

NEW SOUTH WALES SUPREME COURT

CITATION: Arakella v Paton (No.2) [2004] NSWSC 605

CURRENT JURISDICTION: Equity

FILE NUMBER(S): 4543/03

HEARING DATE(S): 29 June 2004

JUDGMENT DATE: 07/07/2004

PARTIES:

Arakella Pty Ltd (P)

Geoffrey Douglas Paton (as representative of the unitholders of the GNS Trading Trust) (D)

JUDGMENT OF: Austin J

LOWER COURT JURISDICTION: Not Applicable

LOWER COURT FILE NUMBER(S): Not Applicable

LOWER COURT JUDICIAL OFFICER: Not Applicable

COUNSEL:

G Rich (P)

P J Brereton (D)

SOLICITORS:

Clayton Utz (P)

Henry Davis York (D)

CATCHWORDS:

TRUSTS - relief of trustee from liability for breach of trust - corporate trustee operates trading trust in apparent breach of trust instrument and Corporations Act - during initial period, directors of trustee rely on external accountant and do not obtain legal advice or acquaint themselves with the trust instrument - in subsequent period, after legal advice, the directors act assiduously to minimise breaches and restructure the trust - whether trustee should be relieved from liability in respect of breaches prior to receiving legal advice, and in respect of any breaches thereafter

ACTS CITED:

Trustee Act 1925 (NSW), ss 63, 81, 85

DECISION:

Plaintiff wholly relieved from all and any breaches of trust as trustee of the GNS Trading Trust, occurring in and after August 2002; no relief from any breach of trust occurring before August 2002.

JUDGMENT:

**IN THE SUPREME COURT
OF NEW SOUTH WALES
EQUITY DIVISION**

AUSTIN J

WEDNESDAY 7 JULY 2004

4543/03

**ARAKELLA PTY LTD V GEOFFREY DOUGLAS PATON (AS
REPRESENTATIVE OF THE UNITHOLDERS OF GNS TRADING
TRUST) (NO.2)**

JUDGMENT

1 **HIS HONOUR:** This is an application by the plaintiff Arakella Pty Ltd, the trustee of a trading trust ("the GNS Trading Trust" or "the Trading Trust"), for an order under s 85 of the Trustee Act 1925 (NSW), relieving it from personal liability for breach of trust. The application is associated with an application for orders under ss 81 and 63 of the Trustee Act, having the effect of enabling the trustee to implement a scheme of reconstruction of the Trading Trust. The implementation of the restructuring does not depend on my making orders under s 85.

2 The detailed facts and circumstances surrounding the matter are set out in my reasons for judgment, *Arakella v Paton* [2004] NSWSC 13 (30 January 2004), dealing with the determination of questions under Part 31 of the Supreme Court Rules. Subsequently, as envisaged by my reasons for judgment, the unitholders of the Trading Trust have met to consider the proposed reconstruction. At their meeting on 23 June 2004, they passed resolutions overwhelmingly supporting the implementation of the scheme of reconstruction, and on 29 June 2004 I made orders under ss 81 and 63.

3 All that remains is to consider whether to relieve the trustee of liability under s 85. The present application was foreshadowed to unitholders in the explanatory memorandum distributed to them with the notice of meeting. No one has sought to appear to oppose the application. Mr Paton, the representative appointed in the circumstances described in my earlier judgment, appeared and supported the application.

The establishment of the Trading Trust

4 The GNS Trading Trust carries on business as a wholesaler of stationery and office supplies. "GNS" stands for Group Newsagency Supplies. The vast majority of the customers of the Trading Trust are individual newsagents operating in New South Wales, Queensland, Victoria and Tasmania.

5 The GNS business was established for the benefit of newsagents, to concentrate the buying power of many disparate newsagencies and thereby enable individual newsagents to obtain stationery and office supplies at cheaper prices. The business has not been conducted with a view to maximisation of profit, but rather to supply customers with products at the lowest possible prices. Arakella does not charge or receive any fees for performance of its duties as Trustee. The current annual turnover of the Trading Trust is approximately \$100 million. In the early years of its operation, the Trading Trust business was conducted at

a loss. In some subsequent years, the Trading Trust has shown an accounting profit, offset by losses carried forward. The Trading Trust paid tax for the first time in 1999.

6 The Trading Trust was established in 1989. Prior to that time, the business of Group Newsagency Supplies was operated through three proprietary companies, each having 50 shareholders who were newsagents. Three companies were used so as to avoid running the business through a public company. The evidence does not reveal why those concerned wanted to avoid the public company structure, but it may have had to do with the prospectus and financial reporting requirements for public companies.

7 By 1989 it was becoming apparent that the structure would need to be reviewed. In that year a much larger organisation called Ancol, which operated as a buying co-operative for approximately 1200 newsagencies in New South Wales and was the principal competitor of GNS, became insolvent, with the result that a large number of New South Wales newsagencies were looking for an alternative supplier of stationery and office supplies.

8 Those behind the GNS business realised that they could not multiply proprietary companies so as to cater for such a large intake of new shareholders. They sought advice from their external accountant, Mr Dennis Manche. He told them to establish a trading trust, apparently because he considered that a trust structure would be suitable for the growing operations of the GNS business, and because he believed that a trust structure would give more protection against hostile takeover than a company structure. Those responsible for the GNS business accepted Mr Manche's advice. The trading trust deed was prepared by a small local firm of solicitors on the instructions of Mr Manche. Originally the trustee of the Trading Trust was another company, but the present trustee, Arakella, took up that role in March 1990.

The directors of Arakella

9 Evidence was given by Edward Rogan, who was one of the two founding unitholders of the Trading Trust. Mr Rogan has been in the newsagency industry for over 34 years and has been the full-time managing director of GNS for 15 years. He is actively involved in the Newsagents Association of New South Wales.

10 There are now five other directors of Arakella. Geoffrey Boyce, a member of the board since 1982, has been involved in the newsagency industry for 25 years, and was the other founding unitholder of the Trading Trust. Rod Brown has been a newsagent for the last 23 years, and has been on the board for 9 years. Laurie Farrell joined the board in 1987 and was a newsagent for 13 years, having previously been a bank manager. Paul Squires has 24 years' experience in the newsagency and stationery businesses, and has been a member of the board for 4 years. Allan Wilbers has been a newsagent for 27 years and joined the board in 1981. It will be seen that the directors of Arakella have an enormous amount of experience in the newsagency business, but they do not have professional qualifications in accountancy or law.

11 The total fees paid to each director of Arakella are capped at \$20,000 per annum, and until five years ago directors were not paid at all. Except in the case of Mr Rogan, who is paid a salary as a full-time executive, the directors hold their positions as part-time positions. They are required to attend 12 board meetings per year in Sydney (which involves travel for some of them) and they must spend a substantial amount of time outside board meetings looking after the affairs of the Trustee.

Arakella's relationship with its customers

12 The Trading Trust purchases stationery and office supplies and holds them in storage and various locations. Individual customers, including members, buy stock from the Trading Trust as and when required. There are over 3,400 customers, the vast majority of whom are newsagents, but the Trading Trust will supply anyone who is a retail seller of stationery.

13 As part of the terms and conditions of trade, customers of the Trading Trust pay an additional amount by way of a security deposit, as well as the invoice price for the goods. The additional amount is paid as a 2% contribution until the total security deposit, currently set at \$6,500, is reached. The security deposit is, in effect, a form of working capital to enable the Trading Trust to finance the stock which it holds.

14 Until 2003, if the customer was a newsagent, once his or her contribution had reached \$1,500, the newsagent would be offered units in the Trading Trust, applying that \$1,500 as a "joining fee" to acquire the units. Units would be issued at a nominal value of \$1 per unit, without reference to the value of the assets of the Trading Trust at the time of issue. A unitholder would be required to maintain a security deposit of only \$5,000.

15 If the customer ceased to trade with the Trading Trust, the security deposit would be returned after deducting any amount owing under previous invoices. To the extent that the security deposit was represented by units in the Trading Trust, they would be redeemed at \$1 per unit, again without reference to the value of the assets of the Trading Trust at the time of redemption.

16 In the year ended 30 June 2003, a total of 45 unitholders redeemed their units for \$1,500 each, and a further 24 unitholders did so in the period to 30 December 2003. Approximately 52 out of the total 345 current unitholders are former newsagents, some of whom have decided to retain their units and await the restructure, after being told of the restructure proposal and the possibility that the units might be worth more than \$1 each.

The Discretionary Trust

17 In August 1999 the Trustee established a discretionary trust for the purpose of holding real property and, in particular, to purchase the existing GMS property in New South Wales. The trustee of the Discretionary Trust is a company called Group Owners Pty Ltd. The directors of the Trustee hold all of the issued share capital of Group Owners. The beneficiaries of the Discretionary Trust are the Trading Trust and the unitholders (collectively) for the time being.

18 The Discretionary Trust was established and the real property was acquired by it on the advice of Mr Manche. He was concerned to protect the real property of the Trading Trust in the event that the GNS business ever became insolvent. The directors of Arakella accepted Mr Manche's advice. They did not seek to obtain legal advice for the Trustee, and no-one suggested to them that the establishment of the Discretionary Trust might involve a breach of the Trading Trust Deed.

19 The Discretionary Trust now has gross assets of \$16 million and debts of approximately \$16 million, comprising a combination of bank debts and the loan from the Trading Trust. The Trading Trust pays variable rent to the Discretionary Trust, sufficient to enable the Discretionary Trust to break even.

20 The financial statements for the Trading Trust do not disclose the existence of the Discretionary Trust assets, on the basis that the income and assets of the Discretionary Trust do not vest in the Trading Trust or unitholders unless and until Group Owners makes a distribution in their favour. However, the notes to the 2002 GNS Annual Report disclosed the contingent liabilities of the Discretionary Trust, and the balance sheet reflected the amount owing by the Discretionary Trust to the Trading Trust.

Arakella's legal advice

21 Clause 5(c) of the Trading Trust Deed states if a unitholder ceases to be an authorised newsagent as defined, the Trustee is required to redeem the units of the unitholder within three months. An authorised newsagent is a newsagent authorised by a Newsagency Council.

22 The Newsagency Council was dissolved in 2002. This was discussed by the directors of Arakella, and someone referred to the requirement that unitholders be authorised by a Newsagency Council. The directors then decided to obtain legal advice.

23 The advice that they received went well beyond the dissolution of the Newsagency Council. It informed the directors of Arakella, for the first time, that several of the practices of the Trustee appeared to be in breach of the Trading Trust Deed and also the Corporations Act. Thereafter, Arakella sought legal advice as to how to regularise the position and to restructure the Trading Trust so as to allow it to operate lawfully for the benefit of newsagents. From August 2002 onwards, upon receiving legal advice, the Trustee has not issued any new units.

Non-compliance with Trading Trust Deed and Corporations Act

24 I have dealt with these matters more fully in my reasons for judgment, *Arakella v Paton* [2004] NSWSC 13 (17 December 2003). To summarise, the following may have involved breaches of the Trading Trust Deed:

- (a) failure to ensure that all unitholders are authorised by the Newsagency Council as newsagents, the issuing of units after the dissolution of the Council, and failure to redeem such units (clause 5(c));
- (b) the issuing of new units without first procuring a special resolution, and without first offering the units to the original unitholders (clause 6(c));
- (c) the issuing of new units at a price of \$1 per unit, without regard to the value of the Trust Fund (clause 6(e));
- (d) failure to value units for the purpose of redemption (clause 9(a); see also clause 6(a));
- (e) establishment of the Discretionary Trust without express authority, and consequently the undervaluation of units by omitting to take into account the Trading Trust's interest in the Discretionary Trust.

25 Possible contraventions of the Corporations Act include failure to register the Trading Trust under the managed investment provisions (Ch 5C) or their predecessors, and failure to make adequate disclosure under the fundraising provisions (Ch 6D) or the product disclosure statement provisions (Part 7.9).

Jurisdiction to excuse breaches of trust

26 Section 85 of the Trustee Act 1925 (NSW) provides, to the extent relevant, as follows:

"85 Excusable breaches of trust

(1) Where a trustee is or may be personally liable for any breach of trust, the Court may relieve the trustee either wholly or partly from personal liability for the breach.

(2) The relief may not be given unless it appears to the Court that the trustee has acted honestly and reasonably, and ought fairly to be excused for the breach of trust or for omitting to obtain the direction of the Court in the matter in which the trustee committed the breach."

27 The effect of subsection (2) was explained by Cohen J in *Pateman v Heyen* (1993) 35 NSWLR 188, 199:

"The court has a wide discretion but before it can exercise it the trustee must establish the three essential elements, namely that he or she has acted honestly, has acted reasonably and further, ought fairly to be excused for the breach. There have been many cases dealing with the application of the section, or its

equivalent in other jurisdictions, but each case must be decided upon its own facts and circumstances. One of the matters to be looked at is whether the trustee is unpaid for services rendered, but it would seem that this is a fact to be taken into account when considering the third question, namely whether the trustee ought fairly to be excused for the breach."

28 Here it cannot quite be said that Arakella is an unpaid trustee, but to the extent that it operates the GNS business not with a view to profit but for the purpose of benefiting members by minimising prices, there is an analogy with the "unpaid trustee" cases. Nevertheless, even if the trustee is unpaid, the three conditions must be satisfied and in particular (in view of the present facts), it must be shown that the trustee has acted reasonably. In *Pateman v Heyen* the trustee, though unpaid, had failed to reinsure the trust property, and it burned down. Cohen J declined to excuse the trustee.

Arakella's case for being excused from liability

29 Mr Rogan's evidence is that for approximately 30 years until about 1999, Mr Manche was the chief adviser to the appointed directors of Arakella and predecessor companies. They relied heavily upon him in respect of financial issues, and they relied on him to identify when the trustee needed to engage solicitors.

30 Mr Rogan says that after the Trading Trust had been established, the directors of the Trustee regarded it as primarily a "vehicle or structure" through which the existing business would be run. He says that they did not realise the extent to which the trust structure actually governed and constrained the Trustee in the running of the business. No independent legal advice was obtained as to the desirability of establishing the Trading Trust, nor as to the terms on which such a trust should be established. Mr Rogan says that until the year 2002, the directors of the trustee rarely sought legal advice, and he says they never sought legal advice as to the meaning and correct interpretation of the Trading Trust Deed. The directors simply relied on Mr Manche's advice as to how the Trading Trust was intended to operate, and acted on the basis of and in reliance on the business experience of each director as to the conduct of the GNS business in the interests of unitholders and customers.

31 Mr Rogan's evidence is that, prior to August 2002, he and (as far as he was aware) the other directors of Arakella did not understand that units in the Trading Trust had a value reflecting the value of the underlying assets, and therefore their value might increase over time and generate a material profit for individual unitholders. He has put into evidence a pamphlet dated April 2001 which seems to confirm that misunderstanding.

32 As from August 2002, when Arakella obtained legal advice that its practices did not fully comply with the Trading Trust Deed and the Corporations Act, it has changed its practices to avoid or minimise contraventions. Where a unitholder has informed the Trustee that he or she wishes to retire as a newsagent, the practice since August 2002 has been to inform the person that the Trading Trust would be restructured, and that the units might be worth more than \$1,500. If the retiring newsagent has been prepared to await the restructure, the Trustee has allowed that person to remain as a unitholder. In cases where the retiring newsagent has elected not to await the outcome of the restructure, that person's units have been redeemed for \$1,500. The directors of Arakella have tried to convey the position to retiring newsagents by speaking to them and by following up their discussions with a letter, the form of which is in evidence. The letter seems to me to explain the basic position clearly and adequately.

33 Mr Rogan's evidence is that at all times, Arakella has treated the unitholders in an even-handed and consistent manner. He says that since August 2002, the directors of Arakella have come to a much better understanding of how the legal documents (specifically, the Trading Trust Deed) govern the manner in which the GNS business may be conducted, and the rights that they confer on unitholders. He says that Arakella, through its directors, has every intention of ensuring that in future the GNS business is conducted according to law and that the terms of the Trading Trust Deed (which is to be amended) are complied with.

34 Several of the directors of Arakella are approaching retirement age. They have devoted much of their time over a period of years to the GNS business, in the interests of small independent newsagencies. Mr Rogan says the directors are embarrassed by the fact that a number of business practices of Arakella have been in breach of the Trading Trust Deed, and they are committed to ensuring that the position of the company as trustee is regularised. He also says: "The directors of the Trustee are aware that it may be difficult to find new directors to replace them when they retire if there are past breaches of trust which [the court] has declined to excuse".

35 Although there is no specific evidence on this point, I infer from the evidence that no claim has been made against Arakella or its directors arising out of the apparent breaches to which I have referred.

Conclusion

36 It seems to me that there is a major difference between the conduct of the directors of Arakella as Trustee before August 2002, and their conduct afterwards.

37 Before August 2002 they were content to rely on the advice of a chartered accountant with respect to the establishment of the trust structure and the conduct of the business after the structure was adopted, without causing Arakella to obtain legal advice. Mr Rogan's evidence indicates that they paid little or no regard to the terms of the Trading Trust Deed, which was the constitution under which they operated a very large business. Even when it came to such matters as the issuing and redemption of units, when would one would have expected those involved in the management of the Trading Trust to take into account the requirements of the trust instrument on those matters, Arakella appears to have acted in disregard of its terms. It did so not only with respect to the ambiguous requirements of clause 5(c) concerning authorisation by the Newsagency Council, but also in other basic respects, such as the requirements of clause 6(c) with respect to the circumstances and manner of issue of units, and clause 9(a) with respect to the valuation of units.

38 Nothing in the evidence before me would suggest a failure to act honestly, by any of the directors of Arakella, or by Arakella through any agent. However, my opinion is that on the evidence, it is not possible for me to conclude that Arakella, by its directors, acted reasonably in the period up to August 2002. The first duty of a trustee on appointment, and one of the most fundamental, is to become acquainted with the terms of the trust instrument. In the case of a corporate trustee, that duty is to be discharged on its behalf by its directors. I cannot see how it could be reasonable for the directors of Arakella to believe that they could administer the affairs of the Trading Trust without personally reaching an understanding of the way in which the trust instrument affected the operation of the GNS business. While company directors are permitted to delegate certain tasks, and to rely on others, within the limits prescribed by the Corporations Act and the general law, it is clearly not reasonable, in my opinion, for the directors of a corporate trustee to rely on external advice from an accountant as to all structural matters, without any personal attention to the constitutional structure of the business. (I should make it clear that my observations are directed to reasonableness for the purposes of s 85, and I do not purport to make any finding as to breach of duty.)

39 During the period after advice was received in August 2002, it appears that the Trustee has acted not only reasonably, but very conscientiously. Counsel submitted on their behalf that they should be congratulated. Without necessarily going that far, I find that after August 2002 the directors of Arakella did everything they could reasonably be expected to do to address the problems that had been identified in the legal advice. They put forward what seems to me have been a thorough and effective proposal to overcome the problems, they have frankly acknowledged the mistakes that have been made, and they have caused Arakella to apply itself assiduously to the implementation of the restructuring scheme. In the circumstances they ought to be excused in respect of any breach or continuation of breach during that period.

40 Consequently, I am not prepared to make an order under s 85 in respect of any breach of trust by Arakella that occurred prior to the receipt of legal advice in August 2002, but I am prepared to make an order in respect of its conduct thereafter. This result will leave Arakella with the risk that someone may take proceedings against it alleging liability arising out of conduct before August 2002. If such a claim is made, the directors of Arakella may have to consider whether the company or they themselves would be

exposed to some avoidable risk by continuing to trade. But until the time (if it ever arrives) that a claim is made of a sufficient magnitude to raise such an issue, I fail to see how the absence of exoneration under s 85 should provide any rational disincentive to anyone considering the acceptance of a board position.

LAST UPDATED: 07/07/2004