**

***LENDING WHERE TRUSTS ARE INVOLVED***

# **Definition**

A trust, in the legal and commercial sense, is money or property vested with an independent third party, known as the trustee, who administers it on behalf of others, who are known as the beneficiaries of the trust.

The functions of a trust vary in many ways. They can be used to separate the management of trust property from the enjoyment of it. Property can be managed for the benefit of people who are unable to effectively do so themselves, such as children, the very elderly or handicapped people. Deceased estates are generally administered by way of a trust (the executor becomes the trustee). Superannuation schemes for employees are usually established under trust arrangements. Trusts can be used for socially useful purposes, such as charitable trusts for the benefit of educational or religious institutions, the poor or medical research. Variety Australia is a well-known example of a charitable trust.

There are different types of trust, the most common being:

*Unit Trust –* where the beneficiaries are the unit holders, whose ownership of units determines the proportionate interest each has in the distribution of income and capital. Unit trusts may range from those found in family business structures to listed property trusts, cash management trusts and equity trusts. The trustee usually has no discretion in respect of income or capital distribution.

*Discretionary Trust –* where the interests of the beneficiaries are not fixed in any specific proportions by the trust deed. The trustee is given the discretion to determine the amount, timing and beneficiaries of any income or capital distribution. This form of trust is generally used for family income and taxation planning, as income can be divided among the family members (beneficiaries) so as to minimise tax liability. If dealing with a family trust, it is highly likely to be a discretionary trust.

*Hybrid Trusts (comparatively rare)* – a hybrid trust is both a discretionary and a unit trust. A certain portion of the trust property must be applied to the unit holders, with the trustee having a discretion as to the application of the balance. The terms of the trust deed will specify the manner in which the trust is to operate.

## **Creating a Trust**

A *settlor* (usually a person, but can be a company) transfers a sum or asset to the trustee (who may be a person or company) for a specific purpose and for the benefit of specified beneficiaries. The settled amount can be any sum, and after that the trust can accumulate its own funds. The beneficiaries (some of whom may not be known as they have yet to be born) have an equitable interest in the trust fund.

## **Trust Powers**

The trustee manages the trust in accordance with the wishes of the Settlor, as set out specifically in the trust deed, in the form of powers given to the trustee to manage or administer the trust fund. The trustee’s powers are restricted to the powers contained in the trust deed and in relevant State legislation such as the *Trustees Act, 1925* (N.S.W.).

## **Legal Capacity**

A very important point to note is that a trust is **not** a legal entity. The trustee contracts for the benefit of the trust. Hence, when a financial institution enters into transactions with a trustee, the borrower will be described as:

“(Name of trustee) as trustee for the (name of trust)” e.g. “William Henry Thomas as trustee for the Thomas Family Trust” or “ABC Pty. Ltd. as trustee for the Thomas Family Trust”.

Liabilities of a trust are incurred in the name of the trustee, personally, given that the trust is not a legal entity. The trustee will generally have the right to be indemnified out of the trust property for liabilities the trustee incurs on behalf of the trust. Limitations on the level of indemnity will be specified in the trust deed. The beneficiaries of the trust are not liable in any way for the actions of the trustee undertaken on behalf of the trust and if a trustee is changed, the new trustee is not liable for the liabilities incurred by the previous trustee.

For these reasons, lending institutions will generally require guarantees, from the trustee in its own right. That is, from the trustee insofar as it has assets and operations of its own that are unconnected with the trust. Where the trustee is a company, personal guarantees will be sought from the directors of the trustee company. Where possible, some lenders may seek to obtain personal guarantees from the beneficiaries. This is to avoid situations where the trust distributes income, leaving the trust with insufficient funds to meet the debts incurred by the trustee.

## **Can you lend to a trust?**

## A lender cannot directly provide finance to a trust. Instead, when a transaction involves a trust, the lenders will be providing the finance to the trustee as borrower.

The description of the borrower should not contain any reference to the capacity in which the trustee is acting. For example, the borrower would be described as ABC Limited, as that is the legal borrowing entity borrowing.

However, to make it clear that the lender will have access to the trust assets, a clause should be included in the loan contract to acknowledge that the trustee is liable in its own right and in its capacity as trustee of the relevant trust.

Five key issues to consider when lending to a trustee:

##### The trustee’s right of indemnity

A trustee is personally liable for its obligations incurred as trustee of a trust. However, the trustee will usually have a right to be indemnified from the trust assets. The trustee’s right to be indemnified from the trust assets is usually explicitly set out in the trust deed. It is usual to provide that the trustee will be indemnified except to the extent that a loss is caused by the fraud, negligence or willful default of the trustee.

A lender to a trust will only have recourse to the assets of the trust to satisfy its obligations under the loan agreement through the trustee’s right of indemnity.

It is therefore very important to ensure that the trustee has all the necessary power under the terms of the trust to do what the trustee intends to do. The powers to act will usually be contained in the trust deed. If the trustee does not have the power, it will not have the right to be indemnified out of the assets of the trust. For a lender, this could mean that it will only have recourse against the trustee personally and not to the assets of the trust, which may see the lender being an unsecured creditor of the trustee – an unintended and undesirable position to be in.

ABN v. ACN

Australian Company Numbers or ACNs were introduced to the *Corporations Act* many years ago. The purpose was to give a unique identifier number to each company.

Australian Business Numbers or ABNs came along with the introduction of GST in 2000. The ABN for most companies is the ACN plus a two-digit prefix.

A single company can have more than one ABN. A separate ABN may be held in respect of the enterprises in conduct in its capacity as trustee of a trust. Many pro-forma legal documents now provide the option for inserting the ABN or the ACN. However, the use of an ABN could unintentionally reduce or limit the operation of a legal agreement.

Consider the following example:

Company X has an ABN for itself and also the discretionary trust under which its main business is conducted.

If Company X is described in a loan agreement by using the ABN for the company; arguments could arise as to whether the lender will have any recourse to the trust assets. This would be so despite a general clause saying that Company X enters the agreement in its own right and as a trustee of any trust. The argument could arise because the specific use of a specific ABN may override general catch all provisions.

An even more awkward situation could arise if the ABN for the discretionary trust was used. As trusts do not comprise a separate legal entity, arguments could arise as to whether the trustee is a party to the transaction. This could jeopardize the validity of the entire loan arrangement.

One would hope that in the ordinary course, courts will prevent parties avoiding commercial obligations by use of this type of argument. However, a party could gain valuable time while arguing the point, particularly when it is a novel point which has not previously been considered by the courts.

Therefore, it is preferable whenever preparing a legal contract (whether it takes the form of a formal deed, an agreement, or an exchange of letters) to use ACNs and not ABNs. However, ABNs are required on tax invoices.

##### Removal of a trustee

##### The removal of a trustee is regulated by the trust deed. Trust deeds frequently provide for the automatic removal of the trustee without the appointment of a replacement trustee in the following circumstances:

##### If the trustee, being an individual, is found to be of unsound mind or becomes bankrupt.

##### If the trustee is a company, it enters into liquidation (whether compulsory or voluntary), is placed in receivership or under official management order of any court.

##### Lenders do not want the trustee to be automatically dismissed because if the lender enforces its security against the trust assets, the act of appointing a receiver will immediately terminate the office of the trustee. It may then be necessary to apply to court for the appointment of a replacement trustee, which will cause delay and cost.

##### It is recommended that any trust deed, which provides for the automatic removal of the trustee without a replacement trustee being appointed be amended prior to settlement.

### Serviceability Assessment

Where the trust has been established for asset holding purposes only, and has no income as such, loan serviceability assessment is completed for the trustee, be it an individual or company, as if the trustee were applying for the loan in their own right. Income and commitment calculations and evidence requirements are as per MoneyQuest standards.

#### If trust income is being relied upon to service debt, it will need to be assessed. For this to take place, the most recent 2 years’ accounts will need to be obtained (note that some lenders may require 3 years). The important information to provide to the lender relates to what type of income the trust receives and from where or what activities, how permanent the income stream is and who has effective control over how the income is distributed to beneficiaries.

It may be necessary to assess both the trust and the Trustee income and commitments. These can be combined to derive final amounts upon which serviceability can be assessed. In such cases, it will probably be advisable to consult with the lender to gain some understanding of the most appropriate way to analyse the figures involved.

### Lender fees

Note that loans where trusts are involved are more complex and require considerably more documentation than a “standard” loan. Consequently, the fees payable by the client will be more than what would normally be paid. The lender legal fees will not be fully covered by the standard Application Fee – it is advisable to confirm with the lender the likely fees payable before quoting to the client.

Similarly, because the trustee will need to execute a guarantee, the lender will often seek the use of an independent legal advisor by the trustee. This will impose an additional cost to the borrower.

## **Conclusions in relation to trusts**

* Always ensure that the trust has power to enter into the transaction. Always ensure the borrower is bound in both capacities – personal and as trustee.
* When preparing a legal contract, use ACNs and not ABNs.
* Ensure the trust deed does not provide for the automatic removal of the trustee without a replacement trustee being appointed.

Loans involving trusts can be somewhat daunting and will necessitate obtaining a good deal more documentation that is usually involved. Analysing and assessing the financial records applicable to the application may well require some assistance, that the Compliance team is always pleased to provide. Never hesitate to contact them if you are uncertain of how to approach a potential application, what questions you need to ask and what information and documents you will need to gather.

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