share pari passu in the trust assets, after providing for the costs of administration including the Liquidator's remuneration and expenses."*

This case and the next one distinguish trustee companies from the corporate priority regime, leaving employees and the ATO for the superannuation guarantee charge liability ranking alongside other unsecured creditors.

**Re Amerind Pty Ltd (Receivers and Managers Appointed) (In Liquidation) [2017] VSC 127**

The Victorian Supreme Court expanded on *Independent Contractor* in March 2017 when it found that not only was the trust property not susceptible to the statutory priority regime in s556 (liquidation), but that s433, which deals with a receiver's obligations which largely reflect the priority regime in liquidations, was not applicable. This means that assets subject to a circulating security interest (the old floating charge), will also not be available to priority creditors such as employees or the ATO for the superannuation guarantee charge. Furthermore, the trustee's right of indemnity against the assets held on trust is not itself property of the company.

In addition to following the abandonment of the corporate priority regime in *Independent Contractor*, this case confirms the resulting 'windfall' for creditors with general security interests, usually banks.

We understand this judgment is to be appealed.

## 16. Discussion points

(i) Are trusts monstrosities?

(ii) Will we see an increased reluctance by directors to utilise trust structures in the future?

(iii) If legislation is passed to address the problems with trusts, should it simply overlay the Corporations Act and Bankruptcy Act priority regimes, or should it prohibit trustees from indulging in trading activities altogether?

(iv) How about legislating to make directors of corporate trustees personally liable for all the debts incurred in connection with the trust?

## 16. Discussion points (continued)

(v) Are the provisions in the Corporations Act regarding voidable transactions, insolvent trading and breaches of director's duties available for a liquidator of a corporate trustee?

(vi) If assets held on trust are not property of the trustee company, how may this affect creditors' rights under the PPSA?

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