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# Piercing the “veil of obscurity” – the decision in *Hanel v O’Neill*

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*Following the popularity of the trading trust in the 1970s, there was a general recognition that legislation was required to level the playing field in favour of trust creditors. Legislation (now reflected in Corporations Act 2001 (Cth), s 197) came into effect in 1986 imposing liability (jointly and severally with the corporation and other directors (if any), subject to s 197(2)) for debts and other trust obligations on directors of corporate trustees in certain circumstances. The recent decision in *Hanel v O’Neill* has, however, brought into question the scope of that liability. The original basis on which the corporate veil was to be pierced in the case of corporate trustees seems to have been obscured during the legislative “simplification” and economic reform programs of the 1990s. A legislative clarification of the scope of that liability is now required.*

## 1. INTRODUCTION

The *Hanel* decision (*Hanel v O’Neill* (2003) 48 ACSR 378; (2004) 22 ACLC 274; [2003] SASC 409) propounds a “wider” view of s 197(1) of the *Corporations Act 2001* (Cth)<sup>1</sup> that a director of a corporate trustee will be liable for liabilities incurred by the trustee merely because there are insufficient trust assets to meet them. This will be so, according to the majority in *Hanel*, even if the trustee has a legal right to indemnification, but has no assets. The majority decided that an insufficiency of assets meant that the corporate trustee was not “entitled” to be fully indemnified thereby triggering liability under s 197(1).

The majority inferred that Parliament had intended, because of the rewording of the section in 1999,<sup>2</sup> to reverse the previous position<sup>3</sup> that an insufficiency of assets, by itself, did not mean that a director would be taken not to be entitled to be fully indemnified. The court made such an inference even though the explanatory materials relating to the 1999 legislation said that no substantial changes were intended.<sup>4</sup>

*Hanel* was a case about a corporate trustee that, through the actions of its sole director in distributing all of its assets to a beneficiary, could not pay the rent under its lease. The landlord sought to make the director liable under s 197(1). *Hanel* was the first time that s 197 has been considered.<sup>5</sup>

Section 197(1) caused both the court and commentators<sup>6</sup> difficulties in discerning its meaning. Debelles J had the following view (at [37]):

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<sup>1</sup> See Schedule 1 at the end of this article for the full text of the section.

<sup>2</sup> See section 6 below and Schedule 1 for the legislative history of the section.

<sup>3</sup> A position which the court acknowledged without question – see *Hanel* (2003) 48 ACSR 378; (2004) 22 ACLC 274; [2003] SASC 409 at [40] and [65].

<sup>4</sup> See section 8(c), below.

<sup>5</sup> *Hanel* (2003) 48 ACSR 378; (2004) 22 ACLC 274; [2003] SASC 409 at [67] per Gray J.

<sup>6</sup> Dannecker L, “Trustee directors’ liability: implications of *Hanel v O’Neill*” <http://www.aar.com.au/pubs/fmres/fofmresmar04.htm> viewed 22 June 2004; Cowley B and Thornycroft B, “Developments impacting on the personal liability of directors” (2004) 42(2) LSJ 68 at 71; Lyons A, “Directors of Corporate Trustees at Risk”

It is as if the corporate veil which was drawn back to impose a liability in the prescribed circumstances on a director of a corporation acting as a trustee was replaced by a veil of obscurity.

Nonetheless, it appears that the desire to make directors liable in the circumstances confronting the court, in order to protect future trust creditors, has led to an unsatisfactory construction of the section.

The interpretation of s 197(1) favoured in *Hanel* exposes directors to personal liability whenever there is an insufficiency of trust assets, without regard to their state of mind or conduct, subject to s 197(2). It pierces the corporate veil so completely and puts directors of corporate trustees at such a profound disadvantage to other directors that it is hard to see how it could ever have been intended to operate in that way without the clearest direction from Parliament.<sup>7</sup>

*Hanel* represents a major and unwarranted increase in potential liability for directors of trustee companies and requires a legislative solution.

## 2. THE FACTS IN HANEL

Daroko Pty Ltd was the trustee of the Daroko Unit Trust and Mr Kerry Hanel was its sole director.<sup>8</sup> The trust deed gave the trustee an adequate right of indemnity.<sup>9</sup>

Daroko was the tenant of premises owned by Mr O'Neill under a formal, fixed term lease. Daroko failed to pay rent after deciding to quit the premises about two years before the lease was due to expire. Daroko had previously distributed all of its (substantial) income to Forcett Pty Ltd, the trustee of a trust connected with Mr Hanel. Having done so, it had no money or other assets from which to pay the rent.

As part of its decision to quit the premises, Daroko found a firm of accountants prepared to take over the lease on the same terms. The offer of a new tenant was rejected by O'Neill and in July 2002 he got judgment in the Magistrates Court against Daroko for roughly \$23,000 in damages, representing the cost of finding another tenant. The judgment remained unsatisfied by Daroko so, in November 2002, O'Neill brought further proceedings claiming that Forcett, as a beneficiary of the Daroko Unit Trust, was liable to indemnify Daroko and seeking an order under s 197(1) of the *Corporations Act* that Hanel, as Daroko's sole director, was liable to pay the judgment debt. In January 2003, the Magistrate gave summary judgment against Hanel on the s 197(1) ground.

## 3. THE DECISION

The case was the hearing of an appeal to the Full Court of South Australia by Mr Hanel from the judgment against him.

The Full Court (Debelles J dissenting) decided that if there are insufficient assets in the trust fund to meet a trust debt or other obligation, there is no "entitlement to be fully indemnified" and any director of the corporate trustee is therefore liable under s 197(1) both individually and jointly with the corporation and each other director (subject to s 197(2)).

Mullighan J said that the question whether there was an entitlement to be indemnified was a matter of mixed law and fact. He agreed that there was a clear legal entitlement to indemnification under the trust deed, but as a matter of fact, there were no assets left in the trust by reason of Hanel's conduct and hence there would be no actual indemnification. His Honour was clearly troubled by the potential for a director to be shielded from personal liability in such circumstances merely because

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(2004) 21 *Brisbane Lawyer* 12; Chaird C and Cook H, "Directors' Personal Liability for Debts of Corporate Trustees – Hanel v O'Neill" (2004) 1 (6) *Corp Prac* 61.

<sup>7</sup> Which was lacking in the case of the rewording of s 197 in 1999 – see section 8(c), below.

<sup>8</sup> Section 197(2) was, therefore, never relevant.

<sup>9</sup> Even if it had not, *Trustee Act 1936* (SA) s 36(2), implies a right of indemnity that is not capable of contradiction in the terms of trust. In this article, the expression "right of indemnity" is used to describe the right to recoupment or reimbursement for expenses incurred out of the trustee's own pocket, along with the right of the trustee to be exonerated for trust expenses and liabilities by having them paid directly out of the trust fund.

the trust deed contained an express indemnity. His Honour concluded that if there are no assets comprising the trust fund, there is no entitlement to be indemnified.

Gray J (in the majority) summed up his view (at [74]):

The construction ... would ensure that the director of a corporate trustee had a personal liability in circumstances where a debt was incurred and there were insufficient trust assets to meet the debt. Such a result is not unfair nor unreasonable. Section 197 represents an extension to the liability of the director of a trustee company.

This key passage from DeBelle J (dissenting) puts the opposing view (at [40]):

Section 233(2)<sup>10</sup> states that the corporation will not be deemed to be not entitled to be fully indemnified out of the trust assets merely because the trust has no assets or the assets of the trust are insufficient to indemnify the corporation for the relevant liability. In other words, where the company is entitled to be indemnified out of the trust assets, the director will not be liable merely because the assets of the trust are insufficient to indemnify the corporation for the relevant liability. It will be seen, therefore, that s 197(1) has the same meaning and effect of s 233(1) and (2). In other words, s 233 has been re-enacted, albeit in different and obscure terms. If Parliament intended that s 197 should alter the operation of s 233, it would have been easily done in clear and unambiguous terms.

#### 4. WHAT IS SECTION 197 ABOUT?

Section 197’s progenitor<sup>11</sup> was introduced in the mid 1980s to address the negative impacts on unsecured<sup>12</sup> creditors who dealt with corporate trading trusts (a structure that had become popular in the 1970s). On the insolvency of a trust, unsecured creditors do not have direct access to trust assets. A liquidator only stands in the shoes of the trustee and takes the benefit of the trustee’s equitable charge or lien over trust assets to secure its right of indemnity. If, however, a liability has been incurred in favour of a creditor either in breach of trust which has not been remedied,<sup>13</sup> or ultra vires the terms of trust, the corporate trustee has no right of indemnity in relation to it.

Another concern at the time was that trust deeds were purporting to restrict the right of indemnity<sup>14</sup> of the trustee in respect of claims from creditors and other third parties. A style of drafting had emerged that purported to allow the trustee a right of recoupment for expenses incurred in running the trust (in order to allow the trust to function), but to bar the right of exoneration against claims from third parties. It has been held that a trustee is free to accept limitations of its rights of indemnity and that such limitations will be upheld against creditors, but there have also been decisions to the contrary.<sup>15</sup>

The archetype of the mischief sought to be addressed is the situation where a creditor is owed money by a corporate trustee with a \$2 share capital and either the terms of trust or the conduct of the trustee deny the creditor access to the trust assets via subrogation to the trustee’s right of indemnity.

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<sup>10</sup> The precursor to s 197 – see section 6.

<sup>11</sup> Section 299A of the Companies Codes, which was first introduced on 31 March 1986.

<sup>12</sup> The position of secured creditors is obviously different.

<sup>13</sup> Brooking J in *RWG Management Ltd v Commissioner for Corporate Affairs (Victoria)* [1985] VR 385 makes it clear, at 397-398, that the right to indemnification is lost only to the extent that the breach damages the trust estate. Also, the fact that there has been a breach (even if it does damage the trust estate) does not mean the trustee loses its right of indemnity across the board. It is only liabilities that have some causal or other meaningful connection with the breach of trust that are affected (see *Re Staff Benefits Pty Ltd and the Companies Act* [1979] 1 NSWLR 207 at 214 per Needham J).

<sup>14</sup> The trustee legislation of each State and Territory gives a trustee a statutory right of reimbursement for expenses incurred in carrying out trust duties (sometimes referred to in the legislation as an “implied indemnity”) – see *Trustee Act 1958* (Vic), s 36(2); *Trustee Act 1925* (NSW), s 59(4); *Trusts Act 1973* (Qld), s 36(2); *Trustees Act 1962* (WA), s 71; *Trustee Act 1936* (SA), s 36(2); *Trustee Act 1898* (Tas), s 27(2); *Trustee Act* (NT), s 26; and *Trustee Act 1925* (ACT), s 59(4). Only the Victorian, West Australian and Tasmanian Acts do not prevent the implied right being overridden by contrary intention in the trust instrument.

<sup>15</sup> See section 9 below, for an analysis of this issue.

The Second Reading Speech relating to the introduction of s 229A of the *Companies Act 1981* (Cth), made this clear.<sup>16</sup>

Section 197, in its original form, was, in its terms, principally aimed at *conduct* dis-entitling the trustee from being indemnified. It used language that suggested that default was necessary because it excused directors who were “innocent directors” in relation to the incurring of the liability. The Explanatory Paper to the original s 229A<sup>17</sup> (1985 Explanatory Memorandum), however, showed that it was also intended that a director would be liable for no other reason than allowing the terms of trust to contain an exclusion of the right of indemnity.<sup>18</sup> This did not come through clearly in the drafting of the section and also sits somewhat at odds with the “innocent director” exclusion.

Section 197(1) says that a director is liable “both individually and jointly with the corporation and anyone else who is liable ...” under it. It has been suggested<sup>19</sup> that the burden should be shared pro rata, although the position becomes more complex as “innocent directors” seek the protection of s 197(2) and where a director is also a beneficiary liable to indemnify the corporation under the rule in *Hardoon v Belilios* [1901] AC 118.<sup>20</sup> In the latter example, it seems that such a director is taken to be liable to indemnify directors who are not beneficiaries, thereby giving them protection under s 197(2) (ie if they are “fully indemnified”).

Section 197(1) does not make a director liable to the beneficiaries for equitable compensation for a breach of trust. It is concerned with liabilities of the trustee to creditors, not beneficiaries (see *Young v Murphy* [1996] 1 VR 279; (1994) 13 ACSR 722; (1994) 12 ACLC 558). As was said in that case per J D Phillips J at 314 and 315, the section applies to liabilities incurred in breach of trust, not to liability arising out of a breach of trust.

Section 197(1) does not create a criminal offence, nor is it a “civil penalty provision”,<sup>21</sup> but there is no defence from liability, other than under s 197(2). Whether criminal liability (eg under s 184 of the *Corporations Act*) could also arise out of circumstances to which s 197(1) applied would depend on the circumstances.

## 5. 1984 PROPOSAL – “CORPORATIONS ACTING AS TRUSTEES”

In 1984, a package of proposals was put forward in the *Companies and Securities Legislation (Miscellaneous Amendments) Bill (No 2) 1984* (Cth) seeking to protect creditors dealing with corporate trustees. Clause 72 of that Bill proposed a new Div 3A of Pt XIII of the *Companies Act 1981* (Cth) incorporating the following three components:

(a) Notification

This proposal would have required a corporation acting as a trustee to give notice of that fact in all business documents (much like the current ACN/ABN disclosure requirement).

(b) Constructive notice of trust

It was also proposed that a person would not be taken to have constructive notice of the terms of a trust merely because there had been a notification of its existence as was required by the first proposal. This was to prevent the need for creditors to insist on reviewing the trust deed before dealing with a trustee (or at least to protect those who did not do so) from having a presumption of knowledge raised against them.

(c) Directors’ personal liability

The third proposal was the precursor to s 197 creating a personal liability for directors where the corporation was not entitled to be indemnified.

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<sup>16</sup> See Schedule 3.

<sup>17</sup> It appears that the EM was called an “Explanatory Paper” to distinguish it from the EM to the first version of the *Companies and Securities Legislation (Miscellaneous Amendments) Bill 1985* (Cth) which was circulated earlier in 1985. See Schedule 2 for relevant extracts.

<sup>18</sup> Para 301.

<sup>19</sup> Corkery JF, *Directors’ Powers and Duties* (Longman Professional, 1987) p 216.

<sup>20</sup> See also *J W Broomhead (Vic) Pty Ltd v J W Broomhead Pty Ltd* [1985] VR 891; (1985) 9 ACLR 593; 3 ACLC 355.

<sup>21</sup> *Corporations Act 2001* (Cth), Pt 9.4B.

In retrospect, this was a salutary package and should have proceeded, even though it did not outlaw the obvious mischief of the limitation of the trustee’s right of indemnity in the terms of trust. The Bill was never passed and evolved into the 1985 Act<sup>22</sup> which did not include the first two proposals and so only the third proposal became law.

## 6. LEGISLATIVE BACKGROUND

Section 197 first appeared<sup>23</sup> in Australian law as s 229A of the Companies Codes on 31 March 1986 when s 66 of the *Companies and Securities Legislation (Miscellaneous Amendments) Act 1985* (Cth)<sup>24</sup> was applied to them. There was no predecessor under the Uniform Companies Acts<sup>25</sup> and it does not appear that there was an equivalent provision in the United Kingdom either.

When the *Corporations Law* came into effect,<sup>26</sup> s 229A became s 233. The *Corporate Law Economic Reform Program Act 1999* (Cth)<sup>27</sup> repealed s 233 and introduced a new s 197, in the new Ch 2D dealing with officers and employees, with effect from 13 March 2000.

The *Corporations Act 2001* (Cth)<sup>28</sup> came into effect on 15 July 2001 and included s 197 in its current form, with a new subs (4) reintroducing jurisdictional limitations present in earlier versions (ie s 229A(1)(a)(iii) and s 233(1)(a)(iii)).

## 7. MEANING OF “ENTITLED” IN S 197(1)

The majority’s view in *Hanel* strained the meaning of the word “entitled” in s 197(1)(b). Their interpretation conflicts with the intention expressed in paras 297 and 299 of the 1985 Explanatory Memorandum. In those paragraphs, it is clear that the legal right to “access” trust funds (and not their existence or sufficiency) is the basis on which a trustee is taken to be “entitled” to an indemnity. Paragraph 299 makes it clear that the drafter intended that:

the reference to the entitlement to be indemnified relates to the legal right of indemnity rather than the financial capacity of the trust to meet an indemnity obligation.

## 8. “THIS IS SO EVEN IF THE TRUST DOES NOT HAVE ENOUGH ASSETS ...”

### (a) What do those words mean?

A key part of s 197(1) is the sentence “This is so even if the trust does not have enough assets to indemnify the trustee” (for convenience, referred to as the “sentence”). It was accepted in *Hanel* that the word “this” in the sentence was a reference to the liability of a director (at [68]), but the meaning of the sentence itself is still the subject of a range of views:

#### (i) *His Honour Justice Debelle in Hanel*

Debelle J expressed his view on the meaning of the sentence in the following terms (at [37] – [39]):

The meaning of the sentence... is not immediately apparent.

...

As a matter of syntax, the word “this” refers to the whole of the preceding part of s 197(1). However, that does not immediately clarify the meaning of the sentence. If a director is liable because of the operation of the first part of s 197(1), that liability will exist because, among other

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<sup>22</sup> *Companies and Securities Legislation (Miscellaneous Amendments) Act 1985* (Cth).

<sup>23</sup> There was an earlier version of the section which was proposed as a new s 504C in the *Companies and Securities Legislation (Miscellaneous Amendments) Bill (No 2) 1984*, but it never became law.

<sup>24</sup> Act No 192 of 1985.

<sup>25</sup> They did contain s 374C (liability for insolvent trading) which became s 556 of the Companies Codes and later s 588G of the *Corporations Law/ Corporations Act*.

<sup>26</sup> Act No 110 of 1990 effective 18 December 1990.

<sup>27</sup> Act No 156, 1999.

<sup>28</sup> Act No 50, 2001.

things, the corporation is not entitled to be indemnified out of the trust. Thus, the statement, “This is so even if the trust does not have enough assets to indemnify the trustee”, adds nothing. It has nothing on which to operate because the corporation is not entitled to an indemnity. If the director is liable, he is liable, and the sentence adds nothing to that liability.

I think, therefore, that the sentence is intended to apply to the obverse effect of the terms of s 197(1), that is to say, to those instances where a director of a corporation acting as trustee will not be liable for the debts of the corporation because the corporation is entitled to be fully indemnified out of the assets of the trust. The meaning and effect of the sentence is that 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.

**(ii) Ford, Austin and Ramsay**

Ford’s *Principles of Corporations Law*, LexisNexis Butterworths 2003, says at [20.170]:

Section 197(1) asserts that the director is liable to discharge the corporation’s liability if conditions (a) and (b) are met, and then says, “This is so even if the trust does not have enough assets to indemnify the trustee.” The word “This” is ambiguous. It could be taken to refer to the proposition that the director is liable in the stated circumstances. If that construction were adopted, the quoted sentence would be a statement of the obvious point that the director’s liability is not diminished by the trust’s lack of sufficient assets to indemnify the corporation. Alternatively, the word “This” might refer only to condition (b), the condition that the director is not liable unless the corporation is not entitled to a full indemnity out of trust assets. On that construction, the quoted sentence asserts that condition (b) is satisfied [sic] in a case where the trustee has an undiminished entitlement to an indemnity out of trust assets although its entitlement cannot be satisfied because of a deficiency of assets. That was clearly stated to be the position under the former s 233(2). Although the drafting of s 197(1) is uncertain and tortuous, it is probably that the latter construction was intended, in view of the legislative history.

**(iii) The author**

In the author’s view,<sup>29</sup> the sentence means nothing more than that a director will not escape liability just because there are insufficient trust assets.

If paras (a) and (b) of s 197(1) are satisfied (ie “triggered”), it should be no answer for a director to say “well there are no assets any way so the lack of a right of indemnity is irrelevant to the position of creditors and so I shouldn’t be liable”.

The sentence clarifies the position that even if the breach of trust or other limitation on the right of indemnity does not, in fact, frustrate the indemnification (ie because there are no assets anyway) a director will still be liable. This interpretation gives the sentence real work to do. One of the key mischiefs to which the section is directed is the case where there are assets, but creditors are denied access to them. The sentence merely confirms that liability will also be imposed where there are no assets and therefore the conduct of the directors (ie procuring the trustee to act in breach of trust or by adopting a trust deed with a limited right of indemnity) has not actually prejudiced creditors. It is an important point for the section to make because, without this feature, the provision might lose some of its punitive and deterrent effect.

However, the overall effect of each of these interpretations is the same. The section imposes a liability when there is non-payment, coupled with a dis-entitlement to indemnity which liability is not affected by the presence or absence of trust assets.

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<sup>29</sup> This view is supported by the Hon Justice R P Austin in a paper entitled, “The Incorporated Superannuation Trustee”, presented for the Superannuation Lawyers Association of Australia – Libby Slater Plenary Session, Marriott Resort, Surfers Paradise, Queensland, 28 February 2004 which can be accessed at [http://www.lawlink.nsw.gov.au/sc/%5Csc.nsf/pages/austin\\_260204](http://www.lawlink.nsw.gov.au/sc/%5Csc.nsf/pages/austin_260204). His Honour said that the sentence “should be taken to mean that the director’s liability (if it exists because the right of indemnity has been destroyed) is not diminished by reference to the fact that the trust has insufficient assets to indemnify the trustee”.

### (b) Inferring legislative intent

One of the major difficulties in *Hanel* was the way the Court dealt with the inference that should have been drawn from the transformation of s 233(2) of the *Corporations Law* into the sentence. DeBelle J said (at [42]):

The fact that s 197(1) is expressed in terms which are different from s 233 does not require the conclusion that Parliament intended to alter the law. The real question is what the words in s 197(1) mean and, on examination, it is apparent that they substantially re-enact s 233.

The submission that the sentence was simply a re-enactment of s 233(2) of the *Corporations Law*, by the use of different words, was rejected by Gray J who said (at [70]):

No explanation was offered as to why the legislature would completely redraw the sub-section if all that was intended was to repeat earlier words that had a settled meaning. The fact that a new sub-section was introduced replacing the old sub-section in its entirety suggests that a legislative change was intended.

### (c) CLERP/simplification

With respect, both views overlooked two important references to which regard could have been had in interpreting the provision.<sup>30</sup> The first is para 6.5.4 of the Corporate Law Economic Reform Program (CLERP) 3 Reform Proposal Paper<sup>31</sup> which was in the following terms:

The Government has indicated that the program for rewriting the Corporations Law in order to simplify it will be subsumed within its overall corporate law reform program. Bills to rewrite the Law arising from this reform agenda will be prepared in a style which is consistent with the earlier work on simplifying the Corporations Law. In the context of the reforms to the provisions concerning directors addressed in this paper, it is proposed to rewrite *without substantial change* the provisions concerning officers,<sup>32</sup> related party transactions, oppression and civil penalties.  
(emphasis added)

Paragraph 4.3 of the summary of key amendments proposed by the *Corporate Law Economic Reform Program Bill 1998* in the Explanatory Memorandum to that Bill (1998 Explanatory Memorandum) also said:

The Bill will also rewrite *without substantial change* the remaining provisions in Parts 3.2 (Officers) ... of the Law.  
(emphasis added)

The court in *Hanel* seems to have proceeded on the basis of submissions, and a general acceptance, that the 1998 Explanatory Memorandum did not refer to s 197.<sup>33</sup> While that is literally correct in that s 197 by itself was not expressly mentioned in the 1988 Explanatory Memorandum, the two passages set out above quite clearly show that the drafter intended to rewrite Pt 3.2 of the *Corporations Act* (which included s 197) without substantially changing its legal effect.

Even ignoring those two passages, it must be accepted that CLERP had a unique “simplification” flavour and many provisions in the *Corporations Law* were simplified without much comment because it was not intended to change their legal effect. This trend was a continuation of the style of revision undertaken in the *First Corporate Law Simplification Act 1995* (Cth). Whatever the normal principles of statutory interpretation, the court in *Hanel* should have had regard to the special nature of the CLERP legislation in amending provisions for the purpose of “simplification” without changing their legal effect (whether or not simplification was actually achieved).

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<sup>30</sup> In a case where it was accepted that the provision was ambiguous, regard could have been had to the Explanatory Memorandum in its interpretation – *Acts Interpretation Act 1901* (Cth), s 15AB.

<sup>31</sup> Corporate Law Economic Reform Program Proposals for Reform: Paper No 3 – *Directors Duties and Corporate Governance – Facilitating innovation and protecting investors* released on 20 October 1997.

<sup>32</sup> *Corporations Law*, Pt 3.2 (which included s 197).

<sup>33</sup> See footnote 3 to para [66] of the judgment in *Hanel* which says: “The explanatory memorandum to the Corporate Law Economic Reform Program 1998 did not refer to the proposed s 197.” Also, Gray J said at [70]: “Counsel for Mr Hanel submitted that s 197(1) simply re-enacted s 233 by the use of different words. It was suggested that this was confirmed by the absence of any reference in the explanatory memorandum to the section.”

The majority in *Hanel* substantially re-interpreted and expanded the operation of s 197(1) based on an inference of Parliament's intentions without there being any express indication that it intended to depart from the earlier enunciation that an insufficiency of assets by itself would not lead to liability.

In a recent judgment given in *Beck v Tuckey Pty Ltd* [2004] NSWSC 357; (2004) 22 ACLC 633, his Honour, Austin J, explained the outcome in *Hanel* in the following terms:

Of course, it can happen that the drafters of legislative amendments intended only to simplify the law might fail to give effect to that intention. In the context of corporate law simplification, *Hanel v O'Neill* (2003) 48 ACSR 378 provides a dramatic recent example of a case where a court has held that to be so.

*Mathieson v Burton* (1971) 124 CLR 1 was referred to by Debelle J in *Hanel* as being authority for the proposition that there is an exception to the traditional rule that repealed legislation must be treated as if it had never existed. The exception being that the history of a legislative provision can be reviewed in the case of ambiguity or uncertainty. The predecessor provisions and the 1985 Explanatory Memorandum<sup>34</sup> should therefore also have been regarded as relevant to the meaning of the current provision.

## 9. CAN THE TRUSTEE'S RIGHT OF INDEMNITY BE EXCLUDED IN THE TERMS OF TRUST?

Although this question did not arise in *Hanel*, a substantial part of the role that s 197 is intended to play in protecting trust creditors arises because of attempts to limit the trustee's right of indemnity against trust assets in the terms of trust.

### (a) Summary of the legal position

A trustee has an implied right of indemnity out of trust assets for liabilities properly incurred in carrying out duties as trustee.<sup>35</sup> The trustee legislation in each Australian jurisdiction,<sup>36</sup> merely confirms this right. The right will also exist directly against beneficiaries in some situations (eg a sole, sui juris beneficiary),<sup>37</sup> but is clearly capable of exclusion<sup>38</sup> and hence does not need to be discussed here.

It seems clear that as between a creditor and the trustee, the trustee's right of indemnity out of trust assets can be limited or removed by contract. The question remains whether the same result can be achieved in the terms of trust so that all who deal with the trustee are affected by the limitation.

In Australian jurisdictions where the trustee legislation can be overridden,<sup>39</sup> it is still not entirely clear that a trustee can disentitle itself from recourse to trust assets to discharge liabilities.<sup>40</sup>

In *RWG Management Limited v Commissioner for Corporate Affairs (Victoria)* [1985] VR 385 at 395, Brooking J upheld a provision in a trust deed excluding the trustee's right to be indemnified. His Honour was influenced by the fact that a trustee's right to claim against the beneficiaries was accepted as being capable of exclusion in *Hardoon v Belilios* [1901] AC 118 at 127. While accepting the proposition that the trustee's rights in respect of trust assets were inherent in the office, Brooking J found that this did not mean they could not be expressly excluded, but rather that they did not have to be expressly mentioned in order to be available.

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<sup>34</sup> See also *Acts Interpretation Act 1901* (Cth), s 15AB.

<sup>35</sup> *Vacuum Oil Pty Ltd v Wilshire* (1945) 72 CLR 319 at 324 per Latham J and at 335-336 per Dixon J.

<sup>36</sup> Above n 14.

<sup>37</sup> *Hardoon v Belilios* [1901] AC 118 at 127 and *J W Broomhead (Vic) Pty Ltd v J W Broomhead Pty Ltd* [1985] VR 891; (1985) 9 ACLR 593; 3 ACLC 355.

<sup>38</sup> *Hardoon v Belilios* [1901] AC 118 at 127.

<sup>39</sup> See references in n 14. In Queensland, for example, s 65 of the *Trusts Act 1973* (Qld) says that the Part of the Act in which the implied indemnity is located applies "whether or not a contrary intention is expressed in the instrument (if any) creating the trust".

<sup>40</sup> Ford HAJ, "Trading Trusts and Creditors' Rights" (1981) 13 MULR 1 at 14 and 17-18 suggested that a denial of the right of indemnity might bind the trustee, but might be susceptible to challenge by creditors in certain circumstances.

However, it could be said that the Victorian *Trustee Act 1958* weighed heavily in the analysis. That Act allows a contrary intention to be expressed in the instrument creating the trust (see s 2(3)), opening the way for the statutory right of indemnity to be ousted. The legislative background lessened the force of some of the other reasoning in the decision.

In *Kemtron Industries Pty Ltd v Commissioner of Stamp Duties (Qld)* [1984] 1 Qd R 576; (1984) 15 ATR 627; 84 ATC 4380, McPherson J suggested (at 585), by way of obiter, that the right of indemnity was inseparable from the office of trustee and probably could not be excluded by the terms of trust (although he did not need to conclude this because s 65 of the *Trusts Act 1973* (Qld) has the effect that a non-excludable statutory right exists anyway).

Recently, the question was considered by Santow J in *J A Pty Ltd v Jonco Holdings Pty Ltd* [2000] NSWSC 147; (2000) 33 ACSR 691. In that case, Santow J preferred McPherson J’s view in *Kemtron* [1984] 1 Qd R 576 and concluded that, ignoring the statutory position, the trustee’s right of indemnity could not be excluded by the terms of trust. His Honour considered that the right of indemnity was integral to the office of trustee for the benefit of both the trustee and the creditors (who might or might not be aware of the trusteeship) and arose independently of the terms of trust.<sup>41</sup>

Nonetheless, at least so far as Victoria is concerned, it being a jurisdiction in which the statutory right of indemnity can be overridden, *RWG Management* is still binding authority for the proposition that a trustee’s right of indemnity against trust assets can be effectively negated in the terms of trust.

### **(b) Policy considerations**

Brooking J, in *RWG Management* [1985] VR 385 at 395, while deciding that a trust deed could validly exclude the trustee’s right of indemnity (in Victoria at least), noted the policy considerations in the following terms:

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

As a matter of principle, the right of indemnity against trust assets (as opposed to rights against beneficiaries) should be incapable of limitation in the terms of trust (without notice to the public at large)<sup>42</sup> for the following reasons:

- (i) Limitation of the right of indemnity tends to defeat legitimate creditors (who are generally strangers to the trust relationship and not aware of the limitation) favouring beneficiaries who are privy to the limitation;
- (ii) A situation where a person or entity acting on behalf of others can neither look to those persons nor their assets for recoupment or exoneration for expenses or liabilities is unrealistic and uncommercial and gives rise to an inference of artificiality and ulterior purpose;
- (iii) The arrangement tends to prejudice less sophisticated creditors;
- (iv) A right of indemnity is an incident of the office of trustee and should be regarded as inseparable from it; and
- (v) A trustee without a right of indemnity must act in the best interests of the beneficiaries (ie not for the trustee’s own benefit) in the knowledge that all expenses and liabilities must be met out of its own pocket. This creates an irreconcilable conflict of duties and interests.

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<sup>41</sup> Austin J referred to *Commissioner of Stamp Duties v Buckle* (1998) 192 CLR 226 at 245 which cited Lord Eldon LC in *Worrall v Harford* 32 ER 250 at 252: “It is in the nature of the office of a trustee, whether expressed in the instrument, or not, that the trust property shall reimburse him all the charges and expences [sic] incurred in the execution of the trust.”

<sup>42</sup> The *Companies and Securities Legislation (Miscellaneous Amendments) Bill (No 2) 1984* (Cth) proposed a s 504B which required that trustee status be notified on much the same documents as are now required to display the ACN or ABN, but it was not adopted.

Australian Law Reform Commission Report No 45, released in 1988, recommended<sup>43</sup> that any provision purporting to limit a trustee's right of indemnity against trust assets should be void against a liquidator. That proposal should be adopted, but in a wider form so that all such limitations are void and not just in a winding up. Section 197 could then be aimed solely at the conduct of the corporate trustee (rather than limitations in the terms of trust), at the hands of the directors, in disentitling itself to its right of indemnity.

## 10. OTHER HYPOTHETICAL IMPLICATIONS ARISING OUT OF HANEL-TYPE CONDUCT

Because the court decided that Daroko was not liable to O'Neill (O'Neill's loss was caused by his unlawful refusal to the assignment of the lease, rather than Daroko's non-payment of rent), s 197(1) could not operate in relation to Hanel and the court did not consider his conduct any further. However, had Daroko been found to be liable, Hanel's conduct in procuring the distribution of all of the trust assets in the face of the ongoing rent commitment could have given rise to a number of legal issues. The following is a brief consideration of some of them.

### (a) Breach of trust

The decision in *Hanel* did not consider whether the distribution of all the income of the trust by the trustee, Daroko, to a related party beneficiary,<sup>44</sup> was a breach of trust.<sup>45</sup> Had Daroko been found to be liable to O'Neill, this question would have been important in analysing Hanel's liability under s 197(1). If there had been a breach of trust by Daroko, then it would have had no right of indemnity because the trust fund did not benefit from the breach.<sup>46</sup>

Daroko distributed all of its income (apparently without requiring a subordinated loan back to it of sufficient funds to meet its ongoing rent obligations) prior to effecting a proper assignment of the lease to which the landlord consented. This placed Daroko in the position of being incapable of honouring its commitment to pay rent under a formal five year lease which expired on 30 September 2003, some three years after it made the distribution. It was only O'Neill's unlawful refusal to consent to the assignment that prevented Daroko from continuing to be liable under the lease. To have distributed all of the assets of the trust in those circumstances (ie with the lease still on foot) seems very likely to have been a breach of trust.

As it happened, the trust estate was not damaged by the breach because the court found that Daroko was no longer liable under its lease, having proposed an assignment to which O'Neill could not lawfully refuse to consent. However, Mr Hanel had effectively rendered Daroko's right of indemnity worthless by distributing all of the trust assets when its liability under the lease was uncertain to say the least.

Gray J (at [59]) referred to affidavit evidence from Mr Hanel to the effect that the distribution "was undertaken with a view to meeting obligations that arose under a bank charge". Presumably, the charge referred to was one given by Forcett Pty Ltd and not Daroko. Otherwise, the payment would have been made directly to the chargee and not distributed to Forcett.

Finding a breach of trust would have allowed the court to determine that both limbs of s 197(1) had been triggered (ie because of the "dis-entitling" conduct) and that Kerry Hanel would have been liable, without resorting to the "wider" view of the section that it applies to all cases where there are insufficient trust assets.

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<sup>43</sup> ALRC 45 Report on General Insolvency Inquiry (Harmer Report) Vol 1, para 251.

<sup>44</sup> The income was distributed to Forcett Pty Ltd, in its capacity as the trustee of the Kerry Hanel Investment Trust. Kerry Hanel was the sole director of Daroko Pty Ltd and a director of Forcett Pty Ltd.

<sup>45</sup> Although the decision at [56] refers to the fact that in the Magistrates' Court proceedings O'Neill had claimed against Forcett Pty Ltd (the recipient of the distribution) that the payment was made to defeat his rights as a creditor of Daroko with the intention of defrauding him.

<sup>46</sup> Above, n 13.

**(b) Voidable transaction?**

Had the court found Daroko liable and Daroko were then wound up, it is likely that the distribution to Forcett Pty Ltd would have been voidable. Part 5.7B of the *Corporations Act* gives the court wide powers to make orders in relation to uncommercial and insolvent transactions. *Re Pheon Pty Ltd* (1986) 4 ACLC 669 discussed the circumstances in which a liquidator could recover distributions to beneficiaries made by an insolvent corporate trustee according to voidable transaction principles under earlier (and narrower) legislative provisions.

**(c) Breach of directors’ duties**

A director of a trustee company does not, ordinarily, owe fiduciary duties to beneficiaries of the trust.<sup>47</sup>

However, a company might have rights against a director who, in breach of their duties, exposes the company to a liability for which it has no right of indemnity from the trust of which it is a trustee where a related party benefits from the breach.<sup>48</sup> Remembering that s 180(1) of the *Corporations Act* probably elevates the standard of care and diligence of a trustee director,<sup>49</sup> it is likely that this right would be enlivened in most cases where s 197(1) is relevant. Interestingly, such rights are not accessible by the trustee (belonging to the company in its own right) but could be exercised by an external administrator or even derivatively by members.

An inference can be drawn from the 1985 Explanatory Memorandum that it was thought that the involvement of directors in acts which may deny creditors access to trust assets was prima facie a breach of their duties as directors. Paragraph 301 said:

[The Bill] proceeds on the basis that it is reasonable to encourage all directors of companies acting as trustee to ensure that the company does not enter into trust deeds which are designed to deny creditors access to trust assets to meet liabilities incurred by the company.

Query also whether conduct of this type could amount to a criminal offence under, for example, s 184(2) of the *Corporations Act*.

**(d) Residual application of section 588G**

Paragraph 300 of the 1985 Explanatory Memorandum made it clear that the more general insolvent trading provision (now s 588G) might have a residual operation where the right of indemnity had not been excluded, but there was an insufficiency of assets (ie the situation in *Hanel*). It is submitted that this is another reason why the court in *Hanel* did not need to give s 197(1) a wider scope of operation.

Michael Inglis, in his 1984 article on the personal liability of trustee directors,<sup>50</sup> thought that when a director was instrumental in a breach of trust by a corporate trustee, they in effect caused the company to become liable to relevant beneficiaries. He thought it at least arguable that the company thereby “incurs a debt” in terms of s 556 of the *Companies Code* (the predecessor to s 588G) and (if the other elements of the section are present) directors become personally liable for the payment of that debt.

**(e) Pursuit of beneficiaries**

Presumably, although it is not clear from the decision in *Hanel*, the trustee was precluded by the deed constituting the Daroko Unit Trust from proceeding against the beneficiaries.

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<sup>47</sup> *Hurley v BGH Nominees Pty Ltd* [1982] 31 SASR 250 at 255; (1982) 6 ACLR 791; 1 ACLC 387; Barrett RI, “Directors’ Fiduciary Duties – Whether Interest of Beneficiaries under Trust of which Company is Trustee is to be taken into Account” (1985) 59 ALJ 46; Coleman AR, “Duties of Directors of Corporate Trustees to Beneficiaries” (1984) 2 C&SLJ 147; Inglis MW, “Personal Liability of Directors of Corporate Trustees of Trading Trusts and Superannuation Funds” (1984) 2 C&SLJ 48.

<sup>48</sup> See, for example, *Adler v ASIC* (2003) 46 ACSR 504; 21 ACLC 1810.

<sup>49</sup> The “circumstances” of a trustee company call for additional care and diligence in a number of respects.

<sup>50</sup> Inglis, n 47 at 54.

## 11. OBITER ANYWAY

Insofar as the decision in *Hanel* [2003] SASC 409 dealt with s 197(1), it was obiter dictum and should not be regarded as authoritative.

The court found (at [23]) that the landlord, O'Neill, caused his own loss by unreasonably refusing to consent to the assignment of the lease. There being no breach of the lease on the part of Daroko, there was no liability on which s 197(1) could operate. The court used the analogy of a guarantee (at [61] and [75]) under which there needed to be a debtor principally liable to explain why Hanel could not be liable under s 197(1).

The Full Court found that the Magistrate should have considered the defence of the landlord's failure to mitigate his loss<sup>51</sup> and set aside the summary judgment.

It was therefore not necessary to have considered the meaning of s 197(1) or how it would have operated in relation to Mr Hanel.

## 12. IMPLICATIONS AND ACTIONS FOR DIRECTORS

### (a) Much wider potential liability

If *Hanel* is correct, directors of corporate trustees are now exposed to a much greater potential for personal liability than non-trustee directors under, for example, s 588G of the *Corporations Act*. Section 588G is limited in its scope by the restrictions on who can sue for compensation, the fact that it depends on establishing a state of mind (albeit according to an objective standard) and is subject to a number of defences. Civil liability for a breach of s 588G is also, of course, limited to situations where the company is being wound up. No such limitations apply to liability under s 197(1).

### (b) Directors' and officers' insurance

*Hanel* was decided in December 2003. It is only a matter of time before its impact flows through to the cost of premiums for directors' and officers' insurance for directors of corporate trustees.

### (c) All corporate trustees affected

Directors of all corporate trustees are potentially impacted by *Hanel*. This includes directors of nominee companies, custodians, trustees of self-managed superannuation funds, responsible entities of managed investment schemes and trustee companies, as well as discretionary and family trustees.

### (d) Can directors be expressly protected from s 197(1) in the trust deed?

The question arises whether directors can be given an express right of indemnity from trust assets (and possibly even against beneficiaries) for liabilities arising under s 197(1). As a matter of principle, such a right should be available other than where dishonest, intentional or reckless conduct is involved.

Given that beneficiaries are not "strangers" vis-à-vis the terms of trust (as creditors generally are), it follows that beneficiaries should be able to consent to the directors being indemnified by the terms of trust in respect of liabilities arising under s 197(1) in appropriate circumstances. If this were allowed, the purpose of s 197(1) would not be thwarted, provided that the rights of the directors were subordinated in priority to all creditors' claims.

Interestingly, s 57 of the *Superannuation Industry (Supervision) Act 1993* (Cth) permits the terms of trust of a superannuation entity to indemnify directors of the trustee from the assets of the entity for a liability incurred while acting as a director of the trustee. There is an exception for dishonesty, intentionally or recklessly failing to exercise due care and diligence or where the liability is for a monetary penalty under a civil penalty order.

Perhaps a similar provision, applying to all trustee corporations, should be included in Ch 2D of the *Corporations Act*.

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<sup>51</sup> See section 2 of this article for a summary of the facts of the case.

### **(e) Mitigating exposure using a non-trustee special purpose vehicle**

It is possible that the impact of *Hanel* might be ameliorated by corporate trustees using a special purpose vehicle (SPV)<sup>52</sup> to hold trust assets. This would involve the trustee of a trust agreeing to sell the relevant trust assets to a specially incorporated company, the SPV, in consideration of an issue of shares by the SPV. The assets of the trust would then comprise only the shares in the SPV. The SPV would then carry on, in its own right, the activities previously carried on by the trustee and would incur all the liabilities and so on. The boards of directors of the trustee and the SPV could be identical. The trustee would not carry on any activities, but would merely hold shares in the SPV.

On the basis that the SPV would be acting in its own right and not as a trustee, it follows that its directors would not be exposed to s 197(1). As a corollary, the trustee, by not incurring any liabilities, would also shield its directors from exposure under s 197(1).

However, this mechanism is not as simple as it sounds. The terms of trust would have to accommodate it and the tax and stamp duty implications would also have to be considered. Also, it would be a matter of careful documentation to ensure that the SPV was not regarded as a sub-trustee or custodian in respect of the former assets of the trust thereby thwarting the whole purpose of the restructure. Although in an entirely different context, the recent decision of the New South Wales Court of Appeal in *Churnin v Pilot Developments Pty Ltd* [2003] NSWCA 391<sup>53</sup> illustrates how the nuances of drafting remain as important as ever.

### **(f) What about implied trusts?**

Section 197(1) applies where a corporation is “acting, or purporting to act, as trustee”. Therefore, it seems to follow that directors could be exposed whenever the law implies a trust (eg where the corporation has sold and been paid for an asset, but still holds the bare legal title) and not merely where the corporation is the trustee of an express or documented trust. This is undesirable and the legislation should be clarified so that liability is only imposed where the corporation is consciously acting as a trustee.

## **13. LEGISLATIVE SOLUTION**

Following *Hanel*, s 197 needs to be clarified by legislative amendment.

### **(a) Three basic paths**

There are three ways that s 197(1) could be redrafted:

- (i) Give legislative effect to the majority view in *Hanel* that if there are insufficient assets, a director would be liable, subject to s 197(2);
- (ii) Recast s 197(1) so that it unambiguously applies only in the event that the right of indemnity of the trustee had been lost through dis-entitling conduct on the part of the director (ie the breach of trust or ultra vires grounds), but not merely where the terms of trust limited the right of indemnity; or
- (iii) Follow the path described in (ii) above, but add a further ground of liability beyond dis-entitling conduct on the part of a director, being where a restriction in the terms of trust purported to deny a right of indemnity against its assets. In the absence of dis-entitling conduct, this limb of s 197(1) would, in practice, only operate where there were assets available in the trust.

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<sup>52</sup> This language has been chosen because the entity, although the trustee would hold all of its shares, would be neither a subsidiary, nor a controlled entity owing to s 48(2) and s 50AA(4), respectively, of the *Corporations Act*. This also means that s 187 could not apply to the arrangement.

<sup>53</sup> In that case, the court held that a clause which said that a vendor “shall proceed with all due expedition” was not absolute or imperative so that a failure by a vendor to meet a deadline because of a builder’s delay did not trigger a contractual right of rescission. Santow JA considered that the words “shall”, “proceed” and “due” all weakened the obligation.

The preferable approach is to legislate against the majority view in *Hanel* and deal with both dis-entitling conduct and restrictions in the terms of trust. A suggested new provision is set out in section 14 of this article.

### **(b) Section 197(2)**

In its current form, s 197(2) retains the “innocent director” concept found in the original s 229A, but uses different language. Determining whether a director could look to a co-director for indemnification (as if the co-director were a co-trustee) depends on a body of complex case law not readily accessible to directors and their advisers. This is undesirable. The section should be redrafted to impose liability only on a director “knowingly concerned”<sup>54</sup> in the contravention so that directors can have a clearer understanding of when they might be exposed to personal liability. This test is used in other contexts such as in s 1324 relating to the basis on which injunctions can be obtained against persons involved in contraventions of the *Corporations Act*.

## **14. SUGGESTED REDRAFT OF SECTION 197**

### **197 Directors liable for debts and other obligations incurred by corporation as trustee**

(1) A director of a corporation who is knowingly concerned in the incurring of a liability (other than a liability for breach of trust) by that corporation while it is acting, or purporting to act, as trustee under an express or documented trust, 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.

The person is liable both individually and jointly with the corporation and anyone else who is liable under this subsection.

(2) For the purposes of subsection(1), a corporation is only taken not to be entitled to be fully indemnified to the extent that the right to indemnification is reduced by:

- (a) a breach of trust on the part of the corporation;
- (b) the corporation acting outside its powers as trustee under the document creating or evidencing the trust or some other document; or
- (c) something in a document creating or evidencing the trust or in some other document,

and not merely by reason that there are insufficient assets where none of (a), (b) and (c) applies.

(3) Subject to subsection (4), the terms of any trust of which a corporation is trustee may provide for a director of the corporation to be indemnified out of the assets of the trust in respect of a liability under subsection (1) incurred while acting as a director of the corporation.

(4) A provision of the type referred to in subsection (3) is void in so far as it would have the effect of indemnifying a director against:

- (a) a liability that arises because the director:
  - (i) fails to act honestly in a matter concerning the corporation or trust; or
  - (ii) intentionally or recklessly fails to exercise, in relation to a matter affecting the corporation or trust, the degree of care and diligence that the director is required to exercise; or
- (b) liability for a monetary penalty under a civil penalty order.

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<sup>54</sup> *Corporations Act*, s 79 which says:

#### **79 Involvement in contraventions**

A person is involved in a contravention if, and only if, the person:

- (a) has aided, abetted, counselled or procured the contravention; or
- (b) has induced, whether by threats or promises or otherwise, the contravention; or
- (c) has been in any way, by act or omission, directly or indirectly, knowingly concerned in, or party to, the contravention; or
- (d) has conspired with others to effect the contravention.

(5) A director of a corporation may be indemnified out of the assets of a trust in accordance with provisions of the terms of that trust that comply with this section, but any claim for indemnification will, despite any agreement or other arrangement to the contrary, be subordinated in priority of payment to all other unsecured claims on a winding up of the trust.

(6) This section has effect despite Part 2D.2 and Chapter 2E.

(7) This section does not apply to a liability incurred outside Australia by a foreign company.

(8) This section does not apply to a liability incurred by a registrable Australian body outside its place of origin.

Other possibilities include entrenching a right of indemnity against trust assets for a corporation acting as a trustee to overcome the common law position in those States where the statutory confirmation of the right of indemnity is subject to the possibility of contradiction in the terms of trust.<sup>55</sup>

## SCHEDULE 1

### The legislative history of section 197<sup>56</sup>

Section 197 of the *Corporations Act 2001* (Cth)<sup>57</sup>

197 Directors liable for debts and other obligations incurred by corporation as trustee

(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.

(3) This section does not apply to a liability incurred outside Australia by a foreign company.

(4) This section does not apply to a liability incurred by a registrable Australian body outside its place of origin.

Section 197 of the *Corporations Law*<sup>58</sup>

197 Directors liable for debts and other obligations incurred by corporation as trustee

(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.

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<sup>55</sup> Above n 14.

<sup>56</sup> The section started life as part of cl 72 of the *Companies and Securities Legislation (Miscellaneous Amendments) Bill (No 2) 1984* released as an exposure draft in June 1984 which was superseded by cl 44A of the Second Exposure Draft of the *Companies and Securities Legislation (Miscellaneous Amendments) Bill 1985*, which became Act No 192 of 1985.

<sup>57</sup> Effective from 15 July 2001.

<sup>58</sup> Effective from 13 March 2000.

(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.

(3) This section does not apply to a liability incurred outside Australia by a foreign company.

Section 233 of the *Corporations Law*<sup>59</sup>

**233(1) [Guilty directors liable]** Where:

- (a) a relevant body corporate while acting or purporting to act in the capacity of trustee of a trust, incurs a liability:
  - (i) in the case of a company – whether within or outside Australia; or
  - (ii) in the case of a registered foreign company – within Australia; or
  - (iii) otherwise – within this jurisdiction; and
- (b) the relevant body corporate is for any reason not entitled to be fully indemnified out of the assets of the trust in respect of the liability; and
- (c) the relevant body corporate has not discharged, and is unable to discharge, the liability or a part of the liability;

the relevant body corporate and the persons who were directors of the relevant body corporate when the liability was incurred and were not innocent directors in relation to the incurring of the liability are jointly and severally liable to discharge the liability or the undischarged part of the liability, as the case may be.

**233(2) [Exempt circumstances]** For the purposes of this section, a trustee of a trust shall not, merely because:

- (a) the trust has no assets; or
- (b) the assets of the trust are insufficient to indemnify the trustee in respect of the liability concerned;

be taken not to be entitled to be fully indemnified out of the assets of the trust in respect of a liability.

**233(3) [Definitions]** In this section:

‘Australia’ includes the external Territories;

‘innocent director’, in relation to the incurring of a liability by a relevant body corporate while acting or purporting to act in a capacity of trustee of a trust, means a person who:

- (a) was a director of the relevant body corporate at the time when the liability was incurred; and
- (b) if the persons who were directors of the relevant body corporate at that time had been at that time the trustees of the trust and had incurred the liability, would have been entitled to be fully indemnified in respect of the liability by one or more of the other trustees;

‘liability’ means a debt, liability or other obligation;

‘relevant body corporate’ means:

- (a) a company;
- (b) a registrable body other than a registrable local body.

Section 229A of the *Companies Codes*<sup>60</sup>

**Liability of directors for debts, &c, incurred by corporation acting as trustee**

229A. (1) Where—

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<sup>59</sup> Effective from 18 December 1990.

<sup>60</sup> Effective from 31 March 1986.

- (a) a relevant corporation, while acting or purporting to act in a capacity of trustee of a trust, incurs a liability–
  - (i) in the case of a company – whether within or outside Australia;
  - (ii) in the case of a registered overseas foreign company – within Australia; or
  - (iii) in the case of a foreign company that is neither a registered overseas foreign company nor a recognised foreign company – within the Territory; and
- (b) the relevant corporation is for any reason not entitled to be fully indemnified out of the assets of the trust in respect of the liability,

the relevant corporation and the persons who were directors of the relevant corporation at the time when the liability was incurred and were not innocent directors in relation to the incurring of the liability are jointly and severally liable to discharge the liability.

(2) For the purposes of this section, a trustee of a trust shall not, by reason only that–

- (a) the trust has no assets; or
- (b) the assets of the trust are insufficient to indemnify the trustee in respect of the liability concerned,

be taken not to be entitled to be fully indemnified out of the assets of the trust in respect of a liability.

(3) In this section–

‘Australia’ includes the external Territories;

‘innocent director’, in relation to the incurring of a liability by a relevant corporation while acting or purporting to act in a capacity of trustee of a trust, means a person who–

- (a) was a director of the relevant corporation at the time when the liability was incurred; and
- (b) if the persons who were directors of the relevant corporation at that time had been at that time the trustees of the trust and had incurred the liability, would have been entitled to be fully indemnified in respect of the liability by one or more of the other trustees;

‘liability’ means a debt, liability or other obligation;

‘registered overseas foreign company’ means a registered foreign company that was formed or incorporated outside Australia;

‘relevant corporation’ means–

- (a) a company;
- (b) a registered overseas foreign company; or
- (c) a foreign company that is neither a registered overseas foreign company nor a recognised foreign company.

## SCHEDULE 2

### Extract from the Explanatory Paper to the Companies and Securities Legislation (Miscellaneous Amendments) Bill 1985<sup>61</sup>

Cl 44A: Liability of directors for debts, etc incurred by company or foreign company acting as a trustee

295. Background Persons contracting with a trustee (corporate or individual) are entitled to be subrogated to the trustee’s right of indemnity out of the trust assets to meet liabilities properly incurred. However, this right will be valueless if the trustee’s right to indemnity is lost as a result of the trustee acting in breach of trust or in a manner which is not authorised by the terms of the trust.

296. Proposed amendment Cl 72 of ED1<sup>62</sup> which has been deleted from ED2,<sup>63</sup> proposed amongst other new provisions a new s 504c. That new section is now proposed to be inserted, in an amended

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<sup>61</sup> Second Exposure Draft released in June 1985.

form, in the CA as new s 229A. The other provisions in ED1 cl 72, namely proposed ss 504A and 504B will not proceed. The reason for their omission is explained in para 485 below.

297. Proposed s 229A will provide that where a company, that is a trustee and is acting or purporting to act in that capacity, incurs a debt in respect of which it is not entitled to be indemnified out of the assets of the trust (cf where the company is entitled to be indemnified but there are insufficient or no trust assets to indemnify the trustee) then the directors of the company at the time when the debt was incurred will be jointly and severally liable with the company for the payment of the debt.

298. The purpose of this proposed amendment is to ameliorate the consequences for creditors where there is no access to trust funds to meet liabilities incurred by a corporate trustee.

299. Some of the many submissions received in relation to cl 72 of ED1 called for clarification of the proposed new section 504C to make it clear that the reference to the entitlement to be indemnified relates to the legal right of indemnity rather than the financial capacity of the trust to meet an indemnity obligation. In response sub-section (3) has been added to proposed s 229A (ED 2 cl 44A – proposed s-sec 229A(3)).

300. It should be noted, however, that notwithstanding the insertion of proposed s 299A CA s 556 might still operate to make directors personally liable where the right of indemnity has not been excluded but there are insufficient trust assets to indemnify the trustee.

301. Some submissions criticized the “strict liability” nature of the new provision and comparison was made to CA s 556 which incorporates a defence. The defence in s 556 revolves around the extent to which an individual director was involved and the reasonableness of his expectations (about the company being able to repay the relevant debt) at the time that the company incurs the debt. By contrast, if imposition of personal liability is to have the desired effect of discouraging the insertion in trust deeds of provisions relieving the company’s right of indemnity from trust assets, and to encourage trust deeds to be drafted so as to minimise or even eliminate the possibility that the trustee company may be in breach of trust then the relevant time to consider the involvement of individual directors in acts which may deny creditors access to trust assets is the time when the trust deed is being prepared. ED2 proceeds on the basis that it is reasonable to encourage all directors of companies acting as trustee to ensure that the company does not enter into trust deeds which are designed to or which by their operation may, deny creditors access to trust assets to meet liabilities incurred by the company.

302. Moreover, a fundamental corollary of the objective of overcoming the use of a corporate trustee with a nominal share capital to effectively render worthless the right of a creditor to hold the trustee liable for the debts incurred, is the lifting of the “corporate veil” and the treatment of the directors as if in fact they were the trustees. Under the law of trusts the trustee is, in the first event, personally liable to a creditor for the debts of the trust (*Muir v City of Glasgow Bank* (1897) 4 App Cas 377; *Octavo Investments Pty Limited v Knight* (1979) 54 ALJR 87 at p 89). Where there are a number of co-trustees, each is jointly and severally liable to creditors for the debts of the trust. It is this aspect of the trustees’ liability to the creditors which proposed s 299A seeks to impose on the directors of a corporate trustee.

303. However, it is not intended that the equitable rights of contribution which may arise as between the co-trustees themselves who are jointly and severally liable for a debt, where some are not responsible for the incurring of the debt in question (which principles have been applied to company directors: *Ramskill v Edwards* (1885) 31 ChD 100), will be affected by this provision.

304. One further matter raised in the submissions concerned the fact that ED1 cl 72 s 504C did not address the territorial question of where the debt had to be incurred by the trustee company in order to attract the consequent liability. By comparison, it was noted that CA s 556 specifically refers to the situation where “a company incurs a debt, whether within or outside the State”.

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<sup>62</sup> ED1 means the *Companies and Securities Legislation (Miscellaneous Amendments) Bill (No 2) 1984* (Cth) which was exposed for public comment in 1984.

<sup>63</sup> ED2 means the *Companies and Securities Legislation (Miscellaneous Amendments) Bill 1985* (Cth) which was a redraft of ED1.

305. Proposed para 229A(1)(a) deals with the issue of jurisdiction and refers to three categories of corporation to which proposed s 299A applies, specifying the extent to which the provision applies to each category –

229A(1)(a) –

(i) refers to a company which incurs a debt within or outside Australia;

(ii) refers to a registered overseas foreign company which incurs a debt within Australia;

(iii) refers to a foreign company that is neither a registered overseas foreign company nor a recognized foreign company which incurs a debt in the Territory (this reference will of course be modified by “translator” regulation to refer to the appropriate State in each State Code).

### SCHEDULE 3

#### Second Reading Speech

Extract from the Second Reading Speech in the House of Representatives made on 11 October 1985 by Mr Lionel Bowen, Attorney-General, in relation to the *Companies and Securities Legislation (Miscellaneous Amendments) Bill 1985*.<sup>64</sup>

##### Liability of Directors of Trading Trusts

Currently persons contracting with a trustee, whether an individual or a corporation, are entitled to be subrogated to the trustee’s right of indemnity out of the trust assets to meet liabilities properly incurred. However if the trustee acts in breach of trust or in a manner which is not authorised by the terms of the trust, the trustee’s right of indemnity, and therefore the creditor’s right of subrogation, is lost.

The problem this creates for creditors has been exacerbated by the widespread use of business structures involving a nominally capitalised corporate trustee to carry on business on behalf of a trust, together with other refinements, such as the careful siphoning of funds into the trust business. In such cases the creditor’s primary right to sue the corporate trustee for the debt may well be worthless.

I think there is a general recognition in the business community that the legal system cannot tolerate the continued use of artificial legal contrivances which result in the deliberate avoidance of liabilities legitimately owed to other persons. It is proposed to amend the Companies Act to impose personal liability on directors of companies acting as trustee when a debt has been incurred but the trustee company is not entitled to be indemnified out of the assets of the trust.

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<sup>64</sup> House of Representatives, *Weekly Hansard*, No 14, 1985, p 1923.