



## **Corporations Amendment Bill (No 1) 2005**

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## Corporations Amendment Bill (No 1) 2005

**Date Introduced:** 2 June 2005

**House:** House of Representatives

**Portfolio:** Treasury

**Commencement:** Schedule 2 commences from 30 June 2004; the remaining provisions commence on Royal Assent.

### Purpose

The purpose of the Bill is to repeal the existing, and insert a **new section 197** into the *Corporations Act 2001* so as to correct a perceived anomaly arising due to the interpretation placed upon the section by the Supreme Court of South Australia. The Bill also proposes a technical amendment to subsection 1462(2) of the Corporations Act.

### Background

#### Corporate trustees

In order to understand the existing section 197 of the Corporations Act and the proposed changes, it is necessary to have an appreciation of trusts and the role of a corporate trustee. A 'trust' is a 'fiduciary relationship in which one person is the holder of an interest in property but is subject to an equitable obligation to use or keep that property for the benefit of another person or for some committed object or purpose'.<sup>1</sup> A 'corporate trustee' is a company that fulfils the role of the holder of the interest subject to an equitable obligation in a trust. Like all companies, corporate trustees act through their agents – usually their directors. When a trustee, individual or corporate, properly incurs liabilities on behalf of the trust, they are entitled to be indemnified out of the trust assets for those liabilities. Persons contracting with trustees are entitled to be subrogated to – that is, entitled to assume – the trustee's right against the trust assets. In the case of persons seeking to enforce rights against corporate trustees, two problems can arise:

- where the trustee has lost its right to be indemnified out of trust assets (which can occur either because of improper conduct by the trustee or through terms of the trust limiting the right of indemnity), then the creditor cannot access those assets or
- where the trust has no assets or insufficient assets to meet the liability.

These are the circumstances that give rise to the issues surrounding section 197 of the Corporations Act.

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## Section 197 Corporations Act 2001

In 1985 section 229A (the forerunner to section 197 Corporations Act) was inserted into the now defunct Companies Codes. Its purpose was ‘to ameliorate the consequences for creditors where there is no access to trust funds to meet liabilities incurred by a corporate trustee’.<sup>2</sup> It achieved this by imposing liability on both the trustee corporation and its directors where debts were incurred by a trustee corporation and that corporation was for any reason not entitled to be indemnified out of the assets of the trust.<sup>3</sup> Both the wording of section 229A and the explanatory material accompanying the relevant Bill made clear that the phrase ‘not entitled to be indemnified out of the assets of the trust’ referred to the legal right of indemnity and not to circumstances where the indemnification could not occur due to lack of trust assets.<sup>4</sup>

In 1990 section 229A became section 233 of the Corporations Law and in 1999 it was repealed and replaced with section 197 of the Corporations Act, which had been rewritten apparently without any intent to substantially change its effect.<sup>5</sup> The rewritten section 197 was considered by the Supreme Court of South Australia in *Hanel v O’Neill* [2003] SASC 409. The wording of the rewritten section is in much less clear terms than its predecessor. By majority, the Court interpreted the phrase ‘not entitled to be indemnified out of the assets of the trust’ to include circumstances where indemnity could not practically be achieved because of a lack of trust assets. The most potent objection to the decision is this:

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.<sup>6</sup>

The proposed new section 197 will effectively return the regulatory position to that under the original section 229A. Among the critics of the decision in *Hanel* is the Business Section of the Law Council of Australia and it is from a submission of that body that the proposed new section 197 is, in substance, drawn.<sup>7</sup> An article, in substantially the same terms as the Law Council submission, has been published in the *Company and Securities Law Journal*.<sup>8</sup>

## Subsection 1462(2)

In 2004 the Corporations Act was amended to provide for a new auditor independence regime. Subsection 1462(2) is a transitional provision applying the new regime for auditor independence to financial years commencing after 1 July 2004. The intention was that the requirements for auditor independence outlined in repealed sections 324 and 331AA of the Corporations Act would continue to operate in respect of financial years commencing prior to 1 July 2004. Because the latter was not expressly mentioned in section 1462(2), it could be argued that the provisions in sections 324 and 331AA no longer apply even in respect of financial years commencing prior to 1 July 2004. The proposed amendment is

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intended to ensure that the auditor independence provisions in sections 324 and 331AA continue to apply in relation to financial years commencing prior to 1 July 2004.

## Main Provisions

**Schedule 1, clause 1** of the Bill repeals the existing section 197 of the Corporations Act and inserts a new section 197 which makes trustee corporations and their directors liable to trust creditors where the trustee corporation is not entitled to be fully indemnified out of trust assets solely because of:

- (i) a breach of trust by the corporation
- (ii) the corporation's acting outside the scope of its powers as trustee or
- (iii) a term of the trust denying, or limiting, the corporations right to be indemnified against the liability.

**Schedule 2, clause 1** clarifies the operation of section 1462(2) of the Corporations Act.

## Concluding Comments

In substance, the Bill overrides the decision of the South Australian Supreme Court in *Hanel v O'Neill* and ensures that the liability of directors of trustee corporations will extend only so far as intended when section 197 was introduced in its original form in the corporations legislation.

## Endnotes

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- 1 B. Marks and R. Baxt, *Law of Trusts*, CCH Australia, Sydney, 1981, p. 2.
  - 2 Explanatory Memorandum, Companies and Securities Legislation (Miscellaneous Amendments) Bill 1985, p. 88.
  - 3 Companies Act 1981, section 229A(1).
  - 4 Companies Act 1981, section 229A(2) and Explanatory Memorandum, op. cit., note 2.
  - 5 The explanatory memorandum to the Corporate Law Economic Reform Bill 1998 (at p. 31) asserts that the provision of Part 3.2 (which contained section 233) would be subject to a 'rewrite without substantial change'.
  - 6 Explanatory Memorandum, Corporations Amendment Bill (No. 1) 2005, p. 6.

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- 7 Corporations Committee, Business Law Section, Law Council of Australia, 'The decision in *Hanel v O'Neill* – legislative clarification required', 21 May 2004.
- 8 J. Cooper, 'Piercing the "veil of obscurity" – the decision in *Hanel v O'Neill*', *Companies and Securities Law Journal*, vol. 22, 2004, p. 313.

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