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Trustee and unitholder liability in unit trusts

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Introduction

When establishing a unit trust, consideration of legal risks and liabilities are often overlooked. Asa general principle of law, the trustee bears the primary liability for all the liabilities of the trust. Inmost instances, the trustee will have a right to indemnity against the assets of the trust and if that is not sufficient, the unitholders may also be personally liable.

If a trust has individual trustees, their personal assets are exposed. This includes unforeseen legal liabilities in respect of the trust such as where a trustee is sued by someone injured on an unsafe property. This is a compelling reason why all trusts should have a corporate trustee appointed. Indeed, we strongly recommend that a sole purpose corporate trustee generally be appointed to limit liability.

There may be instances where a trustee may lose its right of indemnity against trust assets, and the directors become personally liable for liabilities they incur on behalf of the trust.

This article explores how to minimise liability.

When may a director of a corporate trustee be held to be personally liable?

Section 197(1) of the *Corporations Act 2001* (Cth) ('CA') states that a person who is a director of a corporation when it incurs a liability while acting or purporting to act as a trustee, is liable to discharge the whole or part of a liability if the corporation:

(a) has not discharged, and cannot discharge, the liability or that part of it;

(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.

This section was varied after the case of *Hanel v O'Neil* [2003] SASC 409 considered whether a director of a corporate trustee had a right of indemnity under a trust deed with insufficient assets. The court ultimately concluded that the right of indemnity was not sufficient to excuse personal liability in a situation where the trust fund had insufficient assets. (To read our old article on the *Hanel v O'Neil* decision, please click here.)

Fortunately however in 2005, the CA was amended to provide greater protection to directors of acorporate trustee. From 2005 a director could be liable under s197(1)(b) if:

- the corporate trustee acted in breach of trust;
- the company acted outside the scope of its powers as trustee; or
- a term in the trust deed denies or limits the trustee's right to indemnity.

In addition, directors of a corporate trustee are personally liable for the company's debts:

- by taking on debts which they know the corporate trustee is unable to repay; and
- under certain tax debts where the law imposes direct liability on directors, eg, pay as you go(PAYG), superannuation guarantee charge (SGC) and goods and services tax (GST) via a director penalty notice. If a company fails to meet its PAYG withholding, net GST or SGC liability in full by the due date, the directors become personally liable for director penalties equal to the unpaid amounts.

When may a trustee not have a right to indemnity?

In *Fitzwood v Unique Goal Pty Ltd(In Liq) (ACN 064 926 843) [2002] FCAFC 285* the full federal court held that the trustee could not discharge a liability against trust assets, as it had acted in breach of trust. The court stated at 112-113:

None of the conduct of the Trustee described was consistent with the conclusion that Mr Drapac, and through him the Trustee, had acted in good faith when it engaged in the breach of trust described.

….. the declaration that the Trustee is entitled to be indemnified by the Trust in respect of the claims against the Trustee for commission and damages for breach of contract, must be set aside.

The trustee in this instance lost its right to indemnity due to a breach of trust.

Can unitholders be personally liable?

Unitholders can be personally liable to indemnify a trustee for liabilities that the trustee incurs in carrying out its duties. As a principle of law, the trustee's right of indemnity against liabilities properly incurred in the execution of its duties is not limited to the trust property, but extends where the trust assets are insufficient to satisfy the indemnity, to a right of indemnity against the beneficiaries.

The full federal court in Fitzwood referenced this principle and cited Mc Garvie J in *JW Broomhead (Vic) Pty Ltd (in liq) v JW Broomhead Pty Ltd (1985)* 9 ACLR 593 at 635:

The basis of the principle is that the beneficiary who gets the benefit of the trust should bear its burdens unless he can show some good reason why his trustee should bear the burdens himself.

Given this principle, to afford unitholders with protection against personal liability, appropriate wording must be included in the deed to limit the liability of unitholders to the assets of the trust. Otherwise, unitholders' personal assets may be exposed to risk.

How to further limit liability

As noted above, it is recommended that a corporate trustee is appointed as a trustee of each unit trust. Further, it is recommended that a sole purpose corporate trustee is used rather than a company that acts in several capacities (eg, as a trading entity and trustee of a trust). This is particularly important where the trustee is sued and then must prove its ownership of assets in its different capacities.

Under the DBA Lawyers' unit trust deed, liability is limited to property of the trust and the deed precludes liability to unitholders.

Naturally, further protection is afforded if unitholders themselves, eg, SMSFs and family trusts, also have corporate trustees.

Thus, there are a number of measures to limit liability. It is important to check that each unit trust deed has appropriate limitation of liability provisions to minimise exposure.

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Related articles and links below

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