

Trading Trusts:
**An Examination of Trustees Liability
and Creditors' Rights**

by

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Introduction

This article deals with some of the more interesting legal questions raised when a trust structure is used to conduct trading or business activities. Such a trust is commonly known as a "trading trust". It is suggested that the use of such trusts in New Zealand will become more common in the light of certain advantages they have over the most common trading enterprise, the company.

The two principle advantages of utilising the trust structure involve firstly, the ability to create a real limited liability business structure and secondly, certain taxation advantages.

The focus of this article however will be the problem of trustee's liability. A large number of Australian cases will be given considerable attention, for it is submitted that they lie at the "cutting edge" of this developing area of law. All relevant early English trust and equity cases are dealt with. Throughout this discussion comparisons with relevant company law principles will be made in order to illustrate advantages and differences in the trust structure.

Trustee's Liability

Trustees are generally personally liable for all trust debts. Their position may be contrasted with company shareholders or directors, who are not generally liable for the debts of the company. This is because the debts are those of the company as a separate legal entity. A trust is not a separate legal entity. Of course, some relatively recent developments in company law have made it possible in certain circumstances to make

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directors or shareholders personally liable for the debts of their company, notably if the company has traded recklessly, or fraudulently, or if the directors incurred debts for the company when they did not honestly believe on reasonable grounds that the company would be able to pay the debt when it fell due.¹

As has already been outlined, the analysis to be presented in this article is of a "trading trust". This involves presenting problems that arise when one replaces personal trustees with a corporate trustee. The following discussion backgrounds the trust law relating to trustee's liabilities and their rights to personal indemnification from trust property and beneficiaries.

Trustee's Rights to Indemnity

A trustee is usually personally liable for liabilities associated with the trust. The "trading trustee" will generally be liable to trade creditors for the debts incurred in that business. In other words, he will usually be liable for the trust debts as if he had been carrying on the business on his own account.²

Trustees will usually have a general right to indemnify themselves out of the trust property. If there is not sufficient trust property to cover the trustee's liability, the trustee bears the deficiency personally unless he has a right of indemnity against the beneficiaries. Apart from rights to recover expenses from trust assets, the trustee may, in certain circumstances, have rights to indemnity against persons associated with the trust.

It is relevant to examine the position of the settlor of the trust. As a general rule, the settlor will not be personally liable to indemnify simply because of his position as settlor. In order to make the settlor personally liable something more is required. An example of this would be when the settlor has indicated that he is prepared to indemnify the trustee in consideration for the trustee accepting the office. Alternatively, the settlor may retain very wide powers over the trustee, thus establishing a relationship of principal and agent between settlor and trustee. Ford³ cites as authority for this the case of *Fraser or Robinson v Murdoch*⁴ and quotes this passage:⁵

The trustee voluntarily accepts the trust, and can only incur liability in consequence of his own act in so accepting; unless there be an express or implied bargain for indemnity from the maker of the trust, he must be taken to accept the trust relying on the trust funds. He has, no doubt, a right to charge the trust funds with all just allowances.

There is another situation where a settlor may be held liable to indemnify the trustee. It is founded on the general equitable principle that where any one requests another to incur a liability which would other-

¹ Section 320(1) Companies Act 1955.

² Early authority for this is *Wightman v Townroe* (1813) 1 M&S 412; 105 ER 154.

³ Ford, "Trading Trusts and Creditors' Rights" (1981) MULR 1.

⁴ (1881) 6 AppCas 855.

⁵ *Ibid.*, 872-73, per Lord Blackburn.

wise have fallen on himself, he is bound at law and in equity to indemnify him. Authority for this statement comes from the cases of *Balsh v Hyham*⁶ and *Jervis v Wolferstan*.⁷

In the leading case of *Hardoon v Belilios*⁸ the question arose as to whether the plaintiff trustee, who was the registered owner of some shares in a banking company which was being wound up, was entitled to be indemnified by the defendant who was the beneficial owner of those shares, against calls made upon them in the winding-up of the company. The Privy Council held that the beneficiaries were personally bound, in the absence of a contract to the contrary, to indemnify the trustees as registered holders of the shares. Lord Lindley clearly held that the trustee had a right of indemnification which extended beyond the trust property. It extended to include an unlimited personal liability on the part of a *sui juris cestui que trust*. He said:⁹

But where the only cestui que trust is a person *sui juris*, the right of the trustee to indemnity by him against liabilities incurred by the trustee by his retention of the trust property has never been limited to the trust property; it extends further, and imposes upon the cestui que trust a personal obligation enforceable in equity to indemnify his trustee.

As the basis for these statements Lord Lindley referred to the case of *Balsh v Hyham*¹⁰ and said:¹¹

This language ... shews plainly enough that it was taken for granted as well settled that, speaking generally, absolute beneficial owners of property must in equity bear the burdens incidental to its ownership and not throw such burdens on their trustees.

The general right of trustees to indemnification *out of trust property* is now contained in Section 38(2) of the Trustee Act 1956. That subsection reads:

(2) A trustee may reimburse himself or pay or discharge out of the trust property all expenses reasonably incurred in or about the execution of the trusts or powers; but, except as provided in this Act or any other Act or as agreed by the persons beneficially interested under the trust, no trustee shall be allowed the costs of any professional services performed by him in the execution of the trusts or powers unless the contrary is expressly declared by the instrument creating the trust:

Provided that the Court may on the application of the trustee allow such costs as in the circumstances seem just.

The Nature of the Trustee's Rights —

The Australian Cases and the Question of Proprietary Interests

Difficulties relating to the nature of the trustee's rights to be indemnified and to the ability to exclude those rights by the terms of the trust instrument have been examined in some recent Australian decisions.

⁶ (1728) 2 P Wms 453, 24 ER 810.

⁷ (1874) LR 18 Eq 18, 24.

⁸ [1901] AC 118.

⁹ *Ibid*, 124.

¹⁰ *Supra* at note 6.

¹¹ *Supra* at note 8, at 124.

The case that appears to have caused some controversy is the decision in *Octavo Investments Pty Limited v Knight*.¹² That case involved a 'typical' corporate trustee for a trading trust. This trustee company was incorporated with a paid up capital of five dollars. It had power to carry on any business, to employ the trust fund in such businesses and to borrow money and give security for loans. The trustee company borrowed extensively and its business eventually failed. Within six months of the winding up order the trustee company had made payments to one of its creditors, Octavo. The question of a voidable preference arose.

On the facts there was little doubt that the major elements of a voidable preference were present. The trustee made the payments when it was in insolvent circumstances. The creditor receiving the payments had reason to at least suspect that such payments were affording them a preference.

Octavo argued that the relevant voidable preference provision did not apply in such circumstances. Octavo's principal argument was that the trust property did not come within the description of 'property divisible amongst the creditors of the bankrupt' contained in Section 116 of the Bankruptcy Act 1955 (Cth).

This statutory provision was critical to the case. It reads:

116 (1) Subject to this Act —

- (a) all property that belong to, or was vested in, a bankrupt at the commencement of the bankruptcy, or has been acquired or is acquired by him, or has devolved or devolves on him, after the commencement of the bankruptcy and before his discharge; and
 - (b) the capacity to exercise, and to take proceedings for exercising, all such powers in, over or in respect of property as might have been exercised by the bankrupt for his own benefit at the commencement of the bankruptcy or at any time after the commencement of the bankruptcy and before his discharge, is property divisible amongst the creditors of the bankrupt.
- (2) The last preceding sub-section does not extend to the following property:
- (a) property held by the bankrupt in trust for another person;

Under Section 116(2) property held by the bankrupt on trust for another person is excluded from the property divisible amongst the creditors of the bankrupt. However, the provision does not prevent a trustee's right of indemnity out of the trust property and his associated lien being available to the creditors. Section 116(1) determines that the trustee's power to seek indemnity is property divisible amongst creditors because it is a power that might have been "exercised by the bankrupt for his own benefit". Under Section 132(1) of the Act, this property divisible amongst creditors vests in the trustee in bankruptcy. It was this passing of the trustee's beneficial interest in the trust estate (his right to indemnity) to the trustee in bankruptcy that led Stephen, Mason, Aickin and Wilson J J to hold that the relevant voidable preference provision applied.

Their decision was clearly based around the premise that the trustee's

¹² (1979) 27 ALR 129.

right to indemnity gave him a proprietary interest in the trust assets. Their Honours made this statement:¹³

If the Trustee has incurred liabilities in the performance of the trust then he is entitled to be indemnified against those liabilities out of the trust property and for that purpose he is intitled to retain possession of the property as against the beneficiaries.

It is the thesis of Ford's article¹⁴ that the trustee's right to exoneration is not a proprietary right at all. Ford suggests that the trustee "has no more than a power over the trust property which, ..., is a fiduciary power, at least in cases where the beneficiary has an interest in seeing that the trust creditor is paid".¹⁵

In *Re Enhill Pty Ltd*¹⁶ the company in question was incorporated with a paid up capital of two dollars and, inter alia, for the purpose of undertaking the office of trustee for a trading trust. The proceedings concerned the winding up of this company because of insolvency.

The principal question facing the court related to priority of payment of debts to various unsecured creditors. The claim was based upon Section 292(1)(a) of the Companies Act (Cth). That paragraph provided that in a winding up there should be paid in priority to all other unsecured debts the costs and expenses of the winding up and the remuneration of the liquidator. Such payments were to be made from company assets available to the liquidator. The question therefore turned on whether the liquidator had control of any trust assets of the company. In summary, the question was whether the trustee company's right of indemnity was an asset of the company's.

Referring to the decision in the *Octava Investments*¹⁷ case Young C J said:¹⁸

I think that we are bound to treat that case as authority for the proposition that the right of a trustee to be indemnified out of the assets of the trust, or the proceeds of the exercise of that right, are assets of the trustee in a winding up.

Also,¹⁹

But subject to one consideration I should have said that the trustee's proprietary interest in the trust assets was clearly property of the company under the control of the liquidator and liable as such to the payment of the items in Section 292(1)(a).

The 'one consideration' referred to relates to the cases of *Re Byrne Australia Pty Ltd*²⁰ and *Re Byrne Australia Pty Ltd (No 2)*.²¹ Byrne Australia Pty Limited was wound up in a creditors voluntary winding up in March 1979. The company was the trustee of a trust and under the

¹³ Ibid, 136.

¹⁴ Supra at note 2.

¹⁵ Ibid, 26.

¹⁶ (1983) 7 ACLR 8.

¹⁷ Supra at note 12.

¹⁸ Supra at note 16, at 11.

¹⁹ Ibid.

²⁰ [1981] 1 NSWLR 394.

²¹ [1981] 2 NSWLR 364.

terms of the trust deed the trust company was given wide powers of management and to carry on business. This action was brought to determine, inter alia, whether the costs and expenses of the winding up could be paid out of trust assets in priority to claims of all the trust's creditors. The trustee company had no assets of its own, so the real question at issue was whether the liquidator could look to trust assets for payment of his outgoings and his remuneration. Needham J, referring to the *Octavo Investments*²² case, said:²³

In other words, the case is not authority for the proposition that, where a trustee company carries on business with a trust fund and incurs liabilities and then is wound up, the whole of the trust fund is property divisible amongst all the company's creditors, whether trust creditors or not. The right of indemnity arises only because the trustee is liable to creditors whose debts arose because of its activities as trustee of the fund. If there is no right of indemnity, there is no 'proprietary interest'.

Needham J illustrated this with an example of a company which traded both on its own account and as trustee for a trading trust. There would be no indemnity from trust assets for debts incurred by the company trading on its own behalf. It was held in the *Byrne*²⁴ case that trust assets were available only to meet the claims of trust creditors. The result in the *Enhill's*²⁵ case was that the liquidator was allowed to claim his expenses out of the trust assets. The court held that:²⁶

the trustee company's right of indemnity forms part of the assets of the company in a winding up and is property under the control of the liquidator.

Furthermore:²⁷

that proposition led to the conclusion that the trust assets were divisible among the company's creditors generally and not merely among the trust creditors and that those assets were available to meet the liquidator's costs and expenses by virtue of Section 292 of the Companies Act.

Another recent Australian case dealing with this same issue is *Re Suco Gold Pty Ltd (in liq)*.²⁸ The trustee company in this case was incorporated with a paid up capital of two dollars and apart from its right of indemnity against trust assets it had no assets. The company incurred debts in carrying out the business of the trust under two identical trust deeds. Although the trustee had a right of indemnification against trust assets, the assets of the trust were insufficient to cover such debts.

Practically, a problem lay in finding the necessary money to pay costs and expenses of the winding up. The case was an application seeking a ruling from the court as to whether trust assets could be used to meet such expenses.

²² *Supra* at note 12.

²³ *Supra* at note 20, at 398.

²⁴ *Supra* at note 20.

²⁵ *Supra* at note 16.

²⁶ (1983) 7 ACLR 873, 877.

²⁷ *Ibid.*

²⁸ *Ibid.*

Once again the decision in *Re Byrne Australia Pty Ltd*²⁹ proved relevant. The net result of this decision, as already discussed is that the trust fund is only available to meet the claims of trust creditors. Therefore, a liquidator could only seek costs and expenses from trust assets if he could be shown to be a trust creditor. The liquidator's argument was that:³⁰

... as the right of indemnity does not depend upon payment of the debts by the trustee, but is effective to protect him against debts which he has incurred but not paid, he is entitled to transfer trust property sufficient to meet the unpaid debts to himself notwithstanding that he has not paid them. That property, so the argument runs, then ceases to be trust property and, if bankruptcy, or, in the case of a company, liquidation, supervenes before payment of the debts, the transferred property is property of the bankrupt divisible amongst the general body of creditors, not merely among those whose debts were incurred in the performance of the trust. The trustee's right of indemnity vests in the liquidator and if the right of indemnity has not been exercised before liquidation, it is argued that the liquidator is entitled to property of the trust, ... notwithstanding that those liabilities have not been paid, and that that property is divisible among the general body of creditors.

Significantly, this argument was rejected in *Suco Gold*.³¹

King C J based his rejection upon fundamental principles of trust law. Firstly, King C J stated³² that trustees have no legal right to apply trust property other than for the authorised purposes of the trust. In particular, he has no right to use trust property for his own benefit or for the benefit of third parties.³³ King C J agreed with Needham J in *Re Byrne Australia Pty Ltd*³⁴ that the *Octavo*³⁵ case was not authority for saying the whole of the trust fund is property divisible amongst all the company's creditors, whether trust creditors or not.

Despite all of this, the net result in the *Suco Gold*³⁶ case was that the liquidator was allowed to apply moneys resulting from the sale by him of assets held by the insolvent trust company in paying and discharging the costs and expenses properly incurred in the course of winding up the trustee company. Essentially this is a policy decision, for unless the liquidator's costs and expenses could be met from this source, the liquidation of a trustee company without assets of its own could not proceed.

With all due respect, the court in the *Suco Gold*³⁷ case have simply said one thing and done another. The bulk of the judgments of both King C J and Jacobs J covers all the reasons why the result in *Byrne*³⁸ is correct and *Enhill*³⁹ incorrect. However, at the very end, requirements

²⁹ Supra at note 20.

³⁰ Supra at note 28, at 878-879.

³¹ Supra at note 28.

³² *Ibid*, 879.

³³ *Keech v Sandford* (1726) 2 EqCas Abr 741.

³⁴ Supra at note 20.

³⁵ Supra at note 12.

³⁶ Supra at note 28.

³⁷ *Ibid*.

³⁸ Supra at note 20.

³⁹ Supra at note 16.

of policy direct both judges to allow the liquidator to claim his costs from trust assets. Jacobs J says:

Looking at the whole legislative scheme, therefore, I can find nothing in the language or structure of the legislation to deny the proposition that in a case such as this, Section 292 can operate upon the trust assets to provide for the remuneration of the liquidator in priority to other claims To hold otherwise would defeat, or at least frustrate, the legislation.

It is submitted that this policy is wrong in two ways. Firstly it denies the law as laid down in *Byrne's*⁴¹ case and indeed as accepted and justified in the *Suco*⁴² case. It is a fundamental principle of trust law that trust assets ought only be available for legitimate trust purposes. One such purpose is to provide for trust creditors. Providing for others, including liquidators of the trustee, is contrary to this. Secondly, if a policy decision is to be made, it should at least be a correct policy. Simply letting a liquidator have access to the trust assets because of the fear that the winding up could not otherwise proceed is not, it is submitted, the correct response. The court should instead simply remove the insolvent trustee and appoint a new one.

The case of *Kemtron Industries Pty Ltd v Commissioner of Stamp Duties (Qld)*⁴³ involved the valuation of unit shares in a trust for stamp duty purposes. Relevant to these valuations was the trustee's right to indemnity from trust assets and also from the beneficiaries personally. The unit trust in question was insolvent. It had assets valued at \$6,122,547 and its liabilities were \$6,324,622. The Commissioner assessed stamp duty of \$50,224.50 on the value of a conveyance of trust assets. The conveyance in question involved the transfer of five units out of a twenty unit trust from the previous owner to Kemtron Pty Limited for five dollars. The taxpayers objected and appealed, successfully claiming that the only stamp duty payable was \$1.50 on the \$5.00 consideration for the units conveyed. Clause 18.3 of the trust deed read:

[The trustee does not have] any power or authority to enter into any contract that shall impose any obligation whether at law or in equity on the registered holders personally or call upon them or any payments whatsoever other than the amounts of their respective subscriptions for units.

Campbell J recognised, importantly, that this was no ordinary trust deed in the fact that it excluded, by virtue of Clause 18.3, a right of recourse against the beneficiaries personally. Campbell J then quoted⁴⁴ this well-known passage from *Hardoon v Belillios*:⁴⁵

"It is quite unnecessary to consider in this case the difficulties which would arise if these shares were held by the plaintiff on trust for tenants for life, or for infants, or upon special trusts limiting the right of indemnity. In those cases there is no beneficiary

⁴⁰ *Supra* at note 28, at 886.

⁴¹ *Supra* at note 20.

⁴² *Supra* at note 28.

⁴³ (1984) 15 ATR 627.

⁴⁴ *Ibid*, 631.

⁴⁵ *Supra* at note 8, at 127.

who can be justly expected or required personally to indemnify the trustee against the whole of the burdens incident to his legal ownership; and the trustee accepts the trust knowing that under such circumstances and in the absence of special contract his right to indemnity cannot extend beyond the trust estate, ie, beyond the respective interests of his *cestui que trustent*. In this case their Lordships have only to deal with a person *sui juris* beneficially entitled to shares which he disclaimed. The obligation of such a person to indemnify his trustee against calls upon them appears to their Lordships undisputed in a court of equity unless, of course, there is some contract or other circumstance which excludes such obligation. Here there is none."

Having regard to the nature of the beneficial interests in *this* trust, Cambell J concluded that the units in question were transferred for five dollars only. They were not conveyed subject to the payment of any money over and above the five dollar consideration.

Exclusion of the Right to Indemnity

It is now relevant to determine whether such rights of indemnification may be excluded. As has been outlined in the introduction, the 'model' trading trust structure to be examined involves a corporate trustee whose right of indemnity against the trust property and against the beneficiaries is specifically excluded by the terms of the trust deed.

1. Statutory Exclusion

The starting point for any discussion on this point is to be found in Section 2(5) of the Trustee Act 1956. The terms of Section 38(2) of the Act were recorded earlier when it was noted that there exists a statutory right of indemnity against trust property. Section 2(5) allows parties to modify this statutory right. Therefore, by virtue of Sections 38(2) and 2(5) of the Trustee Act 1956 it is open to the creator of the trust to deny the trustee a right to recoupment or exoneration against the trust property.

2. General Exclusions

As will be apparent, the trustee's right to recoupment or exoneration will be potentially of great value to trust creditors, especially in circumstances where the trustee is a company with a very small paid-up capital. Therefore it is relevant to examine the circumstances, aside from where the rights of indemnity are excluded by the trust deed, where such rights will not be recognised.

There will be no right to recoupment in respect of liabilities improperly incurred by the trustee. A trustee's right to indemnification out of trust property is limited to liabilities and expenses incurred in the proper execution of the trust.⁴⁶ The right to indemnity will be lost if the trustee incurs a liability in excess of his trust powers; *Leedham v Chawner*.⁴⁷ In addition, it will also be lost when the trustee incurs a liability in breach of his duty to execute his trust responsibilities with reasonable diligence

⁴⁶ *RWG Management Ltd v CAC* (1985) 9 ACLR 739, 749 citing as authority *Stott v Milne* (1884) 25 ChD 710, 715 and *Re Beddoe* [1893] 1 Ch 547, 568.

⁴⁷ (1858) 4 K&J 458, 70 ER 191.

and care; *Ecclesiastical Commissioners v Pinney*.⁴⁸ Ford⁴⁹ makes a detailed analysis of this issue and it is proposed to follow his categorisation of the various types of liabilities that will be incurred by the 'trading trustee'.

EXPENSES OF CARRYING ON A BUSINESS

Various situations deserve discussion under this heading. Firstly, there is the situation where the trustee carries on a business without any authority in the trust instrument. In such circumstances, the trustee will have no authority to reimburse himself out of trust property.⁵⁰ It is relevant to compare this position of the trustees in a trading trust with the ultra vires rule in a corporate structure.

The 1983 amendments⁵¹ to the Companies Act 1955 give a company all the powers of a natural person. Aside from any questions of directors authority, a company may now perform any act freely and without restriction from its Memorandum of Association. Therefore creditors of a company may have access to company assets to recover their debts without the need to worry about whether the company had the ability to incur the debt or obligation.

The position of a trustee company is not so simple. While such companies, under the 1983 amendments, have all the powers of a natural person, their ability to incur debts in the name of the trust is restricted and controlled by the terms of the trust deed. Effectively the trust deed overrides the theoretically unlimited corporate capacity provided to companies under the 1983 amendments. Creditors of a corporate trustee can only access those trust assets that the trustee can, by the terms of a trust deed, use to pay trust debts. In other words, only debts that are 'legitimate' in the terms of the trust deed will be recoverable by the creditor. This leaves a significant disadvantage to the trust creditor over a normal company creditor.

LIABILITY IN TORT

A trustee's right to indemnity covers any tortious liability. However, this will be lost if the trustee has not "acted up to the standard of the reasonable, prudent person in relation to the activity out of which the liability arose".⁵² This would appear to exclude all negligence claims.

TRUSTEE'S RIGHT OF INDEMNITY WHERE A BENEFIT HAS BEEN CONFERRED ON TRUST PROPERTY

Numerous authorities⁵³ exist for the principle that a trustee may

⁴⁸ [1900] 2 Ch 736, 742-743 per Rigby LJ.

⁴⁹ Supra at note 3, at 9-13.

⁵⁰ *Vacuum Oil Co Pty Ltd v Wiltshire* (1945) 72 CLR 319, 325.

⁵¹ Sections 15A and 18A inserted in 1983.

⁵² Supra at note 3, at 12.

⁵³ *Vyse v Foster* (1872) LR 8 ChApp 309; *re Leslie* (1893) 23 ChD 552; *Jesse v Lloyd* (1883) 48 LT 656; *Daly v The Union Trustee Co of Australia Ltd* (1898) 24 VLR 460; *In re Smith's Estate*; *Bilham v Smith* [1937] Ch 636.

enjoy a right of indemnity in circumstances where an unauthorised liability has been incurred by the trustee in good faith and in incurring that liability, a benefit has been conferred on trust property. The right to indemnity will be limited to the extent of the benefit conferred on the trust property.⁵⁴

An example comes from the case of *In re Smith's Estate: Bilham v Smith*.⁵⁵ In that case a husband took out a policy of life assurance payable after ten years or upon his earlier death and expressed it to be for the benefit of his wife. It was accepted that this policy was therefore held in trust for the wife. Two years after the policy was taken out, the wife died. The husband kept the policy on foot, paying the premiums, until it matured, when the insurance company paid the policy moneys into a deposit account in the joint names of the husband and another as personal representatives of the deceased wife. The husband died and his administratrix claimed a lien on the policy moneys for the amount of the premiums paid after his wife's death.

It was held that the estate of the husband was entitled to a lien on the policy moneys for the amount of the premiums paid by him since his wife's death. He was entitled, as a trustee, to an indemnity and associated lien over the moneys because he expended money in the preservation of trust property.

3. Contractual Exclusions

This section deals with the question of whether the creator of a trust can exclude a trustee's rights of indemnity by the terms of the trust deed.

Although the trust deed clauses *provided* rights to indemnity in the leading recent Australian decision in *RWG Management Ltd v Commissioner for Corporate Affairs (Vic)*⁵⁶ the power to remove this right of indemnity also fell to be considered.

The case involved the proposed transfer of the assets and goodwill of a firm of stockbrokers into the hands of a trading trustee. The Commissioner for Corporate Affairs, acting as delegate of the National Companies and Securities Commission granted the appellants (the trustee company) a conditional dealer's licence. One of the conditions of the licence directed that in calculating the "adjusted liquid capital" of the appellant its rights of indemnity against the trust assets should not be recognised as a current asset. The case made an examination of the security value of such rights of indemnity for creditors of the trust business.

As part of this examination the Court enquired as to the ability of trustees to contractually exclude the rights of indemnity that would normally accrue to them. Brooking J recognised that the trustee's right to be indemnified by the beneficiaries personally could be excluded by the

⁵⁴ *Ex parte Chippendale, Re German Mining Co* (1854) 4 DeGM&G 19; 43 ER 415.

⁵⁵ [1937] Ch 636.

⁵⁶ (1985) 9 ACLR 739.

trust instrument.⁵⁷ He cited three cases as authority; *Hardoon v Belilios*,⁵⁸ *Gillan v Morrison*⁵⁹ and *Kemtron Industries Pty Ltd v Commissioner of Stamp Duties (Qld)*.⁶⁰

Having established that, Brooking J then turned his attention as to whether the trustee's general law right of indemnity out of the assets of the trust could be similarly excluded. Referring to the *Kemtron Industries Case*⁶¹ Brooking J reported that McPerson J and Andrews SPJ had:⁶²

suggested that, because the right of indemnity out of assets was inseparable from the office of trustee, it was probably incapable of being excluded by the trust instrument. With so much trade nowadays in the hands of corporate trustees which have a trifling capital, do not own beneficially the assets of the business and are able to incur debts without bringing the real owners under any personal liability to the creditors, it might be thought a wholesome principle that the trustee's right of indemnity, which is really all that is left to the creditors, should not be ousted by the deed of trust.

Brooking J also made a cogent analysis of the fundamental nature of the trustee's rights based on the founding case of *Hardoon v Belilios*.⁶³ He said:⁶⁴

Hardoon v Belilios ... grounds the trustee's right to be indemnified by the beneficiary upon this same broad notion of justice. The Judicial Committee accepts, at p 127, that the beneficiary's obligation can be excluded, and it is difficult to see why the right against the trust estate should stand in a different position. Observations in *Re German Mining Co; Ex parte Chippendale* ... suggest that exclusion is possible. If a trustee is willing to accept office where the trust instrument ousts his indemnity, I do not see why he should not be free to do so.

To conclude this analysis of the case, it is to be noted that Brooking J felt the trading trust structure proposed for the business presented sufficient potential prejudice to trust creditors to render use of the structure inappropriate. This was so, even though the trust did not exclude any rights of indemnification for the trustee, which, of course, would be the logical step in structuring the ideal "zero liability" trading enterprise.

The case of *McLean v Burns Philp Trustee Company Pty Ltd*⁶⁵ concerned a unit trust, and Clause 48 of its trust deed is of relevance here. It reads:

Subject to Clause 49 hereof, neither the trustee nor the manager shall have any claim of any nature against any unit holder for any liabilities incurred in connection with any investment or in respect of any action taken by either of them hereunder.

This clause was given its intended effect by the court. It was effective to

⁵⁷ *Ibid*, 747.

⁵⁸ *Supra* at note 8.

⁵⁹ (1947) 1 DeG & Sm 421; 63 ER 1131.

⁶⁰ (1984) 15 ATR 627, 631 & 634.

⁶¹ *Ibid*.

⁶² *Supra* at note 56, at 748.

⁶³ *Supra* at note 8.

⁶⁴ *Supra* at note 56, at 748.

⁶⁵ (1985) 9 ACLR 926.

exclude the trustee's right of indemnity against the beneficiaries and was not contrary to public policy. Young J had this to say with regard to Clause 48:⁶⁶

The effect of a clause such as Clause 48 operates so as to deny the trustee rights against the beneficiary so that there is no right for which the creditor can be subrogated.

He cited two authorities for his statement. They were *Re German Mining Co; Ex parte Chippendale*⁶⁷ and *Wise v Perpetual Trustee Co Ltd*.⁶⁸

The plaintiff in the *McLean*⁶⁹ case was a unit holder seeking an order for the general administration of the trust. As part of his application, the plaintiff sought to argue that there were public policy provisions that would prevent a trustee or a beneficiary being able to limit its liability. Young J did not consider that any public policy provisions prevented the trustees or beneficiaries from limiting, or eliminating their liability. He said:⁷⁰

I do not believe that there is any matter of public policy which mitigates [sic] against a party limiting its liability except in two situations The two exceptions are that where the exclusion of liability is with respect to negligence or breaches of trust, courts will be very careful in approaching the clause and will read it as strictly as possible: see *Hollier v Rambler Motors (AMC) Ltd* [1972] 2 QB 71 at 78, and courts will not allow such clauses to be used as a cloak for fraud. So that where there is a discretionary trust which is so geared to enable a person to avoid his creditors by hiding behind the vehicle of the trust, equity would not allow that to happen.

Therefore, although a clause such as Clause 48 will not generally be ineffective as contrary to public policy, nevertheless it will not be able to be used as an element of a blatant "zero liability" trading enterprise. One could hypothesise examples of blatant liability avoiding enterprise, such as a trust set up to avoid known debts or perhaps even risks.

Creditors' Rights against Trust Assets via Subrogation

As is clear from the heading of this section, creditors' rights against trust assets have generally been thought to be rights of subrogation. The rights the creditor is subrogated to are trustee's rights. If the trustee has no right to indemnity from trust assets it logically follows that the creditor can have no such access to trust assets. In other words, the creditors' rights depend on the trustee's rights.

The question to be examined is this: what is the nature of the right of the creditors against the assets specifically appropriated by the testator or the settlor for the purpose of carrying on the trade?

The case of *Ex parte Garland*⁷¹ decided that creditors have no right to go beyond the assets devoted to the trade. However, all the case really does is decide that the creditors' rights against trust property are

⁶⁶ *Ibid*, 940.

⁶⁷ *Supra* at note 54, at 427.

⁶⁸ [1903] AC 139.

⁶⁹ *Supra* at note 65.

⁷⁰ *Ibid*, 940.

⁷¹ (1803) 10 Ves Jun 111; 32 ER 786.

limited. It does not say anything about the nature of those rights. It does not determine what exactly those rights are, nor does it specify when such rights arise. Those questions were addressed to some degree at least in the case of *In re Johnson*.⁷²

That case concerned a trader who had by his will directed his executor or trustee to carry on his trade and to employ a specific portion of the trust estate for this purpose. The trustee was personally liable for trust debts. He also had a right of indemnity against such trust assets as had been allocated for trading purposes. It was held that the creditors of the trust were entitled to stand in the place of the executor and trustee and to claim the benefit of the trustee's right of indemnity in order to satisfy their debts.

This right of the creditors is directly related to the right of the trustees. If the trustee is himself not entitled to a right of indemnity then the creditors are in no better position. They cannot obtain any right greater than the trustees. On the facts of the *Johnson*⁷³ case the trustee had not accounted for over £2,400 of trading profits. The trustee therefore had no indemnity against trust assets until he had made good his default. The trust creditors therefore had no rights to take over for their own benefit.

It is clear that the creditors' right recognised in this case is a right of subrogation. It is also clear that it is an unusual type of subrogation. Jessel M R outlined the right in these terms:⁷⁴

I understand the doctrine to be this, that where a trustee is authorised by a testator, or by a settlor ... to carry on a business with certain funds which he gives to the trustee for that purpose, the creditor who trusts the executor has a right to say, "I had the personal liability of the man I trusted, and I have also a right to be put in his place against the assets; that is, I have a right to the benefit of indemnity or lien which he has against the assets devoted to the purposes of the trade". The first right is his general right by contract, because he trusted the trustee or executor: he has a personal right to sue him and to get judgment and make him a bankrupt. The second right is a mere corollary to those numerous cases in Equity in which persons are allowed to follow trust assets. 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.

Ford presents a cogent criticism of this analysis of creditors' rights. He says:⁷⁵

according to this explanation the creditor's rights, ... arise only as an incident to the prevention of the unjust enrichment of another person. The explanation by Jessel M R would exclude a creditor who had not conferred a benefit on the trust.

The effect of denying the trustee company a right to indemnity is to deny creditors' claims via subrogation. Whether such a denial would be allowed to have such an effect by a Court is yet to be decided. Ford determines that:⁷⁶

⁷² (1880) 15 ChD 548.

⁷³ *Ibid.*

⁷⁴ *Ibid.*, 552.

⁷⁵ *Supra* at note 3, at 16.

⁷⁶ *Ibid.*, 17.

The only case law clearly pointing an analogy is that dealing with a settlement which confers an interest on the settlor determinable on his bankruptcy. Such a provision for determination is void as against the settlor's trustee in bankruptcy.⁷⁷

Further, Ford says:⁷⁸

By parity of reasoning a settlor could not be permitted to benefit under a trust which denied to trust creditors recourse to the trust property. But that still leaves trusts under which the settlor has no interest.

These statements would appear to restrict the effectiveness of using a two dollar trustee company to attempt to achieve a "zero-liability" trading enterprise. Note too, that this theme of not letting beneficiaries escape accountability for risks taken for their benefit is of some considerable vintage.⁷⁹

It is the author's thesis that this use of subrogation is an invidious one. The creditors ability to obtain a proprietary interest in the trust assets by being subrogated to the right of the trustee effectively enables alert and fast creditors to immediately gain access to the insolvent's property to satisfy their debts. Other creditors who have not been so alert or fast may arrive later to find nothing more available to meet their claims. This runs totally against all the general principles of bankruptcy and insolvency law that require that all creditors should rank *pari passu* in a bankruptcy or winding up.

It may be, for policy reasons, that creditors of such trading entities require special protection. If that is so, then some legislative changes may be required. It is the author's view, however, that creditors should not be protected by the incorrect use of the concept of subrogation.

In summary, the position of the creditor of a well-designed trading trust is a precarious one. It is generally accepted that the trading trust creditor can only obtain satisfaction of his claims by subrogation to the trustee's rights. However, it is open to the creators of the trading trust to determine the trustee's rights. By contractually restricting such rights, and by making the trustee a two dollar company, the modern day 'man of straw', the creator of the trading trust is technically, at least, able to create a 'zero-liability' trading enterprise.

The above proposition, of course, takes no account of some practicalities of borrowing money. Most financial institutions would demand personal guarantees from either trust beneficiaries, or directors or shareholders of the trustee company.

Ford regards the position of the creditor as an anomalous one. He responds by hypothesising a number of solutions to the presently precarious position of creditors. It is interesting to note that one of his last ideas⁸⁰ is to legislate for trusts similar provisions to Section 320 of the Companies Act 1955 in New Zealand. This discussion therefore

⁷⁷ *In re Burroughs-Fowler; The Trustee of the Property of W J Burroughs-Fowler (A Bankrupt) v Burroughs-Fowler* [1916] 2 Ch 251.

⁷⁸ *Supra* at note 3, at 17-18.

⁷⁹ See *Balsh v Hyham* *supra* at note 6⁶.

⁸⁰ *Supra* at note 3, at 30.

finishes where it began with a foreshadowing of legislative provisions for trusts which the trust structure is presently designed to avoid.

Conclusion

With regard to 'trustees liability' and its related problems, it can be seen that the trading trust structure offers some real advantages over the company structure. As mentioned, the notion of limited liability in the company context is somewhat of a misnomer. The provisions of Section 320 of the Companies Act 1955 may be partially avoided with the use of the trading trust structure.

Some other smaller, but nevertheless practically important, advantages can also be gained from using a trading trust. An example is the secrecy one may enjoy in operating the trust compared with the formal return requirements of companies. However, the necessity to use a corporate trustee may render the whole structure more expensive than a private company. It must also be said that the exact legal effect and status of such a trading enterprise is far from settled. There is no significant New Zealand law on the status of trustees of such trusts. Of necessity, Australian law in this area has had to have been relied upon.

The taxation advantages of such trusts are, in contrast, reasonably well settled. The trust structure's principal tax advantage lies in its ability to split income so as to have it taxed in the hands of individuals on low marginal tax rates. Furthermore, as compared to a company structure, the trust structure does not suffer exposure to double tax liability. These advantages are of great importance under the present regime of high marginal personal income tax rates in New Zealand. Some of the tax advantages over traditional company business structures will of course be lost if and when a full imputation system of company taxation is introduced. Nevertheless the estate planning advantages of such trusts will endure and this alone may still ensure the popularity of these trusts in some circumstances.

It is accepted that trading trusts will not be the ideal business structure for many or most commercial people. They have, however, significant advantages over private companies in some areas, while of course possessing some disadvantages as well. They form another arrow in the commercial lawyer's quiver, and provide additional flexibility in deciding exactly how to organise a client's business affairs for his maximum advantage. There will be circumstances when such structures are invaluable particularly when organising highly speculative ventures. It is submitted that a growth in the use of such trusts in New Zealand ought to be forthcoming.