A Consideration of Trustees and Creditors Exposure to Risk

It is said that trading trusts (so called), which have been operating for some years in Australia, and, more recently, in New Zealand, provide flexible and discrete structures for the operation of small to medium sized businesses with clear advantages for beneficiaries in relation to taxation and the distribution of income over existing structures such as partnerships and limited liability companies. There are no perceived benefits for creditors or for trustees, however.

Unlike a limited liability company, a trading trust is not a legal entity. It is simply a trust, perhaps a family trust, which trades or does business. The business of the trust is undertaken by a trustee (whether an incorporated company or an individual) or in the trustee’s name.

A creditor dealing with the trustee is frequently unaware that he is not dealing with the ultimate owner of the trust's assets to which the creditor does not have direct recourse in the event of a default because the trust property does not belong to the trustee. The creditor’s only remedy lies against the trustee unless the debt is secured by a registered mortgage over trust land or a registered security interest under the Personal Property Securities Act 1999 or unless the creditor is able to claim the right to be subrogated to the trustee’s legal entitlement to an indemnity out of trust assets.

A trustee is generally entitled to an indemnity in respect of debts or liabilities which have been incurred by the trustee on behalf of the trust. This entitlement confers on the trustee an equitable lien over the trust assets which, in the case of the trustee’s insolvency, will pass by subrogation to the creditors of the trust; but such indemnity may be lost if the debt or liability has not been properly incurred or if the trustee is in breach of trust. The indemnity is then said to be impaired.

Further, if the trustee is a limited liability company, inability to pay is likely to lead only to liquidation with no consequences for the directors unless they have breached their duties under the Companies Act when their actions may be challenged by a liquidator for, by way of example, allowing the company to trade whilst insolvent.

Sometimes, trustees are prepared to relinquish their entitlement to an indemnity in order to provide greater protection for trust assets against the claims of creditors by avoiding the consequences of subrogation which we discussed above. However, the extent to which a trustee’s right to an indemnity out of trust assets can be contractually excluded is legally debateable.

Minimise the risk

Individuals who accept appointment as trustees as a favour to friends or family, and leave the running of the trust in the hands of the settlor or the beneficiaries, risk everything. Bankruptcy or liquidation of the trustee, often resulting from debts and liabilities incurred by the trust without the knowledge of the trustee, may be an unwanted consequence of the favour or service.

Creditors who suspect that they are dealing with a trust (because it is not always obvious) should:

- first undertake appropriate credit and company searches to confirm that they are dealing with a trust and, if they are,
- ensure that full details of the trust, the trustee and the beneficiaries are supplied in the credit application and obtain, wherever possible, a guarantee from the beneficiaries;
- examine the trust deed to satisfy themselves that the trustee’s right of indemnification out of trust assets has not been limited or excluded;
- obtain legal advice to ensure there are no fish hooks.
There is no certain way in which trustees can avoid the consequences to themselves of the trust’s insolvency. To some extent, the risks can be avoided by:

- checking that contracts, loan agreements and security documents that they may be required to sign on behalf of the trust expressly limit the other contracting party’s recourse to trust assets in the event of default;
- keeping up-to-date accounts for the trust;
- ensuring that any liabilities incurred on behalf of the trust are lawfully incurred so that the right of indemnity from trust assets is not forfeit;
- obtaining personal indemnities from the settlor and/or the beneficiaries in respect of transactions which the trustee is expected to enter into for their benefit;
- ensuring that debts are not incurred without the trustee’s knowledge;
- declining to accept appointment if the trust deed purports to limit or exclude the trustee’s right to be indemnified out of trust assets;
- obtaining legal advice about the risks of the specific trust.

Whilst none of the above recommendations is guaranteed, taken together, they represent a useful check-list for cautious creditors and trustees.

How can we help?

At Jackson Russell, we are trust specialists and can provide both potential or existing trustees and creditors with advice regarding the structure and risks associated with a trust.

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