



Briefing paper

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Trusts and creditors: an overview

1. What is a trust?

A trust is not an entity but a relationship. The trustee holds the trust property for the benefit of the beneficiary of the trust (or for a trust purpose). Because the trust property is held on behalf of the beneficiary, the trustee is not authorised to deal with the trust property as if it were its own.

A person can be a trustee for some property it owns (the trust property) but hold other property in its own capacity.

2. Trading trusts

If the trustee is carrying on a business for the trust it is known as a trading trust. A trading trust could be set up as a unit trust where each of the beneficiaries has a specific interest in the assets of the trust, or (more commonly) as a discretionary trust, where the trustee has a discretion as to making distributions to the beneficiaries.

3. Why use a trust?

Trusts are used for various reasons. These include tax and asset protection. In this paper we will not go into further detail on the reasons why trusts are used.

4. Personal liability

A trustee is personally liable to its creditors for all the debts it incurs in the course of carrying on a business as trustee (unless there is agreement to limit or exclude such liability). The trust is not a

separate entity: contracts are entered into with the trustee, not the trust.

5. Requirements for a valid trust

If the trust has not been properly set up, the trust will not be effective.

The trustee needs to be someone who is capable of being a trustee (not an infant, and having mental capacity). The trustee can be an individual, a group of individuals, or a company (unless its constitution says that it cannot act as trustee).

There must be either identified beneficiaries of the trust or a permitted object of the trust (a charitable purpose). The beneficiaries of the trust can be identified individually or as a class.

There will normally be a trust deed setting up the trust. The trust deed needs to be properly executed as a deed (witnessed) and duty paid where applicable.

The trust will be invalid if it infringes the "rule against perpetuities": the trust must not continue for a period of more than 80 years.

Bankruptcy and insolvency laws are also relevant: the creation of a trust may be a voidable transaction.

6. Availability of property

Because a trustee carrying on a business is liable for debts in its personal capacity, any personal property of the trustee (i.e., property not held under the trust) is available to creditors.

However the property of the trustee that is held on trust is only available:

- in the case of unsecured creditors, to the extent that the trustee is entitled to be indemnified out of the trust; and
- in the case of secured creditors, where the property has been validly charged with payment of a debt.

7. Trustee's right of indemnity from trust property

The key to ensuring an unsecured creditor can get the property of the trust is the trustee's right of indemnity from the trust property.

A trustee generally has a right to be indemnified out of the trust property for amounts incurred while acting as trustee. The right of indemnity is property of the trustee. It is supported by what is called an "equitable lien" (a type of security interest) over the trust property.

The right of indemnity has two parts:

- the right of reimbursement or recoupment – where the trustee uses its own funds and then seeks reimbursement from the trust property; and
- the right of exoneration – where the trustee is using trust property directly to satisfy a liability to a creditor (for example, paying money from a trust account to repay a loan it has taken out as trustee).

The trustee is only entitled to be indemnified for amounts properly incurred. If a trustee is in breach of the terms of the trust when incurring a liability then the trustee's right of indemnity will be lost.

For example, if the terms of the trust do not allow the trustee to buy goods over a particular value on credit, then the trustee would be in breach of trust if it entered into a contract to buy such goods, and so it would not be entitled to be indemnified out of the assets of the trust for its liabilities under the contract. If the trustee then defaulted under the contract, the property of the trust would not be available to the creditor when enforcing its rights.

In some jurisdictions, the trustee's right of indemnity can also be excluded by the terms of the trust deed if the parties choose to do so. This includes Victoria, but not New South Wales. However there is some question about whether courts would enforce such a

provision if it meant that a trust could avoid its obligations to creditors.

The right of indemnity of a trustee remains against the trust property even if a new trustee has been appointed and the trust property has been vested in a new trustee (i.e., the old trustee continues to have the right of indemnity).

8. Enforcement against the trust property

When an unsecured creditor enforces against trust property, the creditor cannot take the property in executing an order for judgment against the trustee.

Instead, the creditor has what is called a "right of subrogation", which in effect means that the creditor steps into the shoes of the trustee and can take over the trustee's rights to be indemnified out of the trust assets.

9. Trustee's right of indemnity from beneficiaries

As well as a right to be indemnified out of the trust assets, the trustee may also have a right to be indemnified by the beneficiaries personally.

With a discretionary trust, however, usually there is no right of indemnity from the beneficiaries personally.

If the beneficiary is a company, the liability of members of the company will be limited. Using a company as beneficiary may be a device to limit the liability of the real beneficiaries of the trust.

10. Trust creditors vs. other trust creditors

There may be many creditors of the trust with competing claims. Do the unsecured creditors rank equally with each other in being paid out of the trust assets, or should they be paid in priority to when their claims arose? The general view is that they rank equally.

11. Trust creditors vs. general creditors

There may also be creditors of the trustee in its capacity as trustee and creditors of the trustee in its personal capacity. Do creditors of the trust rank equally with personal creditors of the trustee with regard to the trust property?

Here the two parts of the trustee's right of indemnity come into play (see section 7 above). The courts have held that:

- the right of reimbursement is a right that belongs to all creditors; but

- the right of exoneration only exists for the benefit of trust creditors.

Therefore the trust creditors may be in a better position than general creditors.

12. Trust creditors vs. beneficiaries

Creditors of a trustee will also be competing with the beneficiaries of a trust for recourse to the trust property.

Creditors will have priority over the beneficiaries in relation to the trust property when exercising the trustee's right of indemnity.

13. Secured creditors and trust property

Just as a trustee can incur liabilities such as entering into an equipment lease in the course of carrying on a business, a trustee can also grant security interests to secure those obligations.

If the creditor has a security interest in the trust property, the position is different when enforcement occurs. The creditor does not have to exercise its right of subrogation to step into the shoes of the trustee in order to get the benefit of the trustee's right of indemnity. Instead, the creditor has specific security over the trust assets which it can enforce.

By having a security interest, the creditor will therefore be better protected when dealing with trading trusts, because it will be easier to access the assets of the trust on enforcement.

14. Directors and company trustees

Where the trustee is a company, in some cases the directors will be liable for liabilities incurred where the trustee has no right of indemnity. Under section 197 of the Corporations Act 2001 (Cth), a director will be liable where the company cannot discharge the liability and is not entitled to be fully indemnified against the liability out of the trust assets because of a breach of trust by the company, or because the company has acted outside the scope of its powers as trustee, or because there is a term of the trust denying, or limiting, the company's right to be indemnified against the liability.

This means that the directors of the trustee company can be personally liable for the liability, just like guarantors, if the trustee company cannot meet the liability because it can't be indemnified from the trust assets.

15. Dealing with the trust assets

If the trust has no assets, then a creditor (secured or unsecured) will be in a worse position in terms of what is available on enforcement.

When dealing with a trust it is therefore important that the trustee undertakes to the creditor that it will not distribute the capital of the trust to the beneficiaries without the creditor's consent.

16. Bankruptcy and insolvency

If the trustee is an individual who becomes bankrupt, the court will appoint a trustee in bankruptcy to replace him. If the trustee is a company, the company may remain as trustee – the court will assess the best approach.

A liquidator of a company acting as trustee will also have recourse to the trust property to meet the costs and expenses of winding up and the liquidator's remuneration, but only so far as they are incurred in relation to the trust.

17. How can the risks of providing finance to a trust be managed?

Below are some steps that can be taken when dealing with a trustee as a creditor.

- Ensure that the customer declares whether or not they are acting in their capacity as trustee, so that you know if you are dealing with a trust.
- Require the trustee to provide a copy of the trust deed, and review the terms of the trust deed to ensure:
 - that the trust is validly formed (duly executed, stamped, and with a vesting date no longer than 80 years);
 - that the trustee has a right of indemnity from the trust property;
 - that the transaction is within the terms of the trust – i.e.: the trustee has power to enter into the transaction; the transaction is for a proper purpose of the trust; and if the transaction requires some internal procedure to be followed (such as approval at a meeting of unitholders), that the procedures have been followed.

- In the terms and conditions of your agreement with the trustee you could include the following undertakings of the trustee:
 - not to distribute the capital of the trust;
 - not to amend the trust deed;
 - not to grant any other security interest over the assets of the trust; and
 - not to breach the terms of the trust.

Further information:



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