AVOIDING TRANSACTIONS THAT CAN EXPOSE PROTECTED ENTITIES

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Introduction

Half the money I spend on advertising is wasted; the trouble is, I don't know which half.

John Wanamaker

Figure 1 John Wanamaker

The quote from John Wanamaker (considered by many as the father of advertising) can be paraphrased for our client's purposes to read:

Half the money I spend on asset protection is wasted; the trouble is, I don't know which half.

It is this conundrum we will look at briefly today.

Why is there a conundrum?

As lawyers we all know:

1. From ***Salomon v Salomon & Co Ltd*** [1897] AC 22 that a company has a separate and distinct legal personality to that of its directors, officers, employees and members; and

2. From our knowledge of equity that a trust is an obligation enforceable in equity which rests on a person (the trustee) as owner of some specific property (the trust property) to deal with that property for the benefit of another person (the beneficiary) or the advancement of a charitable purpose (see ***The Laws of Australia*** online [15.13.1]); and

3. That as a general rule the personal assets of directors of companies and trustees of trusts are separate from the assets and liabilities of the company of which a person is a director or of the trust of which a person is a trustee.

If the general rule were without exception there would not be any need for us to be discussing this topic today. However, there are exceptions to the general rule that

the assets and liabilities of a company and trust are not the personal responsibility of the director or trustee.

These exceptions can be seen in the following two diagrams:

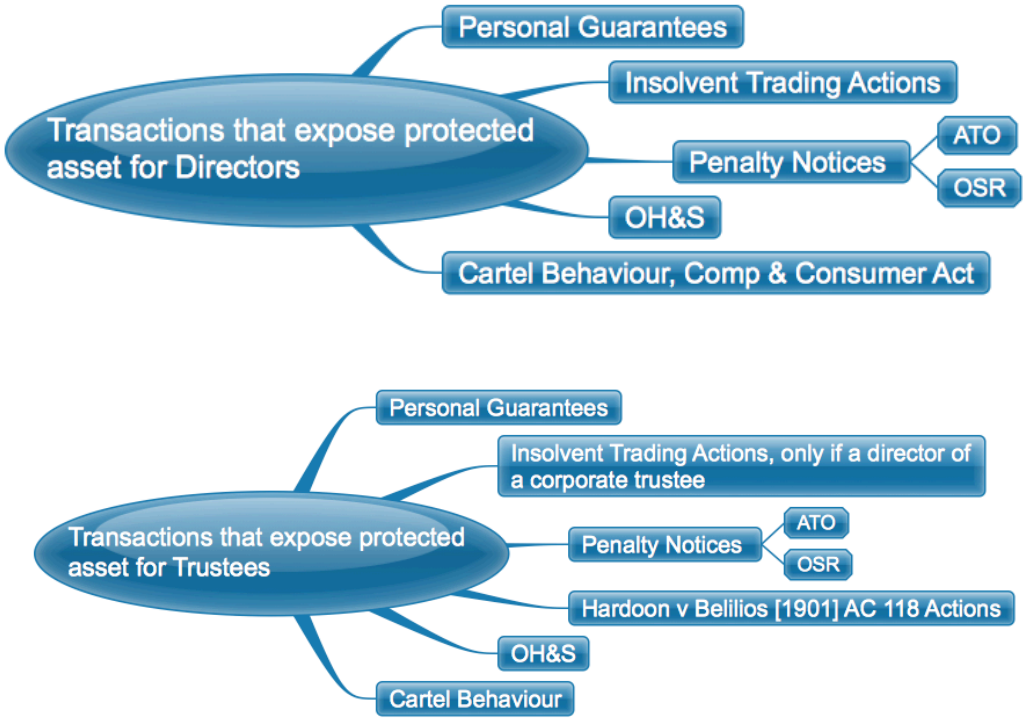

Figure 2 Exceptions for Directors

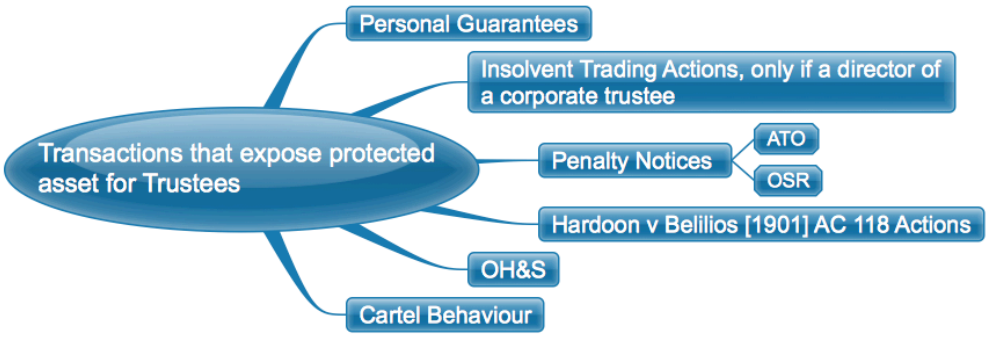

Figure 3 Exceptions for Trustees

As a consequence of our knowledge as lawyers we properly seek to advise our clients to take steps to protect their assets from attack as a consequence of them having been a director or trustee.

Transactions that expose protected assets for directors

The exceptions to the general rule that the assets of directors are not available for creditors of a company to which they hold this office are set out in Figure 2. The three main exceptions are:

1. Providing Personal Guarantees.
2. Insolvent Trading Actions.
3. Penalty Notices.
4. Personal liability under Work Health and Safety laws.
5. Personal liability under Competition and Consumer Act 2010.

We deal with each briefly.

1. Providing Personal Guarantees.

A personal guarantee is usually given to a creditor (eg a creditor or lessor) by a director who is also a shareholder of a company as additional security for the company's borrowings. Personal guarantees are usually required for start-up companies that do not have a credit record.

A guarantor must make sure that they are comfortable with the amount that they guarantee. If the company defaults on the payment of the loan, the creditor will demand payment under the guarantee, and if the guarantor cannot pay the creditor can seek a bankruptcy order against the guarantor. The creditor can ultimately force the personal guarantor to sell any of their to pay the amount owed.

In summary the disadvantages of a personal guarantee include:

- The burden of a personal guarantee stays with the director and/or shareholder who gives it. It does not affect the assets of the company. The creditor can therefore demand payment from the person giving the guarantee, rather than from the company.

- The guarantee is usually given on a full-indemnity basis, which means that to initiate an order for payment the creditor will only have to prove that the money is owed and that the loan repayments have not been made.

- Until the creditor recovers the money owed by the company in full the person giving the personal guarantee remains liable in full.

By providing a personal guarantee the personal property and assets of the director is directly exposed should the company not meet its rent payments.

Providing personal guarantees is a voluntary means by which directors enter into transactions that expose their personal assets.

2. Insolvent Trading Actions.

The general proposition is that directors are not personally liable for the debts of the company for whom they act as a director. The principle of limited liability in Australian company law has never been seriously challenged, the legislature has nonetheless recognised some circumstances in which the protection will not be available. The most important of these provisions is contained in ss 588G – 588U of the *Corporations Act 2001* (Cth), under which directors of an insolvent company who fail to prevent it incurring a debt may be made personally liable to pay the debt.

Section 588G(1)(a) of the *Corporations Act 2001* (Cth) provides that the duty to prevent insolvent trading applies to a person who is a director at the time when the company incurs the relevant debt. This is in contrast to the now repealed s 592 of the *Corporations Act 2001* (Cth), which imposed liability on persons who take part in company management as well as directors. The duty is imposed on directors because they control overall management of the company and have the ultimate power to prevent debts being incurred (See Australian Law Reform Commission, *General Insolvency Inquiry*, Report 45 (1988) Vol 1 at [325]) imposing the duty on directors is consistent with s 295(4)(c), which obliges directors, in the directors' declaration attached to the company's annual accounts, to declare whether or not there are reasonable grounds to believe that the company will be able to pay its debts as and when they become due and payable.

The duties imposed on directors by s 588G of the *Corporations Act 2001* (Cth) require directors to take an active interest in the company. Section 588G imposes a duty on a director to prevent the company trading while insolvent.

An issue that emerged in the cases on the predecessor provision to s 588G, ie s 592, is whether or not a passive director should escape liability under the section. The interpretation of the provision may affect the way that s 180(1) may be interpreted.

Kirby P's dissenting judgments in ***Darvall v North Sydney Brick & Tile Co Ltd*** (1989) 16 NSWLR 260; 15 ACLR 230; 7 ACLC 659 and ***Metal Manufacturers Pty Ltd v Lewis*** (1988) 13 NSWLR 315; 13 ACLR 357; 6 ACLC 725 have been influential. In both dissenting judgments, Kirby P considered that the passive directors were liable under s 180(1) because they had not done enough – they had not made reasonable inquiries. From 1990, a run of cases under s 592 resulted in directors being held personally liable for some of the debts of their insolvent companies. ***Statewide Tobacco Services Ltd v Morley*** [1993] 1 VR 423; (1990) 2 ACSR 405; 8 ACLC 827 was the first. Ormiston J, in the Victorian Supreme Court, noted a toughening in the judiciary's stance against non-performing directors. Opting out of running the company was not a way to escape liability:

> [T]o fail to make any enquiries whatsoever is not excusable and an opinion on the company's solvency based on that ignorance could not be characterised as reasonable. Even in a small company a director should ask for and receive figures, albeit of a basic kind, on a more or less regular basis. If that is sought and it reveals no difficulties and the director has no other reason to suspect the company may not be able to pay its debts as they fall due, then the director may be shown to have acted reasonably. (***Statewide Tobacco Services Ltd v Morley*** [1993] 1 VR 423; (1990) 2 ACSR 405; 8 ACLC 827, Ormiston J at 448 (VR).)

The Appeal Division of the Supreme Court of Victoria confirmed that judgment in ***Morley v Statewide Tobacco Services Ltd*** [1993] 1 VR 423; (1992) 8 ACSR 305; 10 ACLC 1,233 and added that the director cannot gain advantage by pleading his or her own ignorance. Crockett, Southwell and Hedigan JJ said that the Court would not ignore:

> [T]he obvious desire of the legislature to see that directors and persons engaged in the management of companies remain mindful of their obligations. ***Morley v Statewide Tobacco Services Ltd*** [1993] 1 VR 423; (1992) 8 ACSR 305; 10 ACLC 1,233 (CA), the Court at 465 (VR). The Full Court of the Supreme Court of South Australia was of a like mind. It agreed that directors should be asked by the law to do more. In ***Group Four Industries Pty Ltd v Brosnan*** (1992) 59 SASR 22; 8 ACSR 463; 10 ACLC 1,437 (FC), Mrs Brosnan, another passive director, argued that she had not given her consent or authority to the incurring of the relevant debt. Her husband, she said, ran the business completely. However, she failed to make out the defences under *Companies (South Australia) Code*, s 556(2)(a), (b) and the section applied to her.

In ***Commonwealth Bank of Australia v Friedrich*** (***Friedrich/National Safety Council Case***) (1991) 5 ACSR 115; 9 ACLC 946, Tagdell J spelled out his attitude to directors in the modern corporate environment:

> As the complexity of commerce has gradually intensified … the community has of necessity come to expect more than formerly from directors … the parliaments and the courts have found it necessary in legislation and litigation to refer to the demands made on directors in more exacting terms than formerly; and the standard of capability required of them has correspondingly increased.

Tagdell J addressed the crucial matter of what the director ought to know about the financial affairs of the company to adequately discharge his or her duties. How well does he or she have to be informed?

In particular, the stage has been reached when a director is expected to be capable of understanding his company's affairs to the extent of actually reaching a reasonably informed opinion of its financial capacity … he is under a statutory obligation to express such an opinion annually … it follows that he is required by law to be capable of keeping abreast of the company's affairs, and sufficiently abreast of them to act appropriately if there are reasonable grounds to expect that the company will not be able to pay all its debts in due course and he has reasonable grounds to expect it.

The Victorian Court of Appeal in ***Elliot v Australian Securities & Investments Commn*** (2004) 10 VR 369; 185 FLR 245; 205 ALR 594; 48 ACSR 621; 22 ACLC 458; [2004] VSCA 54 said at 185 FLR 116:

> [I]t is in our view clear that the effect of s 588G(2) is that a director contravenes the section by "not preventing" or "failing to prevent" a company

incurring a debt, and that a director will be taken to have so failed if debts are incurred by a company at a time when there are reasonable grounds for suspecting that the company is insolvent.

Breaches of s 588G of the *Corporations Act 2001* (Cth) have pecuniary and criminal penalties attached to them.

An example of the Courts using the criminal sanction is in the unreported case of ***R v Timothy Rhys Hawker Williams***, Supreme Court of Tasmania per Evans J, 24 June 2004.

Mr Williams was a director of a company that manufactured children's furniture, Cotech. The company went into liquidation with debts of around $1.7 million. Mr Williams pleaded guilty to dishonestly allowing the company to incur debts of approximately $330,000 when there was a reason to expect the company was insolvent and entering into transactions involving issuing a fictitious invoice on the company's behalf. The fictitious invoice was issued for the company's benefit.

In considering the appropriate punishment, His Honour Justice Evans noted that the authorities emphasised that those involved in the commercial world are expected to conform to demanding standards of honesty and if they engage in commercial crime, they must expect fitting punishment. His Honour Justice Evans said that, because of the difficulties in detecting commercial crime, the court's predominant consideration when dealing with such crime is deterrence. His Honour went on to say that persons found guilty of commercial crime, even if previously of good character and reputation, will frequently attract custodial sentences as a general deterrent to such crime.

Accordingly, Mr Williams was given a prison sentence of 15 months even though the court found:

- he was not motivated by greed;
- he received no direct personal benefit from his crimes;
- he was genuinely remorseful;
- he had otherwise led an 'exemplary' life;
- he pleaded guilty (which saved ASIC the trouble of proving his guilt); and
- had undertaken to assist ASIC in prosecuting two other people in relation to the activities of the company.

Insolvent trading cannot only have a financial impact on directors personal assets it can in addition impact on their freedom.

3. Penalty Notices.

Commissioner of Taxation (the "ATO")

The ATO has an arsenal of weapons available for the effective and efficient enforced collection of corporate taxation liabilities. One weapon, which quickly focuses the

minds of the directors of a corporate taxpayer, is a Director Penalty Notice ("**DPN**") issued pursuant to s222AOE of the ***Income Tax Assessment Act*** (Cth) 1936 ("**ITA Act**").

As the DPN regime has been in place for some years, its framework will be familiar to many. However, the potential for a DPN to trigger significant personal liability for directors, and the increasing frequency with which DPNs are being issued by the ATO, highlights the importance for us to remind ourselves with the DPN regime and to promptly take steps to advise our clients to have appropriate defenses to ensure that a DPN is disarmed as quickly as possible.

The DPN regime imposes a duty on directors to cause the company to remit to the ATO all withholding amounts (e.g., PAYG instalments) payable to the ATO.

Enforcement of that duty is effected by imposition of a penalty upon the director(s). The penalty is equal to any outstanding taxation amount payable by the company. When the company has paid the outstanding amount to the ATO, the penalty is reduced to zero. Alternatively, should the company be unable to pay the outstanding amount, the penalty can be reduced to zero by way of the director(s) promptly acting to appoint an administrator or a liquidator to the company. Should neither of these measures be undertaken, the ATO is able to take measures to enforce the penalty personally against the director(s).

Before doing so, the DPN regime requires that the director(s) of the company be given a "polite final reminder" of their duty to cause the company to remit withholding amounts to the ATO. Before the ATO can enforce a penalty against a director(s), the ATO must serve the director(s) with a DPN that identifies the relevant outstanding taxation amount.

A director served with a DPN has only 21 days (see s 222APC of the ITA Act) ***from the date of posting*** (See ***Deputy Commissioner of Taxation v Meredith*** [2007] NSWCA 354). Note the use of the word service as opposed to receipt. Just like statutory demands, the ITA Act only requires that the ATO prove posting of a DPN to the directors last known address for service notified to ASIC. Not receipt of the DPN by the director. Once issued a director has 21 days to cause the company to undertake one of the following alternatives:

1. pay the outstanding liability in full;

2. enter into a payment arrangement with the ATO as prescribed under the ITA Act for payment of the whole of the outstanding liability (NB – should the payment arrangement be breached, a director may become personally liable for the unpaid balance in circumstances where a DPN has been issued);

3. appoint an administrator to the company; or

4. appoint a liquidator to the company.

Should a director(s) fail to comply with a DPN the ATO is then entitled to enforce the penalty against the recipient director(s) personally.

Directors appointed after the due date for payment of outstanding tax liabilities may nevertheless become personally liable for those amounts under the DPN regime. It is recommended, therefore, that potential directors satisfy themselves that the company is up to date in respect of the relevant tax liabilities to ensure that they do not incur a potentially significant personal liability because of their accepting an appointment.

Given the potentially dramatic impact of a DPN on a director's personal financial circumstances, the DPN regime must be constantly in the minds of your clients, so as to avoid the disastrous personal liability that could befall them.

It is strongly recommended that directors now, and on an ongoing basis:

1. take adequate measures to ensure they have a clear picture of the financial circumstances of their company and in particular of the company's position in relation to the timely payment of taxation liabilities. Should unpaid tax liabilities exist, it is crucial that directors move proactively to ensure that such liabilities are addressed in an appropriate and considered fashion. For directors who neglect to undertake such measures, the DPN regime imposes significant personal financial consequences; and

2. that directors' address details registered with ASIC are kept current, as failure to do so may result in a director being issued with a DPN at a non-current address, and for the period for compliance to expire without the director ever becoming aware the DPN had been issued.

NSW Office of State Revenue ("OSR")

The OSR has an equivalent power to that of the ATO to issue director penalty notices for payroll tax liabilities of corporate tax payers, under s 47B of the ***Tax Administration Act, 1996*** (NSW).

A notice under s 47B of the ***Tax Administration Act, 1996*** (NSW), has the same 21 day notice and response time frames as the DNP regime. The impact on the personal assets of directors is also the same. While directors have the same options as with the ATO DPN regime, under the TAA they have a fifth option which is to have the debt waived or deferred.

Transactions that expose protected assets for Trustees

The exceptions to the general rule that the assets of trustees are not available for creditors of the trust for which that are the trustee are set out in Figure 3. The four main exceptions are:

1. Providing Personal Guarantees.
2. Insolvent Trading Actions.
3. Penalty Notices.
4. Hardoon v Belilios Actions

We deal with each briefly. For the purposes of our review we are concerned only with trading trusts. We define a trading trust as a trust under which a trustee (individual or

corporate) holds on trust for nominated beneficiaries. The trust may be discretionary or fixed.

1. **Providing Personal Guarantees.**

See comments above regarding provision of personal guarantees generally.

2. **Insolvent Trading Actions. Corporations act 197**

The current state of the law is that a trustee's right to be indemnified out of trust assets is the sole remedy that creditors of a trading trust have against an individual trustee or a director of a corporate trustee. The general rule is preserved such that a director of corporate trustee does not have a personal liability to creditors.

Section 197 of the ***Corporations Act 2001*** (Cth) provides an exception to the general rule in relatively limited circumstances. The limited circumstances are where the corporate trustee's right to be indemnified out of the trust assets has been lost as a result of the trustee's conduct, or where the terms of the trust deed specifically excluded, or could operate to exclude, creditors of the trust from access to meet liabilities incurred by the corporate trustee.

A broader interpretation was given to the predecessor of the current section by the South Australian Supreme Court in ***Hanel v O'Neill*** [2003] SASC 409. ***Hanel*** was a case about a corporate trustee that, through the actions of its sole director in distributing all of its assets to a beneficiary, could not pay the rent under its lease. The landlord sought to make the director liable under s 197(1)

In ***Hanel's*** case, a majority of the court held that the sole director was personally liable for the trust's debts under s197 because the trust had no assets. This was held to be the case, even though the corporate trustee was entitled to be fully indemnified out of trust assets under the trust deed.

Hanel's case was with express reservations followed by in the NSW Supreme Court by McDougall J in ***Intagro v ANZ Banking Group*** [2004] NSWSC 618.

In 2005 the section was amended with the intention of restoring the long standing interpretation of s 197. The current section reads:

> ***A person who is a director of a corporation when it incurs a liability while acting, or purporting to act, as trustee, is liable to discharge the whole or a part of the liability if the corporation:***
>
> ***(a) has not discharged, and cannot discharge, the liability or that part of it; and***
>
> ***(b) is not entitled to be fully indemnified against the liability out of trust assets solely because of one or more of the following:***
>
> ***(i) a breach of trust by the corporation***

(ii) the corporation's acting outside the scope of its powers as trustee

(iii) a term of the trust denying, or limiting, the corporation's right to be indemnified against the liability.

The person is liable both individually and jointly with the corporation and anyone else who is liable under this subsection.

Note: The person will not be liable under this subsection merely because there are insufficient trust assets out of which the corporation can be indemnified.

How it will work in practice

This intended operation can be illustrated by considering the following examples:

A trust has no assets. The trust deed provides that the trustee's right to be indemnified out of the trust funds is capped at $5,000. The corporate trustee incurs a debt of $3,000 which has not been, and cannot be, discharged. If the debt was incurred bona fide in carrying on the business of the trust, the director will not be liable for the debt, despite there not being sufficient assets to discharge the liability. If however the indemnity is lost for one of the reasons listed above, the director will be personally liable.

A trust has $500,000 worth of assets. The trust deed provides that the corporate trustee's right to be indemnified out of the trust fund is capped at $250,000. The corporate trustee has a liability of $300,000 which has not been, and cannot be, discharged. Because the corporate trustee's right of indemnity is limited, the director of the corporate trustee may be liable for the whole $300,000.

3. Penalty Notices.

See comments above as these are applicable to directors of corporate trustees, subject to the provisions of s 197 of the Corporations Act and the comments below.

4. Hardoon v Belilios Actions

Lord Lindley for the Privy Council in ***Hardoon v Belilios*** [1901] AC 118 said that:

> "the plainest principles of justice require that the cestui que trust who gets all the benefit of the property should bear its burdens unless he can shew some good reason why his trustee should bear them himself".

In this case "the beneficial owner of shares was held to be personally bound, in the absence of a contract to the contrary, to indemnify the registered holder against calls upon them." The beneficiary was sui juris and absolutely entitled beneficially to the trust property.

The relevant legal principle is that, where a trustee incurs a liability in conformity with the terms of the trust, the trustee is entitled in equity to indemnity, not only out of the trust estate (***Trustee Act 1925*** (NSW), subs 59(4), and equivalent provisions in other

jurisdictions), but also from each beneficiary who is sui juris and absolutely entitled beneficially to the trust property. The leading authority usually cited for this proposition is ***Hardoon v Belilios*** (1901) AC 118.

The principle is well recognised as part of Australian law*:* ***Paul A Davies (Australia) Pty Limited (In Liq) v Davies*** (1983**)** 1 NSWLR 440; ***J W Broomhead (Vic) Pty Limited (In Liq) v J.W. Broomhead Pty Ltd*** (1985) VR 891 (McGarvie J) ("Broomhead"); ***McLean v Burns Philp Trustee Co Pty Ltd*** (1985) 2 NSWLR 623 (Young J); ***Rosanove v O'Rourke*** (1988) 1 Qd R 171; ***Countryside (No 3) Pty Ltd v Bayside Brunswick Pty Ltd***, unreported, Supreme Court of New South Wales, Brownie J, 20 April 1994 ("Countryside"); Jacobs' Law of Trusts in Australia (5th ed, 1986) at paragraph (2105); Ford and Lee's Principles of Law of Trusts (2nd ed, 1990) at para 1404.2).

It is a well accepted principle in Australian law, therefore, that where a trustee acts at the direction of their fully entitled beneficiary and thereby suffers loss, then to the extent that the assets of the trust do not indemnify the loss by the trustee, the trustee may recover against the beneficiary.

Standing alone, ***Hardoon v Belilios*** may not cause much concern. It involved a beneficiary who was fully entitled as to the assets of the trust, and who directed the trustee as to a particular course of action. It seems only fair, then, that the beneficiary should not escape responsibility for the directions given to the trustee.

But the law of trusts is founded upon principles of equity and fairness. When called upon to consider how to approach new principles of law, the courts fall back upon the principles of fairness and equity.

This was the approach of the Victorian Supreme Court in ***J.W. Broomhead (Vic) Pty Ltd (In Liq) v J.W. Broomhead Pty Ltd*** (1985) VR 891.

In ***Broomhead*** a company which was trustee of a unit trust went into liquidation. Whilst conducting a building business for the unit holders it had properly incurred liabilities. The liquidator was unable to obtain a complete indemnity out of trust assets, and so he sought a personal indemnity from the unit holders. It was held that this right of personal indemnity extended beyond the well-established cases where there is only one beneficiary and that beneficiary is sui juris and absolutely entitled (such as ***Hardoon v Belilios***). McGarvie J decided (at 936) that the right of personal indemnity extends to a case "where there is more than one beneficiary and all of them are sui juris and entitled to the same interest as absolute owners between them."

A reference to "the same interest as absolute owners" should be read as meaning only that the interest must be a vested absolute interest, and not as requiring that each unit holder have the same number of units.

Further, it also appears from ***Broomhead*** (937) that a beneficiary with less than an absolute interest may be liable to the trustee if that beneficiary has requested the trustee to assume office or to incur what otherwise would be an unauthorised liability. Exactly how these principles apply to trusts generally, is still a little uncertain. Certainly, these principles are relevant to unit trusts, particularly where all beneficiaries are fully entitled to the assets of the trust.

How this may apply to a discretionary trust, is somewhat more difficult to determine.

As can be seen from the above, one relevant principle that may be drawn from Broomhead's case is that:

a trustee has a right to be protected from the denials of a beneficiary who directed the trustee to undertake a course of action. The law then enables a person who has rights against a trustee the benefit of subrogation or tracing of the right against and through the trustee to certain of the beneficiaries.

A Practice Point that may be drawn from the Broomhead case is: Ensure that you provide a warning that the law may enable a creditor claiming against an insolvent trustee of a unit trust to trace a claim against the trust unitholders. Thus, it is not sufficient to have a corporate trustee of a unit trust and to believe therefore that asset protection exists.

It was recognized in ***Hardoon v Belilios*** itself that the trustee's right of recourse to beneficiaries may be excluded by the trust instrument or surrounding circumstances. As to the latter, Lord Lindley himself, in ***Wise v Perpetual Trustee Co Ltd*** [1903] AC 139, saw a social club in which members were perpetually changing and were required to pay no more than their annual subscriptions as an example of excluding circumstances.

The principal has not been restricted to small or tightly held trusts. Unitholders were held liable to indemnify the trustee of a unit trust scheme in both ***Causley v Countryside (No 3) Pty Ltd*** (unreported NSWCA 2 September 1996) and ***Fitzwood Pty Ltd v Unique Goal Pty Ltd*** [2002] FCAFC 285.

In the unanimous Supreme Court of New South Wales Court of Appeal decision of ***I.R. Causley & G.J. Causley v Countryside (No 5) Pty Ltd & Ors*** (1996), the Court of Appeal held:

1. the trustee of the unit trust was entitled to be indemnified by unit holders (both original and those that became unit holders by subsequent application) in respect of the liability for damages incurred by the trustee in circumstances where the liabilities exceeded trust assets;

2. one of the unit holders was entitled to recover moneys from the trustee in respect of work done by it for the trustee, and where the trust assets were insufficient to meet that liability, that unit holder was also entitled to indemnity from the other unit holders in respect of the trustee's unpaid liability to it.

Speaking for the Court, Cole JA stated:

> "It is established that, absent provision in the trust deed denying the right of indemnity, or circumstances indicating good reason why a trustee should not be so indemnified, a trustee is entitled to be indemnified by the cestui que trust in respect of liabilities incurred by the trustee in pursuit of functions within power where the cestui que trust is or, if more than one are the absolute beneficial owners of the trust property the legal title to which is vested in the trustee."

In ***Countryside (No.3) v Best/Lawson*** [2001] NSWSC 1152, that court was asked to visit the issue of whether there was an indemnity and if yes, the amount of indemnity by the unitholders in respect of the trustee. The background to the facts were:

On 20 December 1983, a Unit Trust Deed ("the Deed") was executed between Messrs Buckley, Savins, Lawson and Blair (an accountant who had replaced Mr McKerlie), who were called "the Managers" of Rokolat Pty Limited (a company which later changed its name to Bayside Brunswick Pty Limited ("Bayside Brunswick")), the trustee, and Lex, which was the original unit holder.

Lex paid $60 and took up one unit to establish the Brunswick Unit Trust ("the Trust").

The Deed was in general terms. The Deed provided that the Managers should, subject to the overall control of the trustee, "administer and manage the affairs of the Trust". The Managers were to collect and receive all income of the Trust and to pay out all costs and disbursements incurred on behalf of the Trust. The powers of the trustee were extensive but were limited by the words "as directed by the Managers".

It was intended that Bayside Brunswick would operate substantially as a bare trustee and that is effectively what happened. The Managers took decisions, although it seems that Messrs Buckley, Savins and Lawson were also the directors of Bayside Brunswick and Mr Blair was its secretary. The Court found that, probably, no clear distinction in functions was drawn.

The Court of Appeal approved the comments of Brownie J from the earlier ***Causley*** decision:

> "The plaintiff's claim was based on the statements of Lord Lindley, delivering the advice of the Judicial Committee, in ***Hardoon v Balilios*** [1901] AC 118 at 123-125: as between a trustee and a sole cestui que trust, who is under no disability, the plainest principles of justice, and the rules of equity require that the cestui que trust who gets the benefit of the trust property should bear its burden unless he can establish some good reason why the trustee should bear the burden himself; the right of the trustee to indemnity in respect of liabilities incurred by him within the scope of the trust is not limited to the assets of the trust, but extends to the imposition of a personal liability on the cestui que trust; and the liability of the cestui que trust arises from the mere fact of the relationship between the parties, and does not depend upon there having been any request from the cestui que trust to the trustee to incur the liability."
>
> 33 In his conclusion, Brownie J relied, not merely on the fact that the unit holders were beneficiaries who were sui juris and absolutely entitled, but also upon the circumstance that Bayside Brunswick was established as the vehicle to carry out the particular venture. His Honour said:-
>
> "On the evidence, the appropriate inference is that those who applied for units in 1984 did so as participants in some commercial arrangement, in the expectation of profit: they paid a total of $49,920 each for units in a trust the sole function of which was to pay for,

> subdivide, develop and then resell the land in question; and they did this in the expectation that the trustee would make a profit for them. To adapt the language of Lord Lindley in Hardoon, the plainest principles of justice require that the beneficiaries who get all the benefit of the trust property should bear its burden unless they can show some good reason why the trustee should bear it itself; and the fact that there are several beneficiaries, rather than one beneficiary, is not of itself a good reason."

And later:

> 38 I agree with the view expressed by Professor Ford that, in the case of multiple beneficiaries, in order to establish personal liability on the beneficiaries, there needs to be more than the mere fact that the beneficiaries are sui juris and absolutely entitled. An additional fact may arise from a circumstance such that the beneficiary is a settlor of the trust or contributed the funds which were managed or that the beneficiaries requested that the expenditure be incurred or approved of its being incurred or that the trustee was carrying on a business established for the benefit of the beneficiaries.

So it is not the nature of the trust and the beneficiaries interest in it, what is important are the facts and involvement of the beneficiaries in the actions of the trustee that gave rise to the liability. Taken to its logical extreme, such a view might arguably support a liability upon beneficiaries of discretionary trusts, where they where knowingly and directly involved with the actions of the trustee.

And later still:

> 44 In my view, GLI did not, by reason of this transaction (a subscription for units long after the initial establishment and subscription of the early unitholders), come under a liability to indemnify Bayside Brunswick in respect of the expenses which Bayside Brunswick had previously paid or incurred. In my opinion, no principle of trust law or of the law of unjust enrichment requires that GLI be held liable for debts incurred prior to that transaction. The transaction did not amount to adoption and approval of all that had previously occurred. It was merely a transaction whereby a modest sum was raised with a view to overcoming some of the problems which the venture then faced.

So the mere subscription for units at a later time did not make the unitholder/beneficiary liable for the past debts of the trustee.

When pressed, the court found that it could trace, for 'debt' purposes under the insolvent trading provisions, against the unitholders .....

> Therefore, as Bayside Brunswick's obligation was a debt, it seems to me that the corresponding obligation of each unit holder was likewise a debt for the purposes of s 592. I do not accept the submission, which has been put to me on behalf of the defendants, that a trustee must necessarily have recourse to the Trust's assets before seeking personal indemnity. The authorities are to the contrary.

However, on the facts, the insolvent trading provisions did not 'make their way through' the trust to the unitholders, but only because:

> 67 On the facts before me, I cannot conclude, as a matter of probability, that, when Lex, GLI and Buckley Dowdle (the unitholders) took up their units, it was reasonable to expect that they or any of them would not be able to pay all their debts as and when they became due. On the evidence before the Court, both Countryside and the defendants expected that Bayside Brunswick would be able to pay the instalments of the purchase price due to Countryside.

His Honour Justice Debelle in ***Moyes & Anor v J & L Developments Pty Ltd & Anor*** [2007] SASC 261 at [37] said:

> "A trustee is personally liable for debts incurred in carrying on the business of the trust: ***Vacuum Oil Company Pty Ltd v Wiltshire*** *[1945] HCA 37;* (1945) 72 CLR 319 at 324. Equity has provided for the circumstances in which a right of indemnity is available to a trustee. A trustee is entitled to be indemnified from trust funds for the discharge of liabilities incurred in the authorised conduct of the trust: ***Worrall v Harford*** (1802) 8 Ves Jun 4 at 8; 32 ER 250 at 252; ***Octavo Investments Pty Ltd v Knight*** *[1979] HCA 61;* (1979) 144 CLR 360 at 371; ***Kemtron Industries Pty Ltd v Commissioner of Stamp Duties*** [1984] 1 Qd R 576 at 584-586. The right extends to the payment of the costs of an action which are properly incurred: ***National Trustees Executors and Agency Co of Australasia v Barnes*** *[1941] HCA 3;* (1941) 64 CLR 268. The right to indemnity is implied in the trust. Lord Eldon described that right in these terms in ***Worrall v Harford*** (at 8).
>
> > It is in the nature of the office of a trustee, whether expressed in the instrument, or not, that the trust property shall reimburse him all the charges and expenses incurred in the execution of the trust. That is implied in every such deed."

His Honour Justice Debelle at [38 and 39], in the same case then noted the division of judicial opinion on the question of whether the trustee's right to an indemnity under the general law can be excluded by the trust instrument. His Honour noted the views of McPherson J and Andrews SPJ of the Queensland Court of Appeal in ***Kemtron*** that it was "probably not capable of being excluded by the trust instrument", and the contrary views of Brooking J in ***RWG Management Ltd v Commissioner for Corporate Affairs (Vic)*** [1985] VR 385 at 395:

> "So far as the trustee's own position is concerned, although the right of indemnity out of assets has been described as arising out of the nature of the office of trustee, and as inseparable from it, I doubt whether this means any more than that the character of the office makes it unjust to throw burdens upon the trustee without at the same time enabling him to be reimbursed or exonerated out of the trust property. ***Hardoon v Belilios*** [1901] AC 118 grounds the trustee's right to be indemnified by the beneficiary upon this same broad notion of justice. The Judicial Committee accepts, at p. 127, that the beneficiary's obligation can be excluded, and it is difficult to see why the

right against the trust estate should stand in a different position. Observations ***in Re German Mining Co; Ex parte Chippendale*** (1854) 4 De GM & G 19 at p.52; 43 ER 415 at p. 427 suggest that exclusion is possible. If a trustee is willing to accept office where the trust instrument ousts his indemnity, I do not see why he should not be free to do so."

His Honour Justice Debelle concluded that the issue depended upon the terms of the particular States Trustee act (see [40]) and not that a contract is not enforceable if its enforcement would be opposed to public policy by saying:

40 …A contract is not enforceable if its enforcement would be opposed to public policy: ***Mogul Steamship Company v McGregor, Gow and Co*** [1961] HCA 36; [1892] AC 25 at 39, 51; see also the discussion of the principle by Jordan CJ in ***re Jacob Morris deceased*** (1943) 43 SR (NSW) 352 at 355-357. "Everyone may waive the advantage of a law made solely for the benefit or protection of him as an individual in his private capacity, but this cannot be done if the waiver would infringe a public right or public policy": ***Bowmaker, Limited v Tabor*** [1941] 2 KB 1 at 6. As s 35(2) is a provision which is available for the benefit of creditors as well as trustees. It is not, therefore, a provision which may be waived by a trustee. For these reasons, to the extent that the deed executed on 1 June 2004 purported to exclude the capacity of J & L Developments as trustee to be indemnified by the trust assets, it is unenforceable. J & L Developments is, therefore, entitled to be indemnified from trust funds for the discharge of liabilities incurred in the authorised conduct of the trust.

41 An allied proposition is that a creditor to whom a trustee has incurred a liability in the proper administration of the trust is entitled to be subrogated to the trustee's right of indemnity and to enforce that liability directly against the trust property: ***re Johnson*** (1880) 15 Ch D 548; ***re Raybould*** [1900] 1 Ch 199 at 201-202; ***Marginson v Ian Potter & Co*** *[1976] HCA 35;* (1976) 136 CLR 161 at 175-176; ***Octavo Investments Pty Ltd v Knight*** (supra). **In *re Johnson***, Sir George Jessel MR permitted creditors of a trading trust to recover liabilities due to them directly against the trust assets. In his view, it was a corollary to the principle by which persons are allowed to follow trust assets. He said (at 552):

> The trust assets having been devoted to carrying on the trade, it would not be right that the *cestui que trust* should get the benefit of the trade without paying the liabilities; therefore the Court says to him, You shall not set up a trustee who may be a man of straw, and make him a bankrupt to avoid the responsibility of the assets for carrying on the trade: the Court puts the creditor, so to speak, as I understand it, in the place of the trustee.

The right of a creditor to be subrogated to the trustee's right of indemnity in this way exists whether the trust is created by will or *inter vivos*: ***re Johnson*** at 552. As the creditor's right to be paid out of the trust assets is derivative, it follows that the creditor has no higher right than the trustee to indemnity: ***ex parte Edmonds*** (1862) 4 De GF & J 488 at 498; 45 ER 1273 at 1277, and the creditor may claim against the trust assets only to the extent of the amount the trustee could claim out of those assets: ***re Johnson*** at 552; ***re Staff Benefits Pty Ltd*** [1979] 1 NSWLR 207."

The Court held that the cost orders be paid from the assets of the trust, then controlled by a new trustee.

Summary

A creditor of a trading trust does not have a direct claim against the trust's assets so must rely on the trustee's indemnity. Creditors are often unaware of the extent of this indemnity and the law is uncertain as to whether a trust deed can limit or exclude the indemnity from the trust assets and, therefore, a creditor's rights to those assets.

A creditor can only pursue the trust assets (by way of subrogation) where the right of indemnity is not limited in any way. One option is to allow the creditor to rely on the trustee's right of indemnity despite any lack of capacity or authorisation, breach of trust, indebtedness to the trust etc on the part of the trustee.

Proposals for the Future

The Proposed Revamp of DNP Regime

A number of amendments to the DPN regime were introduced into Parliament on 13 October 2011. The changes were wide reaching and were designed to deter fraudulent phoenix activity by directors. In essence the proposed changes were as follows:

- the DPN regime to be extended to superannuation guarantee amounts, making directors personally liable for their company's failure to pay employee superannuation;
- the ATO be given the power to commence recovery against directors under the director penalty regime, without providing a 21 day grace period, for certain unpaid company liabilities that remain unreported after three months of becoming due; and
- in certain circumstances directors and associates of directors will be prevented from obtaining credits for withheld amounts in their individual tax returns where the company has failed to pay withheld amounts to the ATO.

As mentioned, the legislation to enact these changes was introduced into the House of Representatives on 13 October 2011, which immediately referred it to the House of Representatives Standing Committee on Economics ("**the Committee**") to allow a review of the public submissions on the proposed changes.

The Committee has decided to remove the proposed changes relating to the extension of the ATO's DPN powers from the current legislation and in response to the public submissions received, the Committee made the following recommendations:

1. The Government investigate whether it is possible to amend the law to better target phoenix activity;

2. The Government explore whether to expand and strengthen the defences for company directors available;

Notwithstanding the recommendations, the Committee noted as follows:

> "…the committee is of the view that the Bills show great potential in striking a reasonable balance between the interests of the victims of phoenixing, many of whom are low income earners, and compliant company directors. The committee has recommended two refinements to the Bills, but the committee remains of the view that stronger legislation in dealing with phoenix operators will be required."

The Assistant Treasurer, Bill Shorten noted in November 2011 that "some further consultation and possible modification to the phoenix company measures may be required to ensure the proposed amendments do not affect company directors inappropriately in certain circumstances. After further consideration the Government intends to bring the provisions back to Parliament next year."

As such, the existing DPN regime will remain in place, including the maintenance of the 21 day notice period that is currently given to directors prior to the ATO commencing recovery action under the DPN regime, however it will be interesting to see what amendments, if any, are made to the proposed legislation in the forthcoming months.

Personal Liability from Phoenix Companies

The explanatory memorandum to ***The Corporations Amendment (Similar Names) Bill 2012*** (Cth) ('the Bill') reads on page 1:

> "The Corporations Amendment (Similar Names) Bill 2012 (the Bill) amends the Corporations Act to:
>
> • provide that a director of a failed company can be jointly and individually liable for the debts of a company that has a similar name to a pre-liquidation name of the failed company ('similar names measure')."

The Bill is the Gillard's government attempt to clip the wings of those engaged in phoenix activity through imposing personal liability on directors.

The Bill provides that a director will be personally liable if the following is established:

- The director was a director of Company B at the time the debt was incurred.
- The director was a director of Company A at any time during the 12 months prior to Company A being wound up.
- At the time the debt is incurred, Company B is known by a name that is:
  - the same as Company A or
  - similar enough to suggest an association with Company A.
- The debt of Company B is incurred during the five years after Company A was wound up.

For example:
'Sam is a director of Red Car. Red Car is put into liquidation by an unsecured creditor on 1 May 2010. A new company, Red Car NSW, is then incorporated on 2 May 2010 and Sam is a director of this company. Sam is personally liable for the debts of Red Car NSW.'

This Bill raises the following issues:

Is personal liability for directors an effective deterrent against phoenix activity?

The Bill imposes personal liability for the debts of Company B on directors who engage in phoenix activity.

This will have little effect as:

- Directors with knowledge to engage in phoenix activity are unlikely to have assets in their personal name. If assets exist they are likely to be heavily mortgaged and uncommercial to pursue.

- The Bill does not specify who is able to commence an action or how an action is to be conducted. Effected parties are unlikely to pursue directors if they do not know how this legislation operates.

- If existing legislation is not being utilised to deter directors it is unlikely this legislation would be more successful. Directors engaged in phoenix activity are likely to have committed offences and already be personally liable under existing provisions in the *Corporations Act 2001*, like those for insolvent trading and abuse of position, with respect to Company A.

- Personal liability is imposed on directors in relation to the debts of Company B only. If Company B is trading effectively and meeting its liabilities, a creditor of Company B is unlikely to pursue the director personally.

Loopholes

Loopholes exist in the Bill for directors engaged in phoenix activity to easily avoid

personal liability. Some are:

- Using a group of companies that have completely different corporate and trading names.
- Establishing and trading Company B at least a year prior to Company A being wound up. A director of Company A appoints a relative or associate as director of Company B.
- A director will only be personally liable for the debts of Company B if they were director of both Company A and Company B .

Poor definition of 'phoenix activity'

The term 'phoenix activity' is not defined in the Bill. An assumption is made that phoenix activity is defined by an action – eg by Company B using a 'same or similar name' to Company A including incorporated names and business or trading names.

There is no requirement for a transaction to have occurred between Company A and Company B involving assets, employees, premises and/or goodwill.

The Bill fails to address differences between:

- Genuine business failure. Where a business has been responsibly managed and subsequently continues using another corporate entity with a similar name.
- Phoenix activity where Company B is established using a totally different name to Company A.

The Bill states a director can only apply for an exemption from personal liability to the Court or liquidator of Company A. The liquidator must consider the following when granting an exemption:

- if the director has acted honestly
- if having regard to all the circumstances of the case, the director ought to be exempt from the debt or debts
- whether activities undertaken by the companies show elements of phoenix activity, such as both companies using the same premises and staff.

Making a determination on these factors requires the liquidator of Company A to:

- assess the activities of both Company A and B. The liquidator of Company A does not have access to records of Company B or the power to obtain this evidence
- exercise a power to determine the rights of creditors of Company B which is not in liquidation.

Recommendatons for Clients

1. Limit personal guarantees: directors should avoid giving guarantees as far as possible. Where it is not possible to avoid giving guarantees there may be potential to negotiate a cap on the extent of liability or a time limit to the liability.

2. Limit directorships: many businesses have only one key person but still have two or more directors, as was required prior to 1998. The additional directors may be unnecessary, and if so, they should resign their directorship which may remove them from further exposure from their personal guarantee and other directorship-related liabilities.

3. Limit director ownership of assets: a director with few assets in his/her own name is not an attractive target for a company liquidator to pursue if the company goes into liquidation.

4. Avoid insolvent trading: all directors will be personally liable to company creditors for company debts incurred while the company is allowed to trade while insolvent. Significant criminal sanctions may also apply.

5. Be aware of director duties: directors have numerous responsibilities under common law and various statutes. Being aware of these duties, performing them adequately and ensuring the company meets its tax, trade practices and other obligations can reduce personal liability risk.

6. Consider loans and other personal transactions with the company: a liquidator can void certain transactions with a company by a director or related entity of the company (including directors' relatives) where they are favourable to the director or related entity.