# Does the corporate shield protect directors of company trustees?

Andrew Steele, Barrister, Auckland, on *Guest v Guest*

The Court of Appeal in *Guest v Guest* [2019] NZCA 64 imposed court costs on Mr L notwithstanding that:

- He was not a named party in the proceeding; and
- The relevant named party was a company trustee incorporated for the admitted sole purpose of insulating Mr L from 'trustee' liability.

Mr L apparently believed that as a director of the company, the corporate shield would protect him from personal liability for the company's conduct in the administration of the trust.

It is commonplace for lawyers and accountants to use companies to act as trustees rather than acting in the role personally. It is argued there are administrative advantages, for instance, it allows for changes in directors (usually the professionals acting as the company's mind) without there having to be formal transfer of title because the company as 'trustee owner' is unchanged. The shareholders' power to remove and appoint directors mean that they become, in effect, the appointor of trustees, but without the usual fiduciary obligations associated with such powers of appointment (soon to be codified in s 94 of the Trusts Act 2019).

It is also argued that the company's status as a separate legal entity provides a 'shield' for the directors against the liability that a personal trustee ordinarily bears.

In this article, I venture to answer the following questions:

1. To the extent that a company structure provides a shield against personal liability for its directors, has *Guest v Guest* undermined the shield's effectiveness?
2. Aside from *Guest*, does the corporate structure provide an effective shield against personal liability for the company's directors in relation to the company's actions qua trustee?

## THE CORPORATE SHIELD AND *GUEST V GUEST*

The corporate shield or corporate veil arises from the long-standing common law rule, more-or-less codified in s 15 of the Companies Act 1993, that a company is a legal entity in its own right separate from its shareholders (and directors). So contractual or even tortious liability of a company does not become the liability of the company's directors or shareholders.

Chadwick LJ in *MCA Records Inc v Charly Records Ltd* [2003] 1 BCLC 93 at [49] stated:

> … a director will not be treated as liable with the company as a joint tortfeasor if he does no more than carry out his constitutional role in the governance of the company - that is to say, by voting at board meetings. That, I think, is what policy requires if a proper recognition is to be given to the identity of the company as a separate legal person.

When one sees a court apparently 'looking through' a company who is named party in proceedings to impose costs on that company's director, as occurred in *Guest v Guest*, one might apprehend that the court had, effectively, lifted or pierced the corporate veil.

But this is not what occurred. Court costs are not like other forms of liability or expense. They do not arise from the administration of a trust, instead they are imposed at the court's discretion as governed by the Court Rules.

In *Guest*, the Court of Appeal stated that it was settled law (settled in *Erwood v Maxted* [2010] NZCA 93, (2010) 20 PRNZ 466 at [18]) that an award of costs may be made against a non-party. The power derives from s 53 of the Court of Appeal (Civil) Rules 2005 and High Court Rule 14.1(1). The applying principles include consideration of what the non-party stood to gain from, and the level of their involvement in, the proceedings. So no lifting of the corporate veil is necessary. The Court did not refer to s 71 of the Trustee Act 1956, but presumably that section might have afforded the Court another route to imposing costs on Mr L.

On this analysis, a 'corporate shield' is ineffective against the possibility that a court may order costs against the director of a company trustee.

## DO COMPANIES OTHERWISE PROVIDE DIRECTORS WITH A LIABILITY SHIELD?

Company law students learn early on that s 15 of the Companies Act 1993 codifies the fundamental common law principle, ratified in such celebrated cases as *Salomon v A Salomon & Co Ltd* [1897] AC 22 and *Lee v Lee's Air Farming* Ltd [1961] NZLR 325 (PC), that a company is a legal personality separate from its directors and shareholders.

The 'corporate veil' resulting from the company's separate legal personality effectively shields shareholders from the company's liabilities (codified in s 97 of the Companies Act). For the most part, the directors of a company are similarly shielded, but their protection is subject to a multitude of exceptions including, but not limited to, the duties imposed on directors in ss 131 to 137 of the Companies Act and in common law. Perhaps the foremost of these is s 131 obliging a director to act in good faith and in what the director believes to be the best interests of the company.

The corporate shield is a crucial element of the utility of operating a business through a company. It exists to protect directors and shareholders from the risks inherent in business ventures. This is underscored by the listed purposes in the long title of Companies Act 1993, the first of those being:

> … to reaffirm the value of the company as a means of achieving economic and social benefits through the aggregation of capital for productive purposes, the spreading of economic risk, and the taking of business risks.

In 1989, the Law Commission issued a report entitled *Company Law: Reform and Restatement* (NZLC R9, 1989) which included the view that the Companies Act 1955 had been undermining the ability of a company to operate as a vehicle for the taking of business risk (see at [516]). The Companies Act 1993 arguably addressed this concern.

Consistent with the above, the courts do not ignore the concept of separate legal personality, that is, lift or pierce the 'corporate veil', unless the circumstances establish that the persons

controlling the company have acted fraudulently or where the company is regarded as a sham or where a company is used to avoid an existing legal duty. In other words, it will be done if the law requires it to be done to identify the real nature of a transaction (see *A- G v Equiticorp Industries Group Ltd (in stat man)* [1996] 1 NZLR 528, (1996) 7 NZCLC 261,064).

The responsibilities and duties imposed on company directors are very similar to those imposed on trustees of trusts. Presumably, this reflects the fact that a director is a trustee of the company's assets. Both directors and trustees are bound by long recognised and analogous fiduciary duties.

P L Davies, author of Gower's *Principles of Modern Company Law* (10th ed, Sweet & Maxwell, London, 2016) at 598–599 observed that directors' duties come under two heads:

(1) Fiduciary duties of loyalty and good faith (analogous to the duties of trustees stricto sensu); and

(2) Duties of care and skill (differing fundamentally from the duties of normal trustees).

The latter distinction will, arguably, fall away when s 29 of the Trusts Act 2019 comes into force to impose a default statutory duty on trustees to exercise the care and skill that is reasonable in the circumstances.

With the above in mind, I consider the peculiar position of directors of company trustees.

## COMPANY TRUSTEES

The typical company trustee does not engage in any business venture on its own account. So, some of the key purposes of the corporate veil – spreading of economic risk, and the taking of business risks – are not engaged.

The company trustee invariably acts solely as a trustee and usually for a single trust. The company owns assets only qua trustee and hence has no beneficial interest in the trust property. As a result, the company stands on the edge of insolvency. When expenses or liabilities are incurred in the administration of the trust, the company avoids insolvency only by the fact that the expense or liability is balanced by a contemporaneously created, corresponding and equal right of indemnity - itself a proprietary and beneficial interest in the trust property.

The director's potential liability for reckless trading (s 135 of the Companies Act) or possible breach of the obligation in respect to only incurring obligations the company can perform (s 136 of the Companies Act) lurk near. This risk was alluded to in *CIR v Newmarket Trustees Ltd* [2012] NZCA 351, a case involving an insolvent corporate trustee whose directors were lawyers. The company was insolvent because the trust's assets were insufficient to discharge the trustee's liability. The Court of Appeal described as generous the CIR's 'concession' that there had been no conduct on the part of the directors of the company (an asset-less company trustee) that would lay a foundation for claims against them for breach of their duties as directors (at [38]).

Ominously, the Court noted that the liquidator may inquire into the conduct of the directors, particularly given the absence of evidence from the directors of the corporate trustee relating to any system for ensuring that the company's co-trustee complied with his obligations as trustee or for monitoring his activities on behalf of the trust (at [40]).

Do directors of a company trustee have direct personal fiduciary obligations to the beneficiaries of the trust? Avoiding personal liability to creditors arising from a company trustee's administration of the trust is one thing, but does the 'liability shield' extend to the beneficiaries of the trust?

Traditional company law jurisprudence and commentary tends to focus on whether a director's accepted duties to the company, may in certain circumstances extend to the company's shareholders or to other closely owned companies or to the company's creditors. There is little recent jurisprudence as to whether or not a director may owe a fiduciary duty to the beneficiaries of a trust where the company is trustee.

Take *Guest v Guest* – would the courts really have held Mr L free from liability in circumstances where, although he had discharged/fulfilled his directorial fiduciary duties to the trustee company, the company itself had breached its fiduciary duties as a trustee to the beneficiaries of the trust?!

The Trusts Act 2019 was preceded by multiple Law Commission reviews. In its 2012 Issues Paper (NZLC IP31, 2012) the Law Commission stated (at [8.84]):

> It is effectively the case that the directors of the company are to all intents and purposes the trustees, and so should be treated as such. It would seem sensible for the law to recognise the practical reality of the arrangement, notwithstanding the conventional protection of the corporate veil.

And later added (at [8.86]):

On balance, we have concluded that it is preferable to introduce a direct look-through with directors of companies acting as trustees being directly accountable to beneficiaries. We are concerned about the precarious position of beneficiaries and the difficulties involved in attempting to hold a corporate trustee to account through the indirect mechanisms that are currently available. We consider that there is potential for the corporate trustee structure to be used as a means to avoid liability to beneficiaries, and that direct liability on directors is the most straightforward and effective means of addressing this.

Legislation of a 'look through' nature is not without precedent. Section 142(3) of the Financial Markets Conduct Act 2013 provides that a manager of a registered investment scheme established under a trust deed, has the same duties and liability in the performance of its functions as manager as it would if it performed those functions as a trustee.

Another way legislation has made a director of a company trustee liable to the trust's beneficiaries is to empower the court to make enquiry into the director's conduct as was the case in s 27(1) of the now repealed Unit Trusts Act 1960 which provided:

> If, in the course of winding up any company that is the manager of a unit trust, it appears that the company has misapplied or retained or become liable or accountable for any money or property of the unit trust, or committed any misfeasance or breach of trust in relation to the unit trust, the Court may, on the application of the Official Assignee or of the liquidator or of the trustee or of any unit holder, examine into the conduct of any past or present director, manager, or liquidator, or any officer of the company who has been a party to or knowingly permitted the misapplication, retention, misfeasance, or breach of trust, and compel him to repay or restore the money or property or any part

> thereof respectively with interest at such rate as the Court thinks just or to contribute such sum to the assets of the trust by way of compensation in respect of the misapplication, retention, misfeasance, or breach of trust as the Court thinks just.

In its final and summarising report, *Review of the Law of Trusts* (NZLC R130, 2013) the Law Commission proposed that directors of a corporate acting as a trustee should have the same obligations to the beneficiaries of the trust as if they had been the trustees themselves (see [16.9]).

The Law Commission noted that submitters were 'strongly' opposed to the proposal. One wonders why the Law Commission would use the adverb 'strongly'. Surely it is the substance of the opposition that counts not the vehemence of its delivery.

The seven objections noted by the Law Commission are listed below with my brief comment.

Objection 1: The companies legislation already imposes sufficient obligations on directors and there are no problems with the status quo.

Comment: The legislation focuses on directors duties to the company, shareholders and creditors. There is nothing in the Act that addresses the position of a director of a company trustee vis-à-vis the trust's beneficiaries.

Objection 2: It is inappropriate to modify the fundamental principle of limited liability of companies and separate legal personality.

Comment: This is a bare opinion. It lacks an argument or grounds in support.

Objection 3: The proposal would be impractical and ineffective and a significant number of people could become unwilling to act as directors of corporate trustees if liability is expanded.

Comment: This argument is devoid of supporting evidence. It is conjecture to suggest that the proposal will be ineffective and impractical. As a matter of principle, the possibility that a director may conduct the affairs of a trust, but by use of a company avoid the usual duties imposed on trustees seems inconsistent with the jurisprudential underpinnings of fiduciary relationships.

The leading authority in New Zealand regarding fiduciary relationships is arguably the Supreme Court's Judgment in *Chirnside v Fay* [2006] NZSC 68. The Court referred with approval to the following statement by Tipping J in *Estate Realties Ltd v Wignall* [1991] 3 NZLR 482 at 492:

> The word 'fiduciary' derives from the Latin word 'fiducia' the primary meaning of which is trust. Important secondary meanings are confidence and reliance. The cases demonstrate that a fiduciary relationship will arise where one party is reasonably entitled to repose and does repose trust and confidence in the other, either generally or in the particular transaction: see per Casey, J in *Day v Mead* where His Honour said that the relationship in question in that case 'generated that degree of confidence and trust which in my view justifies the intervention of equity'.

In whom do the beneficiaries repose their 'trust and confidence' – the trustee company or the trustee company's directors or both?

Objection 4: The prevalence and usefulness of corporate trustees and that they are generally established for legitimate purposes.

Comment: Even accepting that company trustees are prevalent, useful and legitimate, this does not address the issue of what, if any, responsibility should the controllers and minds of the company have to those whom the company has undertaken to act in the best interests.

Objection 5: That the proposal cuts across the principle that directors owe a duty to the company but not to the beneficiaries of the trust.

Comment: Indeed, the Commission's proposal costs across this principle, but it would not be the first time that this has occurred. The director's principal duty to the company has been extended to include individual shareholders in special circumstances: *Coleman v Myers* [1977] 2 NZLR 225, to closely-owned companies: *Glavanics v Brunninghausen* (1996) 14 ACLC 345 and to creditors when a company is insolvent, or near insolvency: *Nicholson v Permakraft (New Zealand) Ltd (in liq)* [1985] 1 NZLR 242.

I suggest that the issue is not that it cuts across principle, but that it does so on a principled and justifiable basis.

Objection 6: That the proposed change would interfere with the settlor's ability to set up the trust as the settlor wished.

Comment: Settlors are already, or will soon be, constrained in how they may set up a trust. The mandatory duties (s 22) in the Trusts Act 2019 provide one such an example. The statutory bar against indemnifying a trustee for their dishonesty, wilful misconduct, or gross negligence (ss 40 and 41) is another. And the common law bars a trust instrument from ousting the High Court's inherent jurisdiction over the administration of trusts. The reality is that settlors have always been constrained in how they may set up a trust when it comes to the duties and responsibilities of trustees. The question is therefore: Is the proposal to impose fiduciary duties on directors of a company trustee a justifiable interference?

Objection 7: That it would negate the use of a corporate trustee.

Comment: It would remove only one aspect of the 'shield', the other benefits would be unaffected.

Whatever the real strength of the submitters' opposition may be, it sufficed to impel the Law Commission to declare that it would defer further consideration of the issue to an intended future 'corporate trustee review'. The author could discern no date for this review, so one may reasonably expect little legislative change for the foreseeable future.

That leaves development of the law in this area to the courts and equity.

How might the common law proceed?

A sensible starting place for the discussion is the English decision of the Court of Appeal in *Bath v Standard Land Company Limited* [1911] 1 Ch 618. This case obliged the Court to decide whether or not the directors of a company, which itself was in a fiduciary position arising from contract with a stranger, owed a fiduciary duty to that stranger.

The case is best known for the judgment of Cozens-Hardy MR who at 625 stated:

> Directors stand in a fiduciary relation to the company, but not to a stranger with whom the company is dealing. But that does not involve the proposition that if a breach of trust is committed by a company, acting through its board, a beneficiary can maintain any action against the directors in respect of such breach of trust.

And at 627:

> Directors stand in a fiduciary position only to the company, not to creditors of the company, not even to individual shareholders of the company, still less to strangers dealing with the company. This principle applies equally whether the relation between the company and the stranger is one purely of contract, such as principal and agent, or is one of trustee and cestui que trust.

Although these statements are taken as representing the judgment of the Court, each Judge wrote a separate judgment (one dissenting) in which the broad statements of Cozens-Hardy MR do not receive unqualified support. Buckley LJ acknowledged that a fiduciary relationship could arise by "implication of law" on the particular facts of a case (at 642), but the contractual relationship of the company to the plaintiff in the case before him did not warrant such an implication. Hardly a ringing endorsement of the broader statements of law by Cozens-Hardy MR.

Fletcher Moulton LJ took an opposing view. His Honour accepted the "undoubted" proposition that a person does not come into fiduciary relations with the cestuis que trust merely by becoming an agent of the trustee, but observed that it did not follow that this meant that person was consequently barred from entering into such relations. He observed (at 636):

> Fiduciary relations may exist in innumerable forms and are of innumerable kinds. They may arise from specific contract, but they may and often do arise out of acts or relationships creating a duty

Compare how closely the above statement reflects what our Supreme Court said at [73] in *Chirnside v Fay* [2006] NZSC 68 regarding when a fiduciary relationship may arise:

> … a relationship will be classed as fiduciary depends not on the inherent nature of the relationship but upon an examination of whether its particular aspects justify it being so classified. No single formula or test has received universal acceptance in deciding whether a relationship outside the recognised categories is such that the parties owe each other obligations of a fiduciary kind.

Fletcher Moulton LJ went on to address the argument that the directors were mere agents of the company and that being a mere agent of a fiduciary does not transform that agent into a fiduciary him or herself. His Honour stated (at 636):

> Where directors actually perform their part in the management of the company they are both the brains and hands of the company, and they cannot shelter themselves under the plea that the knowledge of the trustee is not their knowledge, or that the nature and intention of the acts of the trustee were unknown to them.

And in relation to the directors in the case before him, His Honour said (at 637):

> They have complete and perfect knowledge of the nature of the acts which the company is doing through them. But they have even more than this. They know that there is no

> mind interposed between them and the cestui que trust which administers the trust. It is they who are in fact doing it and no one else, although it may be done in the name of the company.

I expect that as a general rule it is accepted that a trustee may not profit from his or her position. Would equity nevertheless allow a director of a company incorporated for the sole purpose of being trustee of a trust to do what the company itself is precluded from doing, say, profit from the trust property? One would expect the answer to be 'of course not'.

In a thought-provoking article entitled "The corporate trustee safety net?" [2019] NZLJ 211, James Anson-Holland explored how some Commonwealth courts have overcome the decision in *Bath.* One method was to recognise a 'dog-leg' claim, that is, the right of beneficiaries to sue directors of company trustees for breach of trust, not based on the imposition of a direct duty between director and beneficiary, but through indirect enforcement of the already existent duty between the director and the corporate trustee. This seems contrived and unnecessary.

I believe that New Zealand courts led by the Supreme Court's willingness to consider new forms of fiduciary relationships by reference to the real nature of the relationship will address the issue head-on and not resort to such convoluted causes of action such as dog-leg claims.

An illustration of such judicial directness is to be found in the judgment of Justice McGechan in *Lion Breweries Ltd v Scarrott* (1987) 3 NZCLC 100,042, (1986) 2 BCR 242. His Honour's analysis of *Bath v Standard Land Company Limited* is insightful recommended reading.

The key facts in *Lion Breweries* were that company A held funds belonging to the plaintiff by dint of which it owed the plaintiff 'trustee' fiduciary duties to:

1. Account to the plaintiff for the plaintiff's funds, and
2. Pending such account to refrain from mixing the plaintiff's funds with its own and from using the plaintiff's funds for its own purposes.

The defendant in his capacity as the company's director caused company A to breach these duties. After an in-depth analysis of *Bath*, his Honour concluded (page 22):

> The case is one which a New Zealand Judge even at first instance need not necessarily feel obliged to follow. I think a re-evaluation of the rule generally regarded as derived from Bath's case is open in the light of modern needs, particularly the rise since the beginning of the century in the use of the small private limited company and its inevitably growing involvement in fiduciary situations.

I conclude therefore that there is no impassable barrier preventing a director of a company which itself owes a fiduciary obligation from himself being liable for breach of that obligation. Whether a fiduciary duty exists in the case of any such director must be determined upon the facts of the particular case in which the question arises.

## SUMMARY

The corporate shield continues to offer directors of company trustees a measure of protection from the liability borne by the company. But fissures in the shield exist by virtue of:

1. The duties imposed on directors existing under the Companies Act 1993 and the common law; and

2. Avenues for relief such as 'dog-leg claims', under the Fair Trading Act 1986 and or common law actions such as dishonest assistance/accessory liability.

But these avenues for relief ignore the 'elephant in the room', namely, does a director of a trustee company owe fiduciary duties directly to the trust's beneficiaries? The Law Commission appeared to perceive that the common law in New Zealand was lacking in terms of answering this question positively.

If the legislature does not act, then it is suggested that the courts will. Justice McGechan's statements in *Lion Breweries Ltd v Scarrott* illustrate that the courts will not necessarily apply traditional equitable principles to allow directors to be shielded from new fiduciary duties if the circumstances of a case dictate that they should owe them.

In a different context, *Vervoort v Forrest* [2016] NZCA 375 provides an example of the Court of Appeal acknowledging traditional trust principles, but bending them to take account of the practical realities of the situation. In that case, strict application of the equitable principles requiring unanimity of trustee decision-making and barring delegation by a trustee of his or her powers, would have given rise to injustice, namely, to enable the trust to be unjustly enriched by dint of the trustees' own maladministration. Consequently, the Court would not apply those principles.

It may be, indeed it is contended, that the principles of ascertaining a fiduciary relationships as explained in *Chirnside v Fay* require no bending of the rules of equity. The Judgment in *Lion Breweries Ltd v Scarrott* provides a roadmap for how existing equitable rules may be applied to recognise a fiduciary relationship between a company trustee director and the beneficiaries of the trust.

As Tipping J stated in the celebrated and oft cited judgment in *Lankow v Rose* [1995] 1 NZLR 277, the Court stands as a defendant's conscience (at 294). This is precisely when equity intervenes.