UNSW AUSTRALIA | CLMR Centre for Law, Markets and Regulation

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NSW Law Reform Commission
GPO Box 31
SYDNEY NSW 2001

Delivery by email to nsw-lrc@justice.nsw.gov.au

Dear Commissioners

Thank you for the opportunity to provide a submission to the NSW Law Reform Commission on the laws relating to beneficiaries of trusts.

Preliminary

I am Deputy Director of the Centre for Law, Markets and Regulation at UNSW Law. I research in the areas of trust law, superannuation, managed investments and the regulation of financial markets. I am also retained on a part-time basis as an External Consultant by Herbert Smith Freehills. The views expressed in this submission are informed by my research but they are my own and ought not be taken to reflect the views of either UNSW nor Herbert Smith Freehills, nor any of their clients, employees or associates. I make this submission in my personal capacity and not on anyone's behalf or at anyone's instruction.

The Review

The Commission has been tasked with reporting 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.

Submission

I submit that the answer to both questions is No.

This conclusion stems from three basic insights derived from my research over the past decade into trust structures in the managed investments and superannuation contexts. They are

presented below. I have avoided detailed referencing of cases, sections and the like in order for the essence of the argument to be more readily ascertained.

1. *The balancing act between the interests of various stakeholders in a trust is a delicate, subtle one involving a finite quantum of assets.*

There is no doubt that trust law is intricate and nuanced. One reason for this is that over the years the courts have striven to achieve a balance between the interests of the various stakeholders in the assets that are subject to a trust. In each of the diverse contexts in which trusts are employed, the trustee intermediates between the legal and beneficial claims of a range of different 'stakeholders' with respect to the assets subject to the trust. The law of trusts has developed over the centuries to resolve that balancing act. So, for example, the courts have identified circumstances when beneficiaries can call for distribution of the assets, circumstances when the trustee will be entitled to indemnity out of trust assets and circumstances when the unsecured creditors of the trustee can be subrogated to the rights of the trustee to be indemnified out of the trust assets or (in exceptional cases) to be reimbursed by beneficiaries. In each case, the courts have had to balance the respective merits of the claims of each group of stakeholders to derive an outcome that balances the equities of all the claims.

That balance is often hard-won. There is no 'magic-pudding' solution. Privileging the rights of one individual or group inevitably (ignoring for the moment the impact of trustee insurance) adversely affects the value of the rights of other groups of stakeholders. The Commission ought to recognise that any legislative initiative which prioritises the interests of beneficiaries very directly undermines the value of other stakeholders' rights. In particular, although in most cases trusts are employed by individuals for entirely legitimate personal, commercial or eleemosynary activity, there is a very real risk that unscrupulous operators will use such a preference as an instrument of fraud by creating structures in which the rights of unsecured creditors are substantially compromised. So, for instance, the courts have long recognised that the rights of unsecured creditors can be rendered nugatory by legal devices, such as thin capitalisation of the trustee and/or negation of the trustee's right of indemnity, designed to place trust assets beyond the reach of ordinary contractual counterparties. The balance found by the courts has therefore had regard not just for the vulnerability of beneficiaries (who, as will be discussed below, are in many cases far less unwitting than the trust paradigm might imply) but also the vulnerability of unsecured creditors of the trustee who enter in good faith into contractual relations with the trustee. As it happens, the Commonwealth Department of Employment is currently considering precisely this issue in respect of a form 'phoenixing' activity undertaken in the corporate sphere in which trusts are used in insolvency to place assets beyond the reach of parties (such as employees) who are then left to make claims on the Fair Entitlements Guarantee (FEG) regime.

2. The beneficiaries of trusts come in all shapes and sizes

The second reason for opposing any move to introduce statutory measures to limit the liability of beneficiaries to creditors stems from recognition that just as there are many types of trusts, there are many types of beneficiaries. Importantly, the arguments for favouring different types of beneficiaries' interests over creditors vary in their strength.

Trusts are used in a myriad of different contexts in Australian society. They are widely (but not uniquely) used to structure co-mingled investment funds such as managed investment and superannuation schemes, to administer charitable monies and to give effect to inter-generational familial wealth transfers. That ubiquity arises because key characteristics of trusts, including most notably their tax treatment and flexibility (but also such issues as their potential for confidentiality and for asset-quarantining in insolvency), are attractive in certain circumstances.

Clearly, trusts are not the only choice available to individuals. Australian law recognises a wide range of ways in which individuals can arrange their affairs and property rights. Each of the different arrangements (corporation, trust, partnership, contractual joint venture) has characteristics that are advantageous or disadvantageous in different circumstances. Individuals seeking to undertake a particular activity can (subject to any regulatory restrictions) choose which of the arrangements best meets their needs.

Therein lies the rub. The ability of parties to define a bespoke set of arrangements facilitates innovation and tailoring of solutions, but it can also create risks for parties who are either not present or not able to negotiate the terms of their involvement.

Individuals who are engaged with the process of establishing the trust have an opportunity to negotiate in favour of a set of rights that meets their needs. They may not be successful in getting all they want, but they can typically decide not to participate if the balance achieved is not acceptable to them.

In contrast, the rights of those individuals not involved in the process of establishing the trust can be circumscribed in ways that are robust against legal challenge. Those individuals may be 'voluntary' creditors, 'involuntary' creditors or they may have become beneficiaries after the creation of the trust.

The situation in respect of many creditors is straightforward; they can choose whether or not to enter contractual relations with the trustee. In doing so, however, they assume the risk that there may be a very real asymmetry of information in favour of the trustee, one which corporate law has sought to reduce by requiring the publication of annual reports and other disclosures but which remains in place in respect of many trusts. The Commission ought not however underestimate the position of 'involuntary' creditors (including tort claimants and relevant taxing authorities). They do not have a discretion whether or not to enter into an arrangement giving rise to a claim against the trustee and so cannot choose against becoming a creditor.

More important for present purposes, however, are those beneficiaries who become involved after the creation of the trust. At the highest level of generality, individuals can become beneficiaries of a trust after its creation in one of two ways: through their own actions (for instance by buying units in a unit trust or becoming a members of a superannuation fund) or passively, for instance by being the successful object of a power or appointment in a discretionary family trust.

Where the individual has purchased their interest, the principle of caveat emptor seems fair. They can choose whether or not to acquire their interest and ought not to need much by way of additional protection (absent fraud). On the other hand, where the individual has not purchased their interest but has rather received their interest as a 'volunteer', say as a beneficiary under a discretionary trust, the courts have been less inclined to protect their interests as against other parties, including creditors of the trustee, who have provided consideration for their interests. Again, that seems fair.

The main exception to this bifurcation is in respect of the superannuation interests. Where the superannuation interest is acquired by an employee who has not provided a direction to their employer of where to place their Superannuation Guarantee contributions, ie they are 'default' members, they are in a hybrid situation. Strictly, they are purchasers for value, but their lack of engagement and the inherent coercion involved in requiring them to participate in the superannuation system has inspired the Commonwealth to craft a detailed regulatory regime centred around the *SIS Act* to protect their interests.

Another policy-driven exception arises where the interest falls within the definition of a financial product. In that case the individuals purchasing them will either fall into the 'retail' classification in Chapter 7 of the *Corporations Act*, in which case they have the benefit of the disclosure and advice protections under that Act, or they are deemed to be sophisticated investors who, by assumption, can look after themselves. There may be a need to ensure that appropriate disclosures are actually made, and that any advice that is provided in relation to the structures is actually compliant with the requirements in Chapter 7 of the *Corporations Act* but a legislative initiative in order to protect these customers beyond that seem unnecessary.

All of this this presupposes that it is possible to classify beneficiaries neatly and unambiguously into these groupings. Reality belies that presupposition. It is not hard to imagine circumstances in which the position of the beneficiary is not so clear cut and the delicate balancing act described in the first part of this submission has in addition to consider the particular, and potentially distinctively unusual (but perhaps not unique), circumstances of the case. The courts in their equitable jurisdiction have the ability, through their flexibility and discretion, to accommodate that additional source of complexity.

I submit, therefore, that the nuances, calibration and conditionality present in the approach taken by the courts is quite complex and context-dependent. But that flows from a determination to do justice to the equities of the precise situation and is, from that perspective at least, necessary. Continued reliance therefore on the approach taken by the courts, which already accommodates that diversity and subtlety is preferable to any attempted crystallisation

that would be effected by statutory intervention in the area given the costs and uncertainties inherent in any legislative reform. I reach this conclusion despite being very aware of the advantages that rules in statutory form often have in terms of salience and enforceability.

3. *Financial markets regulation must have at least a national scope.*

The final reason for opposing any move to introduce statutory measures in NSW to limit beneficiary liability to creditors is that material differentiation in the regulation of trusts at a State level can lead to regulatory arbitrage that undermines broader economic policy. In particular, the regimes established by the Commonwealth for superannuation (centred on the *SIS Act*) and for managed investment schemes (found in Chapter 5c of the *Corporations Act*) can be undermined if there is not substantive equivalence across the Trustee Acts of the States. I note for instance the lamentable recent practice of forum shopping in South Australia in respect of trust deed amendments for superannuation funds. Although there are, no doubt, some who would encourage NSW to 'innovate' by providing statutory protection for beneficiaries in the way anticipated in this Enquiry, I suggest that a nationally consistent approach is preferable if the reasons for proceeding on this initiative are ultimately ascendant.

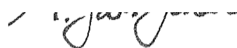
Concluding Comments

In essence, then, my reasons for recommending no change in NSW can be distilled to the following two beliefs, informed by my research:

- It is not realistically possible nor desirable to replicate the nuance and conditionality of equitable doctrine in this area using statutory provisions, notwithstanding the other attractions which statutes may have as regulatory tools; and
- Even if you could accommodate the nuance and complexity in statute, in those contexts where beneficiaries do require greater protection, such as superannuation, it is better for that to be undertaken at the national level by the Commonwealth than at the State level.

Please do not hesitate to contact me on [redacted] if you have any questions or require any further information or elaboration.

Yours sincerely



Dr Scott Donald
Deputy Director - Centre for Law, Markets and Regulation
UNSW Law