Submission to NSW Law Reform Commission Concerning Beneficiaries of Trusts

The conclusions to which this submission argues are:

1. There should be a statutory amendment, applicable to all trusts (or perhaps all trusts except those that fall within (2)), which has the effect that being a beneficiary of a trust is not a sufficient reason to impose a personal obligation on the beneficiary, but can be part of the reason why such an obligation is imposed.
2. The liability of investors in some unit trusts, but not all unit trusts, should be limited to the amount (if any) unpaid on their units.
3. Legislation should exclude the personal liability to indemnify of members of a regulated superannuation fund, other than a self-managed fund.
4. There is no need to have any additional legislation directed to the circumstances in which beneficiaries of the trust, as beneficiaries, are liable to indemnify creditors of the trust.
5. Any changes to legislation to give effect to (1) can be made by State legislation. The legislative changes in (2) and (3) should be made by Commonwealth legislation, not by legislation of any State or Territory. The need for legislative change is such that New South Wales should strongly urge the Commonwealth to consider the introduction of that legislation.
6. New South Wales should not adopt the recommendations of the Victorian Law Reform commission ("VLRC") concerning oppression.

The Nature of the Trustee's Personal Right of Indemnity

Any consideration of amending the beneficiary's personal obligation to indemnify the trustee should bear in mind that trusts are a product of the law of equity, and the obligation to indemnify is part of the law of equity. At the risk of stating what is well known, the conceptual structure of the law of equity is one that involves the recognition of, and competition between, equities. Each equity is a *claim*, of a type recognised by equitable principle, concerning whether the court should grant some particular type of remedy. Some equities are ones asserted by a plaintiff[1] as the basis for seeking relief, others are ones asserted by a defendant[2] and are claims that the court should refuse or modify the relief that the plaintiff claims. The relief, if any, that the court ultimately grants depends on the interaction of the various equities that the litigants assert. A plaintiff's equity results in the court actually granting the remedy that the plaintiff claims only if the plaintiff's equity is not neutralised or modified by some countervailing or competing equity.

A "rule" of equity operates in a fundamentally different way to a statutory rule. A rule of equity says that in certain factual circumstances there is a prima facie claim concerning a particular remedy. A rule of equity invoked by a plaintiff identifies the type of factual circumstances that can be sufficient for the court to grant the remedy. If a plaintiff establishes that the factual circumstances identified in a rule of equity exist, the onus shifts to the defendant to establish a competing equity. The equity that a litigant actually asserts frequently arises from not only the factual circumstances that are stated in a rule of equity, but also from additional factual circumstances.

[1] Including in that expression a cross-claimant
[2] Including in that expression a cross-defendant

According to Lord Lindley in *Hardoon v Belilios,* there is an equitable rule that a beneficiary who is *sui juris* and absolutely entitled to an equitable interest in an item of property should indemnify the trustee for a liability that the trustee incurred in the course of acting as trustee of that property. The leading authorities explain this rule in language appropriate to the right to indemnity being an equity that the trustee has – and thus something that could be defeated by a better equity – rather than an absolute right. Lord Lindley in *Hardoon v Belilios*[3] said:

> "The plainest principles of justice require that the cestui que trust who gets all the benefit of the property should bear its burden *unless he can shew some good reason why his trustee should bear them himself*. The obligation is equitable and not legal, ...".

The way McGarvie J put it in *JW Broomhead (Vic) Pty Ltd (in liq) v JW Broomhead Pty Ltd* ("*Broomhead*")[4] was:

> "The basis of the principle is that the beneficiary who gets the benefit of the trust should bear its burdens *unless he can show some good reason why his trustee should bear the burdens himself*."[5]

It is possible to give some examples of circumstances sufficient to defeat or restrict the equity of a trustee to be indemnified by a beneficiary who is *sui juris* and absolutely entitled. The right can be removed by agreement between trustee and beneficiary, or negated or restricted by the terms of the trust deed. A trustee would not have a right of indemnity for liabilities concerning which it had acted in breach of trust, or for liabilities that were illegal or contrary to public policy. There is the imprecise category of cases where the nature of the relationship between trustee and beneficiary is such that there is no right of indemnity at all[6]. Equitable defences of laches or unclean hands or release could defeat the trustee's equity. There might be an estoppel against enforcing the right. A right of set-off might exist. However it is impossible to be confident of giving a complete list of circumstances in which a court would ultimately not order such a beneficiary to indemnify the trustee.

Sometimes a person who is the beneficiary of a trust comes to have an obligation to indemnify the trustee concerning a particular liability for a reason that does not depend on the fact that the beneficiary is a beneficiary. This can happen if, for example, the trustee is also the agent of the beneficiary[7] and incurs the liability in the course of the agency, if the liability is incurred at the

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[3] {1901} AC 119 at 123; emphasis added

[4] [1985] VR 891 at 936,(1985) 9 ACLR 593 at 635 (emphasis added). This quotation from *Broomhead* was referred to with approval in *Causley v Countryside (No 3) Pty Ltd* [1996] NSWCA 97 at 3 per Cole JA (Clarke and Beazley JJA agreeing), by Gleeson JA in *Chief Commissioner of State Revenue v CCM Holdings Trust Pty Ltd* [2014] NSWCA 42 at [62], and in numerous other cases.

[5] There is a slight difference between the formulations of Lord Lindley and of McGarvie J. Lord Lindley spoke of a cestui que trust "who gets all the befit of the [trust] property", while McGarvie J spoke of a beneficiary "who gets all the benefit of the trust". The differences arise because Lord Lindley was dealing with a trust of a single item of property for a single beneficiary, while McGarvie J was dealing with a unit trust which had several unitholders. The difference is not material for present purposes.

[6] Eg the unincorporated social club (*Wise v Perpetual Trustee Co Ltd* [1903] AC 139), but not the "club" that was in effect a cooperative buying group (*Cockerell v Aucompte* (1857) 2 CBNS 440, 140 ER 489). The situation where a provision in the trust deed, or a particular contract between trustee and beneficiary, has precluded any right of personal indemnity, could be seen as falling into this category.

[7] *Rankin v Palmer* (1912) 16 CLR 285

request of the beneficiary[8], or if the beneficiary has contracted to indemnify the trustee. This list of circumstances where an obligation to indemnify might arise from circumstances other than being a beneficiary is not necessarily complete.

The Commission's Criteria for Decision

The Commission should articulate the criteria it uses in deciding whether or not to recommend any change to the existing law. I suggest that whether there should be a change to the existing law should depend in part on whether the way the existing law operates is fair to those involved in the transactions that are immediately affected by it – beneficiaries, trustees, and creditors of the trustee concerning trust matters. As well it should depend on whether the existing law creates legal structures that interfere with, or that promote, desirable social objectives. Those social objectives include promoting commercial activity, protecting rights of property, enabling the various systems of taxation to operate in a coherent and fair way, and enabling the reasonable expectations of people involved in transactions that are affected by the law to be fulfilled.

In the time for preparation of this submission before the lodgement deadline I have not had time to give any detailed consideration to the second class of consideration. However nothing immediately occurs to me as a reason why those types of consideration would lead to a different conclusion to the one that this submission derives from considering fairness to the people immediately affected by the transaction.

Fairness between Trustee and Beneficiary

Where the test for beneficiary liability should be modified

In a situation like that in *Hardoon v Belilios* the justification for a personal obligation of the beneficiary to indemnify is clear. The trust in question was a bare trust of shares, in relation to which the plaintiff trustee had no power (either legal or equitable) of disposing of the trust property – the shares in question were registered in the plaintiff's name, but the defendant beneficiary held the share certificate, and a signed blank transfer[21]. Further, the defendant had first taken a security interest in the shares in question, then fortified its equitable rights by taking possession of the share certificate and blank transfer. The trustee's liability in question – an obligation to pay calls on partly paid shares - was a liability that arose as an incident of ownership of the trust property, and without any decision of the trustee to impose it. The contingent liability to pay a call, when and if made, already attached to the shares at the time the trustee acquired them, and at the time the defendant acquired its rights in them. The defendant paid the first three instalments of the call, but declined to pay the fourth. Before the fourth instalment was payable the plaintiff had requested the defendant to take a transfer of the shares, but the defendant refused. Lord Lindley placed some reliance on

[8] For reasons similar to those why a guarantor has an obligation to indemnify the principal debtor. But see text at footnote 33 below.

this, saying that the defendant "thereby compelled the plaintiff to continue to hold them as his trustee."[9] Elementary fairness required that the beneficiary should bear the liability to pay the call.

Similarly, in a situation like that in *Balkin v Peck*[10] the justification for the existence of a right of indemnity is clear. Under the original terms of a trust deed the beneficiary was a donee of an interest in remainder in English real estate. The liability in question – an obligation to pay an English tax – arose without any decision on the part of the trustee, as a consequence of the death of the life tenant. The trustee paid the proceeds of sale to the beneficiary without deducting the tax. If the trustee had realised that it had an obligation to pay the English tax it would have been entitled, in exercise of its right of indemnity from the trust property, to deduct the amount of that tax before paying the rest of the net proceeds to the beneficiary. No issue was raised that the trustee had encouraged the beneficiary to believe that the entire amount distributed was at the beneficiary's free disposal (which might possibly have given rise to an estoppel against seeking indemnity). Again, elementary fairness required that the beneficiary should bear the liability, rather than the trustee.

Both of these cases illustrate the way in which the plaintiff's equity to seek indemnity from a beneficiary can arise in factual situation where there is more than a bare relationship of trustee and beneficiary[11]. One needs to consider a simpler situation to decide whether the rule of equity that Lord Lindley articulated is a fair one.

The justification for the right of indemnity is not so clear when the liability arises from an exercise of judgment by the trustee to enter a particular transaction, and the beneficiary has not requested that the trustee do so, and has not acquiesced with knowledge in the trustee doing so. If the trustee is not using its powers bona fide for the purpose for which they were conferred, or not exercising the degree of care that the law requires of a trustee, entering the transaction would be a breach of trust concerning which no equity of indemnity would arise. However, if the trustee is exercising its powers bona fide for the purpose for which they were conferred, and exercising the appropriate degree of care, a choice must be made about which of two parties, neither of which is at fault, should bear the loss. One aid to making that choice is to consider some factual scenarios.

Consider the situation where the beneficiary comes to hold an absolute interest in some trust property upon attaining 18, and almost immediately is called on to indemnify the trustee for a large liability that the trustee has incurred. It seems unfair that a liability could be imposed on such a person, just because he or she was a beneficiary, and regardless of whether he or she even knew of his beneficial interest or of the incurring of the liability.

In that situation the law about disclaimer of trust interests can prevent a liability being imposed on the beneficiary. Until a person finds out that he or she is a beneficiary, and finds out enough about

[9] p 127
[10] (1998) 43 NSWLR 706
[11] Similarly in *Broomhead* the liability arose in a situation where there was far more than a simple relationship of trustee and beneficiary. The liabilities in question were incurred in the course of the trustee running a business. The trustee was a company, the officers and shareholders of which were closely connected with the five men who either were, or controlled, those beneficiaries who were held liable to indemnify. Those men had both instigated the setting up of the trustee, and had been intimately involved in the operation of the business in which the liabilities were incurred.

the trust to be able to make an informed decision about whether he or she wants to keep the trust interest (with any liabilities that attach to it) he or she retains a right to disclaim. In *Broomhead* Lynette Wood had no liability to indemnify when she did not know that she was a beneficiary at the time the liabilities in question were incurred[12], and disclaimed her interest promptly after finding out that she had it.

But the law about disclaimer does not provide a panacea for all potential problems of fairness as between trustee and beneficiary. Disclaimer of a trust interest becomes impossible with the lapse of time after the beneficiary has found out about being entitled to the beneficial interest[13]. Consider the situation where a beneficiary knows that he or she has a beneficial interest, and has happily accepted trust distributions from time to time. A liability that the trustee has incurred, without committing any breach of trust, but without any knowledge on the part of the beneficiary, then comes home, and is larger than can be met from the trust property. It is far from clear that it is fairer for the beneficiary to bear the liability rather than the trustee. `

I suggest that there is no reason why the bare fact of being the donee of an equitable interest in an item of property, with nothing else, should impose on the donee an obligation to bear liabilities any greater than the value of the property that is the subject of the gift. To go back to equity's original touchstone of obligations of conscience, there is no reason why being the donee of a piece of property imposes on the donee any obligation of conscience to bear obligations any greater than the value of the property itself. If A has been given a piece of property on terms that it is to be administered by B, and in the course of administering it B incurs liabilities, it is not hard to see that it could be contrary to conscience for A to insist on keeping the property and leaving B to bear the liabilities himself. However, it would take more than merely being a beneficiary to generate any obligation of conscience for A to indemnify B against any liabilities that exceeded the value of the property.

As well, it is the trustee who has either incurred the liability through his or her own actions, or, concerning those liabilities that arise as an incident of holding a particular type of property as trust property, has placed himself or herself at risk by agreeing to become trustee of a trust that includes that type of property. It is an inherent feature of a trust that the liabilities that attach to the trust property are liabilities of the trustee. By contrast no action of the beneficiary has contributed to the incurring of the liability.

The equitable rule that Lord Lindley stated in *Hardoon* was much wider than was needed for the decision of the case itself. The process by which case-law develops is that a judge adopts or formulates a rule that is sufficient to decide the particular case before him or her, and is consistent with the previous case law. However, when tested against a different set of facts, the rule that the judge has stated might be shown to be too wide, or in need of qualification. Statements of a rule by a judge are not treated as though they are the words of a statute, and are always read bearing in mind the context in which they were made[14]. I suggest that when one considers a fact scenario in

[12] P 932
[13] See the discussion of disclaimer in *Broomhead* at 930 - 934
[14] The Latin slogan that lawyers have used for centuries to express this concept is *secundum subjectam materiam*. In *Quinn v Leathem* [1901] AC 495 at 506 Earl of Halsbury LC said: " … every judgment must be read

which a beneficiary has no connection whatever with a trust other than being a beneficiary, one can see that Lord Lindley did indeed state the rule too widely in *Hardoon*. Other cases that have adopted the rule as stated by Lord Lindley have been ones in which there was more to the relationship between the trustee and the beneficiary than the bare relationship of trustee and beneficiary. In all of them there has been some active involvement of the beneficiary in the establishment or operation of the trust, in a way that has had a causal relationship to the incurring of the liability concerning which the indemnity is sought to be enforced. While I have not done an exhaustive search of the case law, I am not aware of a case in which there has been a bare relationship of trustee and beneficiary, and nothing more, and the beneficiary has been held to have an obligation to indemnify the trustee against liabilities incurred as trustee[15].

It is not as though the fact that the beneficiary gets the benefit of the trust property is regarded, even by Lord Lindley, as an all-powerful reason for imposing personal liability on the beneficiary. He accepts that in circumstances where the beneficiary is not *sui juris,* or has only a limited interest in the trust property, no right of indemnity arises. Beneficiaries who are not *sui juris*, or who have only a limited interest in the trust property, have the benefit of the trustee's acting as trustee every bit as much as do those beneficiaries who are *sui juris* and have an absolute interest. Yet those beneficiaries, according to Lord Lindley, have no personal obligation of indemnity.

If Lord Lindley is right, if a trustee of settled property incurs a liability the remainderman is not liable to indemnify the trustee concerning it. Yet once the life tenant dies, and the remainderman becomes absolutely entitled, an obligation to indemnify arises. This seems to be quite arbitrary.

The argument that simply because the beneficiary has the benefit of the trust property he must accept all the liabilities that arise from it has a close similarity to the supposed "principle of pure benefit and burden"[16], whereby the person who takes the benefit of a transaction should bear its burdens. Yet the Victorian Full Court has held that there is no rule of law to that effect[17].

I suggest that, if the present judge-made law were to be understood and applied correctly, the mere fact of being a beneficiary of a trust would not be sufficient to impose an obligation of personal indemnity on a beneficiary. In *Countryside (No 3) Pty Ltd v Best*[18] Davies AJ[19] said, following a view expressed by Professor Ford:

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as applicable to the particular facts proved, or assumed to be proved, since the generality of the expressions which may be found there are not intended to be expositions of the whole law, but governed and qualified by the particular facts of the case in which such expressions are to be found". See generally *Leaway v Newcastle City Council (No 2)* [2005] NSWSC 826; (2005) 220 ALR 757 at [75]-[84]; *Commonwealth v Bank of New South Wales* (1949) 79 CLR 497 at 637-638; *R v Beserick* (1993) 30 NSWLR 510 at 517; *Arinson v City of Canada Bay Council* [2015] NSWCA 199, (2015) 18 BPR 35,163 at [65].

[15] *ex parte Chippendale, in re German Mining Co* (1853) 4 De G M & G 19; 43 ER 415 is not such a case. It concerned a deed of settlement company, the property of which was held in trust for the shareholders, but those shareholders were held also to be partners (32, 420 per Knight Bruce LJ; 41, 423 per Turner LJ)

[16] The "Ocean Island equity" that Megarry J found and applied in *Tito v Waddell (No. 2)* [1977] Ch 106, at 289-303. A similar principle was accepted in *ER Ives Investment Ltd v High* [1967] 2 QB 379

[17] *Government Insurance Office (NSW) v K A Reed Services Pty Ltd* [1988] VR 829 at 831- 841 per Brooking J (O'Bryan and Nicholson JJ agreeing with this aspect, at 830 and 856 respectively)

[18] [2001] NSWSC 1152 at [38]

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

If that is the case concerning multiple beneficiaries, it is hard to see why it is not also the case concerning a single beneficiary.

Dr R A Hughes has given an explanation for the rule as stated by Lord Lindley:

> *"… As the authorities stand, the beneficiaries of a trust being sui juris and absolutely entitled are personally bound to indemnify the trustee against liabilities incurred by him or her in carrying out the trust. The trustee must have been acting within the scope of authority conferred by the trust. … The attribution of personal liability to the beneficiaries is a consequence of the express or implied authority of the trustee to carry out the trust on behalf of the beneficiaries, which authority is conceded by the beneficiaries in accepting the benefits conferred by the trust."*[20]

This explanation is not convincing. The relationship of trustee and beneficiary is not one of principal and agent simply by virtue of the beneficiary accepting benefits under the trust. A trustee act for the benefit of a beneficiary, but that is not the same as acting on behalf of the beneficiary, or with a power to create legal relations between the beneficiary and other people. The fact that a creditor of the trustee can make a legal claim against the beneficiary only by being subrogated to the trustee's right of indemnity in itself shows that the mere accepting of benefits from the trust by the beneficiary does not make the trustee the agent of the beneficiary.

If it is the better analysis of the present law that something more than merely being a beneficiary is needed to impose a personal liability on a beneficiary, it would be useful for legislation to make it clear that merely being a beneficiary of a trust is not enough to impose a personal liability to indemnify on a beneficiary. And if the view is taken that the weight of case law that has restated what Lord Lindley said in *Hardoon* is now so great that judge-made law cannot change it, then legislation should be enacted to make it the law that the mere status of being a beneficiary is not sufficient to impose on a trust beneficiary any personal obligation to indemnify.

Legislation stating that merely being a beneficiary is not a sufficient reason to impose on a beneficiary a liability to indemnify would leave the way open for the usual way in which the law of equity develops to proceed. The existing body of case law, that has established that certain fact

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[19] This judge is Hon (John) Daryl Davies QC, sitting as an acting judge of the NSW Supreme Court after retiring from his distinguished career as a judge of the Federal Court

[20] R A Hughes, *The Right of a Trustee to a Personal Indemnity from Beneficiaries* (1990) 64 ALJ 567 at 579

situations in which there has been a relationship of trustee and beneficiary and also additional factors, like involvement of the beneficiary in establishing the trust or incurring the liability in question, could continue to be drawn on. There would not be the total new start that would be involved in making this area of the law depend on a statutory reformulation of it.

An effect of this modest statutory change may well be that people who are nothing but passive investors in a unit trust are freed from the prospect of having a personal liability to indemnify the trustee. That could happen regardless of whether the unit trust in question is a registered managed investment scheme. If such people have no connection with the trust other than being passive investors in a structure that they did not instigate, it would be fair and proper[21] for them to have no obligation to indemnify the trustee for a liability that the trustee incurred without any involvement or encouragement on their part.

There is a question about whether this change should be effected by legislation that applies to all trusts that are governed by New South Wales law, or whether it should apply to all trusts governed by New South Wales law except those that govern registered managed investment schemes, and regulated superannuation funds. I am inclined to think that the latter alternative is preferable. Registered managed investment schemes and regulated superannuation funds are governed by extensive Commonwealth legislation, and the markets in which those trusts operate are national ones in which national uniformity of law is very important.

Making those exceptions from the proposed New South Wales law would have the effect that members of the registered managed investment scheme or the regulated superannuation fund would still be at risk of having a personal liability to indemnify the trustee, unless the trust deed of their particular trust excluded that right. However the importance of uniform national legislation in this area is such that the Commonwealth should be given the opportunity to make the more extensive change to the law which I suggest should be made concerning these two types of trust. If the Commonwealth were not to do so, it would always be possible for the New South Wales Parliament to legislate to remove any carveout of registered managed investment schemes and regulated superannuation funds from the general law that I propose. The NSW government should urge the Commonwealth not to delay in making that change.

It would be necessary for the proposed NSW statute to state clearly whether it applied to existing trusts. There is a negligible likelihood that anyone would have arranged his or her affairs on the basis that a trustee had a right of indemnity from a beneficiary for no reason other than that the beneficiary was a beneficiary. In that situation the law should apply to existing trusts.

<u>Where the right of indemnity ought not apply at all</u>

[21] and also, I think quite consistent with existing principles of the law of equity – though it is not necessary for the Commission to be persuaded that I am right in thinking that before it recommends the legislative change that I suggest

As the number of people who are beneficiaries of a trust established to operate a business increases, and the capacity for the beneficiaries to play any role other than passive investors in the trust decreases, so the trust comes functionally to resemble a corporation more and more. As the capacity for beneficiaries to play any role other than that of passive investors decreases, the likelihood of there being the "something extra" beyond being a beneficiary that can justify the existence of a personal right of indemnity from a beneficiary decreases. It is not possible to identify a clear dividing line when, as a matter of principle, the resemblance of the trust investment to a corporation is such that the reason that usually justifies a trustee sometimes having a right of indemnity from a beneficiary comes to be outweighed by the need to protect a beneficiary from a mistaken assumption that his or her liability is limited.

However the *Corporations Act* provisions about managed investment schemes has already made a judgment about where the dividing line is when an investor in a venture in which assets are pooled and managed needs statutory protections. That dividing line is where the managed investment scheme is one that is required to be registered[22]. Those statutory protections include the requirement that the scheme be operated by a responsible entity that is a public company, holds a financial services licence, and is subjected to statutory duties. Some of the statutory duties arise by virtue of being the responsible entity[23], others arise by virtue of holding the financial services licence[24]. The statutory requirements that are imposed on a registered scheme in themselves make the trust that is the vehicle for the scheme have a closer resemblance to a corporation than does an unregistered scheme, or other trust. The statutory duties are such that a scheme that is operated in accordance with them should have sufficient assets to meet liabilities that the trustee incurs, either from the assets of the scheme itself or the proceeds of insurance.

A trust is a reasonably complicated legal institution. Professional assistance is usually needed to establish the trust, and to find out about the particular conveyancing procedures required to obtain an existing interest in a trust. The need for that professional assistance brings with it at least the opportunity for someone becoming a beneficiary in a trust established for business purposes to acquire advice about his or her potential liabilities. However a comparatively easy method is available to transfer an interest in a registered scheme[25]. There is therefore a lower degree of likelihood that a person would become a beneficiary of a trust operating such a scheme after receiving advice. There is therefore a higher risk that a person could become a member of such a scheme without advice about the risks associated with the investment.

In all these circumstances a good case can be made for members of a registered managed investment scheme not being subject to any obligation of law to indemnify the trustee.

It may be that even concerning some registered managed investment schemes it is appropriate that there continue to be an obligation to indemnify. One of the criteria of a managed investment scheme is that "the members do not have day-to-day control over the operation of the scheme

[22] S 601ED *Corporations Act*
[23] S 601FA – 601FE *Corporations Act*
[24] S 912A *Corporations Act*
[25] S 1071A – 1071D *Corporations Act*

(whether or not they have the right to be consulted or to give directions)"[26]. As the CAMAC report that the LRC has provided as background material points out, there are some schemes, such as agribusiness schemes, which give participants rights of active involvement. The resemblance to a corporation is less strong concerning such schemes. However, because legislation concerning these schemes should be made by the Commonwealth, not a State, it is not necessary for this Commission to reach a final conclusion about the precise terms of any prohibition of the right of indemnity in managed investment schemes.

As well, because of the functional closeness of membership of such a scheme to holding a share in a company, it would be appropriate for there to be legislation that prohibited the inclusion in the trust documentation of such a scheme of a provision requiring the members of the scheme to personally indemnify the trustee. There should be an exception to that prohibition, under which it was possible for a deed to require indemnity of the trustee up to a maximum of the unpaid capital, if any, that the member owed.

It would also be appropriate for there to be legislation stating that the trustee of a superannuation scheme that is not a self-managed one has no right of indemnity from the members, and for there to be a prohibition on the deed of such a fund imposing such an obligation. At present the *Superannuation Industry Supervision Act 1993* (*"SIS Act")* says nothing about the personal right of indemnity of a superannuation trustee[27], so the general law position, that allows such a right of indemnity unless excluded, would apply[28]. It would be an unpleasant surprise to almost any superannuation fund member to be told that he or she had any such liability to indemnify. The vast majority of superannuation fund members have no choice about being a member of a fund, often the fund of which they are members is chosen by the employer and the employee does not exercise the right to switch funds, and it is unrealistic to expect a superannuation fund member to check whether the trust deed of the particular fund of which he or she is a member imposes a personal obligation to indemnify. In these circumstances, it is quite inappropriate for there to be such a right of indemnity.

There is not the same objection of policy to a clause requiring members to indemnify a trustee appearing in the deed of a self-managed superannuation fund, as there is necessarily a close involvement of each member of such a fund in the management of the fund.

Each of these exceptions to liability concerning registered managed investment schemes and regulated superannuation funds should only be effected by Commonwealth legislation.

Fairness between trustee's creditors and beneficiaries

[26] Para (a) (iii) of definition of "managed investment scheme" in section 9 *Corporations Act 2001*

[27] See J C Campbell Some aspects of the civil liability arising from breach of duty by a superannuation trustee (2017) 44 Aust Bar Rev 24 at 33 – 34, 42

[28] There might be some scope for arguing that it was a type of fund concerning which the right of indemnity was inherently inappropriate (cf *Wise v Perpetual Trustee*) but that argument is far from assured of success.

I accept that there is some doubt about whether a trustee's creditors can be subrogated to the trustee's personal right of indemnity[29]. This question will become a live one only if the trustee has not met the liability in question, and the trust assets are insufficient to discharge the liability following an exercise of the creditor's right to be subrogated to the trustee's right of indemnity from the assets. I doubt that that situation would arise sufficiently often for legislation on the topic to be justified. The absence of Australian cases in which this was an issue seems to confirm that doubt.

Dr D'Angelo's proposal

Dr D'Angelo's submission contains a detailed and specific proposal for legislation. The structure of it is to have a statutory prohibition of a trustee having a right of indemnity from the beneficiaries personally, subject only to a statutorily created set of exceptions. Those exceptions arise when, in addition to the relationship of trustee and beneficiary, there is also present some additional factor.

Dr D'Angelo's writing concerning commercial trust law is deservedly very highly regarded. However I suggest that it would be better if the Commission did not adopt this proposal.

Dr D'Angelo makes clear that he does not intend the list of exceptions that he proposes to be exhaustive[30]. That is a fundamental difficulty. If there is a statutory prohibition on trustees having a right of indemnity, then all exceptions to it must be ones created by statute. Unfortunately no-one has foresight enough to be able to articulate all, and only, the circumstances in which it is appropriate for there to be a personal right of indemnity. The present law gives flexibility, allowing the right of indemnity to arise as only a prima facie right, allowing recognition of the particular equities that arise in a particular case, and allowing a decision to be made about which of those equities prevails. That flexibility, which enables the law to be developed as new circumstances arise, should not be given up readily. Statutory obligations are rigid: equitable obligations are not[31].

As well as this basic objection, there are some difficulties with the exceptions that he proposes. I will not try to be exhaustive about those difficulties, but will give some examples.

<u>Exception 1 - liability where the trust instrument expressly so provides:</u>

If it stood on its own this exception could provide just as much a trap for investors as the present law. Indeed if the general or default position were that a beneficiary had no obligation to indemnify the trustee the present tendency for investors in the larger unit trusts to assume they had no such liability would, if anything, be increased. Thus any alteration of the law to abolish the right of indemnity, with such an exception, should also contain a qualification to the exception, under which for *some types* of trust such a clause should be prohibited except to the extent that it permitted indemnity subject to a cap of the amount of uncalled capital on any units that quantified the

[29] Nuncio d'Angelo, *Commercial Trusts* (LexisNexis Butterworths Australia 2014) [3.74] – [3.78]
[30] Submission [4.10]
[31] There is also a problem with the absoluteness with which the proposed section 69A (1) denies the liability to indemnify of a beneficiary of a trust. It is open to the construction that it denies the liability even in circumstances where there is an obligation to indemnify for a reason not dependent on the trustee-beneficiary relationship.

beneficial interest of the beneficiary. It would be difficult to provide a list of all and only the types of trust in which such a clause should be prohibited – the aim would be to identify those trusts in which the likelihood is that the beneficiaries would be investors who were passive providers of capital – but at the least it should include trusts that were managed investment schemes within the meaning of the Corporations Act, concerning which a scheme member had no right to participate in the scheme (save by distributions of profits or capital) and no right to influence the conduct of the business or transaction that the scheme was set up to undertake. This last qualification is directed to the situation identified in the CAMAC report that the LRC has provided as background material, where some schemes, such as agribusiness schemes, give participants rights of active involvement.

Exception 3 - where liability is incurred by a trustee controlled by the beneficiary, or at the request or direction of the beneficiary .

The concept of a liability being incurred at the request or direction of a beneficiary has been given a wide interpretation in the case law. It includes that the trustee became a trustee at the request of the beneficiary[32]. There might be some situations in which the trustee became trustee at the request of the beneficiary, but a right of indemnity is not appropriate. For example, under the present law a defence of laches could sometimes be brought against a trustee's claim for indemnity. Such a defence could not arise concerning a statutory right of indemnity such as is proposed. If a beneficiary had undoubtedly given a request or direction to the trustee to incur a liability, but that request or direction itself had arisen from misrepresentation by the trustee, or was the product of undue influence of the trustee, it is far from clear that under the proposed legislation there would be no obligation to indemnify.

As well, not all situations where a liability has been incurred by A at the request of B are ones where a right of indemnity arises[33]. The proposed legislation would remove the possibility of recognising that some particular situation was one where the liability had been incurred at the request or direction of the beneficiary but a right of indemnity was not appropriate.

Dr D'Angelo proposes that the indemnity operate concerning "trustee liabilities "– broadly, liabilities that the trustee has incurred while purportedly acting as trustee, even if in breach of trust. It is hard to see the justification for the mere fact that a beneficiary has requested the trustee to become trustee obliging the beneficiary to pay for a liability that the trustee has incurred in breach of trust.

He also proposes that the indemnity be limited to circumstances where the trustee cannot fully indemnify itself out of the trust assets, or the trust is insolvent. Establishing insolvency of a trust, in accordance with the definition of insolvency proposed in s 69E(1)(d) of the draft legislation, will be a very difficult forensic task – it will depend on proving the extent of the liabilities that the trustee has incurred and whether each such liability is one in relation to which the trustee has a right of indemnity from the fund, and on proving the extent of the liabilities concerning which the trustee has a personal liability and whether the trustee is able to meet those liabilities. Proving insolvency will be particularly hard for a creditor seeking to exercise the right of indemnity by subrogation, because that creditor will have difficulty in proving the extent of the assets and liabilities of the

[32] *Matthews v Ruggles–Brise* [1911] 1 Ch 194 ; *Buchan v Eyre*[1915] 2 Ch 474 at 477–8; *Broomhead* at 937

[33] *JH Rayner (Mincing Lane) Ltd v Department of Trade and Industry (Tin Council Case)* [1990] 2 AC 418 at 520 - 521

trustee. The direct right of action of a trust creditor against a beneficiary proposed in s 69C operates like an exercise of a right by subrogation, so will be subject to the same difficulties.

The proposed oppression remedy

I agree with the submission made by Hon Mr Barrett. I make two additional points, of which the first is considerably more important:

1. The January 2015 VLRC report that recommended an oppression remedy concerning trading trusts did not consider whether remedies for oppressive conduct concerning a trading trust might be available under any legislation other than the Corporations Act.

2. The definition of "trading trust" used by the VLRC[34] is imprecise. The discussion in Chapter 2 of the VLRC Report proposes the exclusion of superannuation and charitable trusts and managed investment schemes from the oppression remedy, but that still does not give sufficient precision to the trusts concerning which a remedy is proposed to be available. The term "trading trust" is one of those English expressions that is precise enough for quite a few practical purposes, but is not a legal term of art[35], and has considerable open texture. For the VLRC to say that it proposes a "functional definition" of trading trusts[36] does nothing to remove this open texture. If a statutory right is to attach to a "trading trust" considerable precision is needed about the trusts to which it does, or does not, apply. In Singapore the precision arises from the "business trusts" concerning which the Singaporean oppression remedy arises being only ones that are registered. A trust that fits the definition that the VLRC adopted is capable of covering a trust that carries on the business of investing (regardless of whether the trustee has any power to transpose investments), or a trust that has carrying on a business as only a minor or incidental part of its operations[37], or a trust through which bankers financed an operation or entity. It may be that it is unlikely that the facts would justify relief concerning such trusts, but there is no good reason why a court should be given jurisdiction to consider whether relief should be granted for oppression concerning such trusts.

J C Campbell

2 February 2018

[34] 'a trust where some property held by the trustee is employed under the terms of the trust in the conduct of a business' - VLRC Report p 3

[35] Like “discretionary trust" (*Chief Commissioner of Stamp Duties (NSW) v Buckle* (1998) 192 CLR 226 at 234) and "Quistclose trust" (*Raulfs v Fishy Bite Pty Ltd* [2012] NSWCA 135 at [51])

[36] VLRC report [2.122]

[37] If an executor carries on the testator's business for a while is the estate a "trading trust"?