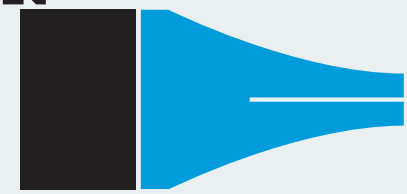
Director's breach of fiduciary duties results in a clawback of super contributions



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Directors of corporate trustees should beware: breaches of their fiduciary duties can result in amounts taken out of the trust, including super contributions, being clawed back.

Introduction

The decision of the Victorian Court of Appeal in *Australasian Annuities Pty Ltd (in liq) v Rowley Super Fund Pty Ltd*[1] (*Rowley Super*) concerns the ability of a liquidator to claw back contributions made to a superannuation fund where such contributions are made as a result of a director breaching his fiduciary duties to the corporate trustee of a discretionary trust. The court unanimously upheld the trial judge's decision that the director breached his duties to the shareholders of that company. However, a 2:1 majority allowed the appeal from the Supreme Court on the basis that the sole director of the discretionary trust trustee was also the controlling mind of the corporate trustee of the self-managed superannuation fund (SMSF) and therefore the knowledge of the director's breach could be imputed on the SMSF trustee.

What some directors (and their advisers) may find concerning about the outcome of the appeal decision is the fact that this type of transaction occurs regularly and is often seen as a "normal" transaction.

The facts of Rowley Super

While the decision of Almond J in the original Victorian Supreme Court decision of *Rowley Super*[2] is discussed in a previous article,[3] it is worthwhile reconsidering the facts and findings of the case at first instance.

Steven Rowley (Steven) was the sole director of Australasian Annuities Pty Ltd (AA). AA was the corporate trustee of a discretionary trust that provided management, administration, accommodation and staffing services to a financial planning business run by London Partners Pty Ltd (London Partners).

London Partners held the relevant financial services licence to operate the financial planning business. AA received a yearly service fee from London Partners that was equivalent to 95% of the client commissions received by London Partners.

Steven also had an SMSF, known as the Rowley Superannuation Fund (RSF). The members (and, prior to 2008, the trustees) of the RSF were Steven, his wife Barbara, and their two sons.

The relevant transactions took place in 2006 and 2007, when the then government announced changes to the superannuation laws, including the introduction of contribution caps and the ability to make up to $1m of non-concessional contributions into superannuation funds before 30 June 2007. Steven had discussions with his accountant and a remuneration strategy consultant in late 2006 to discuss strategies in relation to utilising the deductible contributions limits, making contributions under the transitional $1m non-concessional contribution cap, and taking advantage of the ability to roll over eligible termination payments (ETPs) into a superannuation fund prior to 1 July 2007.

The agreed strategy involved a mixture of contributions from AA to the RSF (as employer contributions and ETPs) and from Steven and Barbara to the RSF (as member contributions). This resulted in the following amounts being paid to the RSF:[4]

> "14. In the financial year ending 30 June 2007, a sum of $1,341,528 ('the First Sum') comprising:
>
> - $225,560 transferred directly by AA into [the RSF's] account; and
> - $1,115,968 being part of moneys transferred by AA to the personal account of Steven and Barbara Rowley, which was immediately transferred to [the RSF's] account.
>
> 15. In the financial year ending 30 June 2008, a sum of $372,296.99 ('the Second Sum') comprising:
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> - five payments totalling $204,088.72 transferred directly from AA's account to the [RSF's] account;
> - a payment of $118,583.27 to the personal account of Steven and Barbara Rowley which was then immediately transferred to the [RSF's] account; and
> - a payment of $49,625 for stamp duty on the purchase of a property for the benefit of the [RSF]."

In order to finance these contributions, AA borrowed approximately $2.5m from Macquarie Bank. Macquarie Bank was aware that the purpose of the loan was to make superannuation contributions.

In 2008, the individual trustees of the RSF were replaced as trustees with Rowley Super Fund Pty Ltd (RSFPL). Its directors were the same as the original trustees.

Sometime after that change of trustees, AA went into liquidation, with the main creditor being Macquarie Bank.

The liquidator brought actions against Steven and RSFPL on the basis that Steven paid money out of AA in breach of his fiduciary duties and that RSFPL (and its predecessor trustees) received those payments with the knowledge of those breaches. Ultimately, the liquidators only proceeded against RSFPL, as Steven was declared bankrupt.

When considering whether AA was entitled to claw back the payments made to the RSF, Almond J considered the following questions:

- Did Steven breach fiduciary duties owed to AA in his capacity as director?

- Did the shareholders of AA prospectively assent to the transactions?
- Did the shareholders of AA ratify the transactions?
- Was there "knowing receipt" of trust property by the RSF?
- Was the RSF a volunteer?
- Does the subsistence of a debtor/creditor relationship prevent the maintenance of AA's equitable claim?
- Is AA disentitled to equitable relief on the basis of having "unclean hands"?

These questions were reconsidered by each of the judges of the Court of Appeal. In this article, we have not discussed the last two questions.

Did Steven breach fiduciary duties owed to AA in his capacity as director?

Broadly, Almond J examined three fiduciary duties of directors:

(1) the duty to act in good faith and in the best interests of the company;

(2) the duty not to exercise powers for improper purposes; and

(3) the duty to avoid conflicts of interest.

His Honour found that causing AA to borrow $2.5m and then allowing those trust funds to be depleted by making substantial contributions to the RSF and by making non-interest bearing loans to Steven (so that he and his wife could make personal contributions) was not in the best interests of AA. Further, it was found that, regardless of the fact that AA had the power to make such payments (under the powers granted by the relevant trust deed), such powers were not sufficiently wide enough so that AA could make any payment that it liked. Further, the fact that AA was a trustee bore on Steven a duty to consider the legitimate interests of the beneficiaries of such a trust, which was found to not have occurred.

RSFPL submitted to the Court of Appeal that Almond J was incorrect in distinguishing between Steven's role as a director of AA and his role as a shareholder (together with Barbara), and that such a distinction was an artificial one. In addition, RSFPL argued that the trial judge erred when taking into account the beneficiaries of the trust, as no beneficiaries complained about the transaction, all beneficiaries were related to Steven and Barbara, and the fact that the trust was of a discretionary nature meant that the beneficiaries' limited interests should not be taken into account in the assessment of Steven's breach of his fiduciary duties.

All three Court of Appeal judges agreed with Almond J's decision that Steven acted in breach of his fiduciary duties to AA in his capacity as sole director. In relation to the interaction between the director's duties to a corporate trustee and a corporate trustee's duties to the trust and beneficiaries, Garde AJA held that:[5]

> "In circumstances where a company is a corporate trustee, a director acting in the best interests of the company as a whole must act in good faith to ensure that the company administers the trust in accordance with the trust deed having regard to the rights and interests of the beneficiaries of the trust. The best interests of the company as a corporate trustee are to act properly in accordance with the trust deed in managing the business of the trust and in dealing with the assets and liabilities of the trust. A director of a corporate trustee must act in good faith to ensure that the company complies with its obligations as a trustee, and properly discharges the duties imposed on it by the trust deed and by trust law generally. It is not in the best interests of the company for it to act in breach of its duties of a trustee, for the company has assumed the responsibilities of that office and must see to it that they are fulfilled."

The court held that Steven did not give consideration to his duties as a director of AA or to his duties to the trust for which he acted as trustee. These findings were primarily based on Steven's evidence that he effectively treated the assets of the trust as his own and that "he clearly assumed the interests of AA and the interests of RSF and the Rowley family were one and the same".[6]

In relation to RSFPL's argument that the beneficiaries of a discretionary trust do not need to be considered (given their limited rights), Garde AJA found that:[7]

> "Although in the case of a discretionary trust, a member does not have any present entitlement to the trust assets, the member does have standing to compel the proper administration by the corporate trustee of the trust. This is not disputed. The director should act in good faith to ensure that there is no cause for legitimate complaint by a beneficiary about the administration of a trust for which the company is responsible."

These findings, while correct from a trust law perspective, are arguably not consistent with how most modern discretionary trusts are administrated. That is, while such trusts are notionally established for the benefit of a wide class of beneficiaries, in reality they are administered for the nuclear family of the controllers of the trust. In that sense, this case can be seen as a "wake-up call" for trustees of discretionary trusts (and directors of corporate trustees) to consider their fiduciary duties when administering a trust.

It shows the importance of ensuring that proper trustee procedures are followed. This includes whether the common recommendation that trustees should not give reasons continues to be the correct approach. For example, would the court's decision be different if Steven, as director of AA, gave reasons under which proper consideration of the beneficiaries were given?

Further, the Court of Appeal agreed with Almond J's finding that the ETPs were not genuine ETPs (and were in fact a charade[8]) as both Steven and Barbara had not retired and had no intention of retiring at the time when those payments were made.

Did the shareholders of AA prospectively assent to the transactions?

RSFPL submitted before Almond J that AA's shareholders (Steven and Barbara) assented to the transactions before their implementation. Almond J agreed that, if such assent occurred and was effective, then Steven would not be liable to AA for his breaches. As Steven was the controlling mind behind the restructure and the transactions, it was found that he had assented to them. The question then became whether Barbara also provided such assent.

Before the Court of Appeal, RSFPL contended that Barbara's consent was informal and occurred at or about the time of the transactions. All three judges of the Court of Appeal rejected this argument and agreed with the trial judge's findings that Barbara did not assent to the transactions before they were implemented. This was because Barbara's knowledge of the transactions was vague (as she relied on Steven to deal with the family's financial transactions) and was not in a position to give informed consent. Her signing of the financial statements of AA was of no assistance as those financial statements did not outline the details of the transactions. Further, the occurrence of the AA meetings, purportedly in the presence of Barbara as evidenced by the minutes of meetings, was queried by the court to have occurred at all.

The Court of Appeal held that, at the most, Steven told Barbara of the superannuation opportunity but did not inform her of the number, nature and magnitude of the transactions, and such detail provided to Barbara was insufficient for Barbara to give fully informed consent. For instance, Garde AJA held that Barbara was "not sufficiently knowledgeable or familiar with the transactions to give her informed consent and the transactions were not exposed to her in sufficient detail".[9]

Did the shareholders of AA ratify the transactions?

Before the Court of Appeal, RSFPL submitted that the trial judge erred in finding that the shareholders of AA did not later ratify the transactions. RSFPL contended that Barbara left Steven with the responsibility of conducting AA's affairs and took little interest in such affairs. On this basis, she was not in a position to later complain of Steven's conduct, as a director, in discharging his obligations to AA's shareholders. In the alternative, it was submitted that Barbara subsequently ratified the breach in her witness statements during the court proceedings.

Almond J at first instance did not accept that Barbara ratified any breach of director's duties (for essentially the same reasons given for rejecting the assent submission). Particularly, there was considerable doubt as to whether Barbara attended any meetings where accounts were approved by Steven and Barbara as shareholders.

The Court of Appeal agreed with the trial judge that Barbara had insufficient knowledge of the transactions to give informed consent at the time of the breaches. In addition, the subsequent ratification was found to be ineffective as AA was at that time in liquidation. This was on the basis that "where the interests at risk are those of creditors, the shareholders are unable to authorise the breach".[10] In addition, it was found that "[l]ittle value attaches to the alleged consent in the witness statement".[11]

Although Garde AJA declined to decide the issue, his Honour did raise the possibility that a shareholder could not ratify a breach of fiduciary duties where the company is the trustee of a trust:[12]

> "As a matter of principle, there would appear to be significant difficulties in the way of the proposition that a director of a corporate trustee can be absolved of a breach of fiduciary duty by failing to act in good faith to ensure that the company properly administers the trust merely because shareholders who may have no actual or contingent interest in the affairs of the trust are prepared to give their consent. While Steven Rowley was a beneficiary of the Rowley Family Trust, no informed consent was given by any other beneficiary to any of the transactions. The transactions profoundly and adversely affected the interests of the beneficiaries ultimately resulting in the insolvency of the trustee."

If this principle is adopted by the Courts it would be almost impossible for ratification to occur for a typical modern discretionary trust (given the large number of discretionary objects of such trusts).

Was there "knowing receipt" of trust property by the RSF?

Although successful in proving the breach of fiduciary duties, the liquidator also had to establish that the trustee(s) of the RSF had received the contributions with the knowledge of Steven's breaches (in order to be able to claw back such contributions).

While the trial judge accepted that an individual may be regarded as the directing mind of a company, he did not find, in this instance, that the knowledge of Steven as co-trustee could be imputed to the other trustees or that he was the controlling mind of RSFPL. This was mainly due to the fact that there was little evidence to establish that Steven was the directing mind of RSFPL (for example, there was no evidence as to how the RSF's investments were chosen or managed).

RSFPL as trustee of the RSF

In dissent, Warren CJ agreed with the trial judge that there was insufficient evidence to find that Steven was the controlling mind of RSFPL. For example, much of the cross-examination of Steven appears to have been in relation to Steven's control of AA, while little evidence was given, or sought, in relation to Steven's involvement in RSFPL.

However, the majority of Garde AJA and Neave J held that the trial judge erred in his findings that Steven's knowledge could not be imputed to RSFPL. Garde AJA found that Steven was the controlling mind of RSFPL as a result of the following:[13]

- the evidence showed that Steven was the only active director of RSFPL and was the directing mind of all transactions and payments to the RSF;
- there was no evidence that Barbara or their two sons were active directors of RSFPL;
- every transaction before the court in relation to the RSF or RSFPL was engineered by Steven; and
- there was no other evidence to establish that any other person was the directing mind of RSFPL other than Steven.

On this basis, it was found that Steven was the directing mind and will of RSFPL (in addition to being the controlling mind of AA). As such, Steven's knowledge was imputed to RSFPL. According to Garde AJA, this knowledge included knowledge obtained by the individual trustees before the appointment of RSFPL.

Individuals as trustees of the RSF

The trial judge initially held that the knowledge of Steven could not be imputed to the individual trustees as there was no agency. The Court of Appeal unanimously agreed with the trial judge's findings and held that to impute Steven's knowledge on the other trustees, who had no real knowledge of the transactions undertaken by Steven, would be unfair and unjust.

The reason for the different approach, as between the individual trustees and the corporate trustee, was on the basis that the "controlling mind" principle does not apply to individual trustees.

Was the RSF a volunteer?

The liquidator further attempted to argue that the trustee(s) of the RSF received the trust property as volunteers by way of gift and therefore (regardless of the knowledge of the trustees/directors) the RSF was either liable to AA for the money it had received (the personal claim) or liable to account to AA as constructive trustee of the money or its traceable proceeds (the proprietary claim).

The trial judge found that the trustee(s) of the RSF were not volunteers on the basis that the contributions had been provided for valuable consideration in accordance with the High Court decision in *Cook v Benson*.[14]

Warren CJ and Garde AJA agreed with the decision of the trial judge that the members of the RSF received valuable consideration in the form of obligations to provide them with sums (ie benefits). However, interestingly, Neave JA distinguished *Cook v Benson* on the basis that that case involved contributions to commercial superannuation funds, whereas this case

involved a related SMSF. Her Honour found that "it would be 'artificial in the extreme' to treat it as a purchaser for valuable consideration when it received AA's monies".[15]

Key practical lessons from the case

The Court of Appeal's confirmation that Steven breached his fiduciary duties to AA is a further example of the courts' willingness to hold the controllers of discretionary trusts to the high standard of fiduciaries under trust law, even where that trust is involved in a "normal" commercial transaction. It is particularly noteworthy that such transactions occurred in the context of individuals trying to take advantage of a government-sponsored transitional opportunity to make superannuation contributions (at a time where many similar transactions were entered into) and that this was done with the full knowledge and consent of the lender (being the major creditor).

Where trust controllers wish to enter into similar transactions, they should consider the following to protect themselves against a similar finding:

- directors of corporate trustees should:
  - comply with and fully document their decision-making processes; and
  - consider documenting the reasons for their decision, including why they considered entering into the transaction and that they have considered all relevant persons (eg shareholders, creditors and beneficiaries of the trust);
- shareholders of the corporate trustee should contemporaneously assent (or subsequently ratify) any breaches by the directors of their fiduciary duties;
- there should be clear evidence that meetings of companies and shareholders are held or, alternatively, resolutions should be signed by all directors/shareholders (for example, by circulating resolutions as opposed to simply have a chair sign the minutes);
- "passive" shareholders/directors should be fully informed and have an understanding of the transactions, should attend meetings and sign relevant documents, or alternatively, they should be removed as directors/shareholders;
- where possible, different entities within a family group should have different controllers and shareholders so that knowledge of one entity cannot be imputed on another entity;
- independent persons could be introduced to director roles to reduce the link between entities and to establish that one person is not the controlling person of each company; and
- the use of individual trustees for superannuation funds where there is concerns that the "controlling mind" principal could apply (although it is generally preferable to use a corporate trustee where those concerns are not present).

Conclusion

The Court of Appeal's decision serves as a timely reminder that directors of private companies, including where such companies act as trustee of a trust, are subject to fiduciary duties and cannot simply do as they wish with the assets of the company or the trust. This is especially important where a number of entities are part of the same family group and the controlling mind of each entity is the same person.

Controllers of such groups often assume that money held by different entities (albeit a part of the same family group) is theirs to do with as they please as it is all the "family's money". This case demonstrates the danger of this approach and that it is important for directors and shareholders to have correct processes in place to ensure that decisions are adequately documented to reduce the risk that breaches of duties will occur.

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References

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5 *Rowley Super* [2015] at [228].
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