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Indemnity crucial to protect trustees' personal assets: Legal expert

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Personal assets of individual trustees in a trust could be exposed if indemnity is not available, warns a legal expert. Matthew Burgess, director of View Legal, said to avoid this it's good practice to set up a trust as a company and use a special-purpose vehicle with nominal assets.

"The trustee of any form of trust including SMSFs and limited recourse borrowing arrangements will generally have a right of indemnity against the assets of the trust," Mr Burgess said.

Many of the liability risks that attach to individual trusteeship can be relatively easily managed by ensuring the trustee of a trust is a company, so long as the company is a special purpose vehicle with nominal assets such as $2 of share capital."

However, he added that the use of a properly structured corporate trustee does not provide complete protection as there are still statutory and third-party obligations imposed.

"For example, directors of a trustee company can be personally liable for things including personal guarantees to financiers, workplace health and safety legislation and insolvent trading under section 588G of the Corporations Act," he said.

"They can also be liable for certain tax obligations such as in relation to phoenix activity, goods and service tax, the pay-as-you-go regime and superannuation guarantee charge and misleading or deceptive conduct under section 18 of Schedule 2 to the Competition and Consumer Act 2010."

Negligence and breaching directors' duties under the Corporations Act can also put them at risk.

Mr Burgess continued there are a range of issues directors may be personally liable for under the Corporations Act. "For example, the duties to act with due care and diligence and good faith and to ensure there is no improper use of position or information," he said.

He said section 197 of the Corporations Act is also relevant.

The Act states that "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".

It continues that the person is liable individually and jointly with the corporation and anyone else who is liable under the subsection.

Mr Burgess said section 197 was varied after the decision in Hanel v O'Neill [2003] SASC 409 in which a director was held personally liable where the trust had insufficient assets to cover the claims for which it was liable.

"This was despite the fact that the general view up until the decision was that a trustee company director would have no liability if the trustee company had a full indemnity against trust assets," he said

“The decision essentially meant that until the legislation was amended the indemnity provided no practical defence unless the trust had the assets to back it up.”

The amendments ensured that a director of a corporate trustee would be personally liable only where the company's right of indemnity as trustee has been lost through disentitling conduct.

“The recent decision of Reliance Financial Services Pty Ltd v Antalija Developments No 4 Pty Ltd (No 4) [2023] NSWSC 1260 bluntly confirms the liability risks where there are individual trustees,” he continued.

In this case, the court confirmed that “it is the clearest of legal propositions that a trustee contracts in the trustee's name and is liable at law under the contracts that the trustee makes in the trustee's capacity as such”.

Mr Burgess said this means that the trustee's only recourse if it becomes liable to a third party because of its actions as trustee, is to enforce its indemnity against the trust assets if those assets are sufficient to meet the indemnity.

“In other words, a court has no discretion to relieve a trustee from this personal liability,” he said.

Another case, Charlton v National Australia Bank Limited [2021] NSWCA 111, provides further context.

In this instance, a person purchased a property with the contract confirming the person was acting as trustee.

Some years later, the person granted a mortgage over the property to NAB as security for financial facilities provided to the trust, although the person was named as a mortgagor without any reference to the trust.

On subsequent default under the mortgage, the individual claimed they had retired as trustee.

Mr Burgess said in this instance the court confirmed that on a proper reading of the trust deed, a trustee was not able to unilaterally retire.

“An appointor under the deed does have such a power,” he said.

“In this case, the purported unilateral retirement was invalid and the individual remained as trustee of the trust.” Secondly, there was no ability under the trust deed to imply a unilateral right to retire, as there was no gap in the drafting of the deed allowing such an approach.

“This outcome was contrasted with the decision in Bunten v Muir (1894) 21 R 370, where a clause in a trust deed assumed that the trustees had the power to resign but did not expressly state that to be the case and therefore was 'implied' into the deed by the court,” Mr Burgess continued.

“Even if the resignation of trusteeship was successful, this would not have discharged the individual from being liable to nab as the liabilities were incurred while acting as trustee.”

He added a trustee is personally liable for debts incurred as a trustee, regardless of whether the trustee contracted with creditors as a named trustee.

The court also rejected the suggestion that the liabilities were not incurred by the trustee but rather were “future debts” at the time of the granting of the mortgage because they were not immediately payable.

“The court confirmed that even assuming that the debts were not due and payable before the default, and therefore somehow not in fact liabilities, the argument was of no assistance to the trustee,” Mr Burgess said.

“The fact that the debts were not payable was irrelevant to the conclusion that they were liabilities to determine the extent of the liability of, and indemnity imposed on, the trustee.”

The right of indemnity available for an individual trustee or director of a corporate trustee is subject to limitations, regardless of whether the assets of the trust are sufficient to cover a successful claim.

Mr Burgess said the right to indemnity may be denied where there is no evidence the conduct of the trustee was carried out in good favour when there has been a breach of trust as was the case in Fitzwood Pty Ltd v Unique Goal Pty Ltd (In Liq) [2002] FCAFC 285.

“The trustee loses its right at law of indemnity due to its breach of trust,” he said.

“Given recent case law and legislative change, it would seem difficult to build a compelling argument justifying the use of individual trustees of any form of trust including SMSFs and LRBAs.”

He concluded that specialist advisers have an opportunity to proactively ensure that new structures are established appropriately and heritage structures are remedied by the use of special-purpose corporate trustees.