

2004-2005

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

CORPORATIONS AMENDMENT BILL (NO 1) 2005

EXPLANATORY MEMORANDUM

(Circulated by the authority of the Treasurer,
The Hon Peter Costello, MP)

Table of Contents

OUTLINE	1
ABBREVIATIONS	3
REGULATION IMPACT STATEMENT AND FINANCIAL IMPACT STATEMENT	4
NOTES ON CLAUSES.....	5

1

Outline

Liability of directors of corporate trustees

1.1 Schedule 1 to this Bill amends the *Corporations Act 2001* (the Corporations Act) to clarify the scope of the potential personal liability of the directors of corporate trustees. The amendments will address concerns that have arisen in the light of the recent decision of the South Australian Supreme Court in *Hanel v O'Neill* [2003] SASC 409, namely, that directors of corporate trustees could be personally liable in any case where there are insufficient assets to discharge the liabilities of the trust. This interpretation could significantly expand the personal liabilities of the directors of all corporate trustees, from large superannuation trusts through to trading trusts running a small business.

1.2 Schedule 1 will replace existing subsection 197(1) of the Corporations Act with a new subsection 197(1) that unambiguously only imposes 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 through 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.

Technical amendment to auditor independence provisions

1.3 Schedule 2 to this Bill will clarify the operation of subsection 1462(2) of the Corporations Act to ensure that the auditor independence provisions in repealed sections 324 and 331AA of the Corporations Act continue to apply to financial years commencing prior to 1 July 2004. This technical amendment has been backdated to the commencement of section 1462 of the Corporations Act (30 June 2004) to ensure that there is no gap in the operation of these provisions.

2

Abbreviations

2.1 The following abbreviations are used in this Explanatory Memorandum.

CLERP Bill 1998	Corporate Law Economic Reform Program Bill 1998
CLERP 9 Act	<i>Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004</i>
CLERP reforms	Corporate Law Economic Reform Program
Corporations Act	<i>Corporations Act 2001</i>
<i>Hanel v O'Neill</i>	<i>Hanel v O'Neill</i> [2003] SASC 409

1

Regulation Impact Statement and Financial Impact Statement

Regulation Impact Statement

Schedule 1 — Liability of directors of corporate trustees

1.1 The Office of Regulation Review advised that a Regulation Impact Statement is not required in relation to the amendments in Schedule 1.

Schedule 2 — Technical amendment to auditor independence provisions

1.2 The Office of Regulation Review advised that a Regulation Impact Statement is not required in relation to the amendment in Schedule 2.

Financial impact statement

1.3 The Bill has no significant financial impact on Commonwealth expenditure or revenue.

1

Notes on clauses

Clause 1 — Short Title

1.1 Upon enactment, the Bill will be known as the Corporations Amendment Act (No 1) 2005.

Clause 2 — Commencement

1.2 The covering clauses (Clauses 1, 2 and 3) will commence on the day the Act receives the Royal Assent. The operative provisions of the Act (Schedules 1 and 2) will, in the case of Schedule 1, commence on the day the Act receives the Royal Assent, and the case of Schedule 2, at the time set out in the Table of commencement information in Clause 2.

Clause 3 — Schedules

1.3 The Acts specified in a Schedule to the Act will be amended or repealed as set out in the applicable items in the Schedules and any other item in a Schedule will have effect according to its terms.

Schedule 1 — Liability of directors of corporate trustees

Background

1.4 Under the law of trusts, persons contracting with a trustee, whether an individual or a corporation, are entitled to be subrogated to the trustee's right of indemnity out of the trust assets to meet liabilities properly incurred. However, if the trustee acts in breach of trust or in a manner that is not authorised by the terms of the trust, the trustee's right of indemnity, and therefore the creditor's

right of subrogation, is lost. In this case, recourse may be limited to the trustee alone, and that trustee may be a company with no assets.

1.5 Section 229A of the former Companies Codes was introduced to address a practice whereby the creditors of corporate trusts were denied access to trust assets when a debt had been incurred but the corporate trustee was not entitled to be indemnified out of the assets of the trust. In practice, the trustee's right of indemnification may have been excluded either by the terms of the trust deed or by virtue of conduct on the part of the corporate trustee, either in breach of trust or by acting *ultra vires* the terms of the trust. Accordingly, the *Companies and Securities Legislation (Miscellaneous Amendments) Act 1985* amended the Companies Codes to impose personal liability on directors of companies acting as trustee when a debt had been incurred but the corporate trustee was not entitled to be fully indemnified against the liability out of the assets of the trust.

1.6 The explanatory material accompanying the 1985 legislation compared the situation where the corporate trustee incurs a debt in respect of which it is not entitled to be indemnified out of the assets of the trust with the situation where the company is entitled to be indemnified but there are insufficient or no trust assets to indemnify the trustee. The 1985 explanatory material indicated that the reference to the entitlement to be indemnified related to the legal right of indemnity, rather than the financial capacity of the trust to meet an indemnity obligation.

1.7 Section 229A was intended, amongst other things, to encourage all directors of companies acting as trustee to ensure that the company does not enter into trust deeds that are designed to, or which by their operation may, deny creditors access to trust assets to meet liabilities incurred by the company.

1.8 Section 197 of the Corporations Act is the statutory successor to section 233 of the Corporations Law (originally introduced as section 229A of the *Companies Act 1981*). Section 197 of the Corporations Law (an amendment made by Schedule 1 to the *Corporate Law Economic Reform Program Act 1999*, Act No 156 of 1999) was introduced in the new Chapter 2D of the Corporations Law, dealing with officers and employees, with effect from 13 March 2000. The Corporations Act, which came into effect on 15 July 2001, included section 197 in its current form, with a new subsection 197(4), reintroducing the jurisdictional limitations present in earlier versions of the provision (that is, subparagraph 229A(1)(a)(iii) and subparagraph 233(1)(a)(iii)).

1.9 In the December 2003 decision of *Hanel v O'Neill*, the South Australian Supreme Court departed from the longstanding interpretation of section 197 of the Corporations Act. The practical impact of the new interpretation is that the directors of corporate trustees may be held to be guarantors for any liability entered into by the trustee. As such, directors of corporate trustees are now

exposed to a greater potential for personal liability than directors of other companies.

1.10 In *Hanel v O'Neill*, the Court considered whether the repeal of section 233 of the Corporations Law and the enactment of section 197 indicated a legislative intention to alter the liability of directors of corporate trustees. The Court found a legislative intention to expand the liability of directors, notwithstanding the unique 'simplification' flavour of the CLERP reforms, and the statement in the Explanatory Memorandum to the CLERP Bill 1998 that the Bill would also rewrite the relevant provisions 'without substantial change'.

1.11 The practical impact of the new interpretation of section 197 arising out of *Hanel v O'Neill* can be seen by considering two businesses: one structured as a company (Business A), another as a family trust with a corporate trustee (Business B). Both businesses are exposed to transport costs and spiralling petrol prices and consequently become insolvent. As soon as the directors realise the businesses are insolvent, they cease trading and put the companies into administration. The directors of Business A will not ordinarily be personally liable for the debts of the business. The directors of Business B, however, could be held to be personally liable for all trade debts as a result of the interpretation of section 197 in *Hanel v O'Neill*.

1.12 The expanded interpretation of section 197 in *Hanel v O'Neill* potentially impacts upon the personal liabilities of directors of all corporate trustees, including responsible entities of managed investment schemes and directors of corporate superannuation trusts, as well as family trustees. Moreover, it is likely that if legislative clarification of the interpretation of section 197 is not pursued, those who have structured themselves through trusts will face the risk of being personally liable for the debts of the trust in the event of insolvency, or the prospect of significant costs to change to corporate structures offering the traditional protections. The decision also has the potential to create flow-on effects on the cost of premiums for directors' and officers' insurance for directors of corporate trustees.

Description of principal changes

1.13 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 through 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.

Clause by clause commentary

Item 1 Subsection 197(1)

1.14 Item 1 will repeal existing subsection 197(1) of the Corporations Act.

1.15 Proposed new subsection 197(1) will make a person who is a director of a corporate trustee liable to discharge the whole or a part of a liability incurred by the corporate trustee, which the corporation is unable to discharge, or has not discharged, where the trustee is not entitled to be fully indemnified against the liability out of trust assets because one or more of the circumstances set out in the proposed subsection applies.

1.16 The circumstances in which the corporate trustee will not be entitled to be fully indemnified against the liability out of trust assets are:

where a trustee corporation has acted in breach of trust and the conduct relates to the incurring of the liability by the corporation;

where the corporation has acted outside the scope of its powers (*ultra vires* the terms of the trust) as trustee; and/or

where there is a term in the trust deed denying, or limiting, the corporation's right as trustee to be indemnified against the liability.

4.1 Thus, where the corporate trustee cannot discharge a particular liability incurred by it, and where one or more of the three sets of circumstances applies, the indemnity is displaced and the trustee is not entitled to be fully indemnified out of trust assets. In those circumstances, the directors will be personally liable (both individually and jointly with the corporation and any other relevant person) to discharge the liability (subject to subsection 197(2)).

4.2 The following possible scenarios illustrate possible outcomes under proposed subparagraphs 197(1)(b)(i), (ii) and (iii) where one or more of the three sets of circumstances operates.

Scenario 1

The trust has assets of \$1 million. The trust deed restricts the trustee's right to be indemnified to \$500,000. The corporation's undischarged liability is \$600,000. The result of applying proposed new subsection 197(1) is as follows: The directors are potentially liable for the whole of the \$600,000, as the corporation is not entitled to be fully indemnified as per subparagraph 197(1)(b)(iii). If the liquidator recovers \$500,000 from the trust assets and uses that money towards discharging the liability, the amount that the directors would be liable to pay is reduced to the \$100,000 that remains unpaid.

Scenario 2

The trust has assets of \$300,000. The trust deed restricts the trustee's right to be indemnified to \$500,000. The corporation's undischarged liability is \$600,000. The result of applying proposed new subsection 197(1) is as follows: The directors are potentially liable for the entire \$600,000, as the corporation is not entitled to be fully indemnified as per subparagraph 197(1)(b)(iii). If the liquidator recovers \$300,000 from trust assets and uses that money to discharge the liability, the amount the directors are liable to pay is reduced to \$300,000.

Scenario 3

The trust has assets of \$1,000. The trust deed restricts the trustee's right to be indemnified to \$500,000. The corporation's undischarged liability is \$300,000. The debts were incurred bona fide in carrying on the business of the trust. The result of applying proposed new subsection 197(1) is as follows: The directors are not liable at all, as the corporation is entitled to be fully indemnified, even though there are insufficient assets to discharge the liability.

Scenario 4

The trust has no assets. The corporation's aggregate undischarged liability is \$10,000, comprising 10 individual debts of \$1,000 each. Two of those debts involved a breach of trust or an ultra vires act. The other debts were incurred bona fide in carrying on the business of the trust. The trust deed restricts the trustee's right to be indemnified to \$5,000. The result of applying proposed new subsection 197(1) is as follows: The directors are potentially liable for \$2,000 for debts that involved a breach of trust or the ultra vires act by the corporation, as the corporation is not entitled to be fully indemnified as per subparagraphs 197(1)(b)(i)-(ii). There is \$8,000 left to be paid. The trustee is entitled to be indemnified to the extent of \$5,000. The directors are potentially liable for the whole of the \$8,000, as the corporation is not entitled to be fully indemnified as per subparagraph 197(1)(b)(iii). If the liquidator does recover \$5,000 from trust assets and uses that money to discharge the debts, the directors will only be liable to pay the remaining \$3,000.

Meaning of Note

1.1 The Note at the end of proposed subsection 197(1) indicates that the relevant person will not be liable under the proposed subsection merely because there are insufficient trust assets out of which the corporation can be indemnified.

1.2 The Note in effect replaces the sentence 'This is so even if the trust does not have enough assets to indemnify the trust', which is a key part of existing subsection 197(1). The interpretation of the sentence by the majority in *Hanel v O'Neill* led to its view that an insufficiency of assets meant that the corporate trustee was not 'entitled' to be fully indemnified, thereby triggering liability under subsection 197(1)). It is this view that has effectively led to the potential expansion of directors' personal liabilities in situations where the trust simply may have no assets to meet the corporate trustee's liability, even though the legal entitlement to indemnification under the trust deed remains in place.

1.3 Nonetheless, the Note itself is merely explanatory and of no legal effect. Section 13 (Heading, schedules, marginal notes, footnotes and endnotes) in Part IV of the *Acts Interpretation Act 1901* provides in effect that marginal notes, footnotes, endnotes and headings to sections of an Act are not to be taken as part of the Act.

1.4 Proposed new subsection 197(1) is intended to operate such that where the corporate trustee is unable to discharge the liability, but the corporation has a right to be fully indemnified in relation to the liability (assuming that none of the three sets of circumstances applies, that is, the corporate trustee has not acted in

breach of trust or *ultra vires* the terms of trust and there is no term in the trust deed denying, or limiting, the trustee's right to be indemnified against the liability), the directors will not be personally liable, regardless of whether there are sufficient trust assets or not to discharge the liability.

Schedule 2 — Technical amendment to auditor independence provisions

Background

1.5 The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (the CLERP 9 Act) amended the Corporations Act to provide for a new auditor independence regime in Division 3 of Part 2M.4 of the Corporations Act.

1.6 Subsection 1462(2) of the Corporations Act is a transitional provision that applied the new auditor independence requirements in the CLERP 9 Act to:

an audit of the financial report for a financial year; or

an audit or review of the financial report for a half-year in a financial year

if the financial year begins on or after 1 July 2004.

3.1 The purpose of subsection 1462(2) was to ensure that the new auditor independence provisions in the CLERP 9 Act would operate prospectively and apply to financial years that begin on or after 1 July 2004 and the intention was that the auditor independence provisions in the repealed sections 324 and 331AA of the Corporations Act would continue to apply in relation to companies and registered schemes whose financial years had commenced prior to 1 July 2004.

3.2 Subsection 1462 (2) however, is silent about the continued application of the auditor independence provisions in the repealed sections 324 and 331AA to a financial year that began before 1 July 2004, and it can be argued that these provisions no longer apply to financial years that commenced prior to 1 July 2004.

3.3 The purpose of the technical amendment in proposed subsection 1462(2A) is to clarify the operation of subsection 1462(2) to ensure that the auditor independence provisions in sections 324 and 331AA continue to apply to financial years commencing prior to 1 July 2004. This technical amendment has been backdated to the commencement of section 1462 of the Corporations Act

(30 June 2004) to ensure that there is no gap in the operation of these provisions.

Description of principal changes

3.4 A proposed new subsection 1462(2A) will clarify the operation of the transitional provision subsection 1462(2) by explicitly providing that the auditor independence provisions in the repealed sections 324 and 331AA of the Corporations Act will continue to apply to financial years that began before 1 July 2004.

Clause by clause commentary

Item 1 After subsection 1462(2).

3.5 Proposed paragraphs 1462(2A)(a) and (b) will ensure that the auditor independence provisions in the repealed section 324 (which apply to the audit of a company) continue to apply to financial years that began before 1 July 2004.

3.6 The effect of paragraph 1462(2A)(c) is to ensure that an auditor is incapable of acting as the auditor of a company in respect of financial years that began before 1 July 2004 where the auditor has contravened the auditor independence provisions in section 324 of the Corporations Act.

3.7 Proposed paragraph 1462(2A)(d) will ensure that the auditor independence provisions in the repealed section 331AA (which apply to the audit of a registered scheme) continue to apply to financial years that began before 1 July 2004.