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[redacted]

2 February 2018

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Chair, Deputy Chair and Commissioners

Review of laws relating to beneficiaries of trusts
Consultation Paper 19
Second Submission

I make this submission in response to *Consultation Paper 19*, published by the Commission on 31 October 2017 and displayed on the Commission's website.

This follows my preliminary submission of 29 June 2017, also displayed on the Commission's website (numbered PBE3).

As with my preliminary submission, I write 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 any person or organisation with whom or which I am associated.

My preliminary submission was detailed and I do not repeat any of it here. I continue to hold the views expressed in it, although I respectfully note the differing positions taken by the authors of some of the other preliminary submissions.

I would add the following. My focus is primarily on the proposal to limit beneficiary liability rather than the proposed oppression remedy but some of the arguments will apply to both.

1 The narrow scope of the Terms of Reference – should NSW be doing this?

1.1 Almost all of the preliminary submissions (including mine) lamented the narrowness of scope of the Terms of Reference. However, several went on to argue that NSW should not be pursuing these changes alone, or that *ad hoc* or piecemeal change limited to beneficiary liability and an oppression remedy is undesirable, or both. In summary, the themes seemed to be that, ideally, reform:

(1) should be undertaken on a national basis; and

(2) should encompass a comprehensive review of trust law as a whole to address, in a balanced and policy-driven way, the material issues facing all of those who participate in, or deal with, trusts (particularly trading trusts and managed investment schemes), including not only beneficiaries but also creditors and trustees.[1]

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1 A third theme also emerged, ie that not all trusts are the same nor can they all be compared to companies, and it is inappropriate to generalise. I do not disagree with that proposition but the point could be accommodated in any reforms with appropriately drafted exceptions where it was decided as a matter of policy that beneficiaries of certain kinds of trusts should not enjoy the benefit of the reforms (although I am not unappreciative of the definitional challenges that might involve).

1.2 No one can sensibly argue against those propositions, as a matter of principle. In particular, arguments for the examination and reform of the many issues affecting trust creditors have been agitated for several decades in various forums.[2] As others have noted, beneficiaries' rights and liabilities are not unconnected to those of trust creditors; the allocation of assets and losses in a collapsed trust as between those two classes of participant is largely a zero sum game. Between them sits the trustee, for whom the balance and mix of duties, powers, liabilities and defences is also in need of reform. This is so particularly for those that manage commercial trusts, in respect of whom it may reasonably be argued that the formula should be closer to that applying to company directors than to Victorian era trustees of gratuitous family trusts.

1.3 When considering reform, there is of course much merit in addressing all of these issues together, and on an Australia-wide basis.

1.4 But perfection should not be allowed to become the enemy of the good. I do not support the implicit proposition that nothing should be done unless and until the Commonwealth, the States and the Territories are aligned and ready to act together to produce some sort of comprehensive national trust law reform 'code' that deals with all of the issues. I am not aware of a current timetable for any such action, or even a serious proposal for it; trust law reform does not appear to be a high priority among our legislators.

1.5 In any case, the issues are capable of reform severally as well as jointly. Reform with respect to discrete issues like those discussed in the Terms of Reference, if done properly, does not foreclose the possibility of later reform in other areas.

2 The persistent failure of the law reform process

2.1 The history of proposed reform in this area does not generate confidence that an opportunity for national comprehensive reform will arise any time soon. Indeed, it is not unfair to say that the process over decades has proven disappointingly infertile. Official calls for reform in relation to trading trusts can be traced back at least as far as the Harmer Report of 1988.[3] Well over a dozen law reform reports and discussion papers since then (and even some before then) have considered issues in various degrees, to very little effect. *Consultation Paper 19* itself records some of these failures with respect to the issue of limiting beneficiary liability, at [2.15] – [2.18].

2.2 Even on the rare occasion when reform has been enacted, it has often misfired or miscarried.

2.3 For example, trusts really only feature twice in the *Corporations Act*: Chapter 5C in relation to trusts that are managed investment schemes and section 197 in relation to personal liability for directors of corporate trustees. Both have their infelicities.

2.4 Chapter 5C, most of the content of which was originally enacted in 1998 ostensibly to better regulate, among other things, the use of trusts to raise money from the public, is manifestly defective in several fundamental respects - even apart from the absence of statutory limited liability for investors, itself a somewhat surprising omission for a regime that is plainly about investor protection.[4] Progress on further reform of the law of managed

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[2] Because they are outside the Terms of Reference I do not discuss here the many issues facing trust creditors but a literature review will unearth numerous journal articles, conference papers and law reform reports exploring them. Some of the issues are discussed in Chapter 4 of my book, *Commercial Trusts* (LexisNexis Butterworths, 2014).

[3] Australian Law Reform Commission, *General Insolvency Inquiry* (Report No 45, 1988). In fact, the late Professor Harold Ford raised the alarm 7 years earlier, memorably labelling trading trusts as 'commercial monstrosities' in 'Trading Trusts and Creditors' Rights' (1981) 13 *Melbourne University Law Review* 1, and not long afterwards exposed specifically the potential for beneficiary liability in HAJ Ford and IJ Hardingham, 'Trading Trusts: Rights and Liabilities of Beneficiaries' in PD Finn (ed), *Equity and Commercial Relationships* (Law Book Co, 1987), at 75-82.

[4] For example, the regime is devoid of basic creditor protections that, frankly, should be essential for entities that are otherwise permitted to carry on business as surrogate companies. It contains no 'innocent outsider' indoor management assumptions for creditors and other counterparties who deal with them (*cf* Part 2B.2 of the Act for those dealing with companies) and, inexplicably, has no regime for dealing with insolvency. In any case, Chapter 5C regulates only about 3,600 registered entities (see *ASIC Annual Report 2016-17* at p182), not all of which would be structured as trusts anyway, while the most recently available ATO figures indicate that over 800,000 trusts file returns declaring business income: see *ATO Taxation Statistics 2014-15*.

investment schemes appears to have been cauterised, at least for the time being, by the unexpected abolition of CAMAC by the Commonwealth Government in 2014. Although the functions of CAMAC were said at the time of abolition to have been transferred to Commonwealth Treasury, there has been no announcement by Treasury about these reforms since, nor is CAMAC's work on managed investment schemes even mentioned on Treasury's website.[5]

2.5 The issues around the various iterations of section 197 of the *Corporations Act* (whose predecessor was enacted in 1985) are notorious and well documented.[6]

3 The role of the courts

3.1 The persistent failure of law reform in this area has left numerous challenges 'to the ingenuity of the Courts and the general law to solve', to quote Chief Justice Bathurst.[7] With great respect to both our Courts and our highly ductile general law (and, of course, to his Honour), in some instances it has proven to be beyond the Courts to do this satisfactorily. Decisions at both State and Federal levels have produced divergent lines of authority on a range of important issues, particularly in circumstances of insolvency, leaving the market in a state of ongoing uncertainty and leading to expensive litigation[8] (not to mention a minor explosion in academic and practitioner literature).

3.2 I fear that a similar outcome might result if the issues around beneficiary liability were litigated today, given the various uncertainties in the current state of the law and the diverse range of trusts within which the issue could arise.[9] In any case, in a modern market economy like Australia, where the use of trusts is so widespread and the wealth held within them so vast, it is hardly ideal to leave the resolution of those uncertainties to the vagaries of an unguided process of case-by-case private dispute resolution between self-interested actors involving difficult factual matrices, in different State and Federal Courts.

4 The Commission *should* make positive recommendations – with two provisos

4.1 If an opportunity for statutory reform presents itself, even if within a narrow ambit, I say it should be taken. Waiting for co-ordinated and comprehensive national action on trust law will only perpetuate the status quo, indefinitely; incremental improvement is better than none, if done properly.

4.2 Law reform, like politics, is the art of the possible.

4.3 Thus, despite the limited scope of the Terms of Reference, I urge the Commission to make positive recommendations for reform, along the lines described in my preliminary submission (as improved by the suggestions of others), *provided that*:

(1) to the maximum extent possible, potential unintended consequences, including effects on persons other than beneficiaries, are exposed in the consultation process and dealt with in any recommendations made by the Commission;[10] and

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5 CAMAC's abolition came after it had produced a very useful Discussion Paper (June 2011) and Report (July 2012) on *Managed Investment Schemes*, and while it was receiving submissions on its Discussion Paper on *Establishment and Operation of Managed Investment Schemes* (March 2014). At the time of writing, these papers were still accessible on CAMAC's website: http://www.camac.gov.au.

6 See the discussion in L Thai, 'Recent amendment to section 197 - is it acceptable?' (2006) 14 *Insolvency Law Journal* 22. For the history of the section, see J Cooper, 'Piercing the "veil of obscurity" - the decision in Hanel v O'Neill' (2004) 22 *Companies & Securities Law Journal* 313. For a recent treatment, see N D'Angelo, 'Directors of insolvent trustees and trusts: duties and liabilities in respect of beneficiaries and trust creditors' (2017) 35 *Company & Securities Law Journal* 75.

7 The Hon TF Bathurst AC, Chief Justice of NSW, speaking of the insolvency of trusts, in 'The Historical Development of Insolvency Law', paper delivered to the Francis Forbes Society for Australian Legal History, Sydney, 3 September 2014, at [97], subsequently published as (2014) 39 *Australian Bar Rev*iew 113.

8 Including an increase in the number of applications by trustees in doubt for judicial advice under section 63 of the *Trustee Act 1925* (NSW) and equivalents elsewhere, and by insolvency officials of corporate trustees under the approximate cognates in section 424 and the former sections 479(3) and 511 of the *Corporations Act* (now see sections 45-1, 90-15 and 90-20 of Schedule 2 of the Act).

9 Some of these uncertainties are mentioned in paragraph 4.4 and footnote 22 of my preliminary submission.

10 Caution about unintended consequences is implied by the Terms of Reference and acknowledged in *Consultation Paper 19*: see [2.25]-[2.27]. In my preliminary submission I sought (including in the draft legislation that was reproduced in Appendix B of *Consultation Paper 19*) to achieve a measure of balance between them. Of course I do not say that I have addressed the entire universe of possibilities.

(2) in its final report the Commission expressly notes aspects of trust law that were raised in the consultation process as being in need of attention but are outside the scope of the Terms of Reference, particularly those affecting trust creditors. This could serve as a signpost to a further, more comprehensive review and an implicit invitation to the Attorney General to commission one (or, preferably, to consult with counterparts in other jurisdictions with a view to a national reference to the Australian Law Reform Commission or a specific national body set up for the purpose).

4.4 There is some hope that the Commission's efforts might catalyse the broader discussion. Change in NSW may encourage other jurisdictions to consider reform. Pressure may be applied via market forces as those adopting the trust as their commercial or investment vehicle increasingly choose the law of NSW as the governing law of their documentation, to take advantage of the additional benefits available to investors.

5 Applicability to trusts that are managed investment schemes

5.1 And, on this point, why shouldn't any reforms undertaken by NSW unilaterally as a result of this Review extend to trusts that are managed investment schemes, where the parties have chosen NSW law as the governing law of the scheme constitution? After all, where constructed as trusts, schemes are formed under State/Territory law and not the *Corporations Act*. Chapter 5C is not and does not purport to be an exclusive regulatory code for schemes but rather acts as an overriding overlay when engaged. The Act expressly states that it operates concurrently with State and Territory laws except to the extent of any inconsistency: see section 5E. I may stand to be corrected by constitutional law experts, but am not aware of anything in Chapter 5C or elsewhere in the *Corporations Act* that would be inconsistent in the relevant sense with provisions in the NSW *Trustee Act* that limit investors' liability or offer them a statutory oppression remedy, so as to override those provisions under constitutional law principles.[11]

5.2 That being so, then after enacting the reforms the law of NSW would almost certainly become the governing law of choice for trusts that are managed investment schemes, since among other things promoters could then confidently offer limited liability to intending investors in their marketing. If that were to cause disquiet or embarrassment in other States and the Territories (or, indeed, at Commonwealth level), that could add momentum to the movement for national reform. While inter-jurisdictional competition based on statutory laws is nowhere near as prevalent or obvious here as it is in, for example, the United States, it can serve a useful purpose in pursuit of the greater good.

6 A final note: the importance of market expectations

6.1 Finally, in the context of beneficiary liability, I wish to offer some observations about the importance of market expectations, in the hope that they are given due weight in the calculus of the reform process.

6.2 The existence of market expectations that are at odds with the law is not, in and of itself, necessarily a reason to change the law; a legitimate response could be better education and disclosure. But the questions posed in the Terms of Reference (ie whether 'there is *a need* to enact statutory provisions' to limit beneficiary liability and whether 'it is *appropriate* for the liability of investors in unit trusts to be limited') bring market expectations fairly into play. When I speak of 'expectations' I mean not simply what parties think the law provides; rather, because of the significant change over time in the role of trusts in our system, as noted in the Terms of Reference, I include also the economic outcomes that participants in trusts expect them to deliver. Not many legal institutions have undergone greater and more radical change in usage and application than the trust. Its use today as a form of a surrogate company for risk-taking entrepreneurial endeavour is a permutation for

[11] In any case, if a decision were made to extend the benefit of any reforms to investors in managed investment schemes, the 'excluded matters' regime in section 5F of the *Corporations Act* could be utilised, as is noted in *Consultation Paper 19* at [2.20].

which trust law was never designed and which it is patently ill-equipped to properly regulate.[12] And yet its similarity in that configuration to the *Corporations Act* company has generated certain expectations about legal and economic outcomes, including investor liability.

6.3 As long ago as 1984 the Companies and Securities Law Review Committee wrote to the Commonwealth Ministerial Council suggesting a legislative amendment to limit the liability of unit holders in public unit trusts, pointing out that

> the investing public sees the purchase of units in a public unit trust as analogous to the purchase of shares in a limited liability company *and generally assumes that the limited liability that attaches to shares in such companies applies equally to units*.[13]

6.4 In *Cachia v Westpac Financial Services Ltd* [2000] FCA 161 the Federal Court noted, at [86], that 'in a commercial sense, ownership of units in a trust may be similar to ownership of shares in a company'. More recently, the learned authors of the latest edition of *Jacobs on Trusts* observe that '[f]rom an investor's commercial point of view, owning units in a unit trust serves the same function as owning shares in a company'.[14] Others have contended that 'the securities market still tends to equate an interest in a unit trust with a share'.[15]

6.5 Shares in companies and units in trusts are listed and traded on the ASX as 'securities' largely without distinction, despite having materially different profiles when it comes to security holder liability.

6.6 The similarity between units and shares is of course not accidental. Over time investors have been encouraged to regard companies and unit trusts, and therefore shares and units, as functionally interchangeable (subject to certain differences in accounting and taxation treatment), even though they are fundamentally different in the eyes of the law.

6.7 The rights and obligations attaching to shares are largely determined by the *Corporations Act* (and, of course, the company's constitution, if it has one). Their legal nature is settled and well understood. By contrast, the unitisation of the beneficial interest in a trust admits of an almost infinite array of possible combinations when it comes to the rights and obligations attaching to units.[16] There being no applicable governing statute like the *Corporations Act*, units are entirely a private construct, a product of the trust instrument and related documents, as affected by applicable law.[17] When promoters (via their trustee) issue units they are creating, through documentation, tradeable securities that deliberately mimic shares in most essential characteristics, while avoiding the strictures of the corporate form.

6.8 However, despite the inclusion of increasingly intricate disclaimers in some trust instruments, a feature they cannot successfully mimic by private means is true universal limited liability for holders, since that can only be achieved by statute. The law extends that privilege to those who invest in *Corporations Act* companies but not to those who invest in trusts, even if they are registered managed investment schemes.

6.9 Is this any better understood by investors today than when the Companies and Securities Law Review Committee wrote to the Ministerial Council in 1984? *Consultation Paper 19*

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12 An argument that I most recently prosecuted in 'The trust as a surrogate company: the challenge of insolvency' (2014) 8 *Journal of Equity* 299.

13 Emphasis added. This letter is referenced in the Turnbull report to the Australian Government, entitled *Review of the Managed Investments Act 1998* (December 2001).

14 JD Heydon and MJ Leeming, *Jacobs' Law of Trusts in Australia* (8th ed, LexisNexis Butterworths Australia, 2016), at [3-12].

15 PW Young, C Croft and ML Smith, *On Equity* (Lawbook Co, 2009) at 433.

16 Consider, for example, the fascinating hybrid sometimes described as a 'discretionary unit trust': see SA Hinchliffe, 'A horse is a horse - of course?: The 'discretionary' unit trust - More than meets the eye' (2012) 6 *Journal of Equity* 208, and the *ElecNet* litigation cited in the next footnote.

17 As the Federal Court noted in *Cachia v Westpac Financial Services*, 'The rights and obligations of … unitholders are not to be determined by reference to company law principles, but rather by the terms of the trust deed, and the law of trusts', at [87]. Numerous cases, usually but not always in a tax or stamp duty context, have considered the nature of a unit. For a recent discussion, see the *ElecNet* litigation, particularly *Commissioner of Taxation v ElecNet (Aust) Pty Ltd (Trustee)* [2015] FCAFC 178 (Full Federal Court) and *ElecNet (Aust) Pty Ltd v Commissioner of Taxation* [2016] HCA 51 (High Court).

acknowledges at [2.14] that there may be an assumption or general expectation among non-expert investors in public unit trusts that they do enjoy limited liability. I would argue that this assumption or expectation does exist and indeed extends to beneficiaries of other trusts, from private family settlements and trading trusts[18] through to substantial managed investment schemes, and even superannuation funds.[19]

6.10 In *Causley v Countryside (No 3) Pty Limited* [1996] NSWCA 394 the NSW Court of Appeal dealt with a claim by a trustee against its unit holders for personal indemnification in circumstances where trust liabilities exceeded trust assets. The trust instrument was silent on the matter of unit holder indemnity. The unit holders resisted the trustee's claim, arguing that they had invested on the assumption or expectation that there was no such indemnity. In a judgment notable for its brevity and bluntness, Cole JA (Clarke and Beazley JJA agreeing) dismissed that argument and affirmed the decision below in favour of the trustee. As harsh a result as that may have been for the apparently unsuspecting investors, it was an unsurprising outcome as a matter of doctrine.

6.11 But of course the market is not comprised solely (or even mostly) of experts in trust law doctrine, nor are investors routinely advised by such experts.

6.12 Anyone arguing for no change to the current position, or no change unless and until it comprises part of a comprehensive national trust law reform package, should consider the following questions:

(1) Do investors in trusts and managed investment schemes generally know that there are circumstances in which they may be personally liable for up to the entire excess of trust liabilities over trust assets on insolvency?

(2) Are those who were at least sufficiently well-informed to have satisfied themselves of the existence of a liability exclusion in the trust instrument before investing likely to be aware that those provisions, no matter how well drafted, do not and cannot provide complete protection?

(3) Would they have invested if they had known of these risks?

(4) Do current pricing models for investments in trusts and managed investment schemes properly take these risks into account and, if not, how would they be affected if they did? Does their current pricing offer a fair return on a risk:reward basis after factoring in the potential for unlimited personal liability?

(5) In an age where investor protection laws, and the regulators who enforce them, place great emphasis on information and disclosure, can it be said with confidence that the market (and I do not just mean the market for listed securities) is well enough informed in relation to these matters?[20]

(6) In any case, is this an appropriate risk to be left solely to disclosure?[21]

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[18] Tony Slater QC has observed, wryly, that the trading trust with a corporate trustee 'provid[es] at least the impression of limited liability': see AH Slater, 'Amendment of trust instruments' (2009) 32 *Australian Bar Review* 301, at 301. An internet search of the marketing and advice material available on the sites of many Australian law and accounting firms and other small business advisers demonstrates the pervasiveness of this 'impression'.

[19] Former NSW Court of Appeal Justice and now Adjunct Professor Joe Campbell noted in a recent article that '[t]here seems to be some variation in practice about whether the rules of [superannuation] funds exclude the personal indemnity of members to indemnify the trustee. Many members would be horrified to know that they had any such liability': JC Campbell, 'Some aspects of the civil liability arising from breach of duty by a superannuation trustee' (2017) 44 *Australian Bar Review* 24, at footnote 68 on page 42. As many would know, superannuation funds have of late expanded their risk profile by themselves becoming significant equity investors in trust-based infrastructure and other projects and have even begun taking on credit risk through the making of substantial commercial loans.

[20] A review of publicly available product disclosure statements for equity investments in trust-based entities shows that, on the whole and with few exceptions, discussion of these issues is either entirely absent or quite inadequate. Some shelter behind a mysterious fig leaf like 'the liability of investors is limited (*subject to the law*)'. In some examples, they are simply wrong insofar as they provide an unqualified assurance of limited liability, based solely on the existence of an exclusion clause in the trust instrument.

[21] While not involving a call on a beneficiary indemnity, the facts of the BrisConnections debacle are apposite in demonstrating the limitations of disclosure made at the time of initial public offering. Disclosure on issue did not protect many retail investors who later acquired BrisConnections units on the ASX from the unexpected shock of having to pay two additional $1 instalments per unit when the entity collapsed in 2008-09. Reports at the time catalogued numerous stories of retail

6.13 I have conducted no empirical research and so cannot answer these questions myself. However, I have some years' experience in practice. And I know from experience that investors - not just retail and foreign investors, but also some professional and sophisticated domestic investors - are often surprised when advised that there is no statutorily assured limited liability when they invest equity in trust-based vehicles and/or that documentary exclusion clauses do not provide complete protection.

6.14 Having said all that, I hasten to add that I am conscious that the Review is not limited to consideration of the position of investors in *unit trusts*. Apropos which, as I said in paragraph [4.8] of my preliminary submission, I do not support the enactment of a specific section 516 *Corporations Act* equivalent, as hinted at in the Terms of Reference. That is a narrow and overly simplistic solution, at least without also bringing across equivalents to the various exceptions to it in the *Corporations Act* and the common law, and the trade-offs, concessions and other compensatory benefits extended by the Act to creditors because of it, for which trust law offers no equivalents. Any change should operate to benefit all beneficiaries of all trusts, subject to policy-based exceptions. The draft legislation I proposed in my preliminary submission and which is reproduced in Appendix B of *Consultation Paper 19* is not limited to unit trusts and seeks to protect investors in those trusts without being specific in that regard.

7 Conclusion

7.1 Beneficiary liability is not a mere technical or theoretical risk. Trust creditors who are left unsatisfied out of trust assets and are faced with an impecunious trustee, or one who enjoys the prophylaxis of contractual limitations on its personal liability, are likely to investigate other avenues of recovery. Now that the issue of beneficiary liability has been revivified by this Review, attention will be directed accordingly. It is not at all beyond imagination that a factual matrix may present itself in relation to a collapsed trust where the creditors are advised that, based on the current state of the law, there are reasonable prospects of success in an action against the investor beneficiaries directly (via agency principles) or indirectly (via the trustee's personal indemnity).

7.2 That, of course, may also have knock-on effects on promoters and professional advisers (and, possibly, even regulators) who may not have warned investors of that possibility at the time they invested.

Yours sincerely

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investors who had purchased large numbers of these securities for a fraction of a cent each, unaware that they were burdened with this liability, with the result that investments of a mere several thousand dollars lumbered unwitting investors with multi-million dollar liabilities. Many simply defaulted: see http://www.smh.com.au/business/why-brisconnections-has-courted-battle-with-unit-holders-20090327-9eca.html.