

# Are directors of trustee companies more exposed to risk than other directors?

There are many advantages for small businesses in using trusts as a business structure. In most instances, advisers recommend that their clients use a company to act as a trustee to obtain the benefit of limited liability. Following changes to the law introduced by section 197 of the *Corporations Act 2001* (C'th), there has been an alarming suggestion that a director of a corporate trustee may be effectively underwriting the company if it becomes insolvent, even in the absence of a suggestion of trading while insolvent.

## Background

As a general rule, an individual who acts as a trustee is personally liable for debts and other liabilities incurred in their capacity of a trustee. A company is no different. In either case, in the absence of an explicit provision to the contrary in the terms of the trust, the trustee will have a right of indemnity against the assets of the trust. A company that acts as a trustee can therefore be sued by a creditor, even though the trustee may have not benefited from the relevant transaction.

## The legislation

There have been provisions in the legislation governing companies for decades that allow a creditor to sue the directors of a company that acts as a trustee where creditors of that trustee company are unpaid and the right of indemnity has been removed by the terms of the trust deed. The most recent incarnation of this provision is section 197 of the *Corporations Act 2001* (C'th). This provision is, however, different from its predecessors in many respects.

Section 197 provides that:

- “(1) A person who is a director of a corporation when it incurs a liability while acting, or purporting to act, as trustee, is liable to discharge the whole or a part of the liability if the corporation:
- (a) has not, and cannot, discharge the liability or that part of it; and
  - (b) is not entitled to be fully indemnified against the liability out of trust assets.

This is so even if the trust does not have enough assets to indemnify the trustee. The person is liable both individually and jointly with the corporation and anyone else who is liable under this subsection.

- (2) The person is not liable under subsection (1) if the person would be entitled to have been fully indemnified by 1 of the other directors against the liability had all the directors of the corporation been trustees when the liability was incurred....”

### The case

In the case of *Kerry Stirling Hanel & Anor v. John O’Neill* [2003] SASC 409, the Full Court of the Supreme Court of South Australia considered the application of this provision.

Mr Hanel was a director of Daroko Pty Ltd that acted as trustee of the Daroko Unit Trust. Daroko Pty Ltd had entered into a lease of premises from Mr O’Neill when running a Wendy’s franchise. The Daroko Unit Trust made a profit of \$512,617.00 before 30 June 2001 (despite losing the Wendy’s franchise) and then distributed this money to its beneficiary. It was left with no assets and then abandoned the lease. Mr O’Neill obtained a default judgment against Daroko Pty Ltd. He then issued proceedings against Mr Hanel under section 197 of the *Corporations Act* 2001 (C’t) asserting that Mr Hanel was personally liable for the judgment debt. He obtained a judgment against Mr Hanel for \$23,132.62, who then appealed to the Supreme Court to have that judgment set aside. Two questions were considered by the Supreme Court.

The successful point for Mr Hanel was an assertion that Mr O’Neill should have mitigated his loss by pursuing a possible tenancy with a firm of accountants. The second point, which has set alarm bells ringing, concerns the liability of directors of a trustee company compared with the “normal” liabilities of directors.

As is common in many trust deeds, the equitable presumption that a trustee has a right of indemnity against the assets of the trust was explicitly stated in the trust deed of the Daroko Unit Trust. Clause 21 of the trust deed provided:

“The Trustee is entitled to be indemnified out of the assets for the time being comprising the Trust Fund against liabilities incurred by the Trustee in the execution or attempted execution of or as a consequence of the failure to exercise any of the trusts, authorities, powers and discretions hereof or by virtue of being the Trustee.”

In our view, this clause clearly establishes a legal entitlement to be indemnified. This was not disputed by the Court. Two of the three judges held, however, that it would be open to the creditor to sue the directors of the corporate trustee of the Daroko Unit Trust because as a practical issue, there were insufficient assets in the trust fund to meet the liabilities of the trust.

The “split” decision is summarised below:

| Judge       | Given clause 21 of the Trust Deed, is it relevant that the Trust has no assets?  | Should the judgment of the Magistrate be set aside?  |
|-------------|--|--|
| Mullighan J | <b>Yes</b> - “... if there are no assets comprising the Trust Fund, there is no entitlement to be indemnified.”(paragraph 13)  | <b>Yes</b> - because it was open to Daroko Pty Ltd to argue that Mr O’Neill had not mitigated his loss and this should be determined by the Magistrate in fresh proceedings. |
| Debelle J   | <b>No</b> - “the director will continue not to be liable for the debts of the corporation even if the trust does not have sufficient assets to provide a complete indemnity to the corporation” (paragraph 39) | <b>Yes</b> - because of the misapplication of section 197.   |
| Gray J      | <b>Yes</b> - “Section 197 represents an extension to the liability of the director of trustee company” (paragraph 74)  | <b>Yes</b> - the Magistrate should have considered the question of mitigation.   |

In our view, a better approach in *Hanel’s* case would perhaps have been to assert that the distribution to the beneficiary of the Trust was a voidable preference. At present, however, it represents a current view of the law as to the application of section 197 to insolvent trustee companies.

**So, what should be done now?**

The advantages of using trusts as a corporate structure remain very real while, despite *Hanel’s* case, the potential increased personal liability of directors of a trustee company is yet to be established

beyond doubt. Holley Nethercote recommends that:

- (1) any director of a company that is acting as a trustee must ***review the trust deed*** to ensure that there is no limitation upon the right of indemnity;
- (2) ***advisers should put their clients on notice before using a trustee company*** that there is a risk that if the company becomes insolvent, they are possibly personally liable to the extent of any shortfall. Naturally, this advice should be documented;
- (3) directors of a trustee company should ***use a “balance sheet” test of***

*insolvency*. This test is, in essence, not whether the company (using its right of indemnity) is able to pay its debts as and when they fall due, but rather whether the assets of the company (including specifically the assets of the trust) exceed the liabilities. Where the trust is used to hold assets that are likely to appreciate in value (such as land in recent years) or has little or no debt, then this test is easily satisfied. The problematical issue is where the company operates an ongoing business;

- (4) a director of a trustee company should ***be careful in making distributions that "strip the trust bare"***. The downside to this issue, of course, is the tax consequence of a trust not distributing income; and
- (5) There is a corollary to this advice. ***Creditors who have been left with a fruitless judgment against a trustee company may well be able to establish a cause of action against the company's directors.*** Even if this is disputed, there is sufficient judicial authority for the claim to avoid being an abuse of judicial process and sufficient prospects of success in many circumstances that the creditor may be able to negotiate a result that might merit the action.

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This paper briefly summarizes a complex area of law and one that is very dependent upon the precise facts that would apply. It is not a substitute for legal advice.

The relevant law is as at July 2004.

If you have any questions regarding this area of law then we invite you to contact Holley Nethercote, commercial lawyers, Tel (03) 9870.9855, fax (03) 9870.3640 email [law@holleynethercote.com.au](mailto:law@holleynethercote.com.au)