DIRECTORS' PERSONAL LIABILITY- IS THE PROPOSED AMENDMENT TO SECTION 197 ACCEPTABLE WHEN COMPARED WITH *HANEL V O'NEILL*?

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[*On 2 June 2005, the Australian Government announced a proposal to amend s. 197 of the Corporations Act. This is to overturn the decision in* Hanel v. O'Neill *("*Hanel"*) where the South Australian Supreme Court has expanded the circumstances in which directors of trustee companies can be held personally liable for the debts under the current section 197(1) of the* Corporations Act 2001 *(Cth). The multiple interpretations presented in* Hanel *highlighted the uncertainty of s. 197 and this uncertainty is heightened in at least two subsequent cases. The article provides a detailed analysis of how the decision in* Hanel *is affecting the directors' freedom of management and suggests some precautionary measures that the directors could take as protection against creditor's actions under s. 197. The author welcomes the proposed amendment because the new section will create certainty for directors as to the scope of their potential personal liability, but contends that the substance of the proposed s. 197 is not acceptable as there is potential for abuse by directors of certain trustee companies.*]

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I INTRODUCTION

Section 197 of the *Corporations Act 2001* (Cth)[1] is concerned with the personal liability of directors in discharging the liabilities incurred by trustee companies. *Hanel v. O'Neill* ("*Hanel")*[2] was the first case that considered the scope and circumstances in which directors would be personally liable under the section. In December 2003, the Full Court of the South Australian Supreme Court in *Hanel* provided multiple interpretations to s. 197. The net effect is that there is now uncertainty faced by many directors of trustee companies as to the extent of their potential personal liabilities.

The decision in *Hanel* also creates complications in other areas of company law, for example, in the insolvency area. When proceedings are brought against directors of a trustee company not on the ground of insolvent trading (even though the company might be nearing insolvency) but on the ground of directors' personal liability under s. 197(1), there seems to be confusion as to whether defences similar to those under s. 588H could still be raised. The lack of appropriate defences under s. 197, which was highlighted in *Hanel*, could bring about some serious ramifications for directors of all types of trustee companies. The decision in *Hanel* has been severely criticised by two subsequent cases.[3]

On 2 June 2005, a proposal was introduced into the Parliament to amend s. 197(1). The intention is to overturn the majority decision in *Hanel* and restore certainty concerning the scope of directors' potential personal liability in a trustee company. The proposed section, if in force, will mean that directors of trustee companies will be treated fairly similar to directors of ordinary trading companies. The proposed section, however, is not entirely acceptable because there is potential for abuse when directors have mastered a way to limit their potential personal liability. Further, the proposed amendment makes no mention of introducing a more appropriate defence mechanism for innocent directors. Section 197(2), in the current form, is not a real defence.

The aim of the article is to contend that the proposed amendment to s. 197 is not entirely acceptable and directors of trustee companies should continue to be cautious of the ruling in *Hanel*. The article is divided into nine parts. Part 2 examines the facts and decision of *Hanel*, followed by a brief historical development of s. 197 in Part 3. Part 4 examines s. 197(1), in particular the sentence that reads, "This is so even if the trust does not have enough assets to indemnify the trustee." Part 5 considers two most recent cases where the courts have criticised the decision in *Hanel*. Parts 6 and 7 explain the flaws contained in *Hanel* and how those flaws could have serious ramifications for directors of all types of trustee companies and how directors could take measures to protect against the interpretation of s. 197 in

[1] All legislative references herein, other than where otherwise noted, are to the Corporations Act 2001 (Cth).
[2] Hanel v. O'Neill, (2003) 48 ACSR 378; (2004) 22 ACLC 274; (2003) SASC 409 (SC of SA 2003).
[3] Intagro Projects Pty Ltd v. Australian and New Zealand Banking Group Ltd, (2004) 50 ACSR 224 (SC of NSW, 2004); and Edwards v. AG, (NSW) (2004) 50 ACSR 122 (NSWCA, 2004).

Hanel. Part 8 considers the proposed amendment to s. 197, provides some possible meanings to it, and considers whether the amendment is acceptable. The final Part is the conclusion.

II HANEL

A *Facts*

Daroko Pty Ltd ("the Trustee Company") was the trustee of the Daroko Unit Trust ("the Trust") and H was the sole director in the Trustee Company. Clause 21 of the Trust deed provided the Trustee Company a right of indemnity.

The Trustee Company was the tenant of a property owned by O'Neill under a five-year lease. The Trustee Company distributed all of its income to Forcett Pty Ltd, the beneficiary of the Trust as well as the trustee of a trust connected to H. Consequently, the Trustee Company had no money left to continue paying for the rent and vacated the property before the lease was due to expire.

By way of compromise, the Trustee Company found a new tenant to take over the lease on the same terms. O'Neill rejected the assignment of the lease and sued for damages and costs, to which he succeeded. Failing to pay the judgment debt by the Trustee Company, O'Neill brought proceedings against H on the ground that H was personally liable to discharge the liability pursuant to s. 197.[4] O'Neill succeeded on that ground. H subsequently appealed to the Supreme Court on the grounds that s. 197 had no relevance to the facts and that the lower court had failed to consider O'Neill's failure to mitigate losses arising from breaches of the lease. The appeal is the subject of discussion in this article.

B *Issues and s. 197*

There were two issues. First, s. 197 required the Court's interpretation as to the extent of the director's personal liability if the Trustee Company, quoting from s. 197(1):

> (a) has not, and cannot, discharge the liability; and
> (b) was not entitled to be fully indemnified against the liability out of trust assets."

The subsection also includes: "This is so even if the trust does not have enough assets to indemnify the trustee."[5]

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[4] In the same case, O'Neill also sued Forcett Pty Ltd, the beneficiary of the Trust, claiming that Forcett Pty Ltd should be made liable to indemnify the Trustee Company. This was not a matter relevant to the discussion of s. 197.

[5] For convenience, the full version of s. 197 is provided in the Appendix at the end of the article.

The second issue was whether O'Neill could have accepted the assignment of the lease to mitigate his losses. This second issue was independent of the court's interpretation of s. 197 but was significant in determining the final outcome of the case.

C *Decision*

The case was decided by the Full Court of the South Australian Supreme Court. Although all three Justices agreed that the purpose of s. 197 was to impose a statutory liability on directors of a trustee company in circumstances where the trustee company had incurred a liability and was not entitled to be fully indemnified out of the trust assets,[6] their opinions differed insofar as the circumstances were concerned.

As for the first issue, the majority - Mullighan and Gray JJ, with Debelle J dissenting - decided against H under s. 197. Their Honours expressed the view that H was personally liable in any case where there was a shortfall in the trust assets to satisfy an indemnity and that rule would remain the same even if the Trustee Company was otherwise entitled to be indemnified under the Trust deed. Mullighan and Gray JJ pointed out that this was because of the wording in s. 197(1) which stated that, "This is so even if the trust does not have enough assets to indemnify the trustee." The majority found that the effect of s. 197 was to deter directors of trustee companies from escaping personal liabilities when those liabilities to creditors exceeded trust assets. Their Honours also held that the existence of s. 197 was to ensure that the indemnity clause contained in the trust deed could not be used in any way as a shield against the director's liability. In the present case, there was an indemnity clause in the Trust deed and the majority acknowledged that there were no assets left in the trust by reason of H's conduct in causing the trust to be without funds. It was on this basis that they concluded there would be no entitlement to indemnification. Mullighan J stated as follows:

> It would be a strange result if s. 197(1)(b) was to be interpreted so that a director could escape personal liability … merely by ensuring that a provision, such as clause 21, was contained in the trust deed and could thereby operate as a shield against personal liability, … [particularly if] the director had caused the trust to be without funds to avoid paying the debt.[7]

Gray J followed the same reasoning process and stated that:

> The construction …[of s. 197(1)] would ensure that the director of a trustee company had a personal liability in circumstances where a debt was incurred and there were insufficient trust assets to meet the debt. Such a

[6] Hanel v. O'Neill (2003) 48 ACSR 378, 379 per Mullighan J, at 384 per Debelle J, and at 391 per Gray J.
[7] Hanel v. O'Neill, (2003) 48 ACSR 378, 381.

> result is not unfair nor unreasonable. Section 197 represents an extension to the liability of the director of a trustee company. [8]

Debelle J, on the other hand, took a very different approach. His Honour stated that:

> …the effect of s. 197(1) is that in those cases where a corporation is acting as a trustee, is unable to pay its debts, and has no entitlement to be indemnified out of the trust assets, the directors of the company are liable to discharge the debts of the corporation.[9]

The implication of Debelle J was that the operation of s. 197(1)(b) was dependent upon an entitlement to an indemnity and not upon whether an indemnity was in fact provided. His Honour concluded that clause 21 of the Trust deed had provided an entitlement to indemnity to the Trustee Company and on this basis H could not be personally liable for the debts incurred by the Trustee Company, even when the Trust did not have sufficient funds to provide such an indemnity.

Despite lengthy review and discussion of s. 197, all three Justices felt that the appeal ought to be upheld and the matter be remitted to the Adelaide Magistrates' Court. Both Mullighan and Gray JJ considered the second issue briefly and allowed the appeal on the basis that the Magistrate had failed to take mitigating factors into account in making a summary judgment. The majority conceded that O'Neill had been unreasonable when he rejected the assignment of the lease on terms that were substantially similar to the original lease. Had O'Neill accepted the assignment and attempted to mitigate his losses, the Trustee Company would not have owed any rent or the liability of the Trustee Company would have been substantially reduced. Debelle J, on the other hand, upheld the appeal on the basis of his interpretation of s. 197 and did not consider the issue of mitigating losses.

This case had a fortunate ending for H as the Trustee Company succeeded on the ground that O'Neill had failed to mitigate losses. The Court's interpretation of s. 197 therefore had no impact on H. According to the view of the majority, if the Trustee Company had not found a new tenant to take over the lease, H would indeed be liable to discharge the debts personally under s. 197.

[8] Hanel v. O'Neill, (2003) 48 ACSR 378, 392.
[9] Hanel v. O'Neill, (2003) 48 ACSR 378, 384.

III SECTION 197 AND LEGISLATIVE HISTORY

Section 197 started its life as s. 229A of the *Companies Codes*[10] in March 1986, when s. 66 of the *Companies and Securities Legislation (Miscellaneous Amendments) Act 1985* (Cth)[11] was applied to the Codes of each state. The intention was to achieve uniformity with respect to the law dealing with companies across and throughout Australia. When the *Corporations Law*[12] came into operation in 1990, s. 229A was re-numbered to s. 233. The section was again repealed and replaced by a new s. 197 through the *Corporate Law Economic Reform Program Act 1999* (Cth).[13] Subsequently, the new s. 197 was placed in the new Chapter 2D[14] of the *Corporations Law* which came into effect in March 2000.

The *Corporations Law* was re-named to *Corporations Act 2001* (Cth)[15] which came into operation in July 2001 with s. 197 included in its current form, as provided in the Appendix together with the full version of the former s. 233. By comparison, the current s. 197 is substantially shorter in length than the former s. 233. The change from s. 233 to s. 197 was thought to simplify the language only, without making substantial change to its substance. This was explained in paragraph 4.3 of the 1998 Explanatory Memorandum to the *Corporate Law Economic Reform Program ("CLERP") Bill 1998*:

> The Bill will also rewrite *without substantial change* the remaining in Parts 3.2… of the Law.[16] (emphasis added)

Further, the same point was re-iterated in paragraph 6.5.4 of the CLERP 3 Reform Proposal Paper in the following terms:

> The Government has indicated that the program for rewriting the *Corporations Law* in order to simplify it will be subsumed within its overall corporate law reform program. Bills to rewrite the law … will be prepared in a style which is consistent with the earlier work on simplifying the *Corporations Law*. In the context of the reforms to the provisions concerning directors…, it is proposed to rewrite *without substantial change* the provisions concerning officers,[17] related party transactions, oppression and civil penalties. (emphasis added)

It seems clear to the author that the parliament intended s. 197 to carry the same meaning and have the same legal effect as its predecessor. In *Hanel*, Debelle J pointed out that:

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[10] In South Australia, it was cited as s 229A of the Companies (South Australia) Code 1985 (SA).
[11] Act No 192 of 1985, effective 31 March 1986.
[12] Act No 110 of 1990, effective 18 December 1990.
[13] Act No 156 of 1999, effective 13 March 2003.
[14] Corporations Act 2001(Cth), Chapter 2D deals with duties of directors, officers and employees.
[15] Act No 50 of 2001, effective 15 July 2001.
[16] Part 3.2 referred to was from the then Corporations Law where s. 197 was found within that Part.
[17] The part in relation to rewriting the Act without substantial change to the provision concerning officers was found in Part 3.2 of the then Corporations Law which is now in s. 197.

> … s. 197(1) has the same meaning and effect of s. 233(1) and (2)… In other words, s. 233 has been re-enacted, albeit in different and obscure terms. If Parliament intended that s. 197 should alter the operation of s. 233, it would have been easily done in clear and unambiguous terms… The fact that s. 197(1) is expressed in terms which are different from s. 233 does not require the conclusion that Parliament intended to alter the law. The real question is what the words in s. 197(1) mean and, on examination, it is apparent that they substantially re-enact s. 233.[18]

Justice Gray rejected Debelle J's view that s. 197(1) was a mere re-enactment of s. 233. His Honour considered the rules of statutory interpretation[19] and concluded that:

> No explanation was offered as to why the legislature would completely redraw the sub-section if all that was intended was to repeat earlier words that had a settled meaning. The fact that a new sub-section was introduced replacing the old sub-section in its entirety suggests that a legislative change was intended.[20]

It appears that Gray J may have overlooked two points when handing down his decision. First, it was made clear in the 1998 Explanatory Memorandum to the *CLERP Bill* that the underlying reasons for the re-enactment of s. 197 are twofold: "simplifying" the language and "without substantial change" to the substance. Second, there had never been any significant case law where an Australian court was asked to consider an interpretation of s. 233 and on this basis there was never any "settled meaning" for s. 233. *Hanel* was the first time that s. 197 was considered in some detail.[21]

Mullighan J made no reference to the legislative change affecting s. 197.

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[18] Hanel v. O'Neill, (2003) 48 ACSR 378, 386.

[19] Hanel v. O'Neill, (2003) 48 ACSR 378, 389-390 (per Gray J). In construing s. 197, Gray J cited a High Court case of Project Blue Sky Inc. v. Australian Broadcasting Authority, (1998) 194 CLR 355, 381-2; 153 ALR 490, 509-510 which provided a very simple and yet very basic principle of statutory interpretation. The principle is reproduced within the body of the article referred to in footnote 28.

[20] Hanel v. O'Neill, (2003) 48 ACSR 378, 391.

[21] This was pointed out by Gray J in Hanel v. O'Neill (2003) 48 ACSR 378, at 390 that s. 197 "does not appear to have been the subject of judicial interpretation".

IV WHAT DOES SECTION 197(1) MEAN?

As illustrated in *Hanel*, the provision is thought to work against directors.[22] Section 197(1) asserts that a director of a trustee company is personally liable to discharge the liability of the company if paragraphs (a) and (b) are satisfied, and immediately goes on to say, "This is so even if the trust does not have enough assets to indemnify the trustee." The problem with s. 197 is in reference to the quoted sentence which will be referred to as "the sentence".

In *Hanel*, the court accepted the word "This" in the sentence to mean a reference to the liability of a director, but the actual meaning of the sentence itself remains unclear.[23] This Part of the article provides a detailed analysis of the sentence and in doing so, the views of the Justices in *Hanel* will be discussed separately below. This Part also highlights the views of other legal commentators, followed by the author's view of the sentence.

A *Debelle J's view of the sentence in Hanel*

In relation to the Sentence in s. 197(1), Debelle J expressed his view as follows:

> The meaning of the sentence … is not immediately apparent.
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> As a matter of syntax, the word 'this' refers to the whole of the preceding part of s. 197(1). However, that does not immediately clarify the meaning of the sentence. If a director is liable because of the operation of the first part of s. 197(1), that liability will exist because, among other things, the corporation is not entitled to be indemnified out of the trust. Thus, the statement, 'This is so even if the trust does not have enough assets to indemnify the trustee', adds nothing. It has nothing on which to operate because the corporation is not entitled to an indemnity. If the director is liable, he is liable, and the sentence adds nothing to that liability.
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> I think, therefore that the sentence is intended to apply to the obverse effect of the terms of s. 197(1), that is to say… the meaning and effect of the sentence is that the director will continue not to be liable for the debts of the corporation even if the trust does not have sufficient assets to provide a complete indemnity to the corporation.[24]

By pointing out that the sentence "adds nothing" to the preceding part of s. 197(1), Debelle J has opined that provided the conditions in paragraphs (a) and (b) are met, as conditions (a) and (b) are joined together with the word "and" which indicates the requirement of the two, then the sentence that follows immediately is

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[22] *See* also Young v. Murphy (1996) 1 VR 279 at 314-315 (per Phillips J in Vic. SC). The decision in this case was based on the predecessor s. 233 of the Corporations Law.
[23] *See* Hanel v. O'Neill (2003) 48 ACSR 378, per Debelle J at 385 and per Gray J at 392.
[24] Hanel v. O'Neill (2003) 48 ACSR 378, at 385 (per Debelle J)

superfluous and redundant. In other words, if a trustee company is financially unable to discharge the liability, as per paragraph (a) in s. 197(1), and there is a clause in the trust instrument (such as in the present case) which "entitles"[25] the trustee to be fully indemnified, as per paragraph (b) in s. 197(1), then the overall effect is that the director of a trustee company is not liable to discharge that liability and the result is the same even if the trust has little or no money.

Although s. 197(1)(b) actually uses the word "entitled", Debelle J, in providing his interpretation of the subsection, placed emphasis on the word "entitlement" instead. His view was that the operation of s. 197(1)(b) depends on an entitlement to indemnity - not on whether the indemnity is in fact given. So the effect is that where a company is acting as a trustee, is unable to pay its debts, and there is no provision in the trust instrument that entitles the company to be indemnified out of the trust assets, then directors of the company are liable to discharge the company debts.[26]

If this is what his Honour intended to convey in his statements regarding s. 197(1), and if his statements are correct (bearing in mind that the statements are obiter only), then there is a potential for directors to misappropriate trust funds which is discussed elsewhere in this article.

B *Gray J's view in Hanel (and briefly Mullighan J)*

In analysing the sentence, Gray J commenced by citing a High Court case of *Project Blue Sky Inc. v. Australian Broadcasting Authority*[27] which provided a basic principle of statutory interpretation:

> The primary object of statutory construction is to construe the relevant provision so that it is consistent with the language and purpose of all the provisions of the statute. The meaning of the provision must be determined by reference to the language of the instrument viewed as a whole…. A legislative instrument must be construed on the prima facie basis that its provisions are intended to give effect to harmonious goals. Where conflict appears to arise… the conflict must be alleviated, so far as possible, by adjusting the meaning…to achieve that result which will best give effect to the purpose and language of those provisions while maintaining the unity of all the statutory provisions.[28]

Gray J then directed his attention to the sentence in the following terms:

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[25] The word "entitled" is referred to in s. 197(1)(b) of the Corporations Act 2001 (Cth).

[26] Hanel v. O'Neill, (2003) 48 ACSR 378, 384 (per Debelle J). In *Hanel*, Debelle J's reasoning was that the appellant (director of the trustee company Daroko Pty Ltd) was not liable to discharge the debts of Daroko Pty Ltd pursuant to s. 197, because clause 21 of the Daroko Unit Trust deed had already provided Daroko Pty Ltd an entitlement to indemnity out of trust assets.

[27] Project Blue Sky Inc. v. Australian Broadcasting Authority ,(1998) 194 CLR 355; 153 ALR 490.

[28] Hanel v. O'Neill (2003) 48 ACSR 378, 389-390. Gray J extracted the statement from the joint judgment of McHugh, Gummow, Kirby and Hayne JJ in the High Court case of Project Blue Sky Inc. v. Australian Broadcasting Authority, (1998) 194 CLR 355; 153 ALR 490 at CLR 381-2; ALR 509-10.

> Section 197(1) imposes a statutory liability on a director of a corporation which acts as a trustee. The section contemplates the circumstance where a corporate trustee has incurred a liability. In the event of the corporate trustee being unable to discharge the incurred liability and the corporate trustee not being entitled to be fully indemnified against the incurred liability out of the trust assets a director of the corporate trustee incurs a liability. That liability is an individual liability and also a joint liability with the corporate trustee. The section provides that the director's liability arises when subs (1)(a) and (b) are satisfied 'even if the trust does not have enough assets to indemnify the trustee'.[29]

In an attempt to ensure that his meaning of the sentence in s. 197(1) was not misunderstood and was a complete opposite to what was provided by Debelle J, Gray J offered an alternative approach to interpretation which had a similar outcome to the preceding statement.[30] He also used the word "entitled" to distinguish his meaning from the meaning provided by Debelle J, by saying that the sentence supports the argument that the "draftsman contemplated that there could be no entitlement to be fully indemnified if there were no trust assets or no sufficient trust assets".[31] Gray J's view is consistent with the view of Mullighan J where his Honour stated briefly "…if there are no assets comprising the trust fund, there is no entitlement to be indemnified."[32]

The reasoning of the majority is also flawed. What Gray J seemed to be saying is that if subsections 197(1)(a) and (b) are satisfied - that is, if a trustee company is unable to discharge the liability for reason of insolvency (or is experiencing financial difficulties) as per paragraph (a), and is not entitled to be fully indemnified because of lack of funds in the trust as per paragraph (b) - then the directors will be personally liable. In other words, regardless of whether or not there is an indemnity clause in the trust instrument, directors of a trustee company will be personally liable to discharge the company debts if the company is unable to do so. Gray J seemed to have completely ignored the existence of an indemnity clause in the Daroko Unit Trust. Mullighan J, on the other hand, seemed to have played down the significance of the indemnity clause by saying that "clause 21 provides a legal basis for the indemnity. However, there were no such assets in the Daroko Unit Trust due to the conduct of the appellant".[33]

If the majority decision is accepted to be correct, the outcome could have disastrous consequences for directors which will be discussed further in the latter part of this article. All directors of all forms of trustee companies will be under a significantly higher risk of having their personal assets exposed to attack than directors of ordinary companies trading in their own right. Under the former s. 233, the provision

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[29] Hanel v. O'Neill, (2003) 48 ACSR 378, 391.
[30] Hanel v. O'Neill, (2003) 48 ACSR 378, 391.
[31] Hanel v. O'Neill, (2003) 48 ACSR 378, 392.
[32] Hanel v. O'Neill, (2003) 48 ACSR 378, 381 (per Mullighan J).
[33] Hanel v. O'Neill, (2003) 48 ACSR 378, 381(per Mullighan J).

specifically referred to an "innocent director" being entitled to make a claim for indemnity "in respect of the liability by one or more of the other trustees". There is no relevant case law specifically on s. 233 which could be used to define what "innocent director" means, but the inclusion of that phrase within the former s. 233 could potentially open an opportunity for some possible defences to be raised if the section was still operative. Under the current s. 197, however, the provision does not refer to that phrase; instead the current s. 197 contains the sentence, "This is so even if the trust does not have enough assets to indemnify the trustee" which, as discussed above, causes major problems in understanding the extent of the director's liability. Under the former s. 233, it was potentially possible for a defendant to raise defences. According to the majority reasoning in *Hanel*, s. 197 has somehow removed the power of defences.

C *Views of other commentators*

Austin and Ramsay[34] collectively provide their view of the sentence in the following terms:

> Section 197(1) asserts that the director is liable to discharge the corporation's liability if conditions (a) and (b) are met, and then says, "This is so even if the trust does not have enough assets to indemnify the trustee." The word "This" is ambiguous. It could be taken to refer to the proposition that the director is liable in the stated circumstances. If that construction were adopted, the quoted sentence would be a statement of the obvious point that the director's liability is not diminished by the trust's lack of sufficient assets to indemnify the corporation. Alternatively, the word "This" might refer only to condition (b), the condition that the director is not liable unless the corporation is not entitled to a full indemnity out of trust assets. On that construction, the ambiguous sentence asserts that the question to be considered in condition (b) is a question about the trustee's entitlement to be indemnified out of such assets (if any) as the trust may have, and that it is not relevant to inquire whether there are sufficient assets to make the enforcement of the indemnity a fruitful exercise. That was the position, stated in clear terms, under the former s. 233(2). The trouble is that one can only extract this meaning out of the ambiguous sentence by a tortuous and syntactically unlikely construction.[35]

Lipton and Herzberg[36] collectively provide a different perspective. Instead of focusing on the sentence and the word "This" in s. 197(1), they approach the section in light of the trustee's right of indemnity against the concept of breach of trust:

> Under s. 197, directors are personally liable to trust creditors where a trustee company incurs a liability and their company's right of indemnity is not

[34] R P AUSTIN & IAN M RAMSAY, FORD'S PRINCIPLES OF CORPORATIONS LAW (12th ed, 2005).
[35] *Id*, at 964.
[36] PHILLIP LIPTON & ABE HERZBERG, UNDERSTANDING COMPANY LAW (12th ed, 2004).

> available to satisfy those debts because they were incurred in breach of trust. Directors, however, are not liable to trust creditors merely because the trust has no assets or the assets are insufficient to fully indemnify the trustee company. In such cases, trust creditors can apply to have the company wound up in insolvency under s. 459A.[37]

Lipton and Herzberg clarify their point further, stating that, "s. 197(2) makes it clear that the directors' personal liability only arises where their company's right of indemnity is unavailable because of a breach of trust."[38] Their focus is on the principle of trust, noting that a trustee's right of indemnity is not always available and that right of indemnity can be lost if the trustee breaches the trust while incurring debts, in which case directors will be responsible for those debts incurred.[39]

The author is in agreement with the view expressed by Lipton and Herzberg as their view reiterates the axiom that directors have actual control of the trust assets and the trustee company is merely a legal entity whose power is vested in the hands of the directors as agents and any breach of the trust is a breach to be accounted for by the directors.

D *The author's view of the sentence in s. 197(1)*

It is clear that the wording in s. 197(1), up to and including paragraph (b), refers to the liability of a director if the two stated conditions in paragraphs (a) and (b) are jointly and inseparably satisfied. The sentence, "This is so even if the trust does not have enough assets…" causes confusion and uncertainty to the entire s. 197. It is sufficient for s. 197(1) to stop immediately after paragraph (b) as the two requirements are already spelt out, that a director is personally liable to discharge the liability of the company if (a) *and* (b) are met; any additional words or sentences after paragraph (b) would only add confusion such as already expressed by a number of commentators.

The inclusion of the sentence by the Parliament might have been intended to clarify the preceding statement in s. 197(1). The word "This" in the sentence probably adds emphasis that a director cannot escape personal liability if conditions (a) and (b) are met. The entire sentence could mean that the obligation of the director in discharging the company debts, as referred to in s. 197(1), is one that imposes a strict liability and there are no exceptions to that obligation; any carefully drafted indemnity clause in the trust instrument or any other limitations on the right of

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[37] *Id*., at 692.
[38] *Id*., at 81.
[39] For a discussion of the directors' duties to the beneficiaries in relation to a trustee company, and to some extent, to the creditors, *see* AR Coleman, *Duties of Directors of Corporate Trustees to Beneficiaries*, 2 COMPANY & S.L.J. 147 (1984); H A J Ford, *Trading Trusts and Creditors' Rights*, 13 MELBOURNE UNI. L. R. 1 (1981); M W Inglis, *Personal Liability of Directors of Corporate Trustees of Trading Trusts and Superannuation Funds*, 2 COMPANY & S.L.J. 48 (1984); R I Barrett, *Directors' Fiduciary Duties – Whether Interests of Beneficiaries under Trust of which Company is Trustee is To Be Taken into Account*, 59 AUSTRALIAN L.J. 46 (1985).

indemnity will not override the director's obligation or alter the position of the director.

Section 197(1) is clearly, albeit unintentionally, ambiguous and therefore is capable of multiple interpretations. As it stands, the overall consensus among judges and other legal commentators is that s. 197(1) imposes a liability on a director when a trustee company is unable to make payments to creditors, coupled with a disentitlement to indemnity because of the absence of trust assets or coupled with a non-entitlement to indemnity because of the absence of an indemnity clause. Whatever the correct interpretation is thereon, the key is to have a functional meaning that is expected and embraced by the community.

It should be noted that, in addition to the ambiguities highlighted, there are also grammatical errors in at least two places within s. 197. First, in s. 197(1), in particular in paragraph (a) that reads: if the corporation "has not, and cannot, discharge …" (reference to "discharged" and "discharge"). Second, s. 197(2) refers to "…had all the directors of the corporation been trustees when…"[40] – the ambiguity here is in reference to the word "directors" followed by the word "trustees" implying that directors are treated as trustees. These are minor errors, but it goes to show that the Parliament, when drafting s. 197(1) and all the other subsections, has overlooked the need for clarity in sentence construction.

V HANEL BEING CRITICISED

The decision in *Hanel* has been criticised by the courts in at least two cases – the Supreme Court of New South Wales in *Intagro Projects Pty Ltd v. Australian and New Zealand Banking Group Ltd* (*"Intagro Projects")*[41] and the New South Wales Court of Appeal in *Edwards v. AG (NSW)* (*"Edwards").*[42]

A *Intagro Projects*

The Court in this case upheld the majority view in *Hanel* but not without reservation. ANZ sought leave to amend its cross-claim to include two directors of Intagro Project Pty Ltd ("the company"), the purpose of which was to argue that the company was at the relevant time acting as a trustee and pursuant to s. 197(1) the directors were personally liable under the guarantees granted by the company. In defence, the company argued that it was acting in its own capacity and not as trustee of any trust, and that s. 197(1) and the decision in *Hanel* had no application. Section 197(2) was not raised as a defence by one director against the other director as the two directors were husband and wife.

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[40] Corporations Act 2001, s 197(2) reads: "The person is not liable under subsection (1) if the person would be entitled to have been fully indemnified by 1 of the other directors against the liability had all the directors of the corporation been trustees when the liability was incurred."

[41] Intagro Projects Pty Ltd v. Australian and New Zealand Banking Group Ltd, (2004) 50 ACSR 224 (SC of NSW).

[42] Edwards v. Attorney-General, (NSW) (2004) 50 ACSR 122 (NSWCA).

The case went before a single judge of the Supreme Court of New South Wales. While McDougall J felt the need to accept the majority ruling in *Hanel* as the current authority and consequently allowed the cross-claim to be amended so that ANZ could make a claim against the directors under s. 197(1), his Honour also felt the need to criticise the decision:

> I have difficulty in accepting the reasoning of the majority in *Hanel*. But, equally, I have difficulty in accepting the reasoning of Debelle J.[43]

McDougall J concluded that he was "tempted" to rule that "the majority view was plainly wrong" but thought that as a matter of precedent, he "should follow the majority view in *Hanel*, notwithstanding the reservations".[44] His Honour pointed out that the approach of the majority could lead to the most undesirable consequences and provided one example - that their approach would impose on directors of trustee companies a personal liability as great as that imposed on directors under s. 588G, but without the defences granted by s 588H.[45]

His Honour also highlighted some difficulties with Debelle J's reasoning, stating that a narrow reading of s. 197 would enable a director to escape personal liability by carrying on a business through a trustee company, by ensuring that the company has full legal right to indemnity in the trust instrument, and ensuring that there will be insufficient assets in the trust to meet any claim pursuant to that indemnity.[46] McDougall J then went on to provide what he thought would be a proper and preferred construction of s. 197, by suggesting some changes to the wording.[47]

B *Edwards*

The decision in *Hanel* was also criticised by the Court of Appeal in *Edwards*. The case concerned an application by two trustee companies for judicial advice under a provision of the *Trustee Act* 1925 (NSW) and by the companies' directors for court orders relieving them of personal liability under s. 1318(2), in relation to actual and prospective asbestos claims which might be brought against the company. Young CJ expressed a similar view that the interpretation of s. 197 by the majority in *Hanel* was unconvincing. Although s. 197 was not directly relevant in *Edwards*,

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[43] Intagro Projects Pty Ltd v. Australian and New Zealand Banking Group Ltd, (2004) 50 ACSR 224, 237.

[44] Intagro Projects Pty Ltd v. Australian and New Zealand Banking Group Ltd, (2004) 50 ACSR 224, 237 and 228.

[45] Intagro Projects Pty Ltd v. Australian and New Zealand Banking Group Ltd, (2004) 50 ACSR 224, 234.

[46] Intagro Projects Pty Ltd v. Australian and New Zealand Banking Group Ltd, (2004) 50 ACSR 224, 234.

[47] Given that the author has highlighted a range of interpretations of s. 197(1), it is not necessary to elaborate on another interpretation from another Supreme Court judgment. For further reading of McDougall J's interpretation and construction of s. 197, the interested reader is advised to refer to pp. 237-238 of the judgment of McDougall J in Intagro Projects Pty Ltd v. Australian and New Zealand Banking Group Ltd, (2004) 50 ACSR 224.

the Court stated that, if it had been required to deal with s. 197, it would have been likely to decide against the interpretation in *Hanel*.[48] Accordingly, the Court of Appeal distinguished the facts and felt that it was not bound by the decision in *Hanel*.

VI HANEL MAKES A BAD PRECEDENT

It is doubtful that the majority decision in *Hanel* makes a good precedent. There are fundamental flaws in the court's judgment of s. 197. Neither the majority nor the minority view is practically functional. As expressed by Austin in a lecture delivered at a conference,[49] "the majority view seems out of accord with the legislative history and is not fully in harmony with the statutory language. The ambiguous sentence seems to be supplementary rather than an independent ground to liability. But Debelle J's reading also seems out of accord with the statutory language." The flaws are now highlighted in turn.

A *Flaws in the majority reasoning*

According to the majority view, directors are required to discharge personally the debts of the company if the company is unable to do so and the company is not entitled to be indemnified because of the conduct of the directors causing the company to be without funds in the trust. This is so regardless of whether or not there is an indemnity clause entitling the company to be indemnified from the trust. In playing down the indemnity clause contained in the trust deed, the majority appears to project the view that the company can only be entitled to indemnify out of trust assets if that entitlement is actual, tangible, real and operative at the present time and not at the time when the indemnity clause is written into the trust instrument. It is submitted that the majority reasoning is flawed in the following ways:

- When the company is unable to discharge the debts, directors are required to discharge personally those debts without exception; this requirement appears to be automatic under s. 197 and there are no available defences that could be raised by innocent directors. In other words, directors of trustee companies have a higher chance of being sued than directors of ordinary companies acting in their own capacity. This is because when a trustee company is unable to discharge the debts, the creditors are more likely to invoke s. 197(1) and not s. 588G. The important difference between the two provisions is that the defences in s. 588H that are otherwise

[48] Edwards v. Attorney-General, (NSW) (2004) 50 ACSR 122, 123, 127, 144 and 145 (per Young CJ in Eq, Spigelman CJ and Mason P).

[49] Paper presented by RP Austin called, THE INCORPORATED SUPERANNUATION TRUSTEE, presented for the Superannuation Lawyers Association of Australia – Libby Slater Plenary Session, Marriot Resort, Surfers Paradise, Queensland 28 February 2004 which is available on the internet *at* <http://www.lawlink.nsw.gov.au/sc/sc.nsf/pages/Austin_260204>, *at* 6. The author has kept a hard copy file printed on 16 December 2004.

available to directors being sued under s. 588G are not available to directors being sued under s. 197(1). When proceedings are brought against directors under s. 197(1), they do not have defences equivalent to s. 588H nor can they rely on the s. 588H defences.[50]

- Creditors now have a real sense of certainty of recoveries from directors personally if the company is unable to settle the debts. There is no appropriate channel for defences other than under s. 197(2), which only allows one director to claim indemnity against another director of the same company. Section 197(2) therefore has no adverse impact upon the creditors.

If the majority view is correct, there is clearly no incentive for people to elect to become directors in a trustee company. The insurance premiums for directors of trustee companies may become proportionately higher than the premiums payable by the other directors or their companies. Things can go wrong and it may not be the fault of the directors and yet directors of trustee companies will be an easy target for creditors to bring s. 197(1) actions. At best, it is hoped that the courts in future cases will distinguish matters on the facts.

B *Flaws in Debelle J's reasoning*

Debelle J's interpretation of s. 197 enables directors to avoid paying debts by carrying on a business through a trustee company. The way to do this would be by ensuring that the company has a right of indemnity in the trust instrument and by ensuring that the trust has insufficient assets to fulfil the company's right of indemnity. This scheme enables directors to deplete funds from the trust as and when the funds come in, leaving no residues for the company to pay the creditors. The flaws are these:

- directors are not responsible for the debts incurred by the company because they have not committed any breach of the law as their actions are regarded as permissible under s. 197, which essentially means that the creditors cannot lift the corporate veil to pursue against directors for recovery;
- the trustee company is also not responsible for its own debts because technically the company has no money to settle those debts, and when the company becomes insolvent the indemnity provision in the trust instrument becomes ineffective anyway due to lack of funds.

In essence, creditors are barred from bringing actions against directors because according to Debelle J's interpretation, s. 197 does not condemn the directors' conduct in causing the trust to be without funds. Directors will not be personally liable for the debts if the company has a legal entitlement to be indemnified and to

[50] The defences provided in s. 588H are only available when proceedings are brought against directors of a company under s. 588G of the Corporations Act 2001 (Cth).

this end having an indemnity provision in the trust instrument is sufficient proof of that entitlement. Technically, directors have not committed a breach of their duties for the corporate veil to be lifted.

The only alternative would be for creditors to apply to court for the company to be compulsorily wound up, if possible, on the ground of insolvency or insolvent trading pursuant to some other discretionary provisions given to the court. Based on the interpretation in *Hanel*, there is no certainty that a trustee company can be wound up under s. 588G as directors of a trustee company do not have the same right of defences under s. 588H as directors of an ordinary company trading in its own capacity. Further, even when the court exercises its discretion to wind up the trustee company, there is no certainty that the creditors would have any recovery from the directors. The uncertainty may be explained in the statement of Debelle J:

> It is as if the corporate veil which was drawn back to impose a liability in the prescribed circumstances on a director of a corporation acting as a trustee was replaced by a veil of obscurity.[51]

Debelle J is suggesting that the position of a director has become somewhat obscured, in the sense that a director could be treated as the 'owner' of a trustee company or a guarantor of trust liabilities.

VII IMPLICATIONS FOR DIRECTORS OF TRUSTEE COMPANIES

One cannot predict how the courts in future will decide on issues relating to s. 197(1) and the majority ruling in *Hanel*. Some courts may be influenced by the ruling in *Hanel* (such as the Court in *Intagro Projects*) while others may view the ruling as no more than obiter dictum. Nonetheless, there are certain implications that directors of trustee companies should be mindful of and if necessary they should take precautionary measures to protect their personal assets and minimise the chances of being sued under s. 197. The following are some examples of the implications which have arisen from the decision in *Hanel.*

A *All trustee companies are affected*

Directors of all trustee companies are potentially impacted by the decision in *Hanel.* This includes directors of trustees of self-managed superannuation funds, trustees of managed investment schemes, nominee companies, custodians, and other trustee companies such as trustees of a discretionary trust and family trust. Section 197 does not spell out the extent of liability as the section refers to "debts and other obligations" in the heading and then "liabilities" in the rest of the section. As a precaution, persons who are acting as director of any form of trustee company should review their insurance policies and perhaps pay additional premiums to

[51] Hanel v. O'Neill, (2003) 48 ACSR 378, 384.

ensure that they are adequately protected against potential law suits under s. 197(1). When entering into contracts with third parties, terms should be incorporated limiting any claims to the extent of the trustee's right of indemnity from the trust. They should also ensure that the only debts incurred on behalf of the trust are those that can be discharged from trust assets and that all outstanding trust liabilities are discharged prior to distributing trust assets to beneficiaries.

It should be noted that in the case of a superannuation scheme, s. 57 of the *Superannuation Industry (Supervision) Act 1993* (Cth) allows directors of trustees in the superannuation funds to be indemnified out of trust assets for a liability incurred while acting as a director of the trustee. The exception to this rule is if the director has been acting dishonestly, or has intentionally or recklessly failed to exercise due care, skill and diligence. A similar provision should be incorporated into the *Corporations Act 2001* (Cth) to apply to all trustee companies.

B *No defence mechanism under s 197 compared with s 588H*

When an action is brought against directors of a company pursuant to s. 588G for insolvent trading, that action is subject to a number of defences available to directors under s. 588H. For example, under s. 588H(4) it would be a defence if it is proved that because of illness or for some other good reason the person did not take part in the management of the company during that relevant period. Under s. 588G, it would be harder for creditors to obtain recoveries as the procedure under that section is more involved and there is a need to establish, *inter alia*, that "there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent".[52] Further, even if an action under s. 588G is successful, creditors cannot possibly expect full recoveries. For these reasons, and given the generous interpretation of s. 197 by the majority in *Hanel*, it is likely that the creditors would turn to s. 197 for recoveries instead. Under s. 197, the focus is on the company's ability to pay and the company's entitlement to indemnity if any – the likely outcome would be that if the company is unable to discharge the debts, the directors must discharge those debts personally and there are no defences equivalent to s. 588H. The creditors could still bring an action under s. 197 against directors who were not involved in the day to day management of the trustee company.

Technically, s. 197(2) is not a real defence. The subsection is only useful if one director intends to obtain indemnity from the other directors of the same trustee company and this action may have to be brought separately from the creditor's action.

It is therefore essential for directors of trustee companies to protect themselves not only against creditor's actions pursuant to s. 197(1) but also against their fellow directors by insisting, for example, that certain major transactions be approved

[52] *See*, in particular, s. 588G(1) of the Corporations Act 2001(Cth).

unanimously and that terms between directors be clear and unambiguous. The aim is to make s. 197(2) as accessible as possible to the individual directors and to ensure that those "innocent" directors can seek indemnity from their fellow directors if, for whatever unforeseen reasons, they are held liable for the company debts under s. 197(1).

C *Director of trustee company is synonymous with guarantor*

The implication of the decision in *Hanel* is that persons who are a director of a trustee company may technically be regarded as the "guarantor" of the trust debts. In theory, all directors are separate from companies by virtue of the separate legal entity principle enunciated in *Salomon v. Salomon & Co Ltd*[53] and in most instances the corporate veil can only be lifted if certain breaches have been established. In practice, however, this does not seem to be the case. Directors of a trustee company are placed in a special category in s. 197 and to some extent by the court in *Hanel*. As seen in that case, the defendant was a related party to the company that was a beneficiary to the Daroko Unit Trust and this may have been the reason for Gray J suggesting that the position of a director of a trustee company is similar to that of a guarantor:

> The situation is directly comparable to the position of the guarantor of a debt. In proceedings against the guarantor the liability to the principal debtor is a material fact to be pleaded and proved. The position is the same in regard to a liability under s. 197(1).[54]

Further in s. 197(2) where it reads, "… had all the directors of the corporation been trustees when the liability was incurred", there is an implication that in the case where a trustee company is involved, a director may be interpreted as the "owner" of the company.

The statement of Gray J was obiter dictum only as it was not mentioned by the other two justices. Nonetheless, the implication is there – a director of a trustee company could either be a guarantor of the trust debts or an owner of the company, in which case, if the company is proved to be unable to discharge the debts, the creditor may turn to the director acting in the capacity of a guarantor/owner for the purpose of discharging those debts.

When contracting with third parties, it may be prudent for directors to insist on terms limiting the application of s. 197 to the extent that, provided directors have acted honestly and have complied with all necessary duties directors are not responsible for the debts incurred by the company.

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[53] Salomon v. Salomon & Co Ltd, [1897] AC 22 (Eng. HL).
[54] Hanel v. O'Neill, (2003) 48 ACSR 378, 392 (per Gray J).

VIII IS THE PROPOSED AMENDMENT ACCEPTABLE?

This Part outlines the proposed amendment to s. 197(1), followed by the author's view of the actual meaning of the proposed amendment and whether that proposed amendment is acceptable.

A *Proposed amendment to s. 197(1):*

On 2 June 2005 the federal Government announced a proposal to amend s. 197(1). The Corporations Amendment Bill (No 1) 2005 (Cth) was introduced into the Parliament proposing to clarify the scope of the potential personal liability of the directors of trustee companies by repealing the current section of the *Corporations Act* and replacing it with the following terms:

> 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.
>
> *Note*: The person will not be liable under this subsection merely because there are insufficient trust assets out of which the corporation can be indemnified.

As discussed above, the current position is that the majority interpretation of s. 197(1) in *Hanel* could significantly expand the personal liability of the directors of all trustee companies, from large superannuation trusts through to small family and discretionary trusts where the trust is serviced by a company as trustee and the directors are there managing the company. The aim of the amendment to s. 197(1) is to overturn the problems highlighted in *Hanel*, and by doing so, the amendment is intended to clarify the scope of the potential personal liability of the directors of trustee companies and in turn, restore certainty for those directors. As stated in paragraph 1.13 of the Explanatory Memorandum to the Corporations Amendment Bill (No 1) 2005 (Cth):

The Bill will replace the current subsection 197(1) of the *Corporations Act* with a proposed new subsection 197(1) that will only impose personal liability on a director of a corporate trustee where the corporation's right of indemnity as trustee is lost through disentitling conduct on the part of the corporation (whether breach of trust or *ultra vires* conduct) or through a restriction in the terms of the trust that purports to deny a right of indemnity against trust assets.

B *What does the new s 197(1) actually mean?*

The Explanatory Memorandum to the Corporations Amendment Bill (No 1) 2005 (Cth) provides four scenarios to illustrate the scope of application of the proposed new s. 197(1), in particular, s. 197(1)(b)(i), (b)(ii) and (b)(iii). The illustrations are overly simplified and may not be appropriate in all cases.[55]

It is the author's view that the proposed new s. 197(1) could mean the following:

1. If there is no breach of trust by the trustee company as per the proposed s. 197(1)(b)(i) and there is no *ultra vires* act on the part of the trustee company as per s. 197(1)(b)(ii) and there is a term of the trust limiting the amount in which the trustee company can be indemnified as per s. 197(1)(b)(iii), then provided there is trust money for indemnification up to the limit, directors of the trustee company will be liable personally for the shortfall.

2. Further, in the event that the trust has no money or assets to indemnify the trustee company as per the term of the trust under the proposed s. 197(1)(b)(iii), directors will potentially be liable for the whole of the debt less the amount limited by the term of the trust.

3. Further, if however, the debt (or the "liability" as the term used in the proposed amendment) is less than the limit in which the trustee company is entitled to be indemnified and there is no indemnification available because the trust has no money or asset, then the directors are not liable at all. This is so because of the last part of the sentence in the proposed s. 197(1) that reads, "Note: The person will not be liable under this subsection merely because there are insufficient trust assets out of which the corporation can be indemnified."

4. In any event, directors of trustee company may still be caught exclusively and personally liable to discharge the debts under either the proposed s. 197(1)(b)(i) or s. 197(1)(b)(ii). That is, directors of trustee company may be liable personally if the company has committed a breach of the trust [s.

[55] *See* Explanatory Memorandum to the Corporations Amendment Bill (No 1) 2005 (Cth) at para 4.2, pp. 8-10.

> 197(1)(b)(i)] or the company has committed an *ultra vires* act [s. 197(1)(b)(ii)]. In effect, the proposed s. 197(1)(b)(i) and (b)(ii) encourage directors of trustee companies to act prudently, not to breach their duties as directors and not to mismanage trust funds.

Under the proposed s. 197(1), it is quite possible for directors of a trustee company to be exempt from personal liability. The exemption comes about when the trustee company is unable to discharge the debt, and yet the company has a right to be fully indemnified against the liability if none of the three sets of circumstances in the proposed s. 197(1)(b) applies. Even if there is a term in the trust limiting the trustee company's right to indemnity as per s. 197(1)(b)(iii), it is still possible for directors to be exempt from personal liability by ensuring that the company's indemnity limit is set as high as possible. This is possible provided the company has not breached the trust and has acted within the scope of its powers as trustee.

The proposed amendment has obviously removed the ambiguous term[56] and has added extra three sets of circumstances to limit the scope of director's personal liability – s. 197(1)(b)(i), (b)(ii) and (b)(iii) - immediately after "solely because of one or more of the following…." Another addendum to s. 197(1) is the part that reads, "Note: The person will not be liable under this subsection merely because there are insufficient trust assets out of which the corporations can be indemnified." The Note itself, however, is merely explanatory and it is unclear whether that Note could be taken as part of the Act if and when the proposed amendment comes into operation.[57] If the Note does not form part of the Act, then that Note has no legal effect. It seems that the Note added to the new proposed section is to abolish the decision in *Hanel* explicitly and if this is the intent then the word "Note" should be omitted from the proposed new section to avoid complication.

C *Is the proposed amendment acceptable?*

If the author's attempted interpretation of the proposed amendment is correct, then indeed the amendment will and should eliminate the undesirable implications of the majority decision in *Hanel* and will introduce a new measure of certainty concerning the company's entitlement to indemnity when acting as trustee. The proposed amendment is acceptable in one way and is a welcome development because the proposed measure will enable directors to work out the scope of their potential personal liability and reduce the cost of director's annual insurance premiums. The amendment will also remove the notion of directors being potentially treated as guarantors of trust liabilities as highlighted by Gray J in *Hanel.* The interest of the

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[56] The ambiguous term in the current s. 197(1), which is no longer in the proposed amendment is "This is so even if the trust does not have enough assets to indemnify the trustee".

[57] Acts Interpretation Act 1901 (Cth), s. 13 (Headings, schedules, marginal notes, footnotes and endnotes) provides that marginal notes, footnotes, endnotes and headings to sections of an Act are not to be taken as part of the Act. It is unclear whether the kind of "Note" placed immediately after and within s. 197(1) could be taken as part of the Act. The Parliament should make clear of its intention on this point in the process of passing the proposed amendment.

directors of trustee companies will be adequately protected under the new proposed s. 197(1) provided they act reasonably and within their duties as directors.

Indeed, the proposed amendment will make it less attractive for creditors to pursue against directors personally simply because it is unlikely that creditors will have knowledge of the terms of the trust as such information is not readily available to the public. Ordinarily, the terms of the trust are known to the trustee companies (and directors who manage those companies) and the beneficiaries of the trust, but not outsiders such as the creditors or the like. If the term of the trust sets a very high limit on the company's right to indemnity and if the trust is lacking assets and the company has not done anything wrong to trigger the circumstances in the proposed s. 197(1)(b)(i) and (ii), the creditors may not succeed in obtaining recoveries from directors personally.

Under the proposed amendment, however, there is a potential for abuse by directors of certain trustee companies, especially in a case where a small business is run through a trust arrangement, with a company being set up to act as trustee of the trust. The promoters of the company may structure the trust in such a way that the three sets of circumstances in the proposed s. 197(1) do not apply. The abuse could be carried out by ensuring that the company has a full right of indemnity pursuant to the trust instrument and by ensuring that the trust has insufficient funds to fulfil the company's right of indemnity. The proposed amendment appears to move towards Debelle J's interpretation of the current s. 197(1) in *Hanel* and the defects attached to that interpretation are highlighted within the discussion of that case.

In the Second Reading Speech to the amending Bill, the Parliamentary Secretary to the Treasurer stated that the proposed amendment "will restore the longstanding interpretation of section 197". The statement was made in connection with the proposed amendment being consistent with the traditional interpretation of the former s. 233 of the *Corporations Law*. The author contends that the proposed amendment is not the same as the former s. 233 of the *Corporations Law*. The former s. 233 allowed an "innocent director" to be exempt from personal liability, though the term "innocent director" was not clearly defined in the former provision.[58] Despite the lack of clarity, some form of defence mechanism was provided in the former s. 233 for an innocent director to raise within the same lawsuit in the event of being sued by a creditor. On the other hand, the proposed amendment does not mention any defence mechanism for directors who may have a valid defence. The proposal is that the current s. 197(2), which is a provision enabling one co-director to claim indemnity from another co-director, will still be applicable when the new proposed s. 197(1) becomes effective. As discussed elsewhere above, unlike the former s. 233 of the *Corporations Law*, s. 197(2) is not a real defence, meaning that a co-director wishing to make a claim of indemnity from another co-director under s. 197(2) may have to institute an action separate from the creditor's action. Under the current s. 197, there is no mechanism for innocent directors to

[58] For comparison, the former s. 233 of the Corporations Law is reproduced in part in the Appendix at the end of the article.

defend against creditors. The proposed amendment should include a defence mechanism similar to that provided in the former section, but with the term "innocent director" clearly defined.[59]

The proposed amendment is a clear departure from the majority decision in *Hanel* which should be celebrated for when it does come into effect. However, further drafting is required to ensure that the new provision is not misused or abused by directors of certain trustee companies and to take into account of the circumstances in which innocent directors may need to defend themselves against creditors and other co-directors. Until a more acceptable amendment is proposed, advice to the directors is that, when contracting with a third party, they should continue to insist on terms limiting their liabilities in the event of an unforeseen complication arising as a result of, for example, a co-director committing a breach of his or her duty, or a negligence claim being made against a trustee company and/or co-directors.

IX CONCLUSION

This article has explored some potential problems arising out of the decision in *Hanel*, particularly as a result of the court's multiple interpretations of s. 197(1). The decision in *Hanel* is significant, because it was the first case where the Full Court of the Supreme Court was asked to interpret s. 197(1) and where the Supreme Court had spent considerable time in delivering a microscopic analysis of the section.

The proposed amendment to s. 197(1), which was introduced into the federal Parliament on 2 June 2005, is indeed a welcome development. It is clearly a departure from the decision in *Hanel.* If the amendment does become effective, it will mean that the scope of the director's potential personal liability will be limited and this will be dependent on the size of the trustee company's right of indemnity. The proposal that was tabled at the Parliament is to amend s. 197(1) and no other subsections. Perhaps, a further amendment is necessary to clarify the kind of defence that an innocent director can raise as against creditors if being sued by creditors under the new proposed s. 197(1). Section 197(2), which is a claim of indemnity from one director against a co-director, is not really a defence in a creditor's action.

Until the Parliament passes the Corporations Amendment Bill (No 1) 2005 to amend s. 197(1), and until it passes further other amendments as suggested in the article, the ruling in *Hanel* is still the law and directors of trustee companies should continue to take precautionary protective measures and have maximum coverage on their insurance policies.

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[59] As discussed elsewhere in the article, the former s. 233 of the Corporations Law came into effect in 1990 and since then, no Full Court has given a judicial interpretation to the section.

APPENDIX

The *Corporations Amendment Bill (No 1)* 2005 (Cth) proposes to amend s 197(1) with the following subsection which was introduced into the Parliament on 2 June 2005:

(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.

Note: 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 current s 197 of the *Corporations Act* 2001 (Cth):

(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, 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.

This is so even if the trust does not have enough assets to indemnify the trustee. The person is liable both individually and jointly with the corporation and anyone else who is liable under this subsection.

(2) The person is not liable under subsection (1) if the person would be entitled to have been fully indemnified by 1 of the other directors against the liability had all the directors of the corporation been trustees when the liability was incurred.

(3) This section does not apply to a liability incurred outside Australia by a foreign company.

(4) This section does not apply to a liability incurred by a registrable Australian body outside its place of origin.

The former s 233 of the *Corporations Law*:

233(1) **[Guilty directors liable]** Where:

(a) a relevant body corporate while acting or purporting to act in the capacity of trustee of a trust, incurs a liability:
  (i) in the case of a company – whether within or outside Australia; or
  (ii) in the case of a registered foreign company – within Australia; or
  (iii) otherwise – within this jurisdiction; and
(b) the relevant body corporate is for any reason not entitled to be fully indemnified out of the assets of the trust in respect of the liability; and
(c) the relevant body corporate has not discharged, and is unable to discharge, the liability or a part of the liability;

the relevant body corporate and the persons who were directors of the relevant body corporate when the liability was incurred and were not innocent directors in relation to the incurring of the liability are jointly and severally liable to discharge the liability or the undischarged part of the liability, as the case may be.

233(2) **[Exempt circumstances]** For the purposes of this section, a trustee of a trust shall not, merely because:

(a) the trust has no assets; or
(b) the assets of the trust are insufficient to indemnify the trustee in respect of a liability concerned;

be taken not to be entitled to be fully indemnified out of the assets of the trust in respect of a liability.

233(3) **[Definitions]** In this section:

'Australia' includes the external Territories;

'innocent director', in relation to the incurring of a liability by a relevant body corporate while acting or purporting to act in a capacity of trustee of a trust, means a person who:

(a) was a director of the relevant body corporate at the time when the liability was incurred; and

(b) if the persons who were directors of the relevant body corporate at that time had been at that time the trustees of the trust and had incurred the liability, would have been entitled to be fully indemnified in respect of the liability by one or more of the other trustees;

'liability' means a debt, liability or other obligation;

'relevant body corporate' means:

(a) a company;

(b) a registrable body other than a registrable local body.