TRADING TRUSTS AND CREDITORS' RIGHTS

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[*The last decade has seen the emergence of the trading trust as an alternative to the proprietary company for the operation of a family business. With a registered company as trustee the result is, as the author points out, 'a commercial monstrosity'. One important repercussion of this union of the law of trusts and the law of limited liability companies is that the rights of trading creditors may be frustrated in ways not possible in dealings with a simple trading company. In this article Professor Ford examines the law governing the rights of trust creditors and then briefly explains the ways in which the courts might give recognition to this shift in the balance between the interests of trust creditors and beneficiaries.*]

Goods or services may be supplied to individuals in the belief that they are making themselves personally liable. Goods or services may be supplied to a company in the belief that the company is making itself liable through its representatives. The decision to supply may be influenced by a belief that assets apparently controlled by the individual belong to that individual or that assets apparently controlled by the company belong to that company. In some cases that belief may be mistaken.

In the last decade in Australia there has emerged a new risk for suppliers of goods and services and providers of credit generally. This new risk has arisen because many controllers of family businesses have abandoned the proprietary company as the instrument through which to operate and have adopted instead the trust. The trust device has proved to be better than the proprietary company as a means of reducing to a minimum the total liability for income tax of the persons interested in the business. The framers of trusts have not wished individual trustees to be burdened with the debts of the business and it became usual to have a registered company as trustee. That company did not require a large paid-up capital and it did not need to have substantial assets of its own. However, because it controlled trust assets it could present a false appearance of credit-worthiness.

The fruit of this union of the law of trusts and the law of limited liability companies is a commercial monstrosity. The scope for frustrating creditors is considerable. They may encounter three main barriers. To appreciate these barriers one may usefully consider the trading trust and its trust assets as an entity and then contrast it with a limited company registered under the *Companies Act* 1961. The contrast is striking.

First, a creditor will not get payment out of trust assets unless the entity, in incurring the debt, was acting within powers given to it by its creators.

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In other words, the creditor is subject to the full rigours of the doctrine of *ultra vires* without the benefit of anything like s. 20 of the *Companies Act* 1961.

Secondly, a creditor will not get payment out of the assets unless the organs of the entity (that is to say, trustees equated to directors) have avoided committing any breach of any of their duties to the entity. Even a breach of a duty unrelated to the creditor's transaction could prejudice him. In other words the creditor can be affected by the internal affairs of the entity. There is nothing like the rule in *Royal British Bank v. Turquand*[1] to protect him.

Thirdly, a creditor will not get payment out of the assets if the constitutive instrument (the trust instrument equated to the memorandum and articles of association) denies access by creditors to trust assets.

The purpose of this article is to explore the law governing the rights of a person who has extended credit to a trustee in order to understand the background to these limitations on creditors' rights.

A TRUSTEE IS ORDINARILY LIABLE PERSONALLY FOR LIABILITIES ASSOCIATED WITH TRUST

In a trust liabilities may arise from the fact that the trustee holds property, from the entry of the trustee into contracts, from tortious acts or omissions of the trustee or of persons employed in connexion with the trust and from the imposition of taxes.

Usually, the liability falls on the trustee personally: the trust property is not an entity which in law can be regarded as a person liable. Before the *Judicature Acts* fused the administration of common law and equity if a trustee were sued in contract or in tort the proceedings would be brought in a court of common law which had no regard to the trust. As a result a trustee could be personally liable at common law without limit. Even after the *Judicature Acts* the liability falls on the trustee personally. For example, a trustee who carries on trade is liable to trade creditors for the debts incurred in that business to the same extent as if he had been carrying on business on his own account[2] and a trustee who holds shares in a company which carry a liability is personally liable to the full amount of that liability regardless of the extent of the trust property.[3] As will be seen later a trustee may have a right to recoup out of the trust property amounts he has personally expended or a right to be exonerated out of the trust property in respect of a liability incurred, but if the value of the trust property is

[1] (1855) 5 E. & B. 248; affirmed (1856) 6 E. & B. 327; 119 E.R. 886.
[2] *Wightman v. Townroe, Dickons, Thomas and James Watson and Aram* (1813) 1 M. & S. 412; 105 E.R. 154.
[3] *Re Phoenix Life Assurance Co.; Hoare's Case* (1862) 2 J. & H. 229; 70 E.R. 1041.

below the amount of the liability the trustee bears the liability to the extent of the deficiency unless he has a right of indemnity against the beneficiaries.

In the ensuing treatment the right of a trustee to reimburse himself from the trust estate for the amount of any expenditure by him for trust purposes will be referred to as his right of recoupment. The right which a trustee has to use the trust property to discharge a liability which he has incurred for the purposes of the trust will be referred to as his right of exoneration. The expression 'right of indemnity' will be used generically to cover both rights.

PERSONS CONTRACTING WITH TRUSTEE MAY AGREE TO LOOK ONLY TO THE TRUST PROPERTY FOR PAYMENT

A trustee and another person when contracting may, by express stipulation,[4] agree[5] that the trustee shall not be personally liable but that the other party shall look only to the trust property for payment.[6] In such a contract the trustee promises that he will exercise his powers over the trust property in order to pay the debt. It was argued in *Parsons v. Spooner*[7] that such an agreement was illegal because it tended to deprive the beneficiary of the benefit of that security which he would have from the diligence of the trustee himself if he were acting upon his own personal responsibility. Wigram V.-C. rejected the argument because the beneficiary's security lay in his power to have the trustee's conduct investigated by the Court.

It will be apparent that even if a trustee were able to obtain agreement in every contract made by him that the other party would look only to the trust property for payment there could still be non-contractual liabilities affecting him personally.

The creditor who contracted with a trustee to look only to the trust property for payment would not for that reason alone be a secured creditor. If X makes an enforceable promise to Y to pay Y a certain amount out of specific property X may intend to charge that sum on that property. If so Y may thereby obtain an equitable charge over the property which would give him priority over X's general unsecured creditors. A trustee who contracts with a trust creditor on terms that the creditor will look only to the trust property for payment would be taken to charge the debt on the trust property only if there were behaviour on his part clearly showing his intention to do so.[8] An intention to charge is not lightly to be

[4] *Re Anderson; ex parte Alexander* (1927) 27 S.R. (N.S.W.) 296, 300 *per* Long Innes J.

[5] This assumes that the other person has power to make such a contract: a company could not contract to issue shares to a person on that basis.

[6] *Lumsden v. Buchanan* (1865) 4 Macq. 950; 13 L.T. 174; *Muir and Ors Trustees v. City of Glasgow Bank and Liquidators* (1879) 4 App. Cas. 337, 355, 388, *per* Lord Blackburn.

[7] (1846) 5 Hare 102; 67 E.R. 845.

[8] *Re State Fire Insurance Co.* (1863) 1 De G. J. & S. 634; 46 E.R. 251; *Swiss Bank Corporation v. Lloyds Bank Ltd and Ors* [1980] 3 W.L.R. 457, 469.

found for it would be commercially inconvenient if successive creditors against the trust property had to be ranked according to the order in which they acquired charges. As unsecured creditors having a claim on a fund they would rank *pari passu*.[9]

A TRUSTEE'S RIGHT TO RECOUPMENT OR EXONERATION OUT OF THE TRUST PROPERTY

Even before statute[10] empowered a trustee to reimburse himself or to pay out of the trust property the expenses properly incurred in the execution of the trusts or powers those rights were accorded to a trustee by case law.[11] Trustees should keep a regular account of their expenses: if they fail to do so and there is a dispute as to the amount to which they are entitled a court may not allow them all they claim. In an old case[12] a trustee claimed £2,500, being an average estimate of his expenses. The Court, considering the nature of the trust, thought that the trustee might well deserve the whole £2,500 but allowed him only £2,000.

A trustee is not bound in the first instance to pay trust creditors out of his own pocket, and then to recoup himself out of the trust property: he can discharge liabilities out of the trust property. He is entitled to be indemnified, not merely against payments actually made, but against his liability.[13]

The trustee has an equitable charge or lien on the trust property which gives a right to retain trust property until the right to indemnity is satisfied and, if need be, to sell it.[14] The trustee's right of indemnity has been described as a right of property in assets of the trust.[15] That description is acceptable where the trustee has paid the debt and he has a right of recoupment but where his right is one of exoneration there can be cases where the trustee's power to apply trust property in payment of trust debts is a fiduciary power to be exercised in the interests of the beneficiary.[16]

[9] *Ibid.*

[10] *Trustee Act* 1925 (N.S.W.) s. 59(4); *Trustee Act* 1958 (Vic.) s. 36(2); *Trusts Act* 1973 (Qld) s. 72; *Trustee Act* 1936-1968 (S.A.) s. 35(2); *Trustee Act* 1962-1978 (W.A.) s. 71; *Trustee Act* 1898 (Tas.) s. 27(2). These provisions are derived from the *Law of Property Amendment Act* 1859 (Eng.) s. 31 through the *Trustee Act* 1893 (Eng.) s. 24. See now *Trustee Act* 1925 (Eng.) s. 30(2).

[11] *Worrall v. Harford* (1802) 8 Ves. 4, 8; 32 E.R. 250, 252 *per* Lord Eldon.

[12] *Hethersell v. Hales* (1679) 2 Rep. Ch. 158; 21 E.R. 645.

[13] *In re Blundell; Blundell v. Blundell* (1888) 40 Ch. D. 370, 377 *per* Stirling J.; *The Official Assignee of O'Neill v. O'Neill and Ors* (1898) 16 N.Z.L.R. 628; *Daly v. The Union Trustee Co. of Aust. Ltd* (1898) 24 V.L.R. 460; *The Governors of St. Thomas's Hospital v. Richardson* [1910] 1 K.B. 271, 276.

[14] *Re The Exhall Coal Company (Ltd)* (1866) 35 Beav. 449; 55 E.R. 970; *Stott v. Milne* (1884) 25 Ch. D. 710. The nature of a particular trust may be such that the trustees would not be permitted to sell the trust property when the effect would be to destroy the trust: *Darke v. Williamson* (1858) 25 Beav. 622; 53 E.R. 774.

[15] *Octavo Investments Pty Ltd v. Knight and Another* (1979) 27 A.L.R. 129, 136, discussed later.

[16] *Infra.*

When that is the case it seems inappropriate to describe the trustee's right as a proprietary right.

The trustee's right to indemnity out of the trust estate is not prejudiced by an assignment by the beneficiary of his beneficial interest: the assignee of an interest under a trust takes subject to the risk that the trust estate may be reduced to indemnify the trustee.[17]

A TRUSTEE'S RIGHT TO INDEMNITY AGAINST PERSONS RELATED TO THE TRUST

If the trust property is inadequate to provide indemnity there is a question whether a trustee can obtain indemnity from persons associated with the trust.

A. The settlor

One might think that since the settlor has requested the trustee to assume an office in which he might incur liabilities there would be an implied undertaking of the settlor to the trustee to indemnify him in respect of liabilities properly incurred. In the law of agency the relation of principal and agent raises by implication a contract on the part of the principal to indemnify the agent against all liabilities, incurred in the reasonable performance of the agency, provided that that implication is not excluded by the express terms of the contract between them.[18]

However, courts have not made a settlor personally liable to indemnify the trustee on the basis of an implied contract. The settlor, merely because he is the creator of the trust, is not personally liable to indemnify unless he has done something more to show that he is promising to indemnify in consideration of the trustee accepting the office or unless he retains so wide a power to direct the trustee that the relationship of principal and agent is established between them. In *Fraser or Robinson v. Murdoch*[19] Lord Blackburn said:

> 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.[20]

There is no implied contract between the settlor and the trustee because the trust developed in English law before there was a common law remedy for breach of a simple contract: before the development of the form of action in assumpsit. The absence of any implied contract between the settlor and the trustee seems to explain another principle of the law of

[17] *In re Knapman; Knapman v. Wreford* (1881) 18 Ch. D. 300.
[18] Halsbury, *Laws of England* 4th ed. vol. 1 para. 807. *Adamson v. Jarvis* (1827) 4 Bing. 66; 130 E.R. 693.
[19] (1881) 6 App. Cas. 855.
[20] *Ibid.* 872-3.

trusts that a settlor, as such, has no standing to sue the trustee for breach of trust.

Moreover, agency, being a common law institution, could attract notions of implied contract when the law of simple contract developed, but a trust was an equitable relation growing in a jurisdiction which was not developing the principles of the law of contract.

A further (and probably the most important) explanatory factor is that a trust was thought of as an alienation of property by the settlor. If we look on the creation of a trust from the point of view of the common law, the settlor is simply a person who has retired from the scene whereas in agency the principal is the person for whose benefit the agency is established and on whose behalf the agent acts.

The position of the maker of the trust is different where the trust is for his benefit. That situation can attract another principle that any one who requests another to incur a liability which would otherwise have fallen on himself is, in general, bound, at law as well as in equity, to indemnify him.[21] The indemnity extends not only to liabilities attached to the property at the time the trust is created but also to liabilities later accruing.[22] Whether this principle makes the settlor personally liable to indemnify has been said to depend 'on the nature of the trust and of the interest of the *cestui que trust*'.[23]

It is settled that where a beneficiary *sui juris* requests his trustee to incur a liability the beneficiary is personally liable to indemnify the trustee.[24] Presumably, if the settlor, although not an original beneficiary, became a beneficiary by assignment he would be liable to indemnify the trustee at least in respect of liabilities incurred after he became a beneficiary.

B. The beneficiaries

According to the Privy Council in *Hardoon v. Belilios*[25] where the only beneficiary is *sui juris*, the right of the trustee to indemnity against him for liabilities properly incurred by the trustee by his retention of the trust property has never been limited to the trust property. Such a beneficiary is subject to an equitable personal obligation to indemnify his trustee. It is not necessary for the trustee to show that the beneficiary requested him to incur the liability.

[21] *Balsh v. Hyham* (1728) 2 P. Wms. 453; 24 E.R. 810; *Jervis v. Wolferstan* (1874) L.R. 18 Eq. 18, 24. The right of indemnity given by this principle is narrower than that given to an agent under the 'implied contract' theory: *Brittain v. Lloyd* (1845) 14 M. & W. 762; 153 E.R. 683.

[22] *Jeffray v. Webster* (1895) 17 A.L.T. 72; 1 A.L.R. 65.

[23] *Fraser or Robinson v. Murdoch* (1881) 6 App. Cas. 855, 872 *per* Lord Blackburn.

[24] *Infra* n. 27.

[25] [1901] A.C. 118. See also *per* Wigram V.-C. *Phene v. Gillan* (1845) 5 Hare 1; 67 E.R. 803 and *Parsons v. Spooner* 5 Hare 102; 67 E.R. 845, 848 in which he said: '*Prima facie*, the trustee has a right to be indemnified by his *cestui que trust* before he incurs any liability'.

One would expect that the same principle ought to apply where there is more than one beneficiary and all of them are *sui juris* and entitled to the same interest as absolute owners between them.

However, in such cases of multiple beneficiaries as have been reported, there has been the further element that the trustees incurred the liability at the request of the beneficiaries.[26] A request from a beneficiary who is *sui juris* to the trustee to assume the office of trustee or to incur liabilities[27] obviously justifies the imposition of a personal liability to indemnify on the beneficiary and this should be so even if the beneficiary has only a limited interest. The Privy Council in *Hardoon v. Belilios* relied on some earlier authority which concerned multiple beneficiaries for the proposition that a sole beneficiary who is *sui juris* is bound to indemnify even though the trustee does not prove a request by the beneficiary. This reliance suggests that the Privy Council thought that personal liability to indemnify would attach to several beneficiaries having the same interest, all of them being *sui juris* and absolutely entitled.[28]

It was stated in *Hardoon v. Belilios* that where property was held on trust for tenants for life, or for infants, or upon special trusts limiting the right to indemnity there was no beneficiary who could be justly expected or required personally to indemnify the trustee. An earlier statement in the opinion that '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 show some good reason why his trustee should bear them himself'[29] must be taken to be limited to cases where the beneficiaries are all *sui juris*, entitled to the same interest and absolutely entitled.

When that is the case the relationship between the trustee and the beneficiaries could be ended at any time by the beneficiaries calling for the legal title.[30] Because the beneficiaries have that power there can be inferred a continuing request by them to the trustee to incur liabilities in the course of the administration of the trust even if the beneficiaries have made no express request. If this rationalization is valid it should extend to cases where all the beneficiaries are *sui juris* and are, between them, absolutely entitled but they have successive rather than concurrent interests.

Perhaps the relevant principles can only be understood in the light of the fact that the decided cases in which beneficiaries have been held personally liable to indemnify concerned not family trusts (they being the

[26] *Ex parte Chippendale; Re German Mining Co.* (1854) 4 DeG. M. & G 19, 54; 43 E.R. 415, 428; *Buchan v. Ayre* [1915] 2 Ch. 474; *Matthews v. Ruggles-Brise* [1911] 1 Ch. 194.

[27] *Balsh v. Hyham* (1728) 2 P. Wms. 453; 24 E.R. 810; *Hobbs v. Wayet* (1887) 36 Ch. D. 256; *Jeffray v. Webster* (1895) 17 A.L.T. 72; 1 A.L.R. 65.

[28] In Ontario in *Clarkson v. McClean* (1918) 42 O.L.R. 1 several beneficiaries were held liable to indemnify.

[29] [1901] A.C. 118, 123.

[30] *Saunders v. Vautier* (1841) 4 Beav. 115; 49 E.R. 282.

only trusts likely to involve successive interests) but trusts associated with business ventures or investments.

It seems clear from the case law that the objects of a discretionary trust, having no more than an expectancy and a right to due administration of the trust,[31] cannot be called upon to indemnify the trustee.

Trustees of unincorporated clubs, trade unions, churches and other unincorporated associations, not formed for the purpose of making profit for their members, have a right of indemnity out of the property of the group but not against the members personally unless that right is expressly conferred by contract. In *Wise v. Perpetual Trustee Company Limited*[32] when speaking for the Judicial Committee of the Privy Council, Lord Lindley said:

> In *Hardoon v. Belilios*[33] this Board had to consider the right of trustees to be indemnified by their *cestuis que trustent* against liabilities incurred by the trustees by holding trust property. The right of trustees to such indemnity was recognized as well established in the simple case of a trustee and an adult *cestui que trust*. But, as was then pointed out, this principle by no means applies to all trusts, and it cannot be applied to cases in which the nature of the transaction excludes it.
>
> Clubs are associations of a peculiar nature. They are societies the members of which are perpetually changing. They are not partnerships; they are not associations for gain; and the feature which distinguishes them from other societies is that no member as such becomes liable to pay to the funds of the society or to any one else any money beyond the subscriptions required by the rules of the club to be paid so long as he remains a member. It is upon this fundamental condition, not usually expressed but understood by every one, that clubs are formed; and this distinguishing feature has been often judicially recognized.[34]

In many of the cases in which a trustee has been held to have a right of indemnity against a beneficiary personally, the trustee has first exhausted his right to indemnity out of the trust estate. It is conceived that it is not absolutely necessary for him to do this before claiming against the beneficiary. There may be circumstances where although the trust property is of some value it is not practicable to convert it to cash at the time the trustee has to discharge the liability. In many instances it will be to the advantage of the beneficiary for the trustee to refrain from converting the trust property on terms that the beneficiary will provide funds.

A trustee who has a right of indemnity against a beneficiary personally is not bound to discharge the liability he has incurred first before looking to the beneficiary.[35] The trustee is entitled to an order that the beneficiary provide a fund to meet the liability.[36]

Where several beneficiaries are liable to indemnify the trustee they are liable to do so in proportion to their shares in the beneficial interest.[37] If

[31] Hardingham I. J. and Baxt R., *Discretionary Trusts* (1975) 137.
[32] [1903] A.C. 139.
[33] [1901] A.C. 118.
[34] [1903] A.C. 139, 149.
[35] *Hobbs v. Wayet* (1887) 36 Ch. D. 256.
[36] *In re Richardson; Ex parte The Governors of St Thomas's Hospital* [1911] 2 K.B. 705.
[37] *Matthews v. Ruggles-Brise* [1911] 1 Ch. D. 194.

any beneficiary is insolvent and unable to contribute his proper proportion the others are liable to meet it[38] rateably.

Where a beneficiary would be liable to indemnify the trustee if there were any liabilities and the beneficiary assigns his equitable interest the assignor remains liable to indemnify the trustee even in respect of liabilities falling due after the assignment.[39] This is consonant with the rule that the trustee cannot in general refuse to recognize an assignment by his beneficiary.[40] If the assignor wishes to avoid liability after assignment he should negotiate a release from the trustee. As between the assignor and the assignee there would be implied from the assignment an undertaking by the assignee to indemnify the assignor.[41] That arrangement as between the assignor and the assignee could not affect the trustee's right to obtain an indemnity from either of them at his option in a case where each would be liable to the trustee.[42]

However, where the beneficiary becomes bankrupt and his interest becomes vested in his trustee in bankruptcy the trustee in bankruptcy is not personally liable to indemnify the trustee for the trustee in bankruptcy takes as an officer of the bankruptcy court in his representative capacity.[43] The trustee in bankruptcy takes the title to the property without prejudice to the lien or charge of the trustee in respect of liabilities properly incurred by the trustee.[44]

A TRUSTEE'S RIGHT TO RECOUPMENT OR EXONERATION IS, IN GENERAL, AVAILABLE ONLY IN RESPECT OF LIABILITIES NOT IMPROPERLY INCURRED

Rates, taxes and other outgoings associated with land properly held in trust would normally meet that test. So also would calls on partly-paid shares where the shares are properly held.

A. Expenses of carrying on a business

Where a trustee of a trust *inter vivos* has authority under the trust instrument to employ the trust property in the conduct of a business the debts are his debts for which he is personally liable but he has a right of recoupment and exoneration in respect of his expenses incurred in the proper conduct of the business.

In general, if a trustee carries on a business without authority given by the trust instrument, by an order of the Court or by all the beneficiaries, they being of full capacity, he has no authority to reimburse himself out of

[38] *Ibid.*
[39] *Ibid.*
[40] *Hardoon v. Belilios* [1901] A.C. 118.
[41] *Matthews v. Ruggles-Brise* [1911] 1 Ch. D. 194.
[42] *Ibid.*
[43] *Trautwein v. Richardson* [1946] Argus L.R. 129, 135.
[44] *Ibid.*

the trust property or to apply trust property to meet liabilities incurred in the business.[45]

A deceased estate which includes a business raises special problems because in addition to beneficiaries who have an interest in the estate there may also be estate creditors who had claims on the deceased and who are entitled to be paid out of the estate. The personal representative can, without express authority in the will, carry on the business for its realization[46] and is entitled to indemnity for trading debts against the beneficiaries and the estate creditors. The testator cannot by his will give authority for the assets in the estate to be used in a business so as to prejudice the right of the estate creditors to be paid out of the estate although such an authority will give the trustee a right of indemnity in priority to the beneficiaries. Unless an estate creditor actively and positively assents to the carrying on of the business beyond the period required for its realization, the trustee is not entitled to recoupment or exoneration out of the trust property in priority to that estate creditor.[47]

Apart from statute[48] the trustee is entitled to recoupment and exoneration in respect of the debts of the business only out of the trust property which the creator of the trust authorized to be used for the purpose of carrying on the business and out of any assets acquired in the course of carrying on the business.[49] The extent of the trust property made applicable for the purpose of the business depends on the terms of the trust instrument.[50]

In *Ex parte Garland*[51] a testator authorised one of his trustees to carry on a business and directed that a limited part of his estate be used for that purpose. Lord Eldon held that the other assets in the estate were not available to meet claims of creditors subsequent to the death of the testator whose debts were contracted by the trustee in carrying on the trade and who were claiming in right of the trustee's right of exoneration. His reasons exhibit concern for the convenience of those beneficiaries who would under the will derive no share in the profits of the business. He was concerned that when trading debts were to be met such beneficiaries should not be liable to pay back money previously distributed to them by the trustee. Nowadays, although trustees have a right to adjust an overpayment to a beneficiary out of future payments, they have no right to recover an

[45] *Vacuum Oil Co. Pty Ltd v. Wiltshire* (1945) 72 C.L.R. 319, 325.

[46] In Queensland by *Trusts Act* 1973 s. 57 and in Western Australia by *Trustees Act* 1962-1968 s. 55 personal representatives are given statutory power to continue a business of the deceased for periods specified.

[47] *Vacuum Oil Co. Pty Ltd v. Wiltshire supra* n. 45.

[48] See n. 46 as to Queensland and Western Australian legislation.

[49] *Strickland v. Symons* (1884) 26 Ch. D. 245, 248; *Ex parte Garland* (1803) 10 Ves. 110; 32 E.R. 786; *Thompson v. Andrews* (1832) 1 My. & K. 116; 39 E.R. 625. *Vacuum Oil Co. Pty Ltd v. Wiltshire* (1945) 72 C.L.R. 319, 324 *per* Latham C.J.; *Octavo Investments Pty Ltd v. Knight and Another* (1979) 27 A.L.R. 129.

[50] *Ex parte Richardson and Ors* (1818) 3 Madd. 138, 157; 56 E.R. 461, 468; *Cutbush v. Cutbush* (1839) 1 Beav. 184; 48 E.R. 910.

[51] *Supra* n. 49.

overpayment by proceedings.[52] Even so, there could be inconvenience to a beneficiary not entitled to the profits of the business if the trustee were to withhold payments to him so that trading debts could be met. It is for that reason that, when a testator directs that a business be carried on, the extent of the property against which the trustee's rights of recoupment and exoneration may be exercised can depend on the intention of the testator.

The effect of *Ex parte Garland* has been stated in later cases in more general terms to be that the trustee is entitled to an indemnity in respect of trading debts out of the trust assets authorized to be used for the purpose of carrying on the business and out of any assets acquired in the course of carrying it on.[53] The principle stated this way would limit the trustee's rights of recoupment and exoneration even if all beneficiaries shared equally in all gains of the trust estate, whether trading or non-trading.

There are *dicta* which could suggest that when a settlor or testator authorizes a trustee to conduct a business the trustee has rights of recoupment and exoneration in respect of trading debts only out of assets specifically appropriated by the settlor or testator for that purpose or that a trading creditor can proceed by subrogation to the trustee's rights only when there has been a specific appropriation.

In *Strickland v. Symons*[54] a business was assigned to trustees of a marriage settlement on trust to sell it and to hold the proceeds on trust for the wife and children. A surviving trustee carried on the business until it was sold. A trade creditor claimed payment out of the trust funds by subrogation to the trustee's right of exoneration. The claim was rejected because no special part of the estate had been appropriated for carrying on the business. The Earl of Selborne L.C. distinguished *Ex parte Garland*[55] and *Re Johnson*[56] as cases where there had not only been an express direction by the testator to carry on a business, but also a special appropriation of part of his property for that purpose. He said:

> Those authorities proceed on this principle, that where a particular part of a trust estate is specifically dedicated to a particular purpose which involves trade debts and liabilities, it is a trust to use it for that particular purpose, and the trustee, though personally liable for the debts which he contracts in the course of the business, has a right to be paid out of the specific assets appropriated for that purpose, and the trade creditors are not to be disappointed of payment so far as the assets so appropriated are concerned.[57]

It is submitted that this statement goes beyond *Ex parte Garland* and that express dedication is not needed either for the trustee to have rights of recoupment or exoneration or for a trading creditor to proceed by subrogation to the trustee's rights. The true effect of *Ex parte Garland* as a

[52] *Merriman v. Perpetual Trustee Co. Ltd and Ors* [1896] 17 L.R. (N.S.W.) 325.
[53] *E.g. Re Johnson* (1880) 15 Ch. D. 548, 553 *per* Jessel M.R.; *Vacuum Oil Co. Pty Ltd v. Wiltshire* (1945) 72 C.L.R. 319, 324 *per* Latham C.J.
[54] (1884) 26 Ch. D. 245.
[55] *Supra* n. 49.
[56] (1880) 15 Ch. D. 548.
[57] (1884) 26 Ch. D. 245, 248.

case concerned with differing beneficial interests is seen in its application in *Fraser v. Murdoch*.[58] In that case, trustees of a testamentary trust, to whom the testatrix had left company stock, set aside some stock in an unlimited company for one beneficiary, X, and appropriated other property for a second beneficiary, Y. Later, calls were made on the trustees in respect of the stock. They sought indemnity out of the whole trust estate. It was held that having exercised their power to sever the trust estate for appropriation to each beneficiary their right of indemnity existed only in respect of the stock set aside for X which, by that time, was valueless.

However, many of the older cases exhibit a view that the conduct of a business is an activity more hazardous than the normal investment-holding function of a trustee and that as between the trustee and the beneficiaries business losses should be shifted from the trustee to that part alone of the trust property which the creator of the trust positively intended to be used in the business.

When that view was adopted a trustee would be personally liable to the full extent of his assets and that was calculated to make trading trustees cautious in the matter of obtaining credit. That restraint, although it might not have been totally effective in all cases, disappeared altogether when limited liability companies could become trustees.[59] With that change and with a greater concern for the interests of trust creditors the limitation of the right of exoneration to part only of the trust property may be seen to be undesirable.

Under the legislation of Queensland[60] and Western Australia[61] a personal representative of a deceased person who conducted a business at his death is empowered to conduct the business for, *inter alia*, a minimum of two years from the death and in doing so may employ any part of the deceased's estate that is subject to the same trusts.

B. Liability in tort

The trustee's right to indemnity extends to liability in tort incurred by the trustee in the course of administering the trust provided the trustee acted up to the standard of the reasonable, prudent person in relation to the activity out of which the liability arose.

In *Bennett v. Wyndham*[62] an accident occurred while woodcutters were employed by a trustee of a settled estate to fell trees. A falling bough injured a passer-by who recovered damages against the trustee. The trustee was held to be entitled to indemnity out of the trust estate. The trustee was

[58] (1881) 6 App. Cas. 855.
[59] *Infra.*
[60] *Trusts Act* 1973 (Qld) s. 57.
[61] *Trustees Act* 1962-1968 (W.A.) s. 55.
[62] (1862) 4 De G.F. & J. 259; 45 E.R. 1183. See also *Re Raybould* [1900] 1 Ch. 199; *Vale and Another v. Whiddon and Another* (1950) S.R. (N.S.W.) 90.

found to have acted with due diligence and to have employed a proper agent, that employment being within the scope of the trustee's duty.

C. Interest on money advanced by trustee to discharge a trust liability

If a trustee advances his own money in order to discharge a liability properly incurred in the administration of the trust he is not ordinarily entitled to interest on the amount advanced.[63] A trustee is not to make a profit[64] out of his trust without authority given by the trust instrument, all the beneficiaries (they being *sui juris* and all ascertained) or the sanction of the Court. There are, however, instances where the trustee having advanced money to pay a debt carrying interest has been allowed interest.[65] In those cases the trustee is subrogated to the creditor's right to interest.

D. Trustee's right of indemnity where benefit conferred on trust property

Even though a liability incurred by a trustee may not be authorized by the terms of the trust, the trustee will have a right to reimbursement or indemnity if the trustee, acting in good faith, has conferred a benefit on the trust property.[66] His right will extend as far as the benefit conferred. If a trustee borrows money, though not authorized to do so, and uses the money borrowed to make proper expenditure in the administration of the trust, he is entitled to indemnity to the extent of the benefit conferred on the trust property.[67]

DENIAL OR REDUCTION OF THE TRUSTEE'S RIGHT TO RECOUPMENT OR EXONERATION BECAUSE HE IS IN DEFAULT TO THE TRUST

Clearly a trustee no longer has those rights if he has withdrawn money from the trust estate ostensibly for the purpose of paying a debt incurred on behalf of the trust but instead of so applying the money he has misappropriated it: his right of exoneration has been exercised and is spent. Suppose, however, that he has paid the debt from his own funds and he seeks recoupment out of the trust property. It is clear that if he has committed a breach of trust for which he is liable to compensate he cannot obtain recoupment until he has provided compensation. This result rests on the principle that a defaulting trustee cannot claim as against the

[63] *Sichel v. O'Shanassy* (1877) 3 V.L.R. (E.) 208.
[64] *Re Jones; Hockings v. Qld Trustees Ltd* [1917] Q.S.R. 74.
[65] *Re Beulah Park Estate; Sargood's Claim* (1872) L.R. 15 Eq. 43; *Finch v. Pescott* (1874) L.R. 17 Eq. 554.
[66] *Vyse v. Foster* (1872) L.R. 8 Ch. App. 309; *Re Leslie* (1883) 23 Ch. D. 552; *Jesse v. Lloyd* (1883) 48 L.T. 656; *Daly v. The Union Trustee Co. of Australia Ltd* (1898) 24 V.L.R. 460; *In re Walder; Townsend v. Walder* (1903) 3 S.R. (N.S.W.) 375; *Re Jones* [1917] Q.S.R. 74; *In re Smith's Estate; Bilham v. Smith* [1937] Ch. 636. *Cf.* Goff R. and Jones G., *The Law of Restitution* (1978 2nd ed.) 35 on officious conferment of benefits.
[67] *Ex parte Chippendale, In the matter of The German Mining Co.* (1854) 4 De G. M. & G. 19; 43 E.R. 415.

beneficiaries any beneficial interest (in this context the trustee's lien for recoupment) until he has made good his default.[68]

If he has not paid the debt from his own funds but seeks exoneration by applying trust property in discharge of the debt he has no beneficial interest in the trust property and that principle should not be applicable.[69] The power given to him to discharge trust debts out of the trust property is a power to be exercised in the interests of the beneficiary. As will be seen below there are cases deciding that a trust creditor may obtain payment out of the trust property by subrogation to the trustee's right of exoneration. It has been said that the creditor can have no higher right than the trustee and it has been supposed that if the trustee was in default to the trust, whether on a matter related to the debt or not, the trustee's right to exoneration would be eliminated or reduced in value.[70] Recently, in *Re Staff Benefits Pty Ltd*[71] Needham J., in *obiter dicta*, opined that not every breach of trust would debar the trustee: to have that effect a breach would have to be related to the subject matter of the indemnity. The reason for and extent of that qualification were not fully expounded although his Honour could have been simply excluding only breaches of trust which caused no loss to the trust estate.

DENIAL OR LIMITATION BY TRUST INSTRUMENT OF TRUSTEE'S RIGHT TO RECOUPMENT AND EXONERATION

In those jurisdictions in which the statutory power of recoupment and the statutory right to exoneration[72] may be excluded[73] it is open to the creator of the trust, by the terms of the trust, to deny to a trustee a right to recoupment and a right to exoneration against the trust property or to limit such rights.[74] On principle it would be open to the creator of the trust to provide that the trustee is not to have any right to indemnity as against any beneficiary personally. It is up to the person who is approached to be trustee to decide whether he will accept the office on such adverse terms.

TRUST CREDITOR'S RIGHT TO SATISFATION OUT OF TRUST PROPERTY

Suppose that a trustee in the proper administration of the trust has incurred an unsecured liability to a creditor. The trustee is personally liable

[68] *Jacubs v. Rylance* (1874) L.R. 17 Eq. 341; *Doering v. Doering* (1889) 42 Ch. D. 203.

[69] *In Octavo Investments Pty Ltd v. Knight* (1979) 27 A.L.R. 129, it is said that the trustee has a proprietary interest. This case is discussed later.

[70] *Infra* n. 89.

[71] [1979] 1 N.S.W.L.R. 207, 214.

[72] *Supra* n. 10.

[73] *Trustee Act* 1958 (Vic.) s. 2(3); *Trustees Act* 1962-1968 (W.A.) s. 5(3); *Trustee Act* 1898 (Tas.) s. 64.

[74] *Ex parte Chippendale, In the matter of The German Mining Co.* (1854) 4 De

to his last cent. But suppose that the creditor wishes to obtain satisfaction out of the trust property. Generally speaking, an unsecured creditor cannot claim to be paid out of the assets of his debtor whether those assets are held by the debtor as trustee or beneficially. An unsecured creditor may, after obtaining a judgment against the debtor, obtain the issue of process of execution in order to enforce the judgment against assets of the debtor. But assets held by the debtor as trustee cannot be taken in execution.[75] This is so even if the judgment is in respect of a liability incurred by the judgment debtor as a trustee.

But a creditor to whom a trustee has incurred a liability in the proper administration of a trust may, by what has been described as a 'lucky accident',[76] be in a better position than other unsecured creditors of the trustee. For the trustee may have a right of exoneration out of the trust property. Lord Eldon, in *Ex parte Garland*[77] said that the creditor had 'something very like a lien upon the estate'. Lord Eldon did not go into detail as to the nature of the rights of a creditor against the trust property but Turner L.J. in *Ex parte Richard Edmonds and Others*[78] explained that the creditor's right to satisfaction out of the trust property is derivative: he stands in the shoes of the trustee and has no higher right than the trustee's right to exoneration. Originally the trust creditor would seek a decree for administration but now he can proceed by originating summons.[79]

However, a creditor is not allowed to enforce his claim against the trust property unless the circumstances are such as to lead to the reasonable conclusion that a judgment against the trustee, if obtained, would be fruitless.[80]

The creditor has this right whether the trust is created by will or *inter vivos*.[81]

What is the justification for an unsecured creditor being able to recover out of the trust property? Sir George Jessel M.R. explained in *Re Johnson*[82] that it was necessary to avoid the injustice of a beneficiary

G. M. & G. 19, 52; 43 E.R. 415, 427. See also the cases under which a trustee authorized to conduct a business may have indemnity only out of the property authorized to be used in that business. *Supra* n. 49.

[75] *In re Morgan. Pilgrem v. Pilgrem* (1881) 18 Ch. D. 92, 101; *Jennings v. Mather* [1902] 1 K.B. 1, 5.

[76] *In re Johnson; Shearman v. Robinson* (1880) 15 Ch. D. 548, 552.

[77] (1803) 10 Ves. Jun. 111, 120; 32 E.R. 786, 789.

[78] (1862) 4 De G. F. & J. 488, 498; 45 E.R. 1273, 1277. See also *Marginson v. Potter* (1976) 11 A.L.R. 64, 75 *per* Jacobs J.

[79] *Ashburner's Principles of Equity* (2nd ed. 1933) 132-3. N.S.W.: S.C.R. Part 68. Vic.: R.S.C. Order 55 r. 3. S.A.: S.C.R. Order 55 r. 1. W.A.: R.S.C. Order 58 r. 2. Tas.: R.S.C. Order 65 r. 1.

[80] *Owen v. Delamere* (1872) L.R. 15 Eq. 134 as explained in *In re Wilson; Kerr v. Wilson* [1942] V.L.R. 177. *Re Morris* (1889) 23 L.R. Ir. 333. *Cf. Fairland v. Percy* (1875) L.R. 3 P. & D. 217.

[81] *In re Johnson. Shearman v. Robinson* (1880) 15 Ch. D. 548, 552. *Cf. Re British Power Traction and Lighting Co. Ltd* [1910] 2 Ch. 470.

[82] (1880) 15 Ch. D. 548, 552.

getting the benefit of assets earned as the result of credit given to the trustee by the creditor. According to this explanation the creditor's rights, like some other equitable rights,[83] 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. Yet in a later case, *In re Raybould; Raybould v. Turner*,[84] the creditor who succeeded in obtaining payment out of the trust property had obtained judgment for damages and costs against the trustee personally in respect of a tort committed in the course of conducting a business. It seems that the doctrine rests on some broader basis than that suggested by Jessel M.R. and that any trust creditor can take advantage of whatever right to exoneration out of the trust property the trustee may have in relation to the liability to that creditor.

If trust estates were legal entities like companies, conduct of trustees in furtherance of the purposes of their trusts could make the trust estates liable to the claims of a creditor in much the same way that the conduct of an organ of a company (normally, the board of directors) can make a company liable to outsiders. But even though trust estates are not legal entities, *Re Raybould* suggests that, as between an outsider and the beneficiaries, loss arising from the trustee's conduct in furtherance of the trust purposes should fall on the beneficiaries at least to the extent of the trust estate. Although the trustee is technically a principal, the Court here recognizes his essentially representative role. It is only loss related to conduct of the trustee for the furtherance of the trust which can be visited upon the trust estate. If the loss arose from activity of the trustee which was *ultra vires* the trustee, there can be no recourse against the trust estate.

If the trustee is also under a liability to other creditors but the liability is unrelated to the trust those other creditors cannot claim against the trust property on the basis of the trustee's right to exoneration. If the trustee had discharged the trust liability out of his own funds he would have a claim for recoupment out of the trust property. None of his creditors could attach that equitable debt by garnishee proceedings because those proceedings are available only where the judgment debtor is owed a debt by another person and a trust estate is not a person. But his general creditors could get satisfaction out of the trustee's claim on the trust property if he were to be made bankrupt.[85]

The reason why it is only the trust creditor, in respect of whose debt the trustee has a right to exoneration (as distinct from a right to recoupment), who can use that right to indemnity lies in the limitations on the trustee's power to apply the trust property. The trustee's power is to apply the trust

[83] Such as the right to enforce a secret trust.
[84] [1900] 1 Ch. 199.
[85] *Infra.*

property only in respect of each particular debt properly incurred in the administration of the trust.[86]

A trust creditor can claim against the trust property only to the extent of the trustee's right to indemnity. The ways in which a right to indemnity may be denied to a trustee or be restricted have been considered earlier.[87] Thus, if the trustee has no right to indemnity because he has committed a breach of trust causing loss which he is liable to make good,[88] the creditor has no higher right than the trustee.[89]

Exceptionally, a trust creditor has been allowed recovery out of the trust property even when the trustee has committed a breach of trust.

In *Devaynes v. Robinson*[90] a testator directed his trustees to sell his real estate. Instead of selling, they retained the estate and mortgaged it. In doing so they committed a breach of trust. Lord Romilly M.R. directed an enquiry as to the loss sustained by the estate. He also declared that the mortgage was not binding and directed a sale of the estate, free of the mortgage. However, the mortgagee was declared to be entitled to stand as a creditor against the purchase money, for so much of his mortgage money as was properly applied by the trustees in the administration.

The principle appears to be that the trust creditor can recover money or property which he has provided and which has conferred a benefit on the trust estate.

It would seem that, if the trust instrument were properly to deny to the trustee a right to indemnity[91] or were to limit his right to indemnity, the denial or limitation would affect the creditor who claims by subrogation. A settlor, framing a trust instrument, who is minded to deny to trust creditors of the trustee a right of recourse against the trust estate may include a provision denying a right of indemnity to the trustee. This practice developed in trading trusts formed as part of tax avoidance measures. Such a provision was particularly necessary where, as was commonly the case, the trustee was a registered company which was judgment-proof because it had very few assets in its own right. The courts have not had occasion to consider whether a trust creditor can properly be impeded by such a provision. 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.[92] By parity of reasoning a

[86] *Cf. Scott on Trusts* (1967 3rd ed.) s. 268.3.
[87] *Supra.*
[88] *Supra.*
[89] *In re Evans; Evans v. Evans* (1887) 34 Ch. D. 597; *Re Morris* (1889) 23 Ir. 333; *Re British Power Traction and Lighting Co. Ltd* [1910] 2 Ch. 470; *In re Johnson; Shearman v. Robinson* (1880) 15 Ch. D. 548, 552; *Re Staff Benefits Pty Ltd and the Companies Act* [1979] 1 N.S.W.L.R. 207.
[90] (1857) 24 Beav. 86; 53 E.R. 289.
[91] *Supra.*
[92] *In re Burroughs-Fowler; The Trustee of the Property of W.J. Burroughs-Fowler (A Bankrupt) v. Burroughs-Fowler* [1916] 2 Ch. 251.

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.[93]

Where the trustee's account is not clear and the amount due from him to the trust estate is less than the creditor's claim, the creditor may pay the amount due from the trustee in order to make the trustee's accounts clear. According to Kekewich J. in *Re Frith*[94] the creditor is then entitled to an assignment of the equity to which the trustee succeeds on the clearing of his account. Where there are several trustees and one of them does not have a clear account, the creditor can rely on the right to indemnity — enjoyed by the others who have clear accounts.

> The indemnity to the trustees is not to the trustees as a body, but to each of the trustees. Each of them who has acted properly is entitled to be indemnified against the debts properly incurred by him in the performance of the trusts imposed upon him. The Court prevents a trustee from insisting upon that right unless he comes in with clear accounts; but if he comes in with clear accounts he is not the less entitled to be indemnified because he has a co-trustee who has run away with certain moneys. I am, of course, excluding the case where a trustee who has a clear account is responsible for a co-trustee who has not.[95]

It is anomalous that a trust creditor can be affected by the state of account between the trustee and the beneficiary. Whether a trust creditor now has a direct claim in his own right on the trust property is a matter considered later.

RIGHTS OF TRUST CREDITORS WHERE TRUSTEE HAS RIGHT TO RECOUPMENT OR EXONERATION AGAINST THE BENEFICIARY PERSONALLY

If a trustee has a right of recoupment against a beneficiary personally the trust creditor who obtained a judgment against the trustee could possibly obtain satisfaction by garnishee proceedings.

Simply because a trust creditor is sometimes allowed to stand in the shoes of a trustee so as to be able to be given the benefit of the trustee's right to indemnity against the trust estate,[96] it does not follow that a trust creditor should be subrogated to the trustee in respect of a right of exoneration against a beneficiary. The right in relation to indemnity against the trust estate stems from the practice of the Court of Chancery in adminis-

[93] *Quaere* whether Jessel M.R. in *Re Johnson* (1880) 15 Ch. D. 548, 552 can be taken to imply that a trust creditor could not be prevented from reaching the trust property by a provision in the trust instrument denying a right of indemnity to the trustee. He said: 'The trust assets having been devoted to carrying on the trade, it would not be right that the *cestui que trust* should get the benefit of the trade without paying the liabilities; therefore the Court says to him, You shall not set up a trustee who may be a man of straw, and make him a bankrupt to avoid the responsibility of the assets for carrying on the trade: the Court puts the creditor, so to speak, as I understand it, in the place of the trustee'.

[94] *In re Frith. Newlon v. Rolfe* [1902] 1 Ch. 342, 345.

[95] *Ibid.* 346 *per* Kekewich J.

[96] *Supra.*

tration actions in the distribution of a fund under administration by the Court. There appears to be no similar procedure for a right of subrogation in respect of a trustee's right against a beneficiary personally although it is not easy to see why, as a matter of policy, there should not be a right of subrogation.

The right of a trust creditor to take advantage of a trustee's right to exoneration out of the trust estate appears to have been accorded under the practice of the Court of Chancery when supervising the distribution of a fund following a suit for administration of a deceased estate. It was not simply a matter of it being convenient for the court of equity to recognize the creditor's claim and to allow him to be paid without requiring him first to proceed at common law. When the Court of Chancery took into its own hands the administration of an estate, it restrained creditors from pursuing their legal remedy at common law.[97] When the Court made the decree for administration it operated as a judgment for all the creditors and the creditors then had to prove their debts under the administration decree.

A creditor who seeks the benefit of a trustee's right of indemnity against a beneficiary personally would have to make the trustee bankrupt.

RIGHTS OF CREDITORS WHEN TRUSTEE IS BANKRUPT

It is necessary to consider first the case where the trustee has discharged a trust debt by payment from his own funds. Under s. 116(2) *Bankruptcy Act* 1966 (Cth) property held by the bankrupt on trust for another person is excluded from the property divisible amongst the creditors of the bankrupt, but that provision does not prevent a trustee's right of recoupment out of the trust property and his associated lien being available to the creditors. Because that power might have been exercised by the trustee for his own benefit it is property divisible among the creditors under s. 116(1) and vests under s. 132(1) in the trustee in bankruptcy.[98] A trustee's right against a beneficiary personally to be reimbursed in respect of a liability which the trustee has discharged may likewise be claimed by the trustee's trustee in bankruptcy on the basis that, being an equitable chose in action, it is property of the bankrupt which vests in the trustee in bankruptcy.

Turning now to the position where the trustee has not discharged a liability to a trust creditor before becoming bankrupt, it is convenient to consider first the case in which the trustee has a right to indemnity from a beneficiary personally. The matter may be tested by supposing that the beneficiary has not paid.

In equity,[99] when X is entitled to be indemnified by Y against a liability to Z, it is not necessary for X to discharge the liability before calling on

[97] *Harrison v. Kirk* [1904] A.C. 1, 5 *per* Lord Davey.
[98] See definition in s. 5(1) of 'the property of the bankrupt'.
[99] In contrast to the common law under which in the absence of an express covenant by the indemnifying party to discharge the liability of the principal

Y.[1] The beneficiary can be ordered to provide money to enable the trustee to discharge the liability.[2]

The right to indemnity against the beneficiary personally will vest in the trustee's trustee in bankruptcy. If the trustee's right of action against the beneficiary were regarded as a right of action enforceable by the trustee only for the benefit of the creditor it would be trust property and would not pass to the trustee in bankruptcy. But it is not so regarded. It is a right of action enforceable for the benefit of the trustee in that it will relieve the trustee and his bankrupt estate from a debt which ought to be borne by the beneficiary.[3] If the trustee in bankruptcy recovers from the beneficiary, is he to use the money to pay the particular trust creditor whose debt gave rise to the indemnity or is the money available for distribution among the trustee's creditors generally? The appropriate principle is that a trustee may not make a personal profit out of his position as trustee without specific authority.[4] Accordingly, the trustee's trustee in bankruptcy must use the money to pay the trust creditor. It is apparently thought that if the money were applied in the bankruptcy administration towards payment of debts other than the trust debt the trustee would derive a personal advantage in that his discharge from bankruptcy might be brought nearer. From the viewpoint of the creditors the trust creditor is no more meritorious than the other creditors: in being preferred over the other creditors he is merely an incidental beneficiary of the principle that the trustee cannot profit from the trust.

In *Re Richardson*[5] R, in 1906, became trustee of two leases for his wife. After the leases expired in 1908 the lessors obtained judgment against R for arrears of rent and for damages for breach of the covenant to repair, in an amount to be ascertained by an official referee. Before the official referee did that R was adjudicated a bankrupt. After the official referee fixed the amount due the lessors obtained leave to sue the beneficiary using the name of R's trustee in bankruptcy on terms that, on recovering any sum from the beneficiary, they would apply to the bankruptcy court to determine whether the sum recovered should be treated as assets divisible among the creditors generally. Their action was compromised on terms of the beneficiary paying them a sum and the judge in bankruptcy held that the sum was divisible among R's creditors generally.

creditor, a contract of indemnity was generally construed as being merely a contract to reimburse the indemnified party against loss actually incurred by him: *In re Richardson; Ex parte The Governors of St Thomas's Hospital* [1911] 2 K.B. 705, 709; *Official Assignee v. Jarvis and Another* [1923] N.Z.L.R. 1009.

[1] *In re Richardson; Ex parte The Governors of St Thomas's Hospital supra* n. 105.
[2] *British Union and National Insurance Co. v. Rawson* [1916] 2 Ch. 476, 486.
[3] *In re Richardson; Ex parte The Governors of St Thomas's Hospital* [1911] 2 K.B. 705, 715.
[4] *Ibid.*
[5] *Ibid.*

On appeal, the Court of Appeal reversed that decision and held that the lessors were entitled to retain the sum. The members of the Court differed in their reasons. Cozens-Hardy M.R. said that to allow the money to be used to assist payment of a dividend to the general creditors would be to allow a trustee to make a profit out of his position as trustee. Fletcher Moulton L.J. said that a trustee could never have obtained an order that the beneficiary should pay him before the trustee had discharged the liability and could at most obtain an order that a fund be set aside in order to indemnify the trustee.[6] From this he reasoned that unless the trustee had discharged the liability there could be no debt that was owing from the beneficiary to the trustee or to the estate of the bankrupt trustee. The right of indemnity against the beneficiary could be used by the trustee only for the purpose of bringing about payment to the head creditor of the claim against which he was indemnified. Buckley L.J. considered that when the trustee became bankrupt he had a right of action against the beneficiary which passed to the trustee in bankruptcy.

He said that the beneficiary's obligation was to indemnify the trustee and that if the money paid by the beneficiary were used to pay a dividend to all the creditors the trustee would not be indemnified.[7] Performance of the beneficiary's obligation required that the money should not be available to the creditors generally but should be paid to the trust creditor.

Of these differing views the reasoning of Cozens-Hardy M.R. seems the best but it applies only where the person entitled to be indemnified stands in a fiduciary relationship to the person who is liable to indemnify. *Re Richardson* has been considered in later cases where the indemnified and the indemnifier were not in a fiduciary relationship. In such cases any decision that the person indemnified was bound to pay money received from the indemnifier to the principal creditor had to be based on some other principle.

In *Re Law Guarantee Trust and Accident Society Ltd: Liverpool Mortgage Insurance Company's Case*[8] a guarantee society was in liquidation. It had guaranteed payment of debentures issued by a company. The guarantee society had entered into a contract with a mortgage insurance company under which the mortgage insurance company guaranteed the society to the extent of two-elevenths of the risk insured by the society.

[6] This proposition was questionable. See *Evans v. Wood* (1867) L.R. 5 Eq. 9.

[7] He gave an example. Suppose the trustee in bankruptcy recovers £520 from the beneficiary and applies it in payment of dividends to all the creditors, say 10 shillings in the pound to all creditors. The trust creditor would receive 10 shillings in the pound like every one else. Further assets come in later. The trust creditor is entitled to a further dividend, and he calls for a further dividend and receives it. The trustee (or his trustee in bankruptcy) can get nothing further from the beneficiary. The result is that the trustee has not been indemnified. Buckley L.J. said that the trustee's estate would still be liable to the trust creditor. With respect, it would seem academic to say that the trustee had not been indemnified since the trust creditor would have no right to sue him but could only prove in the bankruptcy.

[8] [1914] 2 Ch. 617.

Default had been made in the debentures before the guarantee society went into liquidation. The question for the Court of Appeal as stated by Buckley L.J. was whether the mortgage insurance company was liable to pay the liquidator of the guarantee society two-elevenths of the liability of the society or two-elevenths of the ability of the society to meet the liability (that is to say, the dividend which the estate of the society could pay). The contract between the guarantee society and the mortgage insurance company was held to be a contract of insurance under which the mortgage insurance company was liable to pay the liquidator two-elevenths of the liability of the society. Buckley and Kennedy L.JJ., however, considered what the position would have been if the contract had been one of indemnity and, in doing so, considered whether the liquidator, being entitled to receive 20 shillings in the pound under the contract, could use it for the creditors generally. They were of the opinion that he could. They reached this opinion after looking to see whether the indemnifier paying by way of indemnity had an interest in seeing that the money was applied by the indemnified in payment of the claim related to the indemnity.[9] In the case before them the mortgage insurance company had no such interest.[10]

Examples of such an interest on the part of the indemnifier are (i) where an unregistered purchaser of partly-paid shares, being bound to indemnify the registered seller against calls, pays in pursuance of that indemnity, the shares being liable to forfeiture by the company if the calls are not paid; (ii) where two persons are jointly liable to pay a debt to a third and one of the joint debtors indemnifies the other, the indemnifier on paying the indemnified is interested in having that money paid to the creditor for otherwise the indemnifier will remain liable to the creditor; and (iii) where the purchaser of an equity of redemption covenants to indemnify the mortgagor against the mortgage debt, the indemnifier has an interest in seeing that the mortgagee is paid for otherwise the property will remain subject to the mortgage and liable to the mortgagee's power of sale.[11] In the *Liverpool Mortgage Insurance Company's Case*[12] Buckley L.J. distin-

[9] The New Zealand Court of Appeal applied the same principle in *Official Assignee v. Jarvis* [1923] N.Z.L.R. 1009 where an intermediate assignee of an equity of redemption in land was liable to indemnify the original mortgagor against liability on his personal covenant under a third mortgage. Because the first mortgagee had exercised his power of sale without recovering all the money due to him the equity of redemption was destroyed. It followed that when the intermediate assignee paid by way of indemnity to the original mortgagor, the intermediate assignee had no interest in the disposition of the money by the original mortgagor or his trustee in bankruptcy.

[10] Under the law now applicable to the proceeds of insurance against liability of a bankrupt to third parties (*Bankruptcy Act* 1966 (Cth) s. 117) or of an insolvent company in liquidation (*Uniform Companies Act* 1961 s. 292(5)) the proceeds will be payable to the third party unless in the case of a company there are Commonwealth claims having priority.

[11] *Official Assignee v. Jarvis* [1923] N.Z.L.R. 1009, 1018.

[12] [1914] 2 Ch. 617, 633. See also *In re Harrington Motor Co., Ltd, Ex parte Chaplin* [1928] Ch. 105; *Hood's Trustees v. Southern Union General Insurance Co. of Australasia Ltd* [1928] Ch. 793.

guished *Re Richardson* as a case where the beneficiary was concerned to see that the money she paid by way of indemnity went to the lessor so as to relieve the property of which she was beneficial owner from the consequences of non-payment of rent and damages for breach of covenant. This ground of distinction is puzzling because, the lease having expired before the payment by the beneficiary, there was no trust property in which she retained an interest. It is submitted that, in any event, a better distinction is that in *Re Richardson* the trustee indemnified could not be allowed to make a profit out of his position as trustee: he had to apply the money paid by the indemnifier in payment of the claim which attracted the indemnity regardless of whether or not the beneficiary had an interest. This misconception of Buckley L.J. as to the basis of the decision in *Re Richardson* misled Clyne J. in *Re Doyle*[13] into holding that money paid by a beneficiary by way of indemnity to the official receiver of the trustee's bankrupt estate was distributable amongst all his creditors. In the unlikely event that the terms of the trust excluded the duty of the trustee to refrain from obtaining personal profit through his position on receiving payment by an indemnifying beneficiary, the destination of the money could have depended on whether the beneficiary had an interest in the trustee's application of the money. But in the normal trust, principle requires the trustee to pay the claim to which the right of indemnity related.

Suppose that the trustee's right to indemnity is a power to pay the debt out of the trust property. If the debt is secured by an encumbrance on the trust property, or if non-payment of the debt could lead to forfeiture of trust property, the beneficiary has an interest in the debt being discharged. The trustee's power to pay the debt is one which he could not exercise solely for his own benefit but one which he must exercise for the benefit of the beneficiary. It could be exercised only so as to pay a trust creditor in respect of the debt to whom the right to indemnity arose. Even where the debt was unsecured and the creditor had no rights in relation to any of the trust property the power to apply the trust property would still be exercisable only so as to pay a trust creditor in respect of the debt to whom the right to indemnity arose. This would seem to follow from the trustee's power to withdraw money from the trust being limited to one of paying trust debts. Moreover, a beneficiary who could be liable personally to indemnify the trustee has an interest in the trustee's exercise of his right of exoneration as against the trust estate. The beneficiary would want that right to be exercised so as to relieve the beneficiary of his personal liability in case the value of the trust property should decline. It follows that the trust creditor would be preferred over other creditors of the trustee not so much because he has merits over other creditors but because of the limitations on the trustee's powers. However, it would seem that by an

[13] [1943] 13 A.B.C. 128.

application of the doctrine of marshalling, trust creditors would be expected to look to the trust property to satisfy their claims and to compete with other creditors to share in non-trust property only after the trust property is exhausted.

If there were insufficient assets to pay unsecured trust creditors in full, principle would require that the person having the power to apply trust property in payment of their claims should exercise that power so as to treat them as ranking *pari passu*.

If a trustee has a right of exoneration against particular trust debts and he becomes bankrupt, that right, with its associated equitable lien, passes to his trustee in bankruptcy, so that the bankrupt's own creditors will not find his own estate reduced in order to meet his personal liability in respect of trust debts. The trustee in bankruptcy is entitled to have the trust property remain available for the purposes of the indemnity to which the bankrupt was *prima facie* entitled.[14] But does it follow that the legal title to the trust property vests in the trustee in bankruptcy?

In *Carvalho and Others v. Burn and Another*[15] the Court of King's Bench said that property held on trust would pass to the assignee in bankruptcy if, at the time of the act of bankruptcy, the bankrupt possessed a possibility of interest, from which a benefit to his creditors might result. In another case Sir George Jessel M.R.[16] said:

> Under the Bankruptcy Act, where a trustee has no beneficial interest, the legal estate does not pass; but where he has it does pass.

The passing of the legal title to the trustee in bankruptcy occurs in a case where the bankrupt is a trustee with a right of exoneration because retention of the trust property as against the beneficiaries may be necessary to give full effect to the right of exoneration.[17] The point seems to be that although the trust property is not property divisible among the creditors of the trustee, yet it is property over which the bankrupt had an equitable lien and the nature of the property may be such that in order to enable that lien to be given effect the legal title vests in the trustee in bankruptcy.[18] The High Court in *Octavo Investments Pty Ltd v. Knight*[19] noted that there were differing views[20] on the question whether the legal title to trust property over which a bankrupt trustee has a 'charge' vests in the trustee in bankruptcy, but the Court did not have to resolve the question.

[14] *Jennings v. Mather* [1902] 1 K.B. 1, 5. See also *Savage v. Union Bank of Australia Ltd* (1906) 3 C.L.R. 1170.

[15] (1833) 4 B. & Ad. 382, 393; 110 E.R. 499, 503; affirmed (1834) 1 Ad. & E. 883; 110 E.R. 1445.

[16] *Morgan v. Swansea Urban Sanitary Authority* (1878) 9 Ch. D. 582, 585.

[17] *The Governors of St Thomas's Hospital v. Richardson* [1910] 1 K.B. 271, 284.

[18] Vesting of the legal title in the trustee in bankruptcy seems to have been thought necessary in *The Governors of St Thomas's Hospital v. Richardson ibid.* where the trust property was leaseholds but not to have been thought necessary in *Jennings v. Mather supra* n. 113 where the trust property was goods.

[19] (1979) 27 A.L.R. 129, 137.

[20] *Lewin on Trusts* (16th ed. 1964) 400.

Whether or not the legal title vests in the trustee in bankruptcy, it seems that the bankrupt trustee's right, which may be exercised by his trustee in bankruptcy, is a right to have the trust property remain available so that the right to exoneration may be exercised. It is a right to detain and, if need be, to sell, but is it a proprietary right?

In *Re Staff Benefits Pty Ltd*[21] Needham J. held that creditors claiming by subrogation to the trustee's right to exoneration out of the trust property were not claiming to be paid out of property of the bankrupt and therefore they were not affected by the provisions of s. 112 of the *Bankruptcy Act* 1966 (Cth) under which that part of a claim against 'the property of the bankrupt' for interest on a debt which exceeded 8 per cent was, under s. 112 as it then stood, deferred until all other debts had been paid. This view seems preferable to the view of the Queensland Supreme Court that, upon bankruptcy, the right of indemnity, with the charge or lien to secure it, pass to the trustee in bankruptcy and that the right to indemnity is a right of property in such of the assets of the insolvent estate as are trust property.[22]

However, the view of the Queensland Supreme Court has been upheld on appeal to the High Court in *Octavo Investments Pty Ltd v. Knight*.[23]

In *Octavo Investments* a corporate trustee (Coastline Distributors Pty Ltd) with a paid up capital of five dollars, was trustee of a settlement under which it had power to carry on any business, to employ the whole of the trust fund in any such business, to borrow money and to give security for loans. The trustee conducted a business which was financed by borrowings from a bank, advances from Octavo Investments Pty Ltd and loans from the beneficiaries. The business was not successful and the trustee's winding up was ordered. Within a six month period before the commencement of the winding up the trustee had made payments to Octavo. The liquidators of the trustee began proceedings in the Supreme Court of Queensland in which they sought to have the payments to Octavo declared void as voidable preferences under s. 293 of the *Companies Act* 1961-1975 (Qld), incorporating s. 122 of the *Bankruptcy Act* 1966 (Cth). Under that provision 'a . . . payment made . . . by a person who is unable to pay his debts as they become due from his own money, in favour of a creditor, having the effect of giving that creditor a preference . . . over other creditors being a . . . payment . . . made within 6 months . . . before the presentation of a petition on which [that person] becomes a bankrupt, is void as against the trustee in bankruptcy'. It was found, without difficulty, that the payments to Octavo gave it a preference, that the trustee was insolvent when the payments were made and that the directors of Octavo had, at the

[21] [1979] 1 N.S.W.L.R. 207.
[22] *Re Coastline Distributors* (1979) 4 A.C.L.R. 203. See also *St Thomas's Hospital v. Richardson* [1910] 1 K.B. 271.
[23] (1979) 27 A.L.R. 129.

very least, reason to suspect that the trustee was insolvent and that the effect of the payments was to give Octavo a preference. The main issue was whether s. 122 applied to make the payments voidable preferences. Octavo's chain of argument against the application of s. 122 was:

(i) All the property in the hands of the insolvent trustee was trust property.

(ii) Trust property does not come within the description of 'property divisible amongst the creditors of the bankrupt' within the meaning of the *Bankruptcy Act* 1966 (Cth) s. 116.

(iii) Therefore the legal estate in trust property does not vest in the trustee in bankruptcy.

(iv) If the payments to Octavo were to be declared void, in the case of an individual bankrupt, the money would have to be repaid not to the trustee in bankruptcy but to the bankrupt trustee.

(v) Section 122 rendered preferential payments void as against the trustee in bankruptcy but not as against the bankrupt.

In a joint judgment Stephen, Mason, Aickin and Wilson JJ. held that s. 122 applied.[24] They did not find it necessary to decide whether the legal title to trust property passed to the trustee in bankruptcy where the trustee had a beneficial interest in the trust estate. In their view the passing of the trustee's beneficial interest in the trust estate to the trustee in bankruptcy was sufficient to attract s. 122. They said:

> Once it is recognized that a trustee may enjoy a right of indemnity over trust property in respect of liabilities incurred by him in the administration of the trust, it follows that the creditors of a trust business may have resort to the assets of the trust to the extent of the liabilities incurred by the trustee.[25]

The decision is based on the proposition that a trustee who has a right to exoneration has a proprietary interest. With respect, he has no more than a power over the trust property which, as argued earlier, is a fiduciary power, at least in cases where the beneficiary has an interest in seeing that the trust creditor is paid.

At one point their Honours gave a description of the trustee's right:

> 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 entitled to retain possession of the property as against the beneficiaries.[26]

The trustee's right of exoneration was treated as a proprietary interest. That step seems questionable.

If the trustee merely had a power, was it property divisible amongst the creditors? If it were, s. 122 might still operate under the Court's reasoning. Under s. 116(1)(b) the capacity to exercise 'all such powers in, over or

[24] The remaining member of the Court, Murphy J., agreed that the appeal should be dismissed.
[25] 27 A.L.R. 129, 138.
[26] *Ibid.* 136.

in respect of property as might have been exercised by the bankrupt for his own benefit . . . is property divisible amongst the creditors . . .'. This can hardly refer to powers which he is to exercise for the benefit of beneficiaries as well as himself.[27]

The decision that s. 122 operated seems to owe much to the view that the creditors could have resorted to the assets of the trust. Whether in fact they could have been paid out of the trust assets would have depended on whether the trustee was liable for any breaches of trust.

Another puzzling aspect of the case is that the operation of s. 122 to permit the payments to Octavo to be avoided depended on the trustee having a right of exoneration and yet the trustee no longer had any relevant right of exoneration after the payments had been made to Octavo. The payments were voidable only and they would have been effective to discharge the indebtedness *pro tanto*.[28] If there remained a balance owing a right of exoneration could exist in respect of that balance. But if the whole indebtedness had been discharged it is not easy to see any right of exoneration which could have provided the trustee with a beneficial interest in the trust estate.

Octavo Investments Pty Ltd v. Knight seems to be a hard case making bad law. It is obviously unsatisfactory that an insolvent trustee-debtor should be able to prefer a creditor and that the trustee in bankruptcy or liquidator should not be able to avoid the preference. The doctrine of voidable preferences first came into statute law in the English *Bankruptcy Act* 1869 but it was a creature of common law. According to Martin B. in *Marks v. Feldman*[29] it was laid down by Lord Mansfield in *Alderson and Others, Assignees v. Temple*:

> [He] says distinctly what the law was, that under the statutes of bankruptcy a trader up to the moment of an act of bankruptcy was entitled to every power an owner can have over his estate. He then proceeds to establish an exception, that if a man about to become bankrupt, and knowing that the law intends that the creditors shall share equally in the property, voluntarily and not upon pressure does an act which contravenes the spirit of those bankruptcy laws the goods delivered or paid over can be recovered back from the person to whom he may have only paid a just debt.[30]

The common law doctrine may have been wide enough to catch the payment in the *Octavo* case but although the *Bankruptcy Act* 1966 (Cth) is not expressed to be a code it would probably be interpreted as a measure

[27] *In re Taylor's Settlement Trusts; Public Trustee v. Taylor* [1929] 1 Ch. 435.

[28] *In re Yagerphone Ltd.* [1935] Ch. 392, 396; *Re Quality Camera Co. Pty Ltd* [1965] N.S.W.R. 1330. See also *N.A. Kratzmann Pty Ltd (In Liq.) v. Tucker, Liquidator of Reid Murray Developments (Qld) Pty Ltd (In Liquidation) (No. 2)* (1968) 123 C.L.R. 295, 301 where it is said that when payments are recovered by the trustee in bankruptcy following avoidance of a voidable preference they become the moneys of the trustee in bankruptcy and his title to them does not depend upon his succession to any title which the bankrupt had.

[29] (1870) L.R. 5 Q.B. 275, 283.

[30] (1768) 4 Burr. 2235; 98 E.R. 165.

intended by the Legislature to be the sole source of the law on bankruptcy.[31] The result is a good example of legislation constricting a broad common law doctrine.

Where, under the reasoning in the *Octavo* case, a trustee's dispositions are liable to be void as against the trustee in bankruptcy under s. 122 there is a question whether a distribution, made by the trustee to a beneficiary while debts to trade creditors exist, could be set aside as a voidable preference. Section 122 is concerned with dispositions or payments in favour of a 'creditor'. But a beneficiary can be a creditor as well as a beneficiary in some cases. One case is where the trustee 'had stated an account, or, in other words, had admitted himself to the plaintiff that he held any sum of money in his hands payable to him absolutely, he would, with respect to that sum, be a debtor, not properly a trustee, and then an action would have been maintainable against him'.[32] Where a trustee has a right of exoneration out of the trust assets and he, nevertheless, distributes trust funds to a beneficiary-creditor he is, in effect, deferring his right of exoneration so as to give priority to the beneficiary-creditor. Under the reasoning in the *Octavo* case the existence of a right of exoneration makes s. 122 applicable to a disposition by an insolvent trustee and if that disposition is to a beneficiary-creditor then it should be characterized as a voidable preference. If a trustee, when making the disposition, were to release his power of exoneration, there would be a question whether that release would be 'a conveyance or transfer of property' within the meaning of s. 122. If it be accepted, contrary to the thesis of this article, that a right of exoneration is a proprietary right, the release of that right could be a transfer of property to the beneficiary only if a court were prepared to accept that action to destroy a right can be a transfer of that right.

CREDITOR'S CLAIM DIRECTLY AGAINST TRUST PROPERTY

Is there any theory on which a trust creditor can obtain payment out of the trust property directly and not merely by subrogation to the trustee's rights?

From the viewpoint of a creditor who has given credit to a trustee conducting a business, the dependence of the creditor's right on the trustee's right to exoneration is anomalous. If the creditor had given credit to a company conducting a business and had dealt with the board of

[31] *Cf. Park v. Brady* [1976] 2 N.S.W.L.R. 329, 341 (*per* Samuels J.A.) and 332-4 (*per* Hutley J.A.). In *Butcher v. Stead* (1875) L.R. 7 H.L. 839, 846 Lord Cairns L.C. noted that the *Bankruptcy Act* 1869 (Eng.) did not profess to express the existing law without making considerable changes in it.

[32] *Bartlett v. Dimond* (1845) 14 M. & W. 49, 56; 153 E.R. 385, 387 *per* Pollock C.B. See also *Howard v. Brownhill* (1853) 23 L.J.Q.B. 23. Another case of a beneficiary being a creditor is where the trustee has misappropriated the trust fund: *Sharp (Official Receiver) v. Jackson and Ors* [1899] A.C. 419, 426. *Cf. Re Donovan and Another; Ex parte A.N.Z. Banking Group Ltd* (1972) 20 F.L.R. 50.

directors without notice of public limitations on their authority, he would have a right to recover out of the company's assets regardless of any claims of the company against its directors. The trend in company law has been to improve the position of persons who extend credit to companies and not to expect them to make exhaustive enquiries about their prospective debtors. This is exemplified by the recent statutory modification of the doctrine of *ultra vires*. The reasons for improving the position of creditors of companies seem equally applicable to creditors of trustees. For a long time the interests of outside creditors were thought to be served by the fact that the trustee was personally liable without limit. A trading enterprise conducted by a trust, from the viewpoint of an outside creditor, was comparable with the *société en commandite* or limited partnership under which the managing partner (with whom the trustee is comparable) assumed unlimited liability while the inactive members (with whom the beneficiaries are comparable) were liable to lose only the stake in the capital (with which the beneficiaries' shares in the trust property are comparable).[33]

When, in England in 1855, it became possible under the *Limited Liability Act* to register a company with the liability of its members limited by shares, a shift in the balance between the interests of trust creditors and beneficiaries in favour of beneficiaries became possible. By having a limited liability company with a low share capital as trustee, creditors of a trust conducting a business could be frustrated by a combination of an impecunious trustee and a narrow authority in the trust instrument as to the assets to be available to provide an indemnity for the trustee. This mischief remained only potential in Australia until the exigencies of income tax and death duties in the 1970's prompted the wholesale adoption of a trust as a legal framework for a family business in preference to a company. That development has demonstrated that when a limited company with low capital is trustee the old principles are inadequate to provide a proper balance between the interests of trust creditors and beneficiaries. It remains to be seen whether the courts or the legislature will recognize this belated effect of the introduction of the limited liability company.

A court might be able to reason from the accepted proposition that, where a trustee in good faith incurs a liability which leads to the conferment of a benefit on the trust property, he is entitled to a right of indemnity against the trust property to the extent of the benefit conferred.[34] That could possibly support a principle that where it is the creditor who conferred

[33] The analogy between a limited partnership and a trust estate is not complete. The partners in a limited partnership have agreed to associate for the conduct of the business enterprise whereas the beneficiaries of a trust may have nothing more in common than the fact that a settlor or testator made them beneficiaries. There is a question whether the absence of the consensual element should be given weight in the face of a policy of maintaining good commercial standards in relation to credit in the interests of unsuspecting providers of credit.

[34] *Supra.*

a benefit in good faith the creditor should be able to recover out of the trust property to the extent of the benefit conferred.

As an alternative, it has been argued,[35] that once it was conceded that a trustee could contract with a creditor on terms that the creditor would look only to the trust property for payment, it necessarily followed that the creditor's right to payment out of the trust estate could not be affected by the state of account between the trustee and the trust estate. In that case because the trustee is not personally liable he can have no personal claim against the trust estate to which the creditor can be subrogated. It follows that the trustee's power to apply the trust property to meet the debt is not affected by any liability of the trustee to compensate the trust estate for a breach of trust. If this be valid, it should further follow, from the concession that a trustee can confer on a trust creditor a claim directly against the trust estate when he is not liable personally, that the claim of any trust creditor should be direct and not derivative even when the contract does not exclude the trustee's personal liability. If that is too bold a step, there should, at least, be an inference that a corporate trustee without adequate assets in its own right is contracting for the benefit of the trust on terms that the creditor is to look only to the trust property for payment.

If a trust creditor were regarded as having a direct claim against the trust property the procedure by which he could obtain a court order for payment would differ little from that by which he now proceeds by subrogation to the rights of the trustee. It would not be necessary to treat the trust estate as a legal entity analogous to a company. Nor would it be necessary to amend the law to permit a trustee to be sued in his representative capacity as has been done in some American jurisdictions.[36]

Another way of coping with the mischief of the two dollar trustee company is found in provisions of company legislation which make the controllers of some companies liable for debts which they have caused the company to contract when they had no reasonable expectation of the company being able to discharge those debts.[37] By the same token while it remains possible for a trustee to obtain credit on the basis that the creditor is to look only to the trust property for payment there is a need for a principle analogous to that embodied in companies legislation to meet the case of the trustee who so contracts without any reasonable expectation that the debt can be discharged from the trust property.[38]

[35] Stone H. F., 'A Theory of Liability of Trust Estates for the Contracts and Torts of the Trustee' (1922) 22 *Columbia Law Review* 527.

[36] Scott A. W., *Trusts* (3rd ed. 1967) s. 271A.

[37] Uniform *Companies Acts* s. 374C.

[38] *Quaere* whether an order could be made under legislation such as the *Imprisonment of Fraudulent Debtors Act* 1958 for the imprisonment of an individual trustee who obtained credit by fraud. In *Commercial Bank v. Foreman* (1902) 8 A.L.R. (C.N.) 93 Hodges J. held that the legislation should be construed strictly as it imposed a quasi-criminal liability and that it did not apply to an executor who was a judgment debtor in only a representative capacity. A trustee is liable as a principal rather than in a representative capacity.