Who bears the burden for business losses: To what extent are liability issues of business structures taught in Australian accounting degrees?

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Abstract

Sustainable businesses are seen as fundamental for a country’s prosperity. Running a business has its risks, especially as many fail in their early years of operation. A failed business usually means losses. The question as to which stakeholders associated with the business are to bear the loss is an important issue. The answer to this will largely depend on the business structure used to conduct the enterprise.

The sole proprietor “structure’ is the one most often used to operate a business (i.e. no separate legal entity). However, many businesses are operated through companies and trusts (with a very high proportion of the trusts being discretionary trusts). Partnerships are also used but to a lesser extent than companies and trusts, and data demonstrate their decline in utilisation.

Accountants play a central role in the choice of business structure question confronting their clients. Research demonstrates that when accountants are discussing and recommending a business structure to their clients, liability issues are a central consideration, even exceeding tax.

Earlier research of the authors demonstrates the Australian undergraduate accounting curriculum is heavily focused on sole proprietors, partnerships and companies. However, there is scant coverage of the trust structure (both discretionary trusts and fixed trusts) despite them being a popular business structure in the Australian commercial context.

This paper goes back to first principles and examines whether there is justification for the differential coverage in the accounting (business law) curriculum on the liability issues concerning the various business structures that are popularly used.

Given the popularity of trusts in the Australian commercial context vis-à-vis the other heavily used business structures, the paper will argue that the liability issues
with respect to trusts are just as important as that for the other popular business structure to reduce liability exposure, being the company. Further, the paper will, through a consideration of the liability issues for each structure, argue that the liability issues with respect to trusts involve greater uncertainty of outcome compared to that for companies. In addition, the paper canvasses real world examples where advisors appear to have largely failed to comprehend the nature of a trust.

The paper concludes that the current situation of scant coverage of trusts (including the liability issues) in accountants’ undergraduate business law curriculum is a major concern which needs to be seriously re-appraised.
1. Introduction

Accountants are seen as a trusted professional advisor, and can be considered the most important advisor in the set-up phase.\(^1\) An integral part of being a ‘professional’ is the educational requirements.\(^2\) Indeed, professionals are seen as having specialised knowledge, training, qualifications and intellectual skills required for the work they will encounter.\(^3\) These education requirements can canvass both technical knowledge, as well as generic skills. Technical knowledge represents knowledge about a particular discipline area whereas generic skills are not discipline-specific and can be applied to a variety of contexts, including higher education and the workplace.\(^4\)

There have been concerns raised about Australian accounting graduates in terms of their skills and knowledge. Much of this concern focuses on accounting graduates’ generic skills, and the expectation gap between them and employers.\(^5\) However, there have been some research concerns about the technical knowledge being taught to Australian accounting graduates. In particular the research project funded by the Australian Learning and Teaching Council ‘Accounting for the future: more than numbers’ noted there were frequent comments by employers about the need for ongoing training for accounting graduates in terms of superannuation, tax and trusts and companies.\(^6\) Given the growing utilisation of trusts and self-managed superannuation funds (SMSFs) with Australian businesses a curriculum audit raised concerns about the adequacy of the Australian accounting undergraduate coverage of them.\(^7\)

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In terms of business law content, the two main accounting professional bodies in Australia only require graduates to complete the following business law courses in their undergraduate degrees: Commercial Law, Corporation Laws and Taxation Law.\(^8\) It is likely this accreditation requirement influences the structure and content of accounting degrees, as a survey of 231 Australian academics indicated that this is the major driver in designing program requirements.\(^9\)

In the United States of America there have been concerns about the legal education training of accountants, with increased legal business education said to be needed due to the critical role that law pays in society, especially with business structures and the ethical implications that this can entail.\(^10\) Also, questions have been raised as to whether the American curriculum has stayed up-to-date and is representative of growing popularity of alternative new business structures, compared to the traditional ones of companies and partnerships.\(^11\)

Further study by accounting graduates with the two major professional bodies is also unlikely to further their legal knowledge, especially of business structures. Pursuant to the CPA Program there are four compulsory subjects, two electives and a practical component that is required. The compulsory subjects are ethics & governance, financial reporting, strategic management accounting, global strategy and leadership. Also, the two courses ‘advanced taxation’ and ‘advanced audit and assurance’ are compulsory if not completed at the undergraduate level. Otherwise the electives include financial risk management and contemporary business issues. In terms of the CA ANZ Program it is similar having five courses: audit and assurance, financial accounting and reporting, management accounting and applied finance, taxation and a capstone course.

This paper goes back to first principles and examines whether there is justification for the differential coverage in the accounting (business law) curriculum on the liability issues concerning the various business structures that are popularly used being companies and discretionary trusts. Given the popularity of trusts in the Australian commercial context vis-à-vis the other heavily used business structures, the paper will argue that the liability issues with respect to trusts are just as important as that for those other structures.

The structure of this paper is as follows. Firstly, there will be a discussion about the different business structures utilised in Australia which will highlight the

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8 CPA Australia and CA ANZ Accreditation (2012), at pp 12 – 13. Note that the Institute of Chartered Accountants of Australia (ICAA) requires the three courses listed to be undertaken, but CPA Australia allows the Taxation Law course to be undertaken in a candidate’s professional examination process.
popularity of both discretionary trusts and companies. Evidence will be provided about how accountants play an important role in this choice of business structure and how asset protection and liability issues can dominate their considerations. This will be followed by empirical evidence about the likely topic coverage of the law relating to companies and discretionary trusts in the Australian accounting undergraduate curriculum. In the third part of this paper, there will be discussion about the liability issues that can arise when either a discretionary trust or company is utilised. It will be argued that the liability issues with respect to discretionary trusts involve greater uncertainty of outcome compared to that for companies. Then real world examples will be canvassed where advisors appear to have largely failed to comprehend the nature of a trust. The paper concludes that the current situation of scant coverage of trusts (including the liability issues) in accountants’ undergraduate business law curriculum is a major concern which needs to be seriously re-appraised.

2. Choice of business structure in Australia (role of accountants, trusts - and influence of liability issues in choice)

In Australia there is an array of business structures available to be utilised. The choice of business structure can be a fundamental decision as it influences such things as the management structure, ability for the raising of equity, the tax consequences for profits and losses, as well as liability exposure and asset protection. Indeed, the introduction of the modern company over 100 years ago has been celebrated as a critical contribution to modern economic development, due in part to the ability to raise equity from diverse sources while providing some liability protection.¹²

When considering income tax return data, of the 2,999,190 taxpayers in 2012 who indicated that they were conducting a business, 36 per cent were sole proprietors, 27 per cent companies, 25 per cent trusts and 12 per cent partnerships:

Table 1. In terms of trusts, approximately 78% of them are a type of discretionary trust.¹³ Consequently, it can be appreciated that when a formal business structure is being used, then the dominant structures are that of the company and the discretionary trust. Part of this popularity may be attributed to the liability and asset protection that these structures can provide investors. D’Angelo attributes part of the popularity of trusts to the uncertainty surrounding the law applying to them and how this can frustrate creditors’ rights and thereby inadvertently improving liability

protection for investors. In comparison, it has been argued that the lack of liability protection with general partnerships is part of the reason for their steady decline in use both in Australian and overseas.

Table 1: AUS: Lodgement of Tax Returns — Business

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual (sole proprietor)</td>
<td>1,044,386</td>
<td>1,057,392</td>
<td>1,067,700</td>
</tr>
<tr>
<td>Company</td>
<td>779,250</td>
<td>788,985</td>
<td>817,855</td>
</tr>
<tr>
<td>Partnership</td>
<td>382,400</td>
<td>370,000</td>
<td>359,905</td>
</tr>
<tr>
<td>Trust</td>
<td>702,080</td>
<td>729,620</td>
<td>753,730</td>
</tr>
<tr>
<td>Total (exc super)</td>
<td>2,908,116</td>
<td>2,945,997</td>
<td>2,999,190</td>
</tr>
<tr>
<td>Self-managed super fund</td>
<td>373,195</td>
<td>391,165</td>
<td>424,360</td>
</tr>
<tr>
<td>APRA and other funds</td>
<td>4,500</td>
<td>4,100</td>
<td>3,695</td>
</tr>
</tbody>
</table>

Source: Australian Taxation Office, Taxation Statistics 2012, (Australian Taxation Office, 2014), Table 1. *Limited partnerships are not recorded separately and are included in the company figure. In 2010 there were 386 limited partnerships with taxable income greater than $0: Table 3.10, 26.

In terms of size, 99.6 per cent of sole proprietors have less than $2 million in turnover: Table 2. Excluding those taxpayers who have ‘nil business income’ and superannuation funds, of the businesses with less than $10 million income (categorised by the Australian Taxation Office (ATO) as ‘small’), 45 per cent are sole proprietors, 29 per cent companies, 12 per cent partnerships and 13 per cent trusts. For taxpayers with business income greater than $10 million, the corporation is the most popular (74 per cent), followed by trusts (19 per cent), partnerships (5 per cent) and sole proprietors (2 per cent). This re-enforces the dominance of both companies and trusts, especially for larger operations.

14 D'Angelo, N. 2009. The trust: Evolution from guardian to risk-taker, and how a lagging insolvency law framework has left financiers and other stakeholders in peril. JBFLP 20:279-305.
16 According to statistics for Australian Business Numbers, there are currently 2,684 limited partnerships registered with an Australian business number. At <www.abr.business.gov.au/StatisticalSearchResult.aspx> 27 July 2012. Note that the formation, operation, etc, of limited partnerships is governed by state and territory law. The statistics available as to the number of limited partnerships in each jurisdiction are as follows: Queensland: 276 (unincorporated) and 10 (incorporated); New South Wales: 844 (unincorporated) and 119 (incorporated); Tasmania: 123; Australian Capital Territory: 1; Northern Territory: Zero; Other States: Western Australia, South Australia and Victoria do not have a central register of limited partnerships. Limited partnerships can be registered with a number of bodies, which keep different databases. Additionally, partnerships may be registered with more than one body. As such, it is not possible to obtain figures for these three states.
Table 2: AUS: Lodgement of Tax Returns — Size

<table>
<thead>
<tr>
<th>Entity size</th>
<th>Individuals</th>
<th>Companies</th>
<th>Super funds</th>
<th>Partnerships</th>
<th>Trusts</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss ( &lt; $0 )</td>
<td>1,400</td>
<td>1,790</td>
<td>35</td>
<td>275</td>
<td>735</td>
<td>4,235</td>
</tr>
<tr>
<td>Nil (ie not in business)</td>
<td>11,668,330</td>
<td>110,405</td>
<td>59,290</td>
<td>69,170</td>
<td>436,105</td>
<td>12,343,300</td>
</tr>
<tr>
<td>Micro (&gt; $0 but &lt; $2M )</td>
<td>1,062,640</td>
<td>635,150</td>
<td>368,410</td>
<td>281,690</td>
<td>290,480</td>
<td>2,638,375</td>
</tr>
<tr>
<td>Small (&gt; $2M but &lt; $10M)</td>
<td>3,285</td>
<td>53,805</td>
<td>120</td>
<td>7,615</td>
<td>22,070</td>
<td>86,900</td>
</tr>
<tr>
<td>Medium (&gt; $10M but &lt; $100M)</td>
<td>360</td>
<td>14,535</td>
<td>100</td>
<td>4,150</td>
<td>20,200</td>
<td></td>
</tr>
<tr>
<td>Large (&gt; $100M but &lt; $250M)</td>
<td>10</td>
<td>1,185</td>
<td>40</td>
<td>65</td>
<td>150</td>
<td>1,450</td>
</tr>
<tr>
<td>Very large (&gt; $250M)</td>
<td>0</td>
<td>1,010</td>
<td>60</td>
<td>35</td>
<td>35</td>
<td>1,150</td>
</tr>
<tr>
<td>Total</td>
<td>12,736,030</td>
<td>817,885</td>
<td>428,055</td>
<td>359,905</td>
<td>753,730</td>
<td>15,095,605</td>
</tr>
</tbody>
</table>

Source: Australian Taxation Office, Taxation Statistics 2012, (Australian Taxation Office, 2014), Table 2. With the figures above it needs to be highlighted that for companies the numbers are inflated, as a number of business forms are deemed for tax purposes to be companies (eg limited partnerships and certain public unit trusts).

Given the numerous consequences of the choice of business structure, it is understandable that professional advisors are consulted in this process.\(^{17}\) Research from the United Kingdom demonstrates that in terms of setting up business structures, accountants are likely to play a dominant role, compared to such other professional advisors such as lawyers.\(^{18}\) For example, Hicks et al. found that 70% of companies were set up by accountants, whereas only 12% were set-up by solicitors.\(^{19}\) This is supported in part from evidence in Australia that demonstrates that accountants are the most important consultant for entrepreneurs in the start-up phase.\(^{20}\) This is despite that advice in terms of which business structure should be used could be considered legal advice and outside the scope of what accountants are permitted to charge for. Consequently, it would

\(^{17}\) However, it should be noted that for small business operations evidence from the United Kingdom suggest that formal advice is not sought in approximately two-thirds of the time: Hicks A, Drury R and Smallcombe J, Alternative Company Structures for the Small Business (ACCA Research Report No 42) (Certified Accountants Educational Trust, London, 1995).


appear that reflecting upon accountants’ role and their education with respect to business structures is important.

Australian research demonstrates for professional advisors when advising on business structures an important consideration is around liability, with such notions of asset protection, risk and limited liability dominating their advice. A survey of Australian professional advisors, who were predominately accountants (85%), found the most important issue when advising on a business structure was ‘asset protection’ (average ranking of 8.26 on a 10 point scale). Asset protection was seen to be more important than ‘tax benefits/savings’ which was ranked second (average ranking of 6.84 on a 10 point scale). Also ranking in the top five issues were the notion of ‘level of risk’ (5.96), ‘limited liability’ (5.95), as well as ‘business expansion’ (5.98). Indeed it was argued that the notion of asset protection may be more important than limited liability itself, as due legislative and common law duties, the notion of liability exposure is complex, and at the end of the day protection of valuable assets is important. Research from the United Kingdom supports that liability protection can be the most important characteristic when choosing a business structure, especially a company.

However, given the popularity of using companies and discretionary trusts for business operations, to what extent are accounting undergraduates taught about them, and in particular the liability issues surrounding them? In a curriculum audit of Australian accounting degrees in terms of business structures, a survey was conducted of 138 accounting academics from 36 Australian universities who taught into undergraduate accounting degrees. The findings suggest that the five common mandatory business law courses would be where undergraduate accounting students have the greatest exposure to the law surrounding business structures. Overall, the results illustrate that the business structure that has the greatest emphasis consistently throughout lectures, tutorials and assessment was

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26 The five common business law courses were: Introduction to Law/Foundations of Law (‘Intro to Law’); Introduction to Business Law (‘Intro to Business Law’); Law of Business Associations/Law of Commercial Associations (‘Law of Associations’); Company/Corporations Law – Introduction (‘Company’); and Taxation Law – Introduction (‘Tax’). Note it is likely that within each accounting degree there is only three or four mandatory business law courses, but there can be different names used to describe the course.
the company.\textsuperscript{27} This was then followed by general partnerships and sole traders.\textsuperscript{28} Despite trusts, including discretionary trusts, being a popular business structure in Australia, exceeding partnerships, there was low coverage of discretionary trusts and little of unit trusts in the accounting curriculum.\textsuperscript{29} There was also low coverage of limited partnerships, and very little of SMSFs. The authors argued that this raised concerns about the level of knowledge that accounting graduates would have in terms of business structures, especially trusts and SMSFs. The results in relation to the mandatory business law courses lecture time in respect of companies and discretionary trusts is detailed in Table 3. This table demonstrates that on average over 70\% of the mandatory business law courses spent greater than 30 minutes, with 34\% spending greater than 5 hours discussing companies. In contrast, only approximately 2\% of mandatory business law courses on average spent greater than five hours discussing discretionary trusts. There was likely to be greater coverage of discretionary trusts within the tax course, with on average 52\% of them spending greater than 30 minutes but less than five hours.

Table 3: Lecture coverage of Companies and Discretionary Trusts

<table>
<thead>
<tr>
<th>Mandatory Business Law Courses</th>
<th>‘Corporations/Companies’ in the LECTURES</th>
<th>‘Discretionary Trusts’ in the LECTURES</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Not Covered or &lt; 5 min</td>
<td>&lt; 30 mins</td>
</tr>
<tr>
<td>Introduction to Law/Foundations of Law</td>
<td>35%</td>
<td>9%</td>
</tr>
<tr>
<td>Introduction to Business Law</td>
<td>32%</td>
<td>24%</td>
</tr>
<tr>
<td>Law of Business Associations/Law of Commercial Associations</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Company/Corporations Law — Introduction</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Taxation Law — Introduction</td>
<td>21%</td>
<td>14%</td>
</tr>
<tr>
<td>Average for mandatory courses</td>
<td>19%</td>
<td>10%</td>
</tr>
</tbody>
</table>

While not previously reported, the survey also asked what topics were covered in the lectures of these courses in relation to the business structures. This average data in respect of the five mandatory business law courses as it pertains to


companies and discretionary trusts is detailed in Table 4. When considering the lecture coverage for companies, it appears that there is largely equal distribution of time spent on topics, with an average of around 45% of courses spending between 30 minutes to less than 5 hours on such topics as: Nature of and governing law; Formalities; Liability issues (members/controllers); Asset protection; Admission of new (equity) members & ability to sell (equity) membership interests; Profit distribution and Cessation of business. The lowest coverage in this time band was: Taxation of business profits/losses and Tax implications on sale of business.

In comparison, when considering the lecture topics for discretionary trusts there is a greater emphasis on attributes that are relevant to tax. For example, when considering the time frame of between 30 minutes to less than 5 hours, the emphasis is on such topics as: Taxation of business profits/losses (16%); Profit distribution (15%) and Tax implications on sale of business (10%). This emphasis would be in part due to the fact that the mandatory business law courses most likely to discuss discretionary trusts with accounting students were the taxation courses. However, it should be noted that there are some courses devoting substantial time in this time band to the topics of: Liability issues (members/controllers) (11%) and Cessation of business (10%).

Table 4: Lecture Topic Coverage in Mandatory Business Law Courses (Average)

<table>
<thead>
<tr>
<th>Please indicate the extent to which the following topics are covered in the LECTURE for your Mandatory Business Law Course in relation to .....</th>
<th>'Corporations/Companies’ in the LECTURES</th>
<th>'Discretionary Trusts’ in the LECTURES</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Not Covered or &lt; 5 min</td>
<td>&lt; 30 mins</td>
</tr>
<tr>
<td>Nature of and governing law</td>
<td>17%</td>
<td>32%</td>
</tr>
<tr>
<td>Formalities</td>
<td>23%</td>
<td>29%</td>
</tr>
<tr>
<td>Liability issues (members/controllers)</td>
<td>26%</td>
<td>23%</td>
</tr>
<tr>
<td>Asset protection</td>
<td>31%</td>
<td>23%</td>
</tr>
<tr>
<td>Admission of new (equity) members &amp; ability to sell (equity) membership interests</td>
<td>33%</td>
<td>23%</td>
</tr>
<tr>
<td>Profit distribution</td>
<td>29%</td>
<td>22%</td>
</tr>
<tr>
<td>Cessation of business</td>
<td>34%</td>
<td>18%</td>
</tr>
<tr>
<td>Taxation of business profits/losses</td>
<td>48%</td>
<td>26%</td>
</tr>
<tr>
<td>Tax implications on sale of business</td>
<td>64%</td>
<td>17%</td>
</tr>
</tbody>
</table>

This data overall suggests that for Australian accounting undergraduate students they have little exposure to the law relating to discretionary trusts, with there being greater emphasis on sole proprietors, companies and general partnerships. This is
despite the popularity of discretionary trusts as a business structure in Australia. Even when students are exposed to trusts, there is greater emphasis on the law relating to their (and their members) taxation treatment, with reduced coverage on liability and asset protection. Overall this means that accounting graduates are likely to have reduced understanding about the governing law, liability implications and asset protection of using a discretionary trust for a business structure. This brings into question whether accounting graduates are being taught adequate technical knowledge as part of their undergraduate accounting degrees in terms of business structures, especially discretionary trusts.

3. Discussion of liability issues with business structures (demonstrates the complexity of discretionary trusts)

The “choice of operating entity” question (or asset holding vehicle question) is one of the most important to face a person (and their advisors) contemplating the pursuit of a business or the purchase of investment assets. Many considerations are involved including the features and attributes of each entity type, and the desires and goals of the relevant person and their family.

One of the central considerations though, if not the key consideration, is limiting liability to third parties (external parties). In particular, business operators are keen to “outsource” the risk associated with the failure or lack of success of their enterprise, so that the risk is borne by creditors and others that deal with the “operating entity”, rather than the business operator and/or their family. Suppliers or other creditors of the enterprise do not want that risk, or at least seek to minimise it or be able to make an informed decision to take it on.

As noted in the introduction of the paper, the aim of this part is to provide an outline of the liability rules that apply in regard to both discretionary trusts and companies.\(^{30}\) The coverage is sufficiently detailed to allow the reader to obtain an appreciation of the fundamental rules\(^{31}\) for each entity so that a comparison can be made across entities as to where the economic burden (and therefore, the risk) of debts and liabilities incurred will fall (e.g. equity investors, creditors).\(^{32}\) Importantly,

\(^{30}\) They are the: (i) sole proprietor (ii) partnership (ii) trust, and (iv) company. Of course, some of these are not entities in the sense of having a separate legal existence independent of their [equity] owners.

\(^{31}\) When it comes to rules concerning where liability for an entity’s debts should fall, there are numerous exceptions and qualifications to the general or fundamental rule(s). For example, the exceptions to, or departures from, the separate legal entity rule for companies are effectively exceptions to the fundamental liability rule: see Robert P Austin and Ian M Ramsay, Ford, Austin and Ramsay’s Principles of Corporations Law, 16\(^{th}\) ed., LexisNexis Butterworths, 2015 at paras 4.245-4.250 for a brief summary of the main exceptions. As far as possible, this article will be restricted to the fundamental rules for each entity; to deal with even a small number of exceptions would significantly extend the article for marginal benefit vis-à-vis the purpose of the article.

\(^{32}\) The focus is on unsecured creditors and not secured creditors. Secured creditors, for example, providers of loan capital will usually have security over assets and/or personal guarantees from associates of the borrower to secure repayment of debt.
this part is also designed to allow the reader to appreciate the degree of uncertainty surrounding the fundamental rules, and from there, uncertainty of outcome, for each entity.

As also noted in the introduction, another aim of this part is to contribute in helping the reader, in particular, business law academics at Australian universities, to consider the appropriate curriculum coverage in relevant business associations law courses.

Some constraints in coverage are worth noting. First, business or asset holding structures often involve much more than just one operating entity, usually with the aim of buttressing or maximising the limitation of liability aims of those behind the relevant business. These entity and asset holding structures can take many shapes. To attempt to deal with all or even some of the combinations would expand the paper to an intolerable extent. Accordingly, this paper will focus on the liability issues as they relate to an operating entity. In any event, the rules discussed herein in regard to each “entity” would generally apply within a multi-layered structure adopted.

Secondly, coverage of the rules is limited to a non-insolvency or non-bankruptcy situations. Even though the outcome may not change markedly, entry by the “operating entity” into insolvency or bankruptcy raises an extra range of issues. To deal with these here would also extend the paper to an intolerable extent with only marginal benefit. Thirdly, the division of property issues that arise on relationship breakdown will not be examined in this paper. Fourthly, the focus is on debts and liabilities arising under contract, rather than liabilities for torts and wrongs.

3.3.1 Trust

The rules governing trusts and those dealing with them involve a combination of the trust’s governing document (i.e. trust deed), the rules of equity and state trust or trustee legislation. Given the central place of creditor rights in this paper, the contract between the trustee and the creditor may also be important.

A widely accepted definition of a trust under the general law is as follows: “Equitable obligation binding a person (trustee) to deal with property for the benefit of other persons (beneficiaries).” There are essentially four elements here, namely, trust property, trustee, beneficiaries and obligation on the trustee to deal

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33 This would include such things as: (i) whether certain rights form part of the divisible property pool of the insolvent debtor and (ii) reconciling the claims of multiple creditors under the respective regimes.
34 While ascertaining the divisible property pool on relationship breakdown and orders for division of property under the Family Law Act 1975 (Cth), can be seen as an aspect of “asset protection” for the relevant parties, that process does not generally interfere with outside creditors’ rights.
35 The relevant legislation in New South Wales is the Trustee Act 1925 (NSW).
with the trust property for the benefit of beneficiaries. The absence of one element will usually result in there being no trust.\textsuperscript{37}

The trust “entity” is not a uniform entity. They can vary considerably. For example, express trusts can be fixed trusts, where beneficiary entitlements are set out in the trust deed, or discretionary trusts, where beneficiary “entitlements” will largely depend on the favourable exercise of the trustee’s discretion.\textsuperscript{38}

In a similar way to the partnership “entity”, a trust is better described as a relationship. The trust as such does not obtain or have a legal personality (legal persona) or existence. This is the case even though the trust is a vehicle for the pursuit of economic gain for the beneficiaries. This is also the case even though: (i) the commercial world often views the trust as an entity and (ii) the tax law and other law gives semi-entity status to the trust.\textsuperscript{39}

The rule against perpetuities that applies in most Australian states and which applies to most trusts effectively means that a trust must come to an end at some time (i.e. trust does not have perpetual life). More strictly, the property that was gifted to the trustee and is held on trust must vest in people (beneficiaries) absolutely before a given point in time. If this does not occur, the disposition (that created the trust) is said to be void.\textsuperscript{40}

Finally, subject to the qualification below, there is no requirement that a natural person trustee register with a regulatory agency that it is operating a business. A corporate trustee, as a result of incorporation (through registration) under the \textit{Corporations Act 2001}, is necessarily registered with the Australian Securities and Investments Commission (ASIC). Aside from asking for clarification, those trading with a trust (e.g. suppliers) will not necessarily know they are trading with a trust. If the trustee(s), both natural person and a corporate trustee, is trading under a name other than the name(s) of the trustee, there is a requirement to register the trustee’s business name on the Business Names Register.\textsuperscript{41}

The approach is to take a systematic, step-by-step approach that reflects the legal rules that may be relevant to an entity “dealing with” the trust in regard to a particular debt or liability. Unfortunately, the law is a little unclear in some areas.

\textsuperscript{37} The absence of a trustee at a particular time, for example due to death, will not destroy a trust as a replacement trustee can be appointed. It is also worth mentioning that in order for an express trust to be validly constituted, the three certainties must be present (i.e. certainty of intent to create a trust, certainty of trust property and certainty of beneficiaries).

\textsuperscript{38} This article is restricted to express trusts (trusts established under a trust deed with some care and planning) because implied trusts and resulting trusts would not be “used” to pursue economic gains on a sustained basis.

\textsuperscript{39} The income tax law refers to a trust as an entity: s 960-100(1)(f) of the \textit{Income Tax Assessment Act 1997}.

\textsuperscript{40} This brief outline on the life of a trust raises a number of questions (e.g. if the trust is void, would the trust property re-vest in the settlor or testator (deceased) under a resulting trust). However, for the purpose of this article, they do not have to be addressed.

\textsuperscript{41} Section 18 of the \textit{Business Names Registration Act 2001}. 
Accordingly, the main aim is to raise awareness of the “rules”, and the considerations that are relevant, rather than offering a high critique of the rules.

3.1.1 Trustee Primarily Liable for Debts and Liabilities of the Trust

Subject to the comments below when the trustee incurs debts and liabilities, the trustee is acting as a principal. In the first instance, this means the trustee has unlimited liability for debts and liabilities incurred by him/her/it in the course of carrying on the trusts. Put another way, the trustee’s debts are its debts, and not those of anybody else. This is in spite of the fact that the trustee is acting for the benefit of the beneficiaries, and not for himself/herself/itself. Again in the first instance, the trustee’s personal assets (or non-trust assets) can be required to meet the debts that arose from the trust.

It is a combination of factors that leads to this result. The common law does not recognise a trust at all; it is the rules of equity that recognise a trust. But under the rules of equity, the trust is not an entity having a separate legal personality (not a person). Instead, it is an “arrangement” or “relationship”. All this means is that the law of contract, itself a common law creation, applies to the contracting party, namely, the trustee. And, the common law does not generally recognise the representative capacity (as distinguished from personal capacity) in which a person (here, trustee) is acting.

3.1.2 Trustee as Agent for Beneficiaries

Ordinarily, a trustee will not be an agent for beneficiaries. However, if the trustee is acting as an agent for a beneficiary/beneficiaries, the trustee cannot be liable for the debts incurred; the beneficiary, as principal, is liable under [normal] agency law. In some cases, this could be a desirable outcome for a creditor.

The test seems to be that the trustee must be subject to the control of (or have the right to be controlled by) beneficiaries, along similar lines to the control that exists in a clear-cut principal-agent relationship. This is a factual question. Clauses in the trust deed that give beneficiaries’ power to direct the trustee could be an indicator of this control, as would the conduct of the trustee and beneficiaries. One commentator has suggested that nominee trusts and custodian trusts (where trustee has no duties to perform and must refrain from active management) would be examples where agency would exist.

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42 Vacuum Oil Company Pty Ltd v Wiltshire [1945] HCA 37 at para 5 (per Latham CJ) and para 23 (per Dixon J); Octavo Investments Pty Ltd v Knight [1979] HCA 61 at para 13.
43 We will see below though that the rules of equity and/or state and territory trust or trustee legislation and/or the trust deed are likely to overcome the harshness of this outcome (i.e. trustee often has a right of indemnity in regard to trust debts).
44 Scott v Davis [2000] HCA at para 228 (per Gummow J).
In closely held trusts where one person has various capacities, one must be
careful to identify the capacity in which he or she is exercising control “over the
trustee”. For example, where a person is both a director of the corporate trustee
and a beneficiary, it is most likely the person’s control is being exercised as
director of the company so that any question of agency involving the beneficiary is
not tenable.

The fact the trust deed says that an agency relationship does not exist between
the trustee and beneficiaries is not determinative of the issue. In the end, it is
submitted that the degree of control of the trustee by beneficiaries would have to
be quite significant before a finding of agency is made.

3.1.3 Settlor generally not Agent and not Liable for Trust Debts

A settlor or creator is a party to the creation of an express trust; the person who
has agreed to act as trustee of the trust is the other. The settlor (sometimes
called the contributor) is the person who contributes the initial sum or property to
the trust in order for it to get started. Often, a so-called nominal settlor who
contributes $10 will be used to create the trust (e.g. employee in advising
accountant’s office).

The generally accepted position is that even though the settlor has requested the
trustee to assume the office of trustee wherefrom debts and liabilities will be
incurred, the settlor is not obliged to indemnify the trustee for its trust debts and
liabilities. There appear to be two recognised exceptions, which, if one is made
out, could be a desirable outcome for a creditor. First, where the settlor indicates
expressly or by implication that he or she is willing to indemnify the
trustee, perhaps in consideration for the trustee accepting the office of trustee.
This will rarely be the case, and will certainly not be the case with a nominal settlor.

Secondly, and similar to what was said above in regard to beneficiaries, a trustee
is not normally regarded as an agent for the settlor. However, if the settlor were to
reserve a power to give directions to the trustee or to control the trustee, a case
can be made that the trustee would be acting as agent for the settlor. It is
submitted that the degree of control of the trustee would have to be quite
significant before a finding of agency is made.

46 Of course, there must be beneficiaries in order to satisfy one of the three certainties for the existence of a
trust (i.e. certainty of beneficiary).
47 This also helps satisfy one of the three certainties for the existence of trust (i.e. certainty as to trust
property).
48 Fraser or Robinson v Murdoch (1881) 6 App Cas 855 at 872.
624.
50 Nuncio D’Angelo, Commercial Trusts, LexisNexis Butterworths, 2014 at p 127 citing Ford & Lee on
Trusts at para 1.1590.
3.1.4 Trustee May be Able to Limit Liability to Unsecured Creditors through Contract

A trustee can negotiate with each creditor contractually to limit the creditor’s rights to payment to the assets of the trust fund. While there may be very few creditors willing to do this, if done, it would be legally effective. The creditor would then bear the risk of debts and losses rising to a level above the trust fund net assets. For this to be the case, the contract would have to state clearly that this was the intent.

3.1.5 Trustee Claiming that She/He/It is Contracting “as Trustee” is not usually enough to Remove Personal Liability

While this area of the law is a little unclear, the situation seems to be that by simply writing on a contract, a purchase order, letterhead, etc, that the person is “contracting as trustee” or in “the capacity as trustee of the XXX family trust”, will not be enough for the trustee to remove their [normal] personal liability. In other words, simply telling creditors that a person is contracting as a trustee is not sufficient to exclude the normal personal liability rules for the trustee.

The situation might be different if there is other evidence to support the conclusion that the creditors and trustee have excluded liability by implication (e.g. in the past, the creditor has acted on that basis).

3.1.6 Trustee’s Right of Indemnity Against Trust Fund

To help overcome the harshness (unfairness) of the unlimited liability rule that applies to debts incurred by a trustee, the trustee is likely to have a right of indemnity out of the trust fund (trust property). If this right of indemnity is available, the trustee does not have to meet expenses out of their own pocket first and then obtain reimbursement. Instead, trustees can simply meet trust expenses directly out of trust property.

This right of indemnity may come from one or more sources, namely: (i) the rules of equity (ii) the relevant trust/trustee legislation and/or (iii) the trust deed. In a

51 McLean v Burns Philp Trustee Co Pty Ltd & Ors (1985) 2 NSWLR 623 at 640.
52 Re Anderson; Ex parte Alexander (1927) 27 SR (NSW) 296 at 300; Helvetic Investments Corporation Pty Ltd v Knight (1984) 9 ACLR 773. General Credits Ltd v Tawilla Pty Ltd [1984] 1 Qd R 388 at 389.
53 The right of indemnity has or can have two elements. They are: (i) the right of exoneration (where the trustee has incurred a liability but has not yet discharged or paid it) and (ii) the right of reimbursement (where the trustee has discharged or paid a trust liability with his or her own funds). This article will only refer to these two sub-elements where necessary.
54 The right of exoneration arises when the liability is incurred. When the liability is discharged (or paid) from the trustee’s own funds, the right of exoneration is extinguished, and is replaced by the right to reimbursement. Where the trustee discharges the liability from trust assets, the trustee has no further rights.
55 Octavo Investments Pty Ltd v Knight [1979] HCA 61 at para 13.
56 Queensland (s 72 of the Trusts Act 1973); New South Wales (s 59(4) of the Trustee Act 1925); Australian Capital Territory (s 59(4) of the Trustee Act 1925); South Australia (s 35(2) of the Trustee Act 1936);
particular case, it could be important to know which is under discussion (see below). The broad idea though is that as soon as the trustee incurs a trust expense\(^{57}\) (or pays a trust expense),\(^{58}\) this right in the trustee arises.

The legal nature of the trustee’s right of indemnity against trust assets has been variously described. For example, it has been described as a lien, charge and a security interest. The most accurate description is that the trustee has a beneficial interest in the trust assets, and that this beneficial interest it to take priority over the beneficial interests held by beneficiaries, to the extent of the value of the indemnity (debt incurred or amount to be reimbursed).\(^{59}\) Accordingly, beneficiaries cannot demand possession of trust assets while the trustee has an unsatisfied right of indemnity.

3.1.6.1 Condition(s) to establish the indemnity

The key requirement is that the expense must have been incurred in the course of carrying out the trust; it must have been properly incurred or not improperly incurred.\(^{60}\) A failure to disclose to the counterparty (creditor) that he or she or it was acting in the capacity of trustee does not mean the expense was improperly incurred.\(^{61}\) A “mere slip” or “error of judgment” will not mean the expense was improperly incurred.\(^{62}\)

An expense incurred in deliberate breach of trust is unlikely to be a properly incurred expense.\(^{63}\) But even this may be qualified where, even though the expense is improperly incurred, the trustee acted in good faith and he/she has benefited the trust estate.\(^{64}\)

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\(^{57}\) Strictly, right of exoneration arises.

\(^{58}\) Strictly, the right of exoneration is extinguished and the right to reimbursement arises.

\(^{59}\) Octavo Investments Pty Ltd v Knight [1979] HCA 61 at paras 13-14; Chief Commissioner of Stamp Duties (NSW) v Buckle & Ors 98 ATC 4097 at 4105; CPT Custodian Pty Ltd v Commissioner of State Revenue (Vic) 2005 ATC 4925 at 4935.

\(^{60}\) In re Beddoe; Downes v Cottam [1893] 1 Ch 547 at 558; JA Pty Ltd and 1 Or v Jonco Holdings Pty Ltd and 2 Ors [2000] NSWSC 147 at para 50.

\(^{61}\) JA Pty Ltd and 1 Ors v Jonco Holdings Pty Ltd and 2 Ors [2000] NSWSC 147 at para 50.

\(^{62}\) Nolan v Collie [2003] VR 287 at paras 44-50. The decision to instigate legal actions and defend legal actions is one area that raises difficulties in regard to the properly incurred expense question: see Denis SK Ong, Ong on Subrogation, The Federation Press, 2014 at pp 26-26 for a discussion of the cases.

\(^{63}\) Re Staff Benefits Pty Ltd [1979] 1 NSWLR 207 at 214.

\(^{64}\) RWG Management Ltd v Commissioner of Corporate Affairs [1985] 1 VR 385 at 396.
3.1.6.2 Can this right of indemnity be ousted or excluded?

Given the importance of this right of indemnity to trustees, and arguably, the institution of the trust, it is hard to see how anything short of an express statement in the trust deed would be sufficient to exclude the indemnity.

It seems odd to ask this question; why would a trustee give up their right of indemnity against the trust fund and thereby be exposed in an unlimited way to debts incurred as trustee? This will be addressed below when discussing trust creditor rights (Sub-Part 3.1.10), but it is sufficient to say for now that it may be beneficial to the trustee and the trustee’s family or associates to not have this right of indemnity.

3.1.7 Rules of equity

The trustee’s right of indemnity is well established under the general law (rules of equity); the failure to confer this right on the trustee in the relevant trust deed does not disentitle the trustee.

The debate is whether the general law right can be ousted by the trust deed. It is fair to say there is no clear answer. There are statements pointing both ways.

Part of the problem is that some of the cases appear to be cases on the trustee’s legislative right to indemnity against trust assets conferred by state and territory (states) trust legislation (see below). Another complicating factor is that in some states, the relevant trust legislation provides for the [statutory] right of indemnity to be excluded by the trust instrument, and in some states, it cannot be excluded.

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65 Worrall v Harford (1802) 32 ER 250 at 252 (trustee’s indemnity is an incident of the office and is inseparable from it) and Chief Commissioner of Stamp Duties (NSW) v Buckle & Ors 98 ATC 4097 at 4106 (right of indemnity conferred on the trustee is a necessary incident of the office of trustee).

66 Vacuum Oil Co Pty Ltd v Wiltshire [1945] HCA 37 at para 5 (per Latham CJ) and at para 23 (per Dixon J); Octavo Investments Pty Ltd v Knight [1979] HCA 61 at para 13.

67 Moyes & Anor v J & L Developments Pty Ltd & Anor (No 2) [2007] SASC 261 at para 38.

68 In favour of the position that ousting should not be permitted are: Worrall v Harford (1802) 32 ER 250 at 252 (trustee’s indemnity is an incident of the office and is inseparable from it); Kemtron Industries Pty Ltd v Commissioner of Stamp Duties (Qld) 84 ATC 4380 at 4386; Chief Commissioner of Stamp Duties (NSW) v Buckle & Ors 98 ATC 4097 at 4106 (rights conferred upon the trustee as a necessary incident of the office of trustee); JA Pty Ltd and 1 Ors v Jonco Holdings Pty Ltd and 2 Ors (2000) NSWSC 147 at para 50; and Moyes & Anor v J & L Developments Pty Ltd & Anor (No 2) [2007] SASC 261 at 40 (right of indemnity is of benefit not just to trustees but also creditors. A trustee ought not be allowed to waive a right enjoyed by creditors). In favour of ousting being permitted is: RWG Management Ltd v Commissioner for Corporate Affairs [1985] VR 385 at 395 (the trustee is free to waive its right of indemnity against beneficiaries (see Sub-Part 2.4.3 below) and therefore it is hard to see why the trustee should not be free to waive its right of indemnity against trust assets) and the cases cited therein. We will also see below that s 197(1) of the Corporations Act 2001 appears to be drafted on the basis that the general law right of indemnity can be ousted by the trust instrument.

69 Queensland (s 65 of the Trusts Act 1973).
3.1.8 Trust legislation

In short, every state provides a statutory rule conferring on trustees a right to be indemnified out of trust assets for expenses reasonably incurred in or about the execution of the trusts or powers.\(^7^0\) However, in some states, the legislation appears to contemplate that the right can be ousted or curtailed.\(^7^1\) As noted immediately above, some of the [interrelated] issues raised by the state trust legislation are: (i) does the state trust legislation override the general law right of indemnity against trust assets so that the trust law becomes an exclusive code in regard to the conferral of this right. It is submitted the answer is no and (ii) on the assumption that the general law right of indemnity subsists alongside the statutory right conferred, does the legislation in the four "ouster states" also contemplate the ousting of the general law right, or, just the statutory right.

3.1.9 Trustee’s Right of Indemnity against Beneficiaries

This is a separate right to the right against trust assets. It is a rule of equity. It is not provided for in state trust legislation.\(^7^2\) It is unlikely to be provided for in the trust deed.

In certain circumstances, the trustee’s right of indemnity extends to beneficiaries of the trust. That is, if trust property is not enough to reimburse the trustee (or to meet the trustee’s undischarged liabilities), beneficiaries can be required to contribute to the trustee’s costs.

The scope of this right of indemnity is not clear but some principles can be stated. Where there is a single beneficiary who is the absolutely entitled owner (i.e. fixed trust) of trust property and who is of full legal capacity (e.g. over age of majority), the trustee has a right of indemnity as against the beneficiary. The right does not exist or arise where the beneficiary is under age. There is some debate about the situation where there are multiple absolutely entitled beneficiaries of full legal capacity. It is not clear why there should be a difference between a single beneficiary situation, and a multiple beneficiary situation. In any event, the court will be guided by the presence or absence of facts that make it just or unjust for the trustee to be reimbursed.\(^7^3\) This right of indemnity does not apply to objects

\(^7^0\) Queensland (s 72 of the Trusts Act 1973); New South Wales (s 59(4) of the Trustee Act 1925); Australian Capital Territory (s 59(4) of the Trustee Act 1925); South Australia (s 35(2) of the Trustee Act 1936); Northern Territory (s 26 of the Trustee Act 1893); Tasmania (s 27(2) of the Trustee Act 1898); Victoria (s 36(2) of the Trustee Act 1958); and Western Australia (s 71 of the Trustees Act 1962).

\(^7^1\) Northern Territory (s 26 of the of the Trustee Act 1893); Tasmania (s 27(1) of the Trustee Act 1898); Victoria (ss 2(3) and 36(2) of the Trustee Act 1958).

\(^7^2\) In light of the discussion below concerning creditors of the “trust”, it is unlikely that the trust deed will confer this right of indemnity.

\(^7^3\) Countryside (No 3) v Best/Lawson [2001] NSWSC 1152 at paras 31-39.
(potential beneficiaries) of a discretionary trust. It is clear that the trust deed can exclude this right of indemnity.\textsuperscript{74}

\textbf{3.1.10 Creditors Rights}

Given that in closely held trusts, the trustee (natural person or corporate) and beneficiaries will often be associates and/or members of one family, their interests will often be aligned. Thus, those associated with a closely held trust collectively may not be too concerned with ensuring creditors obtain payment for their debts. What they are interested in achieving is limitation of liability against “outside creditors”, should the trust enterprise fail.

If the natural person trustee has assets well below the debt owed to the creditor, the creditor is not going to get his or her debt paid by that person. If there is a $2 corporate trustee, then the creditors are also not going to get their money from the company (aside from $2 of share capital). While the corporate trustees liability to the creditor is theoretically unlimited, the company will have insufficient funds to meet the debt, and the shareholders cannot be required to subscribe more funds to the company (that would help the company meet its debt to the creditor).

The reason for this apparent unfair outcome is that, in the first instance, creditors only have a personal action against the trustee for debts. They have no rights against trust assets or beneficiaries.

\textbf{3.1.10.1 Right of subrogation to trustee rights of indemnity}

To overcome this potential harshness or unfairness to creditors, creditors may have access to the equitable remedy of subrogation. Subrogation involves placing one party (A) in the position of another (B) with respect to rights against third parties...so that A may enforce B’s rights against the third party for A’s own benefit.\textsuperscript{75} In the current context, creditors would be placed in the position of the trustee, so that the creditor can exercise the trustee’s right of indemnity against trust assets (i.e. obtain payment of debt).

There is some debate as to whether the right of subrogation extends to the trustee’s right of indemnity against beneficiaries. The better view is that it is available in these circumstances.\textsuperscript{76}

\textsuperscript{74} \textit{Kemtron Industries Pty Ltd v Commissioner of Stamp Duties (Qld)} 84 ATC 4380 at 4383 and 4385-4386; \textit{Ron Kingham Real Estate Pty Ltd v Edgar} [1999] 2 Qd R 439 at 442.

\textsuperscript{75} \textit{Highland v Exception Holdings Pty Ltd (in liq) & Anor} [2006] NSWCA 318 at para 90 (per Santow J).

\textsuperscript{76} \textit{Marginson v Ian Potter & Co} [1976] HCA 35 at para 12; \textit{Ron Kingham Real Estate Pty Ltd v Edgar} [1999] 2 Qd R 439. It is worth noting, as Denis Ong points out, that the right of indemnity against beneficiaries can only apply to the right of exonerate element (and not the reimbursement element) of the right of indemnity because in regard to discharged liabilities there cannot be trust creditors (and hence no subrogation to the right of reimbursement): Denis Ong, \textit{Trusts Law in Australia}, 4th ed., The Federation Press 2012 at pp 336-337.
3.1.10.2 Limits to right of subrogation

There are a number of concerns for creditors in regard to the right of subrogation. Given that it is an equitable doctrine or remedy, and not a cause of action, it is subject to the usual judicial discretion that accompanies equitable remedies and the usual equitable defences (e.g. delay, unclean hands).\(^7\)

However, the bigger concern for creditors is that the right of subrogation is derivative in nature. This means the creditor can only obtain what the trustee could have obtained under the trustee’s right of indemnity. If either of the trustee’s indemnities is not available to the trustee, the creditor has nothing to be subrogated to.

For example, if the trustee’s right of indemnity against beneficiaries has been excluded by the trust deed, this avenue of recourse will not be available to the creditor. Further, if the trustee’s right of indemnity against trust assets has been impaired or is not available (e.g. breach of trust, expense improperly incurred), this avenue of recourse will also not be available to creditors.

In addition, one can readily appreciate the potential importance to creditors of the debate as to whether the general law right of indemnity can be excluded by the trust deed, and the interaction of the statutory indemnity concerning trust assets and the general law indemnity.

3.1.11 Section 197 of the Corporations Act 2001

Another provision that potential influences the liability protection of a trust is Subsection 197(1) of the Corporations Act 2001, which reads:

“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 discharged, 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 solely because of one or more of the following:

(i) a breach of trust by the corporation;

(ii) the corporation’s acting outside the scope of its powers as trustee;

(iii) a term of the trust denying, or limiting, the corporation’s right to be indemnified against the liability.

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

The note under s 197(1) reads: “The person will not be liable under this subsection merely because there are insufficient trust assets out of which the corporation can be indemnified.”

The clear focus of s 197(1) is directors of corporate trustees, and the section can be described as remedial in nature as in the absence of s 197(1), directors would not be liable for debts of the company. The section does not apply to a company acting beneficially (i.e. non-trustee company). The section can be seen as “lifting of the corporate veil”. Three (or four) observations can be made about s 197(1) being activated.

First, and while obvious, s 197(1) cannot apply to a natural person trustee. Secondly, the definition of “director” in s 9 of the Corporations Act 2001 is relevant to s 197(1). This not only includes persons validly appointed as directors, it also includes “de facto directors” and “shadow directors”. Thirdly, the company must not be able to meet, and does not meet, the liability. This is very likely to be the case where the trustee is a $2 corporate trustee, and the trust enterprise has failed. Fourthly, the impaired indemnity that is the subject of s 197(1) is the company’s right of indemnity against trust assets; the right of indemnity against beneficiaries is not the subject of s 197(1). The consequence is that the s 197(1) remedy is not available where the right of indemnity against beneficiaries is impaired or removed.

Fifthly, the s 197(1) remedy is only available where the indemnity is impaired solely, by one or more, of the listed circumstances. One of those is where the trust deed has excluded the trustee’s right of indemnity against trust assets. Therefore, if the general law indemnity can be excluded by the trust deed, s 197(1) can be triggered. The limitation as to how impairment of the indemnity arose to the three listed circumstances means that a situation falling outside those three items cannot trigger s 197(1). The note to s 197(1), which deals with “mere insufficient trust assets”, confirms this.

Overall, it can be appreciated that the liability rules in terms of a trust are complex and varied. This is the reason that D’Angelo argues that ‘unlike the corporation, the trust was not originally intended, and is poorly equipped, to be used for entrepreneurial risk-taking activities like trading and the carrying on of business’. 80

78 It might be better described as lifting the “trust veil”.
79 Paragraph (b) of the definition of “director” in s 9 of the Corporations Act 2001. A de facto director is a person, while not validly appointed a director, occupies and is discharging the functions attached to the office of director. Therefore, having a nominal director(s) who has no assets, with a “non-director” who has assets and is the real “power behind the throne”, will not be an effective strategy of escaping the reach of s 197(1). See John Gooley, David Russell, Matthew Dicker and Michael Zammit, Corporations and Associations Law: Principles and Issues, 5th ed., LexisNexis Butterworths, 2011 at paras 21.15-21.31 for a good summary of this area.
80 D’Angelo, N. 2009. The trust: Evolution from guardian to risk-taker, and how a lagging insolvency law framework has left financiers and other stakeholders in peril. JBFLP 20:279-305, at p 279.
3.4 3.2 Company

In contrast to the trust, the company has been largely derived to facilitate entrepreneurial activity. The focus here is on companies (associations) incorporated under the Corporations Act 2001 (Cth). In addition, the focus here is on companies limited by shares, and not other types of companies. Companies limited by shares must have the word “Limited” (or Ltd) as part of its name. And, the focus is on proprietary companies as this would be the relevant company classification for operators of small to medium sized businesses. It should also be noted here that we are dealing with a company in its beneficial capacity, and not in a capacity as trustee of a trust.

3.2.1 General Position

3.2.1.1 Company Itself

On registration, a company obtains a legal personality (legal persona) or existence; it becomes a legal person, albeit an artificial person. This artificial legal person has an existence that is independent of shareholders in the company, even though the company is a vehicle for the pursuit of economic gain for the company’s [ultimate] natural person shareholders. The company’s existence continues until it is deregistered.

All the powers and capacities that a natural person has are conferred on the company. This includes owning assets, entering into contracts, operating a business and incurring debts and liabilities. Importantly, a company can also commit compensable wrongs, even though this can only occur through its human agents.

The key point here is that in legal terms, the company is liable to an unlimited extent to meet its debts and liabilities. It is true that in practical terms, this statement needs qualification by the shareholder limited liability rule (see Sub-Part

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81 An association of persons can incorporate under state associations incorporation legislation (e.g. Associations Incorporation Act 2009 (NSW)), but this is only available in regard to non-profit and non-commercial activities. Also, given a single member company can now exist under the Corporations Act 2001 (s 114), the description of a company as an association of persons is no longer completely accurate.
82 Definition of “company limited by shares” in s 9 and s 112(1) of the Corporations Act 2001.
84 As noted in an earlier footnote, it seems strange to talk in terms of a company having a beneficial capacity when the company is an artificial legal person or “mere piece of paper” or a mere vehicle for natural person shareholders to pursue economic gains. Yet, that is the legal position.
86 The Corporations Act 2001 uses the terms “shareholders” and “members” interchangeably.
87 Subsection 601AD(1).
3.2.1.2 below). But, the statement stands as correct account of the legal position. Creditors can sue the company for its debts and liabilities.

There is no legal obligation in the Corporations Act 2001 on a company to disclose on its letterheads, invoices, etc, that it is acting in its capacity as trustee of a trust. Further, there is no such obligation under state trust legislation. Finally, a company is required to register its business name on the Business Names Register if he or she carries on business under a name other than its name.\textsuperscript{89}

### 3.2.1.2 Shareholders in Company

Shareholders in a company have an existence that is independent from the company. This is also the position where there is a single shareholder company.\textsuperscript{90} Putting aside dividend distributions, profits and gains made by the company do not belong to the shareholders. Nor does the shareholder have any interest in the company’s assets.\textsuperscript{91} Debts and liabilities incurred by the company are not debts and liabilities of shareholders.

Shareholders in a company limited by shares enjoy limited liability. Their liability to contribute to the company (and therefore the enterprise carried on “through” the company) is limited to the unpaid amount on his or her shares.\textsuperscript{92} So for example, if shares were issued to a shareholder for consideration of $1, and the shareholder makes full payment, the shareholder cannot be required to make any further contributions to the company even if the company cannot meet all of its liabilities. This is the practical manifestation of “limited liability”; shareholders’ assets cannot be accessed to satisfy a debt owed to the creditor by the company. This effectively means that creditors,\textsuperscript{93} to some extent, bear the risk of a company’s operations not succeeding.

### 3.2.2 Situations where Company’s Actions may be attributed to Shareholders (Piercing the Corporate Veil)

There is a range of legal doctrines, some statutory and some common law based, where the law does attribute actions of the company, and ensuing liability, to the company’s shareholders and/or directors. It is fair to say that attribution only occurs in unusual or extreme circumstances. Accordingly, we will not set them all out here. One though is worth briefly setting out as it is more likely to occur, namely, insolvent trading.

\textsuperscript{89} Section 18 of the Business Names Registration Act 2001.
\textsuperscript{90} Section 114 of the Corporations Act 2001.
\textsuperscript{91} Macaura v Northern Assurance Company Ltd & Ors [1925] AC 619 at 626; Ord Forrest Pty Ltd v FCT 74 ATC 4034 at 4041.
\textsuperscript{92} Definition of “contributory” in s 9, s 117(2)(k) and s 516 of the Corporations Act 2001.
\textsuperscript{93} Unsecured creditors carry most risk because a secured creditor will have access to a particular asset to satisfy the debt owed to them.
3.2.2.1 Insolvent Trading

Section 588G of the Corporations Act 2001 contains the company insolvent trading rule that applies to directors of companies; the rule does not apply to shareholders per se. Insolvent trading occurs when a company incurs a debt at a time that it is insolvent or becomes insolvent by incurring the debt, and there are reasonable grounds for suspecting the company is insolvent or will become insolvent. If a person(s) is a director of the company when the company incurs the offending debt, and none of the defences are made out by the director(s), a number of “penalties” may be visited on the director(s).

However, the key thing is that the court can order directors to pay compensation to the company. The legislation contemplates the aggrieved creditor taking action directly against the director(s), however there are some barriers to this occurring (e.g. liquidator’s consent, leave of court to proceed).

3.2.3 Creditors and Others Dealing with Company are entitled to assume no Internal Company Irregularities

Subsection 128(1) of the Corporations Act 2001 states that persons who have dealings with a company are entitled to make the assumptions listed in s 129, and that the company cannot assert that the assumptions are incorrect. The assumptions may be made even if an officer or agent of the company acts fraudulently or forges a document in connection with dealings. On the other hand, s 128(4) states that a person cannot make the assumptions in s 129 if at the time of the dealing, the person knew or suspected that the assumption was incorrect.

In brief, some of the more important assumptions in s 129 are: (i) company’s constitution has been complied with (ii) directors and company secretary have been properly appointed and they have the authority to exercise powers usually exercised by such persons (iii) anyone that is held out by the company to be an

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94 In closely held companies though, some or all of the directors are likely to also be shareholders. In the end, if a person is held liable for an amount, he or she will not care much about the capacity in which he or she came to be liable.
95 Section 588H of the Corporations Act 2001.
96 Section 588J, s 588K and s 588M(2) of the Corporations Act 2001.
97 Sections 588R and 588S (liquidator consent) and s 588T (leave of court) of the Corporations Act 2001.
98 This area of discourse is often labelled the “indoor management rule”.
99 A person (A) who has dealings with a person (B) who acquired property from a company can also make the s 129 assumptions. This means that B and the company cannot assert that the s 129 assumptions are incorrect: s 128(2) of the Corporations Act 2001.
100 Subsection 128(3) of the Corporations Act 2001.
101 It may be worth noting that s 130 of the Corporations Act 2001 overrides the common law constructive notice rule. That is, persons dealing with a company are not taken to have information about a company merely because the information is on the ASIC public register.
102 Subsection 129(1) of the Corporations Act 2001.
103 Subsection 129(2) of the Corporations Act 2001.
officer or agent of the company has been properly appointed and they have the authority to exercise powers usually exercised by such persons\(^{104}\) and (iv) officers and agents of the company properly perform their duties to the company.\(^{105}\)

The practical effect of ss 128 and 129 is that a company cannot refuse to meet a liability to an “outside creditor” on the basis that an “internal breach” of duties or procedures occurred. For example, where an officer or agent of the company has had their authority to incur debts curtailed and he or she proceeds in any event to contract with a creditor in breach of the limitation, the company will still be liable on the contract to the creditor. Certainly, the company will have an action for breach of contract against the officer, but the liability to the creditor will stand.\(^ {106}\)

4. Evidence of Advisor Misunderstanding Re Items Related to Trust Liability Rules

This part canvasses two categories of “advisor misunderstandings”, and/or judicial commentary on misunderstandings that have come to light before Australian courts. These two categories were chosen as such misunderstandings may impact on liability issues where a trust is involved. Thus, there is no attempt to deal with the other areas of trusts where there have clearly been advisor misunderstandings.\(^ {107}\)

This part does not assert a causal connection between the limited coverage of the law of trusts in commerce degrees and the advisor misunderstandings or errors identified. There are too many other intervening factors at play to allow for such a conclusion. However, as a matter of logic, the limited coverage of the law of trusts in accounting degrees must be a contributor to the lack of education of advisors about the law of trusts. At its lowest, it is a missed opportunity.

The two categories chosen for illustration are: (i) trust is an entity and (ii) failure to clarify the capacity in which a party is transacting.

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\(^{104}\) Subsection 129(3) of the Corporations Act 2001.


\(^{106}\) See Phillip Lipton, Abe Herzberg and Michelle Welsh, Understanding Company Law, 17th ed., Lawbook Co, 2014 at pp 149-163 for a full discussion of the application and scope of the s 129 assumptions, and the exception in s 128(4).

\(^{107}\) For example, the accountant of long-standing, in Canehire Pty Ltd & Anor v Themis Holdings Pty Ltd [2014] QCA 296, appears to have had no appreciation that a trustee cannot put their own interests ahead of the duties they owe to beneficiaries. In Lambert v FCT 2013 ATC 10-322, numerous misunderstandings concerning the rules that applied to a discretionary trust were made (e.g. failure to comply with a trust deed notification requirement, attempt to allocate income for a lengthy period when trust deed required periodical exercises of the discretion). It is fairly clear that the advising accountant was heavily involved in these decisions.
4.1 Trust is an Entity

In the New South Wales Court of Appeal decision in *Kelly v Mina*, Leeming JA made the following comments:

[I]t may be readily inferred that neither party had a correct understanding of the legal nature of a trust, despite their academic and professional qualifications, and despite the fact that the accountancy practice was conducted by the trustee of a unit trust. A trust is not a legal person;...The incorrect but prevalent notion that a trust is a legal person was reflected throughout the trial. It was seen not merely in the ‘Structure’ contained in the parties’ ‘Partnership Agreement’. It was also seen in the appellant’s principal affidavit she [Kelly] had sworn that ‘the Mina Family Trust [sic] and Eastern Suburbs Accounting entered into an agreement to form an entity partnership [sic] called the Kelly and Mina Unit Trust’). Indeed, the proposed pleading the subject of the amendment application alleged a partnership between ‘Eastern Suburbs Accounting Services Pty Ltd and the Mina Family Trust’.

These highly critical comments about the lack of appreciation of the legal structures and entities adopted were mainly directed at the two central parties involved in the litigation (Ms Kelly and Mr Mina), both accountants.

The facts in *Kelly v Mina* involved the merging of two unrelated accounting practices, and the ultimate buyout (exit) of one of the parties from the combined practice after four-years. Ms Karen Kelly was the 100% owner of shares in Eastern Suburbs Accounting Services Pty Ltd, a company that owned and operated the Churton Kelly accounting practice. Mr Akis Mina controlled the Mina Family Trust, a “trust” which owned and operated the Ezy Accounting practice. The trustee of the Mina Family Trust was Mina Enterprises Pty Ltd.

In short, the parties interposed a unit trust (called the Kelly and Mina Unit Trust) between their respective practice “entities”, and their previous practices (now combined). The Kelly and Mina Unit Trust issued units to the former owners (company for Kelly, and trust for Mina) of the separate practices.

It needs to be pointed out that legal advisers involved with the parties and their dispute also allowed the inaccurate description of the parties and legal structure(s) to subsist for considerable time. Indeed Ms Kelly claimed that the reason she changed her solicitor was due to the solicitor’s failure to pick up the point that she was being sued personally, when she was not the correct party.

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110 However, the legal advisors to the parties involved also failed to pick up the mis-descriptions of relevant parties. Indeed, they seem to have created the mis-descriptions.
111 *Kelly v Mina* [2014] NSWCA 9 at para 40.
It may be possible to explain the repeated mis-descriptions of relevant parties in the various documents in *Kelly v Mina* as the use of "loose language". However, the extracted comment of Leeming JA goes further than this, and Leeming JA also suggests that there is a prevalent notion that a trust is regarded as a legal entity. There are other cases that provide some support for Leeming JA's assertion of a wider prevalence of the incorrect view that a trust is a legal entity. In both *HP Mercantile Pty Ltd v FCT*[^112] and *P & M Quality Smallgoods Pty Ltd v Leap Seng*,[^113] the incorrect view appears to stem from, or is embodied in, documents created by lawyers in pursuit and defence of litigation.

In many cases, no harm will arise from an advisor labouring under the incorrect impression that a trust is a legal entity. For example, the attempt by Ms Kelly to take advantage of the parties' mis-descriptions of the entities involved in *Kelly v Mina* was rejected both at first instance and in the Court Appeal.[^114] On the other hand, the incorrect impression of a trust as a legal entity may raise the following [overlapping] enquiries and/or result in the following [overlapping] conclusions.

If the trust is an entity, the next [perhaps logical] enquiry may focus on the character of this entity. It is possible that one may reason that its character is taken from the character of the trustee, either a natural person or company.[^115] From there, one may readily conclude that the liability rules relevant to the two respective legal entities apply. In short, this would be incorrect. In the case of a natural person, this could give the impression that he or she has unlimited liability for debts and liabilities incurred, without any potential recourse to the trust fund and/or beneficiaries. Similarly, in the case of a company, it could give the incorrect impression that, in effect, liability for debts is limited to the company's resources, and that no recourse is available to the assets of those "behind the company".[^116]

Viewed from the perspective of the creditors, the entity view of a trust may invite the incorrect impression that creditors can only look to the entity for satisfying amounts owed to them. After all, this is the general position with the other

[^112]: *HP Mercantile Pty Ltd v FCT* 2005 ATC 4571 at 4572.

[^113]: *P & M Quality Smallgoods Pty Ltd v Leap Seng* [2013] NSWCA 167 at para 6. Barrett JA said:
Naming of ‘Homebush Unit Trust’ or ‘Trustees of the Homebush Unit Trust’ as a party was irregular - and the allegation in the statement of claim that ‘Homebush Unit Trust’ was ‘a corporation and/or business name... liable to sue and/or be sued in and by its name and style’ was a nonsense. However, since no issue is taken about this and the other parties are presumably aware of the person or persons concerned (who appeared below and on appeal), no more need be said about the matter."

[^114]: Ms Kelly argued that the buyout document could not possibly be binding because it imposed obligations on the wrong entities, that is, on Ms Kelly and Mr Mina personally whereas none of the liabilities and assets held within the entities were held by them personally: *Kelly v Mina* [2014] NSWCA 9 at para 36. This was rejected: *Kelly v Mina* [2014] NSWCA 9 at paras 72-82.

[^115]: Let us ignore the multiple natural person trustee situation for present purposes.

[^116]: While not directly on point, one of the authors (Dale Boccabella) regularly hears the comment from both tax students and tax practitioners that a corporate trustee should be used to limit liability. While further enquiry may be necessary from the makers of such statements, it is arguable that the entity view of a trust underlies some of these comments.
indisputable legal entity, the company. But this is not necessarily the case as in some trusts, creditors may have a right of subrogation to the trustee’s right of indemnity against beneficiaries, assuming this right of indemnity has not been ousted.

4.2 Capacity in which Entity owns Property, entered into Contracts

The issue as to whether an entity is contracting in their personal capacity (beneficially), or as trustee (representative capacity and not beneficially) is important, and it arises not infrequently. In regard to the purchase and holding of property, resolution of the capacity question determines who the beneficial [economic] owner of the property is. Where the entity is contracting personally, the property belongs to him or her or it beneficially. This is the case whether a natural person or company is contracting. Where the entity is contracting as trustee, the property does not belong to the trustee beneficially, but rather to beneficiaries.

Where a company is the legal owner of property, and its natural person shareholders differ from beneficiaries of the trust, the question of capacity may be very important to the two potential categories of claimants (for example shareholders through increased value of their shares and beneficiaries). The question may also be important to creditors because, in one case, a debtor may have property of value (such as shareholder in company that beneficially owns property), and yet in the other case, the same debtor may not have property of value (such as object of discretionary trust).

Similarly, in regard to the incurring of debts and liabilities, resolution of the capacity question is also important. Where the entity is contracting personally, the liabilities are its own. Where the entity is contracting as trustee, the liabilities “are its own”, but the trustee may effectively have rights to shift the liability to others (such as beneficiaries). Again, the question may also be important to creditors, as in the latter case, creditors may effectively be able to claim against others (such as beneficiaries).

In Valaress Pty Ltd v Valenest Pty Ltd (in liq), Valenest Pty Ltd (Valenest) owned and developed properties beneficially. On advice from the company’s accountant (Mr Mura), a trust was created and Valenest became trustee so that future property purchases would be made by the “trust”. Valenest purchased a property (Wetherill Park) and entered into various transactions concerning that property after purchase (such as borrowing, providing the property as security for a loan).

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117 See for example, Valeress Pty Ltd v Valenest Pty Ltd [2011] NSWSC 465; Bechara v Sotrip Pty Ltd (in liq) [2013] QSC 100; Canehire Pty Ltd & Anor v Themis Holdings Pty Ltd [2014] QCA 296; Lambert v FCT 2013 ATC 10-322.
118 It seems strange to describe a company, as opposed to the company’s natural person shareholders, as beneficially owning property. But that is the accepted legal position.
119 Where the person is acting in his or her capacity as trustee of a discretionary trust, beneficial ownership of trust property is unlikely to be known yet as property of a discretionary trust is in “suspended ownership”, until an appointment of capital is made by the trustee, or the vesting date of the trust has arrived.
The purchase contract did not state that Valenest purchased the Wetherill Park property as trustee. Other transactions entered into by Valenest and related companies made no mention that Valenest is a trustee.

Both accountants for the company - one from 1999 to 2004 (Mr Mura), and the other post-2004 (Mr Seymour) - prepared Valenest’s financial accounts on the basis that it did not hold any properties on trust, and there was no mention anywhere that Valenest was a trustee. The key issue was whether Wetherill Park was purchased as trust property. Even though there were factors pointing both ways, Sackar J held that the Wetherill Park property was purchased in Valenest’s capacity as trustee.¹²⁰

Sackar J was critical of the accountant’s, Mr Mura’s, failure to prepare separate accounts for the trust, especially in light of the fact Mr Mura set up the trust and he knew of the purchase of Wetherill Park.¹²¹ Mr Seymour is not the subject of criticism from Sackar J, perhaps due to the limited scope of his retainer.

Briefly, in *Bechara v Sotrip Pty Ltd (in liq)*,¹²² the issue was also whether a company (Sotrip Pty Ltd (Sotrip)) purchased a property beneficially or in the capacity of trustee. Sotrip was controlled by an accountant, Mr Sam Cassaniti. The purchase contract did not state Sotrip was purchasing as trustee. The registered transfer did not state Sotrip was a trustee. The loan contract that funded the purchase did not state Sotrip was borrowing as trustee. There was also a failure, even though there is no obligation, to register the interest in the land at the land titles office as one held by Sotrip as trustee.

In spite of the above failures, Philip McMurdo J held that Sotrip did purchase the property as trustee.¹²³

While reference to a small number of cases is not a basis for generalising, there is evidence to raise a suspicion that some accountants may not fully appreciate the distinction between when an entity is acting beneficially, as opposed to when they are acting in a representative capacity (as trustee).

### 5. Recommendations

Increase the coverage of the teaching of trusts (including their legal issues in terms of asset protection and liability). A sound cost-benefit analysis should be undertaken as to whether the increased teaching of the law of trusts should be done in the university program, or in subsequent professional courses of accountants. In particular, the accounting professional bodies should consider their

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¹²⁰ *Valeress Pty Ltd v Valenest Pty Ltd [2011] NSWSC 465 at paras 70-75.*
¹²¹ *Valeress Pty Ltd v Valenest Pty Ltd [2011] NSWSC 465 at para 74.*
¹²² *Bechara v Sotrip Pty Ltd (in liq) [2013] QSC 100.*
¹²³ *Bechara v Sotrip Pty Ltd (in liq) [2013] QSC 100 at para 10.*
accreditation requirements for Australian undergraduate university degrees, as well as their own programs, and the continued professional development requirements of their members.

Also, consideration should be had to providers of business structures and measures that could be implemented to ensure that people nominating a business structure do have some understanding of the legal nature of the structure chosen. Unfortunately, once a business structure has been chosen it can be difficult (and costly) to alter.

Further research could consider how best professor advisors, such as accountants, should be taught about business structures. This could consider what aspects are needed for professional practice, as well as what context is required to be able learn key attributes. This is a fine balance, given that accountants are not legal advisors themselves, but nevertheless they need a legal literacy to be able to advise their clients, as well as in communicating with lawyers.

6. Conclusion

Accountants are seen as a trusted professional advisor, and can be considered the most important advisor in the set-up phase of a business structure. An integral part of being a ‘professional’ is the educational requirements. This paper has sought to bring evidence about the important role that accountants play in the recommendation of different business structures to their clients. It has highlighted the growing use of discretionary trusts and companies in Australia, as well as evidence to suggest that asset protection (as well as liability issues) are large motivators behind accountants’ advice, with tax benefits being secondary. However, through a curriculum audit of Australian accounting degrees concerns were raised about the extent that students are taught about trusts, as well as the interrelated issue of the how this structure affects asset protection and liability. This was then followed by a discussion about the liability issues that can arise with a trust and a company, which sought to demonstrate the increased complexity that a trust structure can entail. Evidence was then presented about where advisors appear to have at times failed to comprehend the nature of a trust.

It is argued that through this discussion that the current scant coverage of discretionary trusts in the Australian accounting curriculum is of great concern, as accountants as professional advisors need this core technical knowledge. This technical knowledge needs to extend beyond just the tax treatment of discretionary trusts, but also how this structure affects the legal relationships and liability issues.

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While accountants are not lawyers, given their intimate and ongoing relationship with clients, it is important that they have a solid foundational technical knowledge about this important business structure in Australia. Given the influence of the professional bodies in driving the Australian curriculum it is incumbent on them to seriously re-consider their accreditation requirements and/or their own study programs. Without a solid foundation knowledge about discretionary trusts, it is questionable how accurate is the trusted accountant as a professional advisor.