Dr Nuncio D'Angelo*

Grosvenor Place
225 George Street
Sydney NSW 2000

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NSW Law Reform Commission
GPO Box 31
SYDNEY NSW 2001

By email: nsw-lrc@justice.nsw.gov.au

Chair, Deputy Chair and Commissioners

Review of laws relating to beneficiaries of trusts
Submission

I make this submission in respect of the above Review being conducted by the Commission under Terms of Reference issued by the Attorney General on 28 April 2017, as displayed on the Commission's website (and reproduced in Schedule 1 of this submission).

I disclose that I am a partner of the law firm Norton Rose Fulbright and an Honorary Associate of the Sydney Law School. However I make this submission in my personal capacity and not on anyone's behalf or at anyone's instruction. The views expressed are my own and do not necessarily reflect those of my firm (or any other member of it) or of any client, or of the Sydney Law School.

In this submission:

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

trust creditor means a person to whom a trustee owes trustee liabilities (not being a beneficiary or the trustee, in those capacities). It is important to bear in mind when considering this submission, and in particular the creditor protection aspects discussed in it, that this category includes, of course, employees of a trustee (a matter of particular relevance for trading trusts);[1]

trust debt means a debt or liability incurred by a trustee to or in favour of a person (not being a beneficiary or the trustee, in those capacities)in circumstances where the trustee is entitled to apply trust assets to satisfy it (even if it is also obliged to satisfy it out of its own assets); [2]

trustee liabilities means debts, liabilities, obligations, claims or expenses incurred, suffered or paid by a trustee to or in favour of persons (not being beneficiaries or the trustee, in those capacities), ostensibly or purportedly in its capacity as trustee, regardless of whether, in the result, the trustee is entitled to apply trust property to satisfy them. They may or may not be 'trust debts';

Trustee Act means the *Trustee Act 1925* (NSW); and

Victorian Report means the Victorian Law Reform Commission Report, *Trading Trusts - Oppression Remedies* (January 2015).

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* BJuris LLB LLM PhD FAAL, Honorary Associate of the Sydney Law School, partner and Head of Banking & Finance Australia at Norton Rose Fulbright. I acknowledge, with thanks, the observations of Dr Allison Silink, barrister and lecturer at UTS Faculty of Law, on a draft of this submission.

1 Noting that unpaid employees of trustees do not necessarily enjoy the preferential treatment in insolvency offered to employees of companies acting as principal: see the cases cited in fn 31

2 Importantly, I say nothing in this submission about trustee remuneration, which is not a 'trust debt' as defined.

1 Preliminary matters

1.1 I have, and for many years have had, an active interest in trusts and, in particular, their use in commercial contexts. I work with trusts daily in my practice as a banking and commercial lawyer and would regard myself as an admirer of this highly useful, but clearly imperfect, device. I am the author of a book and several journal articles and conference papers on the topic.[3] I also created and teach a postgraduate subject on commercial trusts at the Sydney Law School[4] and have guest lectured at other universities on the topic. Much of my academic work has involved identifying risks in the use of trusts in commerce, suggesting private solutions for dealing with those risks and making suggestions for reform. My doctoral thesis (completed in 2012) was entitled *The Trust: From Guardian to Entrepreneur. Why the Changing Role of the Trust Demands a Better Legal Framework for Allocating Stakeholder Risk.*

1.2 Thus, I was pleased to receive notice of this Review.

1.3 That pleasure, however, is tempered with disappointment at the narrow scope of the Terms of Reference. The matters identified are undoubtedly important. The various uncertainties discussed in the *Victorian Report* and in this submission demonstrate that a case can readily be made for reform; indeed, in relation to commercial trusts this Review may even be regarded as an investor protection initiative. However, I am not aware of any particular clamour in the market for reform of those matters over and above others affecting those who are involved in trusts. The issues in relation to the commercial use of trusts are many and complex, particularly, though not only, in insolvency. Some are now notorious, having been exposed in post-GFC litigation and a growing canon of academic and practitioner literature. Even today battles are being fought in the courts over some quite fundamental questions.[5] The issues are not by any means limited in their impact to beneficiaries.[6] They affect trustees (and their directors, where they are corporations) as well as trust creditors and other 'outsiders' dealing or interacting with trustees. I am, and suspect others will be, disappointed that the opportunity has not been seized to take a more comprehensive approach to the review of trust law, at least as it applies to commercial trusts. I hope the Commission is invited to undertake a more wide-ranging review in the near future.[7]

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3 See N D'Angelo, *Commercial Trusts* (LexisNexis Butterworths, 2014). For a recent article, see 'Directors of insolvent trustees and trusts: duties and liabilities in respect of beneficiaries and trust creditors' (2017) 35 *Company & Securities Law Journal* 75. For a recent conference paper, see 'Commercial trusts in practice: the trust as a surrogate company', *Annual Commercial and Corporate Law Conference* (Supreme Court of New South Wales, Sydney, 15 November 2016).

4 *Commercial Trusts* LAWS6333 (http://sydney.edu.au/law/fstudent/coursework/LLM-Units-of-Study/LAWS6333-Commercial-Trusts.shtml), next offered in 2018.

5 See, for example, the issues discussed in the cases cited in fn 31 below.

6 Nor are potential personal liability and the absence of a statutory oppression remedy the only issues affecting beneficiaries. Why not also consider clarifying the unsatisfactory state of the law concerning beneficiaries' rights to take derivative or representative actions against third parties (including a trustee's directors) on behalf of the trustee, as shareholders may do on behalf of their company under Part 2F.1A of the *Corporations Act*? What about giving beneficiaries statutory rights in relation to the appointment and removal of their trustee (or directors of their trustee) in appropriate circumstances, or resolving uncertainties around beneficiaries' rights to receive information from their trustee? Why not dispense with the perpetuity/remoteness of vesting rules, as South Australia has done (see section 61 of the *Law of Property Act 1936* (SA)), thus eliminating the risk of unintentional invalidation of trusts for a drafting error or omission (a risk that is realised more often than one might imagine)? The list is long.

7 There is now ample publicly available material on the reform of trust law: see the many reports cited in *Commercial Trusts*, fn 3, Appendix 2 (current as at March 2014). I recommend, in particular, the substantial body of work produced by the New Zealand Law Commission between 2010 and 2013 on the reform of trusts law in New Zealand, which culminated in the publication of a comprehensive exposure draft *Trust Bill* in late 2016: see the Commission's website at http://www.lawcom.govt.nz/our-projects/law-trusts (I do not, however, endorse all aspects of that Bill). Interestingly, the Bill is silent on the question of beneficiary liability, beyond preserving a provision approximately equivalent to section 86 of the *Trustee Act*: see section 118. The issue of beneficiary liability appears not to have been raised in submissions or considered in any detail in the many reports and papers produced by the Law Commission as part of the reform project.

1.4 While on the matter of scope, I note that the Terms of Reference call for submissions in relation to 'the liability of beneficiaries, as beneficiaries, to indemnify trustees or creditors *when trustees fail to satisfy obligations of the trust*' (emphasis added). The question of personal liability of beneficiaries extends also to indemnifying a trustee where it has paid a trust debt using its own money, ie where it will have actually 'satisfied obligations of the trust'. If the trust fund is adequate the trustee may then recoup that payment out of the fund but in other circumstances it may seek indemnification from the beneficiaries. I have proceeded on the assumption that the Terms of Reference did not intend to limit the inquiry to questions of exoneration in respect of unsatisfied external liabilities.

1.5 Finally on the matter of scope, there is a threshold question as to the kinds of trusts any proposed amendments should affect. I note Part 2 of the *Victorian Report*, headed 'Trusts and companies in Victoria', which contains much useful discussion in this regard. The conclusion was that the Victorian Law Reform Commission should limit its recommendations in relation to an oppression remedy to 'trading trusts', adopting a functional definition that includes all trusts where 'some property held by the trustee is employed under the terms of the trust deed in the conduct of a business,' including discretionary trusts: see para [2.122]. I do not have a strong view on the types of trust that should be within or without the scope of this Review, beyond noting that the amendments suggested below in relation to beneficiary liability limitation should include, but need not be limited to, trading trusts.

1.6 Although trust law is state-based, the issues arise across the Commonwealth and not just in New South Wales. Even if the *Trustee Act* is amended to address the matters raised in the Terms of Reference, the issues will of course remain for trusts that are governed by the laws of another state or territory.[8] There is also the question of whether and how any changes will or should affect investors in managed investment schemes. All registered schemes involve trusts[9] (many of which are unit trusts) and so are subject to state/territory trust law, but they are also regulated by the *Corporations Act*.[10] I say nothing further in this submission about these or other constitutional and jurisdictional issues.[11]

1.7 There is also the question of transition, in particular whether any changes made pursuant to this Review should apply to and in respect of trusts in existence at the date those changes come into effect. There is, quite rightly, an abiding caution with respect to law reform that has retrospective effect, particularly if it has the potential to prejudice parties who have expressly arranged their affairs based on existing law. For example, retrospectivity might deprive trustees (and, possibly, trust creditors – although note paragraph 4.14 below) of the benefit of a pre-existing right of indemnity against beneficiaries. Potential unintended consequences would need to be exposed and dealt with. On the other hand, to have changes apply only prospectively would create two 'classes' of beneficiaries: those under trusts established post-commencement who would enjoy the benefit of any new protections and those under trusts extant at the commencement date who would not. Moreover, the changes would highlight to an otherwise relatively uninformed market the issue of potential beneficiary liability and could encourage trust creditors of extant trusts who are left

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8 Of course, if any amendments enacted following this review are well received in the market, they may well be adopted in other states and territories over time. Alternatively, if they are seen as unacceptable they could, in theory, drive the market to avoid NSW as the governing law of newly established trusts. These are not strictly legal considerations of course but would, it seems to me, be relevant in the assessment of whether and how to amend the *Trustee Act*.

9 See section 601FC(2) of the *Corporations Act*.

10 I note that the recommendations in the *Victorian Report* expressly exclude managed investment schemes: see para [2.70] (they also exclude superannuation funds and charitable trusts). I am, of course, aware of the excellent work of the Corporations and Markets Advisory Committee in relation to managed investment schemes, before it was dismantled as a consequence of the funding cuts in the 2014 Federal Budget.

11 The Terms of Reference for the *Victorian Report* included an instruction to have regard to 'the interaction between State and Commonwealth laws, and the jurisdictional limits imposed on the Victorian Parliament'. There is discussion of these issues throughout the *Victorian Report*, particularly in relation to the interaction with the *Corporations Act*.

unsatisfied out of trust assets to test it in their particular case. If, as I believe should be the case, amendments are to apply to existing trusts, Parliament might consider giving the market a transitional period of, say, 12 months between enactment and commencement to allow affected parties to consider the impact of the new provisions on their arrangements, seek advice and, if necessary, make adjustments to accommodate or otherwise deal with them.[12]

1.8 Finally, I note that the Terms of Reference require the Commission to have regard to 'the widespread use of trusts in commercial contexts as well as in the community'. In Schedule 2 of this submission I set out an extract from the conference paper cited in footnote 3, which offers a brief overview of the scale of use of the trust in Australian commerce, as at the date of that conference.

2 Summary of submissions

In summary:

(1) in relation to the question of whether New South Wales should adopt the recommendations of the *Victorian Report*, for the reasons set out below in paragraph 3 below I am in favour; and

(2) in relation to the question of personal liability of beneficiaries for trustee liabilities, I submit that the *Trustee Act* be amended to include a new Part 2A entitled **Beneficiaries** in or substantially in the form set out in the Schedule 3 of this submission, for the reasons set out below in paragraph 4.

3 A statutory oppression remedy

3.1 The *Victorian Report* is a comprehensive response to its Terms of Reference and is, in my view, well researched and well written. It evidences mature consideration and thought. It benefitted from the publication of a Consultation Paper some seven months after the Terms of Reference were published and a 'round table' conference with academics, practitioners and industry representatives with particular expertise in this area who were invited to discuss the issues with the Commission.

3.2 The laws of New South Wales and Victoria are sufficiently similar for its conclusions and recommendations (with which I agree) to be directly translatable. I do not believe that they would be materially improved by anything I might have to say in this submission.

3.3 Thus, on the question of whether New South Wales should adopt the recommendations of the *Victorian Report*, overall I am in favour (noting my general comments in paragraph 1.3 above in relation to need or otherwise).

4 Personal liability of beneficiaries

There is no true limited liability for beneficiaries

4.1 In my book an entire chapter is dedicated to the legal risks of beneficiaries of commercial trusts.[13] Although much of the discussion there is focused on beneficiaries who are

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12 Parliament might also consider amending the *Duties Act 1997* (NSW) to offer concessional treatment for documents and transactions executed for that purpose, if within certain parameters.

13 *Commercial Trusts*, fn 3, Chapter 3 'Legal Risks of the Beneficiary as an Equity Investor'.

investors in unit trusts, the issues are applicable more broadly. I will not repeat here the analyses in that chapter, but I do reference relevant parts of it below.[14]

4.2 As noted in paragraph 1.3 above, there does not appear to be any particular clamour in the market for reform in this area at the moment. With few exceptions, the issue of potential personal liability of beneficiaries for trustee liabilities has been left largely unexplored in the Australian legal literature, at least when compared to the exposure given to issues and risks faced by trustees and trust creditors. Nevertheless, concern has been expressed from time to time. The issue has been formally brought to the attention of the authorities on numerous occasions over the last 3 decades or so, to no avail.[15]

4.3 It is a fact that trust law does *not* assure beneficiaries of limited liability in anything like the way, for example, that section 516 of the *Corporations Act* limits the liability of shareholders in a company limited by shares to amounts unpaid on their shares. An examination of the history of limited liability for shareholders (in which the trust, in the guise of the unincorporated joint stock company, played a significant part) demonstrates that true universal liability limitation is neither a common law nor a contractual concept; it is a benefit conferred by the state through statute. There is no trust equivalent of section 516 of the *Corporations Act* (including, oddly enough, for trusts that are registered managed investment schemes, despite the obvious investor protection bias of Chapter 5C of the Act).

4.4 The interposition of a trustee between beneficiaries and trust creditors may appear to create a kind of 'trust veil' behind which beneficiaries may shelter, thanks to the fundamental rule of trust law that a trustee incurs debts and other liabilities as principal and is personally liable for them, subject to an indemnity out of trust assets.[16] However, in my book I concluded that this trust veil may be pierced or lifted by trust creditors such that a beneficiary may suffer unlimited personal liability for trustee liabilities, unexpectedly and involuntary, in at least two circumstances:

(1) *indirectly*, via the trustee under a right of personal indemnity. There are two points of contention in this regard: (a) whether and in what circumstances the trustee has a personal indemnity against the beneficiary (that is, in addition to its indemnity with respect to trust property),[17] and (b) if the trustee does have a personal indemnity in any given case, whether trust creditors may subrogate to it in the way they may subrogate to the indemnity against trust property (which would be crucial to affected trust creditors in circumstances where the trustee was unable or unwilling to enforce the indemnity);[18] and

(2) *directly* to a trust creditor, based on ordinary agency law principles, if the relationship between the beneficiary and the trustee has the character of principal and agent, superimposed on the trust relationship because the beneficiary controls the trustee or because the trustee and beneficiary constitute a general law

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14 I am not aware of any superior court decisions here or in the United Kingdom that materially affect the analyses or conclusions in that Chapter since the book was published in 2014.

15 See *Commercial Trusts*, fn 3, at [3.8] and the various reports cited in fn 12 on page 113. In relation specifically to managed investment schemes, see Corporations and Markets Advisory Committee report, *Managed Investment Schemes* (2012) at pages 198-201.

16 Because of this and other factors, trading trusts have been described as offering an 'ill-defined species of limited liability': see Companies and Securities Law Review Committee report, *Forms of Legal Organisation for Small Business Enterprises* (1984) at [115]. Various commentators over the years have hailed limited liability as an advantage of trading trusts with a corporate trustee over partnerships.

17 See *Commercial Trusts*, fn 3, at [3.57]ff. See also JD Heydon and MJ Leeming, *Jacobs' Law of Trusts in Australia* (8th ed, LexisNexis Butterworths, 2016), at [21.05]; and Ford & Lee *The Law of Trusts* (electronic service), at [14.1010] ff.

18 See *Commercial Trusts*, fn 3, at [3.74] – [3.78]. See also *The Law of Trusts,* fn 17, at [14.6310] ff. Of course, personal liability would still be an issue for beneficiaries if an indemnity were found to exist even if creditors did not or could not enforce it via subrogation, since the trustee may choose to enforce it.

partnership (as well as a trust). The point of contention in this regard is how and in what circumstances that might occur in any given case.[19]

4.5 The *indirect* risk may be quite easily addressed (and, in well-constructed commercial trusts, is invariably addressed) by expressly negating the personal indemnity in the trust instrument (usually, in unit trusts, subject to liability for uncalled capital, if any), something which is both effective and uncontroversial as a matter of trust law.

4.6 However, the *direct* risk is more problematic. A provision in the trust instrument would not normally suffice to eliminate that risk since a disclaimer of agency does not always survive conduct inconsistent with it and, in any case, any broader disclaimer of liability would not normally bind an external creditor of the trustee, absent something more (such as estoppel).[20] Rather, beneficiaries seeking protection would need to procure that the trustee obtains some form of express waiver or restraint from each and every external counterparty with which it deals, of any rights that party might otherwise have to pursue the beneficiaries personally, much as commercial trustees currently do in relation to their own personal liability beyond the value of the trust fund.[21] As a matter of practice, I am not aware that this is routinely done, even where commercial trusts are involved. Although I have no evidence to support this assertion beyond the anecdotal, it may be because the market apprehends, wrongly, that the negation of the personal indemnity is sufficient for all purposes.[22]

The solution and necessary exceptions to protect trustees and trust creditors

4.7 As a matter of principle, I am in favour of limiting personal liability of beneficiaries for trustee liabilities, and not just for commercial trusts. In my opinion, beneficiaries should not be automatic implicit guarantors of all trustee liabilities, despite Lord Lindley's exhortations in *Hardoon v Belilios* [1901] AC 118.[23] From there, it is tempting simply to equate the position of beneficiaries (particularly those that are unitholders in unit trusts) with that of shareholders and argue for statutory limited liability in all cases, in effect by enacting a trust equivalent of section 516 of the *Corporations Act* (as indeed is hinted at in the Terms of Reference).

4.8 But that would be overly simplistic. Trusts are, of course, fundamentally different creatures from companies and there are circumstances where it may be appropriate for some personal liability to fall on beneficiaries of full capacity in the interests of protecting trustees and trust creditors.[24] In relation to the latter in particular, it is worth bearing in

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19 See *Commercial Trusts*, fn 3, at [3.30] ff.

20 A trustee liability limitation provision in a trust deed has been held not to bind external parties: *Austrust Ltd v Astley* (1996) 67 SASR 207 at [32] (this aspect not affected on appeal to the High Court: *Astley v Austrust Ltd* (1999) 197 CLR 1).

21 As to which, see *Commercial Trusts*, fn 3, at [4.88]ff.

22 There are numerous ancillary issues associated with beneficiary liability (whether direct or indirect) that I do not traverse in this submission. For example, if a person is a beneficiary at the time an indemnifiable trustee liability arises, may they unilaterally relieve themselves of liability by the simple expedient of ceasing to be a beneficiary (eg by renouncing their interest or, in a unit trust, by redeeming or transferring of their units) or does the liability adhere to them beyond the trust? Does a person who becomes a later beneficiary under an existing trust thereby automatically acquire personal liability for all trustee liabilities extant at the time of becoming a beneficiary, as well as future ones? If a trustee is replaced, do the personal indemnity rights vest in the new trustee so that, once vested, the new trustee may pursue the beneficiaries for pre-incumbency trustee liabilities, or are those rights personal to the outgoing trustee? Is there a natural ordering as between the personal indemnity and the proprietary indemnity, ie must the trustee first exhaust the trust assets? These issues appear not to have been addressed definitively (or in some cases at all) in the authorities.

23 By which I mean primarily his Lordship's assertion 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' at 123. That statement seems more appropriate for agency arrangements rather than for trusts generally. In my respectful view, the ratio of *Hardoon v Belilios* should have been confined to its own quite specific facts. Instead, it seems to have been recruited over the years to support a much broader general principle for which it is only partial authority.

24 Even company law allows creditors to recover from shareholders in some circumstances, eg under the various heads of the corporate veil doctrine and (indirectly) under the statutory cognate in sections 588V-588W of the *Corporations Act*. Various elements of general corporate insolvency law principles can have a similar economic effect.

mind that, unlike company law, the protection of trust creditors is *not* an organising principle around which trust law is constructed (even after taking into account modifications effected by the *Trustee Act* and the *Corporations Act*). Trust law's preoccupation is with the relationship between trustee and beneficiary. It is almost entirely devoid of creditor protections and suffers from the absence of a coherent insolvency regime.[25] As a consequence, trust creditors are disadvantaged in ways that have no equivalents for creditors of corporations contracting as principal.[26]

4.9 Thus, it would be inappropriate to address the issue of beneficiary liability without also considering consequences and protections for trustees and trust creditors, particularly in circumstances of insolvency.[27]

4.10 I would suggest that any statutory limitation should contemplate exceptions at least in relation to the following (there may also be other circumstances worthy of consideration – the following is not intended to be exhaustive).

Exception 1: Where the trust instrument expressly provides

4.11 First and perhaps most obviously, there should be an exception for personal beneficiary liability where the trust instrument expressly preserves it. One obvious example is for uncalled capital on units in a unit trust, but framers of trust instruments may decide that there should be other circumstances in which beneficiaries carry some personal liability to give formal comfort to the trustee or trust creditors or both. For example, in security trusts for multi-lender financings and securitisations the deed invariably contains a range of personal indemnities by the financier beneficiaries in favour of the security trustee, particularly for enforcement costs and liabilities incurred in acting as security trustee (subject to exceptions for the security trustee's own fraud, gross negligence or wilful misconduct).

4.12 Configured in this way, the limitation coupled with this exception would in effect reverse the current position which, subject to some conflicting authorities, appears to be that an unlimited personal indemnity is available to the trustee against beneficiaries who are *sui juris* unless expressly negatived.

4.13 In this regard, see suggested section 69A(2)(a) in Schedule 3. In relation to trust creditors' rights of direct enforcement, see paragraph 4.66 and following below.

Exception 2: Voluntary assumption of liability

4.14 In commercial practice, when a financier or other counterparty deals with the trustee of a commercial trust with fully paid up capital I am not aware that they routinely take into account or rely on the creditworthiness of beneficiaries, on an understanding that they will be personally liable under general law; the assumption is usually to the contrary (even if there is no express negation of the indemnity in the trust instrument). The assessment is usually based on the financial state and creditworthiness of the fund as a standalone economic entity and of the trustee if it transacts on the basis of full personal liability. If the financial support of the beneficiaries is important in the credit assessment then the

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25 Arguably (i) the trust creditor's ability to subrogate to the trustee's indemnity against trust assets, (ii) the bona fide purchaser rule and (iii) the innocent outsider defences against accessorial liability claims by beneficiaries may be considered 'creditor protections' of a kind, but each of them is highly qualified and, in some senses, distinctly fragile, at least when compared to (very) approximate statutory equivalents for creditors of companies under the *Corporations Act*, eg sections 124-129 and, generally, the insolvency regime in Chapter 5.

26 See *Commercial Trusts*, fn 3, Chapter 5 'Legal Risks of the Trust Creditor' and, in relation to the insolvency of trusts, see Chapter 6 'The Commercial Trust in Insolvency' and N D'Angelo, 'The trust as a surrogate company: the challenge of insolvency' (2014) 8 *Journal of Equity* 299.

27 I do note that the Terms of Reference require the Commission to have regard to 'the need for safeguards to ensure that any legislation limiting or removing such liability does not support the avoidance of responsibility for insolvent trading'.

counterparty will usually deal with the issue directly, by bargaining for a guarantee or other contractual surety from the beneficiaries, operating as the economic equivalent of a shareholder guarantee for a company's indebtedness.

4.15 Thus, any statutory limitation should allow for situations where a beneficiary has agreed to personal liability, for example, by giving an indemnity to the trustee outside the terms of the trust instrument or a guarantee or other surety directly to a trust creditor.

4.16 In this regard, see suggested section 69A(2)(b) in Schedule 3. In relation to trust creditors' rights of direct enforcement, see paragraph 4.66 and following below.

Exceptions 3, 4 and 5: 'insolvent trusts'

4.17 It is something of a legal nonsense to speak of an 'insolvent trust' since a trust is not, of course, a legal person. Nevertheless, a trust can be economically insolvent in the sense that the trustee is unable to pay trust debts as and when they fall due out of trust assets and (where obliged) its personal assets. This is in effect a functional definition and it reflects that for companies in section 95A of the *Corporations Act*.[28]

4.18 The reference to 'and (where obliged) its personal assets' acknowledges the prima facie proposition that as a matter of law trustees are personally liable for all trust liabilities without limitation. So, even if the trust fund is inadequate when trust debts are due, the trust (as an economic entity) will remain solvent if and for so long as the trustee is able to satisfy them out of its own money. However trustees are permitted to limit their liability by contract if they are in a position to bargain for it. In relation to a given engagement the trustee and its counterparty may agree that the trustee's personal obligation is limited to the extent that it is able to satisfy the liability out of the trust fund, so that the counterparty rather than the trustee bears the risk of shortfall (usually subject to exceptions for certain types of trustee misconduct).[29] In this case, the counterparty's recourse in enforcement or insolvency is limited to a right to participate in only one fund of assets, ie the trust fund, while trust creditors who engage with a trustee on an unlimited liability basis may participate in two funds, ie the trust fund and the trustee's personal assets.

4.19 Among other consequences, limitation clauses can result in a 'solvent trustee/insolvent trust' scenario, ie where trust assets are inadequate to satisfy trust debts when due but because it has negotiated limitation clauses with all trust creditors, the trustee is not obliged to make up the shortfall out of personal assets, despite being financially capable of doing so.

4.20 Thus, my suggested definition of 'insolvent trust' addresses two scenarios:

(1) the trustee is unable to pay trust debts as and when they fall due out of trust property and, although remaining fully personally liable for the shortfall, the trustee is insolvent; and

(2) the trustee is unable to pay trust debts as and when they fall due out of trust property and the trustee, whether or not solvent, is not obliged to cover the shortfall personally.

4.21 What is the relevance of this? I do not suggest that beneficiaries should be liable for trust debts merely because a trust is insolvent when the debts are due, or even if the trust was insolvent when the debts were incurred. Trustees often conduct the activities of the trust

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[28] See the discussion in *Commercial Trusts*, fn 3, in and around [6.50]. See also the suggested definition in proposed new section 69E(1) of the *Trustee Act* in Schedule 3 of this submission.

[29] This is very common practice in Australian commerce among well-advised trustees: see fn 21. For a recent discussion, see *ALYK (HK) Ltd v Caprock Commodities Trading Pty Ltd* [2016] NSWSC 764.

without reference to or engagement with the beneficiaries, particularly in arm's length, widely-held commercial trusts. It may, however, be appropriate as a matter of trustee and trust creditor protection to consider personal liability where a beneficiary's conduct in or around trust insolvency demonstrates an unacceptable degree of culpability. Towards the more egregious end of the spectrum is the situation where a beneficiary controls a trustee of nominal worth and uses it as a cypher to incur liabilities that cannot be satisfied out of trust assets, or to impoverish the fund by distributing trust assets to themselves, but I do not suggest limiting liability to those scenarios only.

4.22 The argument in favour of preserving some personal beneficiary liability in trust insolvency is given additional force in relation to commercial trusts because:

(1) the usual protections afforded to creditors against transactions in insolvency in the *Corporations Act* (eg sections 197 and 588G) or at general law (eg the directors' duty to consider creditors' interests when a company is in an insolvency context) do not operate to protect trust creditors in a 'solvent trustee/insolvent trust' scenario, since they are predicated on the trustee, as a company, being insolvent or near insolvent;[30]

(2) in any case, the insolvency regime in Chapter 5 of the *Corporations Act*, which operates to protect creditors of corporations by according them certain privileges and preferential treatment over shareholders, does not operate particularly effectively in relation to trusts, trust creditors and beneficiaries, and there is no alternative regime that does;[31] and

(3) general law protections, such as they are, are inadequate.

4.23 The following exceptions address some of these concerns.

Exception 3: Liabilities incurred by a controlled trustee or at beneficiary's request or direction

4.24 There is a moral hazard inherent in allowing beneficiaries to shelter behind a trustee they control, or who will otherwise comply with their wishes, in either:

(1) having the trustee incur liabilities without ensuring that it will be in a position to satisfy them when due; or

(2) having the trustee pay amounts to third parties out of its own money without ensuring it may recoup the payment out of trust property to protect its personal balance sheet.

4.25 As Jessel MR observed *Re Johnson; Sherman v Robinson* (1880) 15 Ch D 548 in relation to a trading trust (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.

4.26 Personal liability for beneficiaries of full capacity consequent upon a request or direction is long established and pre-dates *Hardoon v Belilios*.[32] However, that liability is not limited

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30 See generally the *C&SLJ* article cited at fn 3.

31 See generally *Re Independent Contractor Services (Aust) Pty Ltd (in liq) (No 2)* [2016] NSWSC 106; *Woodgate, in the matter of Bell Hire Services Pty Ltd (in liq)* [2016] FCA 1583 at [36]; *Re Amerind Pty Ltd (recs and mgrs apptd) (in liq)* [2017] VSC 127 at [370]-[371]; *Kite v Mooney, in the matter of Mooney's Contractors Pty Ltd (in liq) (No 2)* [2017] FCA 653.

32 *Balsh v Hyham* 24 ER 810; (1728) 2 P Wms 453.

to the shortfall if the trustee cannot fully indemnity itself out of trust assets, or to circumstances where the trust assets are exhausted.[33]

4.27 Further, as mentioned in paragraph 4.4(2) above, personal liability may also fall on a beneficiary under basic agency principles if it controls a trustee and exerts that control to have the trustee incur a liability. That beneficiary liability too is not limited to any shortfall in trust assets.

4.28 There is a case for preserving personal beneficiary liability in both these situations but only if, at the time the trustee liability is due or paid, the trust is insolvent or the trustee is otherwise unable to be indemnified out of trust property - in other words, liability should not be automatic from the outset.

4.29 Once insolvency strikes, however, liability in these circumstances should be strict, ie it should arise regardless of the beneficiary's state of knowledge as to the solvency of the trust at any time or the trustee's ability to be indemnified out of trust property (*cf* Exceptions 4 and 5 discussed below). It should also operate regardless of any negativing of the indemnity in the instrument creating the trust. As a matter of trustee and trust creditor protection, the onus should be on the controlling/requesting/directing beneficiary to assure themselves that the trust fund will be able to support the liability to be incurred or paid.[34]

4.30 This exception also offers protection to any personal creditors of the trustee. The trustee's claim against the controlling/requesting/directing beneficiary in respect of a payment by the trustee out of its own resources of an amount that cannot be recouped out of trust assets will represent a personal asset of the trustee, available to its personal creditors in liquidation, and able to be enforced by its liquidator.

4.31 Diligent beneficiaries who are prepared to take protective steps before the trustee liability is incurred or paid should be given safe harbour. They ought to be immune from liability if, before that time, they received information from the trustee, or were otherwise in possession of information prepared by or for the trustee (eg if, say, the beneficiary is also a director or shareholder of the trustee), that satisfied them, and would have satisfied a reasonable person in their position, that the trust was and would remain solvent despite the trustee incurring or paying that liability, and that the trustee would be able to be indemnified out of trust property for it.

4.32 In this regard, see suggested section 69A(2)(c) and section 69B in Schedule 3. In relation to trust creditors' rights of direct enforcement, see paragraph 4.66 and following below.

Exception 4: Debts incurred when beneficiary knows of or suspects trust insolvency

4.33 There is also a case for imposing personal liability on a beneficiary directly in favour of an affected trust creditor for a trust debt (but not trustee liabilities more broadly) of an insolvent trust, even where the beneficiary has not procured, requested or directed the trustee to incur it, if:

(1) the debt was incurred when the trust was insolvent; and

(2) the beneficiary had actual knowledge or suspicion of that insolvency at that time; and

(3) the beneficiary had actual knowledge or suspicion that the trustee was to incur that debt before it was incurred; and

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33 *Balkin v Peck* (1998) 43 NSWLR 706.

34 The trustee protection aspect of the proposal would complement section 86 of the *Trustee Act* which protects trustees in limited circumstances by giving them the power to impound a beneficiary's interest (but not a personal indemnity claim) where the beneficiary has instigated or consented to a breach.

(4) the beneficiary had the legal right or practical ability (in any capacity) to prevent the trustee incurring that debt and failed to take all reasonable steps to exercise that right or ability.

4.34 Note that, unlike Exception 5 below, I do not suggest that liability in this situation should be engaged on the basis of objective tests for knowledge or suspicion or any form of deemed or constructive knowledge or suspicion. This scenario involves passive rather than active conduct and a somewhat lower degree of culpable behaviour than Exception 5 and so should have a higher threshold for knowledge of both the fact of insolvency and of the impending incurrence of the debt.[35]

4.35 Note the final requirement in relation to prevention (which echoes faintly section 588H(5) of the *Corporations Act*). It would be unfair to impose liability even in the presence of actual knowledge or suspicion, if the beneficiary could do nothing to stop the trustee from incurring the debt (or, to use *Corporations Act* language, from engaging in insolvent trading). For it to be culpable, passivity should include failing to exercise an available legal right or practical ability to prevent the trustee from incurring that debt. For example, a beneficiary may be a director of the trustee or have the legal right under the trust instrument or other arrangement to prevent the trustee incurring that debt.

4.36 Beneficiaries having a suspicion (but not actual knowledge) of insolvency or of the fact that the trustee is about to incur a debt in insolvency should be given safe harbour for diligence. It should be a defence to an action for liability based on actual suspicion if the beneficiary can show that they received information from the trustee, or were otherwise in possession of information prepared by or for the trustee (eg if the beneficiary is also a director of the trustee), that satisfied the beneficiary, and would have satisfied a reasonable person in the position of the beneficiary, that the suspicion was unfounded.

4.37 This exception should be framed so as to give the affected trust creditor direct rights against the beneficiary, rather than as an obligation to indemnify the trustee or otherwise pay the relevant amount into the trust fund, where it would be available for distribution among trust creditors generally (including those creditors who may have extended credit at a time when the trust was not insolvent). A payment by the beneficiary to the trust creditor should discharge correspondingly any obligation of the beneficiary to pay the trustee.

4.38 This proposed exception to statutory limited liability thus operates as a trust creditor protection mechanism by shifting the onus onto beneficiaries to prevent their trustee recklessly or fraudulently incurring trust debts while the trust is insolvent if they are possessed of both requisite knowledge and the ability to do so. It may be argued that it is not unreasonable to expect beneficiaries in those circumstances to supervise their trustee in this way; as between them (armed with that knowledge and ability) and 'outsiders' dealing with the trustee, the balance of responsibility is clearly against them.

4.39 It is worth remembering when considering beneficiaries' exposure under this exception that, if the suggested definition of insolvent trust is adopted, liability is not engaged even if trust assets are inadequate, if and for so long as the trustee is personally liable without limitation and is solvent.

4.40 In this regard, see suggested section 69A(2)(c) and section 69C in Schedule 3.

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[35] Incidentally, the coupling of knowledge and suspicion appears in section 128(4) of the *Corporations Act* in connection with whether a person dealing with a company is entitled to rely the statutory assumptions in section 129. For the purpose of that section they have been construed to mean *actual* knowledge or suspicion: see *Correa v Whittingham* [2013] NSWCA 263, where the NSW Court of Appeal also discussed the meaning of actual knowledge and actual suspicion in that context.

Exception 5: Insolvent trusts and impoverishment of the trust fund

4.41 I have recently examined certain cases where trustees impoverished their trust fund by distributing trust assets to the beneficiaries or transferring them to another trust for the same beneficiaries, with the effect of depriving trust creditors of recourse to those assets.[36] In each case, a beneficiary controlled the trustee and was the effective decision-maker behind the trustee's actions. My examination was for the purpose of exploring the liability of the trustee's directors. However, there is a related trust creditor protection question as to whether the beneficiaries should have any personal liability in those situations.

4.42 In *Ron Kingham Real Estate Pty Ltd v Edgar* [1999] 2 Qd R 439 the Queensland Court of Appeal upheld a claim made by trust creditors directly against beneficiaries to whom trust assets had been distributed, leaving the trust insolvent. The Court did not make clear whether it was doing so on the grounds of indirect liability via subrogation to the personal indemnity or direct liability on an unjust enrichment basis (although the decision is often cited as authority for the former). Clearly offended by the actions of the trustee (which was controlled by the beneficiaries), McPherson JA said, at 444:

> it is difficult to see why in the circumstances of this case the plaintiff [creditor] here should not be entitled to sue the beneficiaries directly. The defendants had notice of the plaintiff's claim at the time they arranged for the trust assets to be paid to themselves, and they enriched themselves at the expense of satisfying the plaintiff's claim against the trustee. It would plainly be against conscience for them to retain the proceeds of their conduct so as to defeat that claim. In equity they would be considered as constructive trustees of the assets received at least to the extent necessary to satisfy the trustee's liability.

4.43 Sentiments to similar effect were expressed in some of the other cases mentioned.

4.44 Unlike company law, trust law imposes very few constraints specifically on the distribution of assets out of the entity to beneficiaries (including by the redemption of units), leaving the regulation of that matter to the terms of the trust instrument. Again, because trust law pays relatively little regard to trust creditors, there is no doctrine of 'preservation of capital' for trusts, nor are there any inbuilt creditor protections like those in the capital reduction and dividend payment provisions of the *Corporations Act*.[37] There are limited (and somewhat vague) general law protections as described in the cases mentioned in footnote 36 and elsewhere but they cannot seriously be considered as equivalents of those statutory provisions.

4.45 There is an argument for excluding from any statutory limitation, and indeed expressly making a beneficiary personally liable to disgorge the value of distributions and transfers back into the trust fund (ie rather than to pay trust creditors directly), in situations where:

(1) the trust is insolvent; and

(2) any of the following occurred at a time when the trust was insolvent, or its occurrence caused the trust to become insolvent:

(a) the beneficiary received a distribution of trust property, whether of capital, income or any other character (including by way of a redemption of units, if the trust is a unit trust); or

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[36] See the *C&SLJ* article cited at fn 3. The cases are *Jeffree v National Companies and Securities Commission* [1990] WAR 183; *Ron Kingham Real Estate Pty Ltd v Edgar* [1999] 2 Qd R 439; *Hanel v O'Neill* [2003] SASC 409; and *Australasian Annuities Pty Ltd (in liq) (recs and mgrs apptd) v Rowley Super Fund Pty Ltd* [2015] VSCA 9.

[37] For example, a company may only buy back its own shares (section 257A) or otherwise reduce its capital (section 256B) if, among other things, that 'does not materially prejudice the company's ability to pay its creditors'. The same test applies in relation to the payment of dividends: section 254T. Even redeemable preference shares can only be redeemed out of profits or a new share issuance: section 254K. There are some limitations on the redemption of interests out of illiquid managed investment schemes in sections 601KA – 601KE of the *Corporations Act*.

(b) trust property was otherwise transferred to or to the benefit of the beneficiary or a relevant related person of the beneficiary, on non-arm's length terms;[38] and

(3) either:

(a) the distribution or transfer was procured by the beneficiary in an exercise of its control of the trustee; or

(b) at the time of the distribution or transfer, there were reasonable grounds for suspecting that the trust was insolvent, or would so become insolvent, and the beneficiary was aware at the time of the distribution or transfer that there were such grounds for so suspecting or a reasonable person in a like position would have been so aware.

4.46 Note the bifurcation in the third element. The position I have taken with this exception is that if the beneficiary controls the trustee and procures the distribution or transfer to themselves or a related person then liability should be strict, ie knowledge or suspicion of insolvency should be irrelevant. The onus should be on the controlling beneficiary to satisfy themselves that the trust is not insolvent and that the proposed action will not leave it insolvent.

4.47 In all other situations, culpability turns on subjective and objective tests for suspicion of insolvency, which you will note echo section 588G of the *Corporations Act* which imposes personal liability on directors for insolvent trading. That being so, it might be appropriate to consider whether beneficiaries should enjoy the benefit of defences corresponding to sections 588H(2), (3) and/or (5) of the Act (but only where they do not control the trustee).[39]

4.48 You will also note two essential differences in this formulation from that in Exception 4:

(1) first, Exception 4 requires actual (ie subjective) knowledge or suspicion of insolvency. In non-control situations this Exception 5 implies both subjective and objective elements and so is engaged by a wider range of culpability (although I do not go so far as to suggest the full range of first limb *Barnes v Addy* 'knowledge'[40]). In the contest between beneficiaries and trust creditors in the winding up of an insolvent trust, it is not unreasonable to expect beneficiaries to disgorge where they have received trust property with requisite suspicion or culpable indifference as to the trust's insolvent circumstances; and

(2) secondly, while Exception 4 is constructed to give the affected trust creditor direct rights against the beneficiary, this Exception 5 represents an obligation on the beneficiary to return the value of tainted distributions or transfers (plus interest or any accretion in value) to the trust fund for distribution among all trust creditors in the ordinary course of the winding up of the trust. It operates, in effect, as an

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38 The concept of *relevant related person* would need to be defined. Guidance could be taken from the definition of 'related entity' in section 9 of the *Corporations Act,* and should, as an anti-avoidance measure, contemplate beneficiaries that are corporations, trustees, in partnerships and natural persons.

39 Note that this proposal is intended to be quite separate and distinct from the statutory protection against alienation of property with intent to defraud creditors: see s37A of the *Conveyancing Act 1919* (NSW). Granted, that statue is to be interpreted liberally so as to achieve its intended purpose such that there need not be actual proof the alienator had in his or her mind an intention to defraud creditors, or that that was the alienator's predominant or sole intention: *Marcolongo v Chen* (2011) 242 CLR 546. Nevertheless, the question of intention should be entirely irrelevant in these circumstances. It is the outcome that is important, when coupled with control or culpable knowledge of or indifference as to trust insolvency by the beneficiary (being the person to be deprived of property), regardless of the intent of either the trustee or beneficiary around the distribution or transfer.

40 As to which, see *Farah Constructions Pty Ltd v Say-Dee Pty Ltd* [2007] HCA 22 at [178] and *Grimaldi v Chameleon Mining NL (No 2)* [2012] FCAFC 6 at [268].

insolvency claw-back or disgorgement so as to recapitalise the fund. If the trustee (or its insolvency official, if one is appointed) refuses or is unable to enforce the obligation, any affected trust creditor should be entitled to apply to the Court for an order compelling the beneficiary to make that payment into the fund: see paragraph 4.66 and following below.

4.49 Among other things, this exception gives trust creditors an avenue of recourse in the 'solvent trustee/insolvent trust' scenario where the *Corporations Act* does not assist and the trustee's conduct is not of a type that would engage any disapplication provisions in its limitation clause such as would give the trust creditor access to the trustee's personal assets (since typically those disapplication provisions do not include trust insolvency as such, and it might be difficult as an evidentiary matter to prove fraud).[41]

4.50 It also gives trust creditors protection in circumstances where section 197 of the *Corporations Act*, which is ostensibly designed to hold directors liable for trust debts in certain situations, does not operate.[42]

4.51 As with Exception 4, it is worth remembering when considering beneficiaries' exposure under this exception that, if the suggested definition of insolvent trust is adopted, a beneficiary will not be liable even if trust assets are inadequate, if and for so long as the trustee is personally liable without limitation and is solvent.

4.52 In this regard, see suggested sections 69A(2)(c) and 69D in Schedule 3.

Which debts?

4.53 You will note that in this submission (and in the suggested legislation in Schedule 3) I have drawn a distinction between *trustee liabilities* and *trust debts*.

4.54 It is settled law that trustees may only indemnify themselves out of trust assets if the relevant debts are properly incurred, ie within power, for proper purposes and not otherwise in breach of trust.[43] Arguably, the same applies in relation to any personal indemnity, although that position is not as clearly stated in the authorities.

4.55 In my view, any statutory protection against liability ought not be limited to debts that are properly incurred by the trustee. Liability (where warranted), and protection against liability, should not depend on whether the trustee has acted properly in incurring a given trustee liability. Indeed, it may be argued that, subject to the exceptions described above, the need for a limitation is more exigent when the trustee's proprietary indemnity is impaired or unavailable since unpaid trust creditors may be inclined to pursue alternative sources of recovery.

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41 The courts will not allow limitation of liability clauses to be used as a cloak for fraud: *McLean v Burns Philp Trustee Co Pty Ltd* (1985) 2 NSWLR 623 at 641. Contractual disapplication provisions in trustee limitation of liability clauses are usually stated to be triggered by trustee conduct in the nature of fraud, breach of trust, acts beyond trustee power and some other matters (sometimes including gross negligence) but not usually mere insolvency. Incidentally, and although outside the scope of the Terms of Reference, there is a case for statutory reform in relation to trustee liability limitation clauses in this regard. It may be appropriate for liability limitations to be disapplied for insolvent trading, adopting *Corporations Act* section 588G-style criteria. For example, by statute, liability limitations should be deemed to fall away so that unlimited personal liability is preserved or restored if (a) the trust is insolvent at that time the trustee incurs a trust debt or it becomes insolvent by the trustee incurring that debt; and (b) at that time, there are reasonable grounds for suspecting that the trust is insolvent; and (c) the trustee is aware that there are such grounds for so suspecting or a reasonable person in their position would be so aware (possibly subject to certain section 588H-style defences). While this would represent a radical departure from current market practice, it would be justifiable on the basis that the knowledge elements require a degree of culpability of the trustee.

42 Somewhat surprisingly, despite being a creditor protection measure, section 197 does not protect against deliberate impoverishment of the trust fund: see the *C&SLJ* article cited at fn 3, at 90.

43 See the discussion in *Commercial Trusts*, fn 3, at [4.51] ff.

4.56 However, I distinguish beneficiary liability in the insolvency context described in Exception 4. There, liability should be limited to trust debts rather than trustee liabilities more broadly; in the insolvency of a trust the beneficiaries should not underwrite liabilities not properly incurred as trust debts. Although not expressed as such, the value disgorged by culpable beneficiaries under Exception 5 will also only be applied to satisfy trust debts by normal operation of trust law.

4.57 Of course, it is important to ensure that any statutory limitation applies not only to contract debts of the trustee but also debts owed to involuntary trust creditors, such as tort claimants, revenue authorities and other statutory creditors.[44] My suggested definitions of *trustee liabilities* and *trust debts* in section 69E in Schedule 3 would embrace them.

Which beneficiaries?

4.58 Some authorities have held that the implied personal indemnity only burdens beneficiaries who, in addition to being of full capacity, are absolutely entitled, although there is some question as to the status of a beneficiary entitled to a limited interest like a life estate.[45] In any case, it seems clear enough that there is no implied indemnity against the beneficiaries of a discretionary trust.[46]

4.59 Having said that, I do not believe the distinction is relevant for the purposes of the various submissions above. Naturally, the prima facie exclusion of liability should apply to all beneficiaries: see suggested section 69A(1) of the *Trustee Act* in Schedule 3. Apart from preserving anything expressed in the trust instrument (section 69A(2)(a)), personal liability under each exception suggested above is engaged by some positive act or culpable knowledge, indifference or passivity on the part of the beneficiary. That should apply regardless of the entitlement status of the beneficiary involved.

4.60 Finally, where an exception is proposed so that a beneficiary is to be liable, it would be appropriate to limit liability only to those beneficiaries who are of full capacity. I suggest going even further and limiting liability to those who were of full capacity at both the time the relevant trustee liability was incurred as well as when personal liability fixes on them under the proposed new provisions. That avoids the situation where a trustee liability was incurred at, say, a time when a beneficiary was a minor but by the time the statutory liability fixes (eg due to trust insolvency), he or she has attained majority: see suggested section 69A(3) in Schedule 3.

Beneficiaries who are also trustees or directors of trustees

4.61 It is not uncommon for a beneficiary also to be the trustee or one of several trustees, or a director or other officer of a trustee that is a corporation.[47] I do not support a general proposition that the statutory protection against personal beneficiary liability should be forfeited merely because a beneficiary is also a trustee or an officer of a trustee. In any case, where the trustee is a corporation and is insolvent, sections 197 and 588G of the *Corporations Act* will have a role to play in imposing liability on beneficiaries who are directors.

4.62 However, it is important to acknowledge the possibility of this 'dual capacity' and its potential effect on questions of liability where relevant. Some of the exceptions to limited liability described above contain knowledge, suspicion or awareness tests for liability and

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44 Although there is an issue around how a limitation in the *Trustee Act* would or should interact with state and commonwealth revenue statutes and other laws that might *expressly* impose liability on beneficiaries, either at first instance or as a fall-back if the trustee fails to pay. I have not addressed that in this submission.

45 *Balkin v Peck* (1998) 43 NSWLR 706.

46 *Jacobs on Trusts*, fn 17, at [21.05].

47 But, of course, a trust cannot exist if the sole beneficiary is also the sole trustee. I use 'officer' in the sense defined in section 9 of the *Corporations Act*.

defences to liability. To avoid complications arising from arguments around capacity, it might be appropriate to make clear that these tests should apply regardless of how and in what capacity the beneficiary acquired the relevant knowledge, suspicion or awareness, including as a trustee or an officer of a trustee.

4.63 A similar point applies in relation to the exceptions that involve a test of a reasonable person in the position of the beneficiary. There, the position of the beneficiary should include all relevant positions and capacities (including as trustee or as an officer of the trustee).

4.64 Finally, and again by way of acknowledging different capacities, liability imposed on a beneficiary by operation of these new provisions should be in addition to and should not otherwise affect or constitute a defence against any potential liability of that person in any other capacity (including as trustee or as an officer of the trustee), so long as they are not made liable to pay more than the total amount of any given liability.

4.65 In this regard, see suggested sections 69A(4) and 69E(2) in Schedule 3.

Direct enforcement by trust creditors

4.66 If beneficiary liability is accepted in the situations described in the exceptions above, then as a corollary (and where the proposed provision does otherwise not give trust creditors direct rights, eg Exception 4 and section 69C), in order to give trust creditors the full measure of protection there is a case for providing them with mechanism for pursuing beneficiaries directly where the trustee is unable or unwilling to do so - which may happen if the trustee is controlled by the beneficiaries or is in insolvent administration. The current state of the law in relation to whether trust creditors may subrogate to a trustee's personal claim against beneficiaries (as opposed to the trustee's indemnity out of trust assets) is highly uncertain and unsatisfactory.[48]

4.67 In the regime I propose, where an exception (other than Exception 4) applies and for any reason the trustee does not or cannot enforce the beneficiary's indemnity or other payment obligation in its favour:

(1) if the beneficiary's obligation relates to a specific trustee liability, then the affected trust creditor should be able to bypass the trustee and sue the beneficiary for it directly, as a debt due to the trust creditor (ie rather than to oblige the beneficiary to make the payment to the trustee or into the trust fund so as to be available to all trust creditors). The payment to the trust creditor would discharge correspondingly any obligation of the beneficiary to pay the trustee; but

(2) if the beneficiary's obligation is to pay an amount into the trust fund (eg a call on unpaid capital on units) or is a general indemnity in favour of the trustee in relation to all trustee liabilities, which in either case is to the benefit all trust creditors, then any affected trust creditor should be able to apply to the Court for an order obliging the beneficiary to make that payment, even though it is to be paid into the fund or to the trustee and not to that trust creditor directly.

4.68 In doing this, legislation would, of course, need to protect any claim the indemnifying beneficiary may have against the trustee, another beneficiary or any other person, including for breach of trust, contribution, indemnity or set off.

4.69 In this regard, see suggested section 69A(5) - (7) in Schedule 3.

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[48] See fn 18 above.

I would be happy to discuss further any of the above. I may be contacted using the details shown below.

Yours sincerely

Nuncio D'Angelo

Tel (direct): [redacted]
Mobile: [redacted]
Email: [redacted]

SCHEDULE 1

Terms of reference

Review of laws relating to beneficiaries of trusts

Pursuant to section 10 of the *Law Reform Commission Act 1967*, the NSW Law Reform Commission is asked to review certain aspects of the law of trusts in NSW and report on whether:

- there is a need to enact statutory provisions to limit the circumstances if any in which the beneficiaries of trusts, as beneficiaries, should be liable to indemnify the trustee or creditors of the trust, if the trustee fails to satisfy obligations of the trust, or remove such liability
- it is appropriate for the liability of investors in unit trusts to be limited to the amount (if any) unpaid on their units in the same way that the liability of investors in shares is limited to the amount (if any) unpaid on their shares.

As part of this review, the Commission is to have regard to:

- the perceived uncertainty of the case law on the liability of trust beneficiaries in New South Wales and elsewhere
- the widespread use of trusts in commercial contexts as well as in the community generally
- the need for safeguards to ensure that any legislation limiting or removing such liability does not support the avoidance of responsibility for insolvent trading.

The Commission is also asked:

- to propose the terms in which any legislation should be enacted, and
- to consult and report on whether New South Wales should adopt the recommendations of the Report, *Trading Trusts - Oppression Remedies*, January 2015, of the Victorian Law Reform Commission.

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SCHEDULE 2

Extract from N D'Angelo, 'Commercial trusts in practice: the trust as a surrogate company', *Annual Commercial and Corporate Law Conference* (Supreme Court of New South Wales, Sydney, 15 November 2016).

The trust is the chassis of choice for registered and unregistered MIS [*ie managed investment schemes*], listed and unlisted property vehicles, infrastructure projects, managed funds, hedge funds, mortgage funds, and agribusiness schemes.

Of course, the trading trust is a ubiquitous feature of small and medium business in this country.[49]

Not all of these have a public presence so statistics are naturally thin.

ASIC informs us that, as at June 2015, there were about 3,600 registered MIS.[50]

Australian Taxation Office statistics for the fiscal year to June 2014 (the most recent available) show that 802,000 trusts lodged tax returns declaring total income of $345 billion.[51]

That compares to:

- 763,000 companies lodging returns (declaring income of $2.7 trillion); and
- 344,000 partnerships lodging returns (declaring income of $148 billion)

That is, there are more tax returning trusts than companies or partnerships.

Let us turn to the ASX. At the end of September 2016 the market capitalisation of listed AREITs (ie Australian real estate investment trusts) and infrastructure funds was over $200 billion, of which $137 billion was in real estate and $67 billion in infrastructure.[52]

To that, we may add several tens of billions of dollars in listed equities funds.

Of course, that says nothing of unlisted entities, of which we know there are many, including quite large, widely-held ones, managed by immediately recognisable names like Macquarie, AMP, Challenger, Charter Hall and others.

While it is impossible to verify with certainty due to the lack of publicly available hard data, it is not unreasonable to postulate, based on the evidence and experience, that most large-scale commercial, industrial, office and retail real estate, as well as many significant infrastructure assets, in Australia are held in or through listed or unlisted trusts. By infrastructure, I include:

- toll roads[53]
- airports[54]

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49 Not all are unit trusts; many smaller arrangements, particularly when family businesses are involved, are constructed as discretionary trusts.

50 *ASIC Annual Report 2014-15*, page 167. Not all would be unit trusts - some are contractually based - but experience tells me that many and perhaps most are. The arc of growth of the public unit trust and, since 1998, the managed investment scheme is well documented: see 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); G Moodie and I Ramsay, *Managed Investment Schemes: An Industry Report* (Centre for Corporate Law and Securities Regulation, The University of Melbourne, 2003); 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; Alan Jessup, *Managed Investment Schemes* (Federation Press, 2011).

51 ATO Taxation Statistics 2014-15 (https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics-2013-14/?anchor=Trusts#Trusts). Not all of those would be trusts of the type that are the focus of this paper but again it would be fair to surmise that many are. Although trusts must lodge returns and declare their income, as discussed below they do not pay tax on that income as entities so long as they comply with certain requirements.

52 ASX Funds (Listed Managed Investments, mFunds and ETPs) Monthly Update, September 2016 (http://www.asx.com.au/documents/products/ASX_Funds_Monthly_Update_-_Sep_16.pdf).

53 For example, Transurban Group (ASX:TCL).

- utilities, including power lines and oil and gas pipelines[55]
- renewable energy projects
- rail and other transport assets
- hospitals and prisons
- ports and docks

Most of our listed property entities, household names like Lendlease (ASX:LLC), DEXUS Property Group (ASX:DXS), GPT Group (ASX:GPT), Stockland (ASX:SGP) and others, are actually trusts, usually stapled to an operating company.[56]

Clearly, in the Darwinian tussle between the different entity options available to the Australian market, the trust is more than holding its own.

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54 For example, Sydney Airport Trust (ASX:SYD).

55 For example, Spark Infrastructure Trust (ASX:SKI), Australian Pipeline Trust (ASX: APA), DUET Group (ASX:DUE) and AusNet Services (ASX:AST).

56 The expressions 'stapling' and 'stapled securities' evoke an earlier time when shares, units and other securities were certificated. A stapled entity typically comprises a trust (which holds the passive income earning assets) and a company (which conducts the active functions, including management) where each unit in the trust is 'stapled' to a share in the company for trading purposes so that they trade as if a single security. Securityholders receive payments that comprise (untaxed) distributions from the trust and (taxed and franked) dividends from the company. DEXUS is an exception in that it comprises a 4-trust staple.

SCHEDULE 3

Proposed new Part 2A of the *Trustee Act 1925* (NSW)

PART 2A BENEFICIARIES [*]

69A Limitation of liability of beneficiaries

General limitation of liability

(1) No beneficiary of a trust is liable to indemnify or otherwise make a payment to the trustee or any third party in connection with a trustee liability except as provided in this Part 2A.

Exceptions

(2) A beneficiary may be so liable only if and to the extent:

(a) expressly provided in the instrument (if any) governing the trust; or

(b) the beneficiary has agreed to be so liable; or

(c) section 69B, section 69C or section 69D applies.

Beneficiary must be of full capacity

(3) (a) Except in relation to section 69D, a beneficiary may only be liable under this Part 2A if they are of full capacity both at the time the relevant trustee liability is incurred and at the time liability is imposed on them by operation of this Part 2A.

(b) A beneficiary may only be liable under section 69D if they are of full capacity both at the time a distribution or transfer of trust property contemplated by section 69D(1)(b) becomes effective and at the time liability is imposed on them by operation of that section.

Beneficiary liable in other capacities

(4) Liability of a beneficiary by operation of this Part 2A is in addition to and does not reduce or otherwise affect or constitute a defence against any liability of that person in any other capacity (including as a trustee of the trust or, where a trustee is a corporation, as an officer of the trustee) but where liability relates to a specific trustee liability they cannot be made to pay more than the total amount of that liability.

Third party rights

(5) Except in the circumstances contemplated by section 69A(6), if:

(a) a beneficiary is liable by operation of section 69A(2) to indemnify or otherwise make a payment to the trustee in respect of a specific trustee liability; and

(b) the beneficiary has not fully satisfied that indemnity or payment obligation; and

(c) the trustee liability is due and payable but has not been fully satisfied,

the third party to whom that trustee liability is owed may recover it (but only to the extent not paid by the beneficiary to the trustee) directly from the beneficiary as a debt due to the third party by that beneficiary, without having to subrogate to the trustee's indemnity or other right of payment and without having to join the trustee to any proceedings.

(6) Where:

(a) a beneficiary's liability under section 69A(2) (including by operation of section 69D) is to pay an amount to the trustee as a contribution to the trust fund or by way of indemnity in favour of the trustee for trustee liabilities generally, rather than to

[*] Some terms used in this Part are given a defined meaning in section 69E below.

indemnify or otherwise make a payment to the trustee in respect of a specific trustee liability; and

(b) for any reason the trustee does not or cannot enforce that liability,

then any affected third party may apply to the Court for an order compelling the beneficiary to make that payment.

(7) Payment by a beneficiary to a third party under section 69A(5) or section 69C discharges correspondingly any obligation of the beneficiary to indemnify or otherwise make a payment to the trustee in respect of the relevant trustee liability but does not prejudice any right or claim that beneficiary may have against the trustee, another beneficiary or any other person, including for breach of trust, contribution, indemnity or set off.

69B Trustee liabilities incurred by controlled trustee or at beneficiary's request or direction

(1) Without limiting section 86, a beneficiary is liable to indemnify the trustee in respect of a trustee liability if and to the extent it was incurred, suffered or paid by the trustee:

(a) as a consequence of an exercise by the beneficiary of control of the trustee; or

(b) at the request or direction of that beneficiary (as beneficiary)

and, at the time it is due for payment or is paid, either:

(c) the trustee is unable to be indemnified fully out of trust property in respect of that trustee liability for any reason; or

(d) the trust is insolvent.

(2) The beneficiary is so liable regardless of:

(a) whether in incurring, suffering or paying the trustee liability the trustee breached the trust; or

(b) whether the trust was solvent or insolvent at the time the trustee liability was incurred, suffered or paid by the trustee; or

(c) any person's state of knowledge concerning the solvency of the trust at any time or the trustee's ability to be indemnified out of trust property.

(3) If two or more beneficiaries performed the actions contemplated in section 69B(1)(a) or (b) in relation to a particular trustee liability, they are liable jointly and severally.

(4) It is a defence under this section 69B if it is proven that, before the trustee liability was incurred, suffered or paid by the trustee, the beneficiary received information from the trustee, or was otherwise in possession of information prepared by or for the trustee, that satisfied the beneficiary, and would have satisfied a reasonable person in the position of the beneficiary, that:

(a) the trust was solvent before, and would remain solvent despite, the trustee incurring or paying that trustee liability; and

(b) the trustee would be able to be indemnified fully out of trust property for that trustee liability.

69C Trust debts incurred with actual knowledge or suspicion of trust insolvency

(1) A third party may recover a trust debt from a beneficiary of a trust, as a debt due to it by that beneficiary, if:

(a) the trust is insolvent; and

(b) the trust was insolvent at the time the trust debt was incurred; and

(c) the beneficiary had actual knowledge or suspicion of that insolvency at the time the trust debt was incurred; and

(d) the beneficiary had actual knowledge or suspicion that the trustee was to incur that trust debt before it was incurred; and

(e) the beneficiary had the legal right or practical ability (in any capacity) to prevent the trustee incurring that debt and failed to take all reasonable steps to exercise that right or ability.

(2) If two or more beneficiaries satisfy the criteria in section 69C(1)(c), (d) and (e) in relation to a particular trust debt, they are liable jointly and severally.

(3) It is a defence to an allegation of actual suspicion (but not actual knowledge) of a matter described in section 69C(1)(c) or (d) if it is proven that the beneficiary received information from the trustee, or was otherwise in possession of information prepared by or for the trustee, that satisfied the beneficiary, and would have satisfied a reasonable person in the position of the beneficiary, that the suspicion was unfounded.

69D Recovery of distributions and transfers made when trust insolvent

(1) A beneficiary is liable to pay to the trustee the amount calculated in accordance with section 69D(4) if:

(a) the trust is insolvent; and

(b) any of the following occurred at a time when the trust was insolvent, or its occurrence caused the trust to become insolvent:

(i) trust property, whether in the nature of capital, income or any of other character, is distributed to the beneficiary (including by way of a redemption of a unit, if the trust is a unit trust); or

(ii) trust property is transferred:

(A) to the beneficiary other than by way of a distribution; or

(B) to a relevant related person of the beneficiary; or

(C) to another person wholly or partly for the benefit of the beneficiary or a relevant related person of the beneficiary,

on terms that would not be reasonable in the circumstances if the trustee and the transferee were dealing at arm's length; and

(c) either:

(i) the distribution or transfer occurred as a consequence of an exercise by the beneficiary of control of the trustee; or

(ii) at the time of the distribution or transfer there were reasonable grounds for suspecting that the trust was insolvent, or would so become insolvent, as the case may be, and either:

(A) the beneficiary was aware at the time of the distribution or transfer that there were such grounds for so suspecting; or

(B) a reasonable person in the position of the beneficiary would have been so aware.

(2) Except where section 69D(1)(c)(i) applies, it is a defence under this section 69D if it is proven that [*consider including defences corresponding to sections 588H(2), (3) and/or (5) of the Corporations Act*]

(3) The rights of a trustee under this section 69D and amounts recovered from a beneficiary under it, including following an order obtained by an affected third party under section 69A(4), are held by the trustee as trust property.

(4) The amount that may be recovered from a beneficiary under this section 69D is calculated as follows:

(a) if trust property the subject of a distribution or transfer described in section 69D(1)(b) was an amount of money, that amount of money plus interest on that amount from the date of distribution or transfer to the date of payment to the trustee (both included) at the pre-judgement rate prescribed from time to time for the purposes of section 100 of the *Civil Procedure Act 2005*; and

(b) if trust property the subject of a distribution or transfer described in section 69D(1)(b) was other than money, the greater of the arm's length unencumbered value of that property as at the date of the distribution or transfer and its arm's length unencumbered value at the date of payment to the trustee (regardless of whether the beneficiary enjoys the benefit of that property at that date).

69E Interpretation and defined terms

(1) In the interpretation of this Part 2A:

(a) a beneficiary of a trust ***controls*** a trustee of that trust if the beneficiary has the capacity to determine the trustee's decisions as trustee of that trust. In determining whether a beneficiary has that capacity the practical influence the beneficiary can exert (rather than the rights it can enforce) is the issue to be considered, and any practice or pattern of behaviour affecting the trustee's decisions is to be taken into account (even if it involves breaches of agreements or breaches of trust);[57]

(b) ***officer*** has the meaning given in section 9 of the *Corporations Act 2001* (Cth);

(c) ***relevant related person***, in relation to a beneficiary, means [*guidance could be taken from the definition of 'related entity' in section 9 of the Corporations Act, and would need to contemplate beneficiaries that are corporations, trustees, in partnerships and natural persons*];

(d) a trust is taken to be ***solvent*** at any time if the trustee is able at that time to pay trust debts as and when they become due and payable out of trust property and (where obliged) its personal property. A trust that is not taken to be solvent is taken to be ***insolvent***;

(e) a ***third party*** is a person other than a trust party to or in favour of whom a trustee is obliged in respect of a trustee liability;[58]

(f) a debt of a trustee is a ***trust debt*** of a trust if it is owed to a person other than a trust party and the trustee is entitled to apply trust property of that trust to pay it (even if it is also obliged to pay it out of its own property), disregarding for this purpose any application of the clear accounts rule;[59] and

(g) a ***trust party***, in relation to a trust, means a person who is a settlor, a trustee, an executor, a protector, an appointor or a beneficiary of that trust, each in that capacity;

(h) a ***trustee liability*** is a debt, liability, obligation, claim or expense incurred, suffered or paid by a trustee, ostensibly or purportedly in its capacity as trustee, to or in favour of a person other than a trust party, regardless of whether the trustee is entitled to apply trust property to pay or satisfy it. It includes but is not limited to a trust debt.

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57 Some elements of this are taken from the definition of 'control' in section 50AA of the *Corporations Act*.

58 I have chosen to use the expression 'third party' because it may not be appropriate in every case to describe an obligee as a 'creditor'. This definition would include employees of the trustee (as trustee)

59 The clear accounts rule is disregarded because that rule operates to diminish the trustee's aggregate claim against the trust fund in relation to all trust debts but does not change the status of any specific debt as a trust debt: see *Commercial Trusts*, fn 3, at [4.75] – [4.80].

(2) In this Part 2A:

(a) a reference to the knowledge, suspicion or awareness of a beneficiary of any matter includes knowledge, suspicion or awareness acquired by the beneficiary in any manner or capacity; and

(b) a reference to a reasonable person in the position of a beneficiary includes a reference to all relevant positions and capacities of the beneficiary,

including, in each case, as a trust party of the trust or, where a trustee is a corporation, as a shareholder, employee or officer of the trustee.

69F Application

This Part 2A applies in respect of trusts created either before or after [*the commencement date*] and, except where section 69A(2)(a) operates, applies regardless of any contrary intention expressed in the instrument (if any) governing the trust.

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