



LAW·COMMISSION
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COURT JURISDICTION, TRADING TRUSTS AND OTHER ISSUES

REVIEW OF THE LAW OF TRUSTS
FIFTH ISSUES PAPER



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The Law Commission is an independent, publicly funded, central advisory body established by statute to undertake the systematic review, reform and development of the law of New Zealand. Its purpose is to help achieve law that is just, principled, and accessible, and that reflects the heritage and aspirations of the peoples of New Zealand.

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FOREWORD

This is the fifth Issues Paper in the Law Commission's review of the Trustee Act 1956 and the law of trusts. It is the final in a series of Issues Papers that have discussed particular issues and problems with trusts law in order to enable the development of law reform proposals to modernise trusts legislation.

This paper addresses several miscellaneous issues that have not been dealt with in the previous Issues Papers, but which are nevertheless significant to the overall review. A theme that encompasses much of the material is the concept of making it easier for beneficiaries to keep trustees accountable and to have their rights as beneficiaries upheld and enforced. Other subjects addressed include trading trusts and the possibility of better regulation to improve the administration and heighten the transparency of trusts.

We seek comment from all people with views on the issues raised in the paper or with relevant personal or professional knowledge and expertise in these aspects of trusts. Submissions on the issues and questions in this paper will assist us in developing recommendations for legislation to reform the Trustee Act 1956. The submission input we have received thus far on this project is proving to be of great assistance, particularly as we enter the stage of the project where we look to refine our policy preferences.

In the next stage of the project, we intend to issue for comment a document setting out our preferred approach, prior to the release of our final report. This reference has been wide-ranging and complex, and some of our initial views have evolved over the course of the project. We consider that it is appropriate to provide further opportunity for comment on more concrete proposals for reform of the law of trusts.



Hon Sir Justice Grant Hammond KNZM
President of the Law Commission

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The Law Commission gratefully acknowledges the contribution of our Trusts Review Reference Group who have generously given, and continue to give, their time and expertise to assist with this review.

Members of the reference group are:

- Kerry Ayers, Helmore Ayers
- Andrew Butler, Russell McVeagh
- Chris Kelly, Greg Kelly Law
- Greg Kelly, Greg Kelly Law
- Jessica Palmer, Senior Lecturer, University of Otago
- Bill Patterson, Patterson Hopkins
- Professor Nicola Peart, University of Otago

The Commissioners responsible for this reference are Sir Grant Hammond and George Tanner, QC.

The legal and policy advisers for this Issues Paper were Marion Clifford, Jo Dinsdale, and Sophie Klinger.

Call for submissions

Submissions or comments (formal or informal) on this Issues Paper should be sent to Marion Clifford by **2 March 2011**.

Law Commission

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or by email to trusts@lawcom.govt.nz

The Law Commission asks for any submissions or comments on this Issues Paper on the review of the law of trusts. The submission can be set out in any format but it is helpful to specify the number of the question you are discussing.

Submitters are invited to focus on any of the questions, particularly in areas that especially concern them, or about which they have particular views. It is certainly not expected that each submitter will answer every question.

Alternatively, submitters may like to make a comment about the law of trusts review that is not in response to a question in the paper and this is also welcomed.

Official Information Act 1982

The Law Commission's processes are essentially public, and it is subject to the Official Information Act 1982. Thus copies of submissions made to the Law Commission will normally be made available on request, and the Commission may refer to submissions in its reports. Any requests for withholding of information on grounds of confidentiality or for any other reason will be determined in accordance with the Official Information Act 1982.



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Introduction

The Law Commission's fifth Issues Paper in the review of the law of trusts discusses the jurisdiction of the courts, other dispute-resolution mechanisms, the particular features of and possible need for a response to trading trusts, and regulatory mechanisms that could apply to trusts and trust advisors.

The Issues Papers published as part of this review are:

- the history and nature of trusts, recent developments in the structure of trusts, and the scope and framework of a revised Trustee Act (released November 2010);¹
- problems with the use of trusts, including issues relating to relationship property, creditor protection, and sham trusts (released December 2010);²
- the Perpetuities Act 1964 and the revocation, variation and resettlement of trusts (released May 2011);³
- trustees' duties and liabilities, including indemnity provisions and exemption clauses, and the office of trustee and trust administration, including the capital and income distinction, court supervision of trusts, and trustees' powers (such as delegation, investment and insurance) (released June 2011);⁴
- court jurisdiction, trading trusts, and other issues, including registration of trusts, dispute resolution for trusts and the regulation of trust advisers (this paper).

Part 1 of this Issues Paper examines the various powers the courts have in respect of trusts and trustees. There is a public interest in ensuring the effective, prudent and honest management of trusts. The courts have a crucial role in this context, and accordingly, exercise a number of powers, both facilitative and regulatory. The Commission has broken its discussion on the role of the courts down into three broad topics, addressed in separate chapters. Chapter 1 considers the High Court's general supervisory jurisdiction in respect of trusts. The Commission examines the powers exercised in breach of trust cases and the Court's approach to intervening where trustees are exercising discretionary powers not conferred on them by the Trustee Act.

Chapter 2 then considers the powers the High Court currently exercises under the Trustee Act. To avoid repetition with earlier Issues Papers, the Commission focuses on the Court's function and discusses only those provisions that have not been examined in earlier Issues Papers. Chapter 3 examines the equitable jurisdiction of District Courts in respect of trusts. This chapter considers whether District Courts should be able to exercise some (if not all) of the powers under the Trustee Act within their jurisdictional limits. It also briefly considers whether the Family Court should be able to exercise any of the powers under that Act.

Part 2 discusses alternative methods to the courts for resolving trust disputes and making decisions. Chapter 4 outlines the argument for introducing a new mechanism for trust dispute resolution and decision-making. It examines the options of an ombudsman, tribunal and commission. Chapter 5 discusses how alternative dispute resolution methods can be put to greater use in the context of trusts.

Part 3 focuses on a particular type of trust used in New Zealand – trading trusts. Chapter 6 examines the concept of the trading trusts and the Commission's recommendations regarding them in a previous reference. It provides an overview of the issues relating to trading trusts. Chapter 7 considers the interaction of trading trusts with creditors and raises possible options for how problems relating to creditors could be addressed. Chapter 8 raises issues and options arising from the effect of trading trusts on beneficiaries, as well as looking at particular problems relating to insolvent corporate trustees and the definition of a trading trust.

Part 4 discusses placing greater regulatory requirements on trusts. Chapter 9 discusses possible problems with the current lack of regulation of trusts in New Zealand and looks at the ways in which trusts are regulated overseas. It raises several options for regulation of trusts, including registration and reporting requirements. Chapter 10 considers whether there is a need for additional regulation of those providing services to trusts. It examines existing regulation and also looks at the more comprehensive regulatory regimes some overseas jurisdictions have adopted in this area.

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- 1 Law Commission *Review of Trust Law in New Zealand: Introductory Issues Paper* (NZLC IP19, 2010) available at < www.lawcom.govt.nz/project/review-law-trusts/ > .
 - 2 Law Commission *Some Issues with the Use of Trusts: Review of the Law of Trusts Second Issues Paper* (NZLC, IP20, 2010) available at < www.lawcom.govt.nz/project/review-law-trusts/ > .
 - 3 Law Commission *Perpetuities and the Revocation and Variation of Trusts: Review of the Law of Trusts Third Issues Paper* (NZLC IP22, 2011) available at < www.lawcom.govt.nz/project/review-law-trusts/ > .
 - 4 Law Commission *The Duties, Office and Powers of a Trustee: Review of the Law of Trusts Fourth Issues Paper* (NZLC IP26, 2011) available at < www.lawcom.govt.nz/project/review-law-trusts/ > .

Part 1

THE JURISDICTION OF THE COURTS



Chapter 1

Jurisdiction of the High Court

INTRODUCTION

- 1.1 From its establishment (as the Supreme Court) in 1841 the High Court had conferred on it all the common law, equitable, and probate jurisdictions exercised by the superior courts of England at that time. This included an inherent jurisdiction that is most accurately described as a reserve or fund of powers, or a residual source on which the court may draw whenever it is just and equitable to do so.⁵ Inherent jurisdiction allows the High Court to deal with issues in areas of law that are not covered in statute or rules of law. These powers were affirmed (but not created) by section 16 of the Judicature Act.⁶
- 1.2 In New Zealand only the High Court has this inherent jurisdiction. Other courts, including the District Courts, have the particular jurisdiction conferred on them by statute. In the case of District Courts this is now quite broad. The District Courts Act 1947 gives District Courts the same equitable jurisdiction as the High Court in proceedings up to the monetary limits (\$200,000) specified in that Act.⁷ District Courts do also have some inherent powers to enable them to do what is necessary to exercise their statutory functions, powers and duties, and to control their own processes.⁸
- 1.3 In contrast, the High Court's jurisdiction is unlimited. By "unlimited" it is meant that the court's jurisdiction extends to all causes of action (except where expressly excluded by statute) and unlimited in amount.⁹ It has full equitable jurisdiction over trusts in addition to the specific statutory powers conferred on it by the Trustee Act 1956. This chapter considers the court's jurisdiction and powers over trusts. The topics examined here are:
 - breach of trust claims;
 - review of the exercise of trustee discretion;
 - review under section 68 of the Act; and
 - the inherent supervisory powers of the High Court.

CIVIL ACTIONS FOR BREACH OF TRUST

1.4 Beneficiaries are entitled to enforce a trust. Duties imposed on trustees can be enforced by beneficiaries pursuing equitable remedies through the courts.

1.5 The Commission's previous Issues Paper, *The Duties, Office and Powers of a Trustee*, considered the duties of trustees.¹⁰ As discussed there, trustees must adhere strictly to the terms of their trust and carry out their duties as trustees in a diligent and prudent manner. If they fail to adhere to the terms of the trust, or fail to carry out their duties, they breach their trust.

1.6 The courts provides three remedies for claims in equity (including breach of trust claims):¹¹

- requiring trustees to account to the beneficiaries for their administration of the trust funds and assets (the remedy of account);
- obligating trustees to put the trust estate in the same position as if the breach of trust had not been committed (the remedy of restitution); and
- requiring trustees to make good the loss of trust property caused by wrongful acts or omissions (the remedy of compensation).

1.7 Equity is concerned to put the trust fund (and the beneficiaries) in the same position as if the breach had not occurred. The position is clearly summarised in an often cited passage from a Canadian case:¹²

In summary, compensation is an equitable monetary remedy which is available when the equitable remedies of restitution and account are not appropriate. By analogy with restitution, it attempts to restore to the plaintiff what has been lost as a result of the breach i.e., the plaintiff's loss of opportunity. The plaintiff's actual loss as a consequence of the breach is to be assessed with the full benefit of hindsight. Foreseeability is not a concern in assessing compensation but it is essential the losses made good are only those which, on a common sense view of causation, were caused by the breach.

1.8 In a more recent New Zealand Court of Appeal case Tipping J said that where the breach of duty by a trustee has directly caused loss or damage to the trust property:¹³

[t]he relief sought by the beneficiary is usually in such circumstances of a restitutionary kind. The trustee is asked to restore the trust estate, either in specie or by value. The policy of the law in these circumstances is generally to hold the trustee responsible if, but for the breach, the loss or damage would not have occurred. This approach is designed to encourage trustees to observe to the full their duties in relation to trust property by imposing upon them a stringent concept of causation. Questions of foreseeability and remoteness do not come into such an assessment.

- 1.9 A breach of trust is primarily a breach of an equitable obligation by trustees and may lead to civil liability. Where they breach their duties, trustees are personally liable for any losses that would not have arisen if they had not done so. Beneficiaries can bring a civil claim against trustees to restore the trust funds and to make good any loss caused by the breach of trust.¹⁴ If there is no loss to beneficiaries or to the trust fund or no gain to the trustee, then there will normally be no grounds for action.¹⁵

REVIEWING THE EXERCISE OF A TRUSTEE'S DISCRETION

- 1.10 Where a trustee fails to perform one of their duties as a trustee the court may intervene and, if necessary, compel the trustee to perform the duty or will otherwise remedy the situation. Where a trustee has a duty to do something he or she is bound to do that prescribed thing, whether or not he or she considers it the best course of action. However, where a trustee has a power to do something, or the trustee is required to exercise a discretion, the situation is somewhat different. In this situation the trustee is not bound to take a particular action, but to exercise his or her judgement actively and honestly as to whether to do or refrain from doing something, and then to act accordingly.¹⁶ The role of the court in this situation is to ensure that discretions and powers entrusted to trustees are properly exercised by them.
- 1.11 In its introductory paper, *Review of Trust Law in New Zealand: Introductory Issues Paper*,¹⁷ the Commission discussed the problem that has arisen in some cases in distinguishing between a discretionary trust (where a trustee has a duty to select which beneficiaries shall actually benefit and to distribute to those selected beneficiaries) and a bare power of appointment (where the donee of a power generally has no such duty but just a discretion to distribute).¹⁸ Traditionally the classification as either a trust or a power has affected the duties and rights of the parties involved. The objects of a bare power of appointment cannot ask the court to enforce the power,¹⁹ whereas, as discussed below, the court can intervene in a discretionary trust. The Commission invited feedback on whether the law of trusts ought to apply to powers of appointment within a trust where the donee of the power is also a trustee.
- 1.12 In the case of a discretionary trust the court will not interfere just because it believes the trustee's decision is unwise or the court would have done something differently. The court does not sit as a court of appeal on trustees' decisions. It does not consider the issue for itself and substitute its own decision for that reached by the trustees. Rather, the court looks at how the trustees reached their decision.²⁰

- 1.13 Where trustees are exercising a discretion as to some matter under the trust deed, the traditional position is that the court will not interfere with the exercise of that power or discretion unless the trustees have acted in bad faith or beyond the scope of their discretion (*ultra vires*).²¹ Courts are reluctant to review the exercise of discretionary powers largely because they recognise that the settlor has entrusted responsibility to the trustees and the administration of the trust is properly the responsibility of the trustees.

Grounds for intervention

- 1.14 In this context “bad faith” has developed a broad meaning. It includes:²²
- a decision for an ulterior motive;
 - taking into account irrelevant considerations;
 - refusal to take into account relevant considerations; and
 - acting capriciously.
- 1.15 A trustee’s duty of good faith when exercising a power or discretion is consequently a broad one. It has been expanded in case law to encompass obligations of giving relevant matters honest and genuine consideration, to act rationally and not perversely, and to excluding the irrelevant.²³
- 1.16 An exercise of a discretion is also open to challenge where the trustees have acted beyond their powers. Trustees must exercise discretions within the scope of the powers given and only for the purposes for which the discretions are conferred by the settlor.
- 1.17 Fisher J in *Wrightson Ltd v Fletcher Challenge Nominees Ltd* provides a useful summary of those situations where the Court will interfere with a trustee’s decision.²⁴ The court will set aside a trustee’s exercise of a discretion only where the trustee has:²⁵
- (a) acted in bad faith or for an improper motive;
 - (b) failed to exercise the discretion by considering the wrong question or misinterpreting the trust deed;
 - (c) considered irrelevant considerations;
 - (d) failed to consider relevant considerations; or
 - (e) reached a decision that is perverse or capricious.

The rule in *Hastings-Bass*

- 1.18 Fisher J added also that the duty in respect of relevant and irrelevant considerations (in (c) and (d) above) extends to an appreciation of the significant facts and their relevance to the decision being taken by the trustee. Although, a failure to correctly appreciate a given fact or consideration will not provide a ground for intervention if the trustee's decision would have been the same in any event.²⁶ Under what has become known as the rule in *Hastings-Bass*²⁷ the exercise of a dispositive power held in a fiduciary capacity could be upset if the holder of the power had considered irrelevant considerations or failed to consider relevant ones.²⁸
- 1.19 In a recent decision the English Court of Appeal undertook a full review of case-law developments from *Hastings-Bass*.²⁹ It has clarified that a trustee's failure to consider relevant factors, or his or her consideration of irrelevant factors, will only provide a basis for interfering with an exercise of powers if it can be shown that the trustee in doing so acted in breach of his or her fiduciary duty.³⁰ This approach is also likely to now be taken in New Zealand.

Is unreasonableness also a ground for interference?

- 1.20 A question has arisen as to whether trustees must act reasonably when exercising their discretions. This issue is still something of an open question. The traditional view is that there is no requirement of reasonableness. However, a handful of New Zealand authorities have drawn an analogy to the rules developed to justify judicial intervention in the administrative law context.
- 1.21 Tipping J made an obiter suggestion in *Craddock v Crowhen*,³¹ that there should be a power of review founded on *Wednesbury* unreasonableness.³² A decision should not be regarded as unreasonable unless it is such that no reasonable trustee could rationally have reached that decision in all the circumstances.³³ That approach was adopted in a subsequent case.³⁴ In *Wrightson Ltd v Fletcher Challenge Nominees Ltd* Fisher J said that the trust law test that a decision was perverse or capricious may have much in common with "unreasonableness" in an administrative law context.³⁵
- 1.22 In 2002 the Law Commission noted that the obiter comments in *Craddock v Crowhen* and those in the two subsequent cases mentioned above fall well short of an acceptance that challenges to the exercise of trustees' discretions are to be determined by the application of public law principles. The Commission suggested that the most that could be said was that a court, called upon to determine an allegation of perversity or caprice in decision-making by trustees, may find itself grappling with intellectual problems comparable with those that arise in the public law context.³⁶

- 1.23 This remains the position in New Zealand. In *Gailey v Gordon* O'Regan J declined to further develop any grounds for intervention around unreasonableness preferring instead the more traditional approach. He said that:³⁷

[T]he potential for the Court to intervene in the exercise of discretion by Trustees where the discretion has been exercised unreasonably involves some extension of the Court's supervisory role. In the absence of any Court of Appeal authority mandating that approach, I prefer the limited approach which recognises the traditional reluctance of the Courts to intervene in the exercise of a discretion by Trustees unless it is in bad faith (as broadly defined above), or ultra vires.

- 1.24 The authors of *Garrow and Kelly* suggest that authoritative guidance from either the Court of Appeal or the Supreme Court would be desirable on this point. They argue that caution should be exercised, at least in the context of private discretionary family trusts, before importing administrative law concepts such as unreasonableness into this area.³⁸ Requiring trustees of a typical trust to meet standards of reasonableness may set the standard too high. Trustees are selected by a settlor because they are trusted to give effect to the settlors' interests. Chris Kelly suggests that excessive judicial intervention with trustees' decision-making may undermine the value of trusts for settlors. It may also encourage unnecessarily defensive attitudes by trustees. He argues that trustees need to be able to administer the trust fund without being second-guessed by courts. Striking a balance between these considerations and the need for beneficiaries to be able to hold trustees to account is not an easy task.³⁹

REVIEWING TRUSTEES UNDER SECTION 68

- 1.25 In addition to the jurisdiction to review discussed above, the High Court also has a statutory power of review where trustees are exercising a power conferred by the Act rather than a discretion under the deed of trust. The grounds on which the court will intervene and set aside a trustee's decision differ from those discussed above.
- 1.26 Under section 68 a beneficiary with an interest in trust property may apply to the court for a review if:
- (a) he or she is aggrieved by any act or omission or decision of a trustee exercising any power conferred by the Act; or
 - (b) he or she has reasonable grounds to anticipate that an act or omission or decision of a trustee will aggrieve him or her.

- 1.27 The court may make any order that is required in the circumstances. In the case of an anticipated act, omission or decision the court may give directions. Injunctions have, for example, been granted to restrain sales in breach of trust or at less than commercial value to protect the interests of beneficiaries in some cases.⁴⁰ Where the court is asked to make an order that may prejudicially affect the rights of a person who is not a party to the proceedings, it may direct that the person be made a party to the proceedings.
- 1.28 A number of issues have arisen over the scope and application of section 68.

Applicant must be “beneficially interested”

- 1.29 The court has jurisdiction to review a decision of a trustee under section 68 only where an applicant has a beneficial interest in the trust fund.⁴¹ The specific wording in the section is “*any person who is beneficially interested in any trust property*”. One important issue, therefore, is whether discretionary beneficiaries are able to apply for a review under section 68. Professor Rickett says that it is arguable that discretionary beneficiaries cannot apply under the section.⁴² *Garrow and Kelly* expresses the view that it is likely that a person with contingent or vested interests (whether indefeasible or subject to divestment) would be considered “beneficially interested”.⁴³
- 1.30 The Commission considers that clarification as to who may bring an application under the provision would be desirable. The phrase “*any person who is beneficially interested in any trust property*” is used also in section 67 of the Act to describe one of the classes of persons who may apply to the court for an order appointing a new trustee. Clarification as to who is beneficially interested is therefore equally important to the correct interpretation of section 67.

Onus on trustees to defend their actions

- 1.31 When reviewing a trustee's actions under section 68, the court may require the trustee to appear before it to "substantiate and uphold" the action being reviewed.⁴⁴ In one of the very few cases on the provision, *Rossiter v Wrigley*, Doogue J interpreted this to place the obligation on the trustee to defend their actions rather than on the applicant to show the actions were unreasonable.⁴⁵ Professor Rickett says that as it has been interpreted and applied in *Rossiter*, "the applicant may need to satisfy no more than the minimal standing requirement, whilst the trustee then has the heavy onus of showing that he has not breached a duty or standard".⁴⁶ He contrasts this with the approach taken by the courts in Queensland under a similarly worded legislative provision.⁴⁷ In Queensland the onus has been clearly placed on the applicant to show that the trustee's actions are unreasonable before the trustee will be required to appear to defend their actions.⁴⁸ Professor Rickett has argued that the Queensland approach is preferable because, as a matter of policy, powers and discretions are given to trustees, and the courts ought to be wary of exercising those powers and discretions differently.⁴⁹ The Commission is interested in comment on this issue and whether the provision should be amended to place the onus on the applicant to show the trustee has breached the appropriate standard of conduct required of trustees.

What should the standard for review be?

- 1.32 The provision is silent on the appropriate standard to be applied to trustee actions. In *Rossiter v Wrigley* the High Court determined that the appropriate standard for review was one of determining on the evidence whether the trustees "acted reasonably or not in the steps that they took".⁵⁰ Professor Rickett raises this point as a further question that needs to be resolved.⁵¹ Should the appropriate standard for review under the section be whether the decision was "reasonable", or should it be a stricter one, such as the whether the decision was one that was "reasonably open" to the trustees in the circumstances?
- 1.33 This question raises quite a fundamental issue of the threshold that should apply before the courts interfere with the exercise of discretions entrusted to trustees. Section 68, depending on the applicable standard, is potentially very broad.

Only powers granted by the Act

- 1.34 The power of review under section 68 only extends to acts, omissions or decisions of the trustee under a power granted by the Act. It does not extend to powers given to trustees by the trust deed or by any other Act. Where the alleged act or omission arises from the operation of the trust deed, section 68 has no application.⁵² Where the trustees are exercising specific powers and discretions conferred by the trust deed, as already discussed, the traditional attitude of the court has been not to interfere with the exercise of those powers or discretions unless the trustees have acted in bad faith or outside the scope of their powers (*ultra vires*).
- 1.35 The court's power of review under section 68 is expressly limited to powers granted by the Act, but what happens where decisions involve a combination of powers under the Act and under a trust instrument? Also, what if the trust deed gives the trustee a specific power that is also a default power given to trustees generally by the Act? It would seem to be unclear whether an exercise of that power is reviewable under section 68 or not. Can trustees simply avoid review under the Act by stating clearly at the time they exercise such a power that they are exercising it under the trust deed?
- 1.36 This issue has not been considered by the courts in New Zealand. However, it has arisen in a Western Australian case. In *Wendt v Orr* the Supreme Court of Western Australia accepted that if the trustee is exercising a power only conferred by the trust instrument, the Western Australian equivalent of section 68, section 94 of the Trustees Act 1962-1972 (WA), could not be invoked. However, the Court considered that where the power that was being exercised appears in both the Act and in the trust instrument, the Court could review the exercise of the power under the provision.⁵³ Whether the New Zealand courts would take the same approach is unclear. The authors of *Garrow and Kelly* express the more traditional view that if a power is given specifically to trustees by the trust document, then, so long as the power is exercised in good faith and not *ultra vires*, the courts would be reluctant to interfere, even if the terms of the power are similar to those of a statutory power.⁵⁴
- 1.37 Should section 68 be extended to cover trustee decisions under trust instruments? A significant advantage of this approach would be to introduce a consistent standard that would apply to the review of the exercise of all powers by trustees. Such an extension would largely displace review by the courts under their supervisory jurisdiction. In Queensland, their equivalent provision, section 8 of the Trust Act 1973 (Qld), not only covers the exercise of any power conferred by their Act but extends to "the instrument, if any, creating the trust".

- 1.38 However, if the provision was extended to cover trustee decisions under trust instruments, then consideration must also be given to the question of the appropriate grounds of review to be applied to a trustee's actions. Instead of the test being one of reasonableness it should probably be a higher one, such as whether the decision was one that was reasonably open to the trustees in the circumstances. Alternatively, the more traditional grounds for reviewing the exercise of a trustee's discretion the courts have developed (bad faith and ultra vires) might be considered to provide a better test. There is, in the Commission's view, a legitimate concern that extending review under section 68 to all trustee decisions and actions could, if the grounds are not also appropriately limited, result in excessive intervention with trustees' decision-making. That would have the potential to undermine the role of trustees and may also encourage trustees to take an unnecessarily defensive approach to their role.

OTHER SUPERVISORY POWERS

- 1.39 The supervision and control of trustees is currently the responsibility of the High Court. Beneficiaries are able to invite the court to examine the administration of trusts by trustees.⁵⁵ In *Schmidt v Rosewood Trust Ltd* the Privy Council affirmed "the court's inherent jurisdiction to supervise, and if necessary to intervene in, the administration of trusts".⁵⁶
- 1.40 The High Court's inherent power to supervise the administration of trusts means it can, in appropriate circumstances, remove trustees or modify or revoke trusts. These powers are exercised only sparingly by the court and it will only intervene where an application is made. Although the High Court retains these supervisory powers, they have long been displaced for all practical purposes by statutory provisions governing the removal, appointment and replacement of trustees and statutory powers covering the revocation and variation of trusts. Those provisions and the court's residual jurisdiction were considered by the Commission in *The Duties, Office and Powers of a Trustee*⁵⁷ and *Perpetuities and the Revocation and Variation of Trusts*.⁵⁸

COMMON LAW ACTIONS

- 1.41 For completeness it should be noted that in some circumstances beneficiaries may have the basis for a common law civil claim against trustees in negligence or fraud. The primary remedy in such cases would be one of damages.

QUESTIONS

Q1 Should there be a statutory provision setting out the grounds for the Court to intervene in the exercise of a discretion by trustees (in other words, should an amended version of section 68 be retained)?

Q2 On what grounds should the Court be able to review and interfere with the exercise of a trustee's discretion?

Q3 Should the Court's power to intervene be extended to cover trustees' actions, omissions and decisions when they exercise a power under a trust instrument as well as under the Act?

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- 5 See Jack Jacob “The Inherent Jurisdiction of the Court” (1970) CLP 23 at 51.
 - 6 Section 16 states that: “The court shall continue to have all the jurisdiction which it had on the coming into operation of this Act and all judicial jurisdiction which may be necessary to administer the laws of New Zealand”.
 - 7 Section 34 of the District Courts Act 1947 now gives District Courts full equitable jurisdiction within the monetary limits set by section 29.
 - 8 *McMenamin v Attorney-General* [1985] 2 NZLR 274 (CA).
 - 9 *Laws of New Zealand* “Courts” (online ed) at [133].
 - 10 Law Commission *The Duties, Office and Powers of a Trustee: Review of the Law of Trusts Fourth Issues Paper* (NZLC IP26, 2011) [*The Duties, Office and Powers of a Trustee*].
 - 11 N Kelly, C Kelly and G Kelly *Garrow and Kelly Law of Trusts and Trustees* (6th ed, LexisNexis, Wellington, 2005) at [27.3.1] [*Garrow and Kelly*].
 - 12 *Canson Enterprises Ltd v Boughton & Co* [1991] 85 DLR (4th) 129 at 164.
 - 13 *Bank of New Zealand v New Zealand Guardian Trust Co* [1999] 1 NZLR 664 at 687.
 - 14 Kelly, Kelly and Kelly *Garrow and Kelly*, above n 11, at [27.4.1].
 - 15 Chris Kelly “Supervision of Trustees: Enforcement or Problem Solving” (LLM Thesis, Victoria University of Wellington, 2009) at 77.
 - 16 Kelly, Kelly and Kelly *Garrow and Kelly*, above n 11, at [19.3.1].
 - 17 Law Commission *Review of Trust Law in New Zealand: Introductory Issues Paper* (NZLC IP19, 2010).
 - 18 *Ibid*, at [3.16] – [3.23].
 - 19 The concept of “fraud on a power” may be relevant. The expression fraud on a power is historical language for when a power is misused in an ultra vires manner. An appointment is considered a fraud on a power if made for a wrongful purpose or a purpose unrelated to the original purpose of the power. If the power is exercised with the intention of benefiting some non-object of the discretionary power, the exercise is void since it is ultra vires. However, if there is no such improper intention, even though the exercise does in fact benefit a non-object, it is considered valid; see *Wong v Burt* [2005] 1 NZLR 91 (CA) at [30] and *Kain v Hutton* [2008] NZSC 61, [2008] 3 NZLR 559 at [46]–[54].
 - 20 *Wrightson Ltd v Fletcher Challenge Nominees Ltd* (1998)1 NZSC 40,388 at 40,413.
 - 21 Kelly, Kelly and Kelly *Garrow and Kelly*, above n 11, at [19.3.1].
 - 22 *Gailey v Gordon* [2003] 2 NZLR 192 (HC) at [89].
 - 23 *Blair v Vallely* HC Wanganui CP8/98, 23 April 1999.
 - 24 *Wrightson Ltd v Fletcher Challenge Nominees Ltd* (1998)1 NZSC 40,388.
 - 25 *Ibid*, at 40,413.
 - 26 *Ibid*. The authority Fisher J cites here is *Re Hastings-Bass* [1975] Ch 25 (CA).
 - 27 *Re Hastings-Bass* [1975] Ch 25 (CA).
 - 28 See Mathew Conaglen “Reviewing the Review of Fiduciary Discretions” [2011] CLJ 301 at 302.
 - 29 *Pitt v Holt* and *Futter v Futter* [2011] EWCA Civ 197.
 - 30 *Ibid*.

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- 31 *Craddock v Crowhen* (1995) 1 NZSC 40,331.
- 32 *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* [1948] 1 KB 223.
- 33 *Craddock v Crowhen* (1995) 1 NZSC 40,331 at 40,337.
- 34 *Blair v Vallely* HC Wanganui CP8/98, 23 April 1999 at 21.
- 35 *Wrightson Ltd v Fletcher Challenge Nominees Ltd* (1998) 1 NZSC 40,388 at 40,413.
- 36 Law Commission *Some Problems in the Law of Trusts* (NZLC R79, 2002) at [35].
- 37 *Gailey v Gordon* [2003] 2 NZLR 192 (HC) at [89].
- 38 Kelly, Kelly and Kelly *Garrow and Kelly*, above n 11, at 521.
- 39 Kelly, above n 15, at 47.
- 40 Kelly, Kelly and Kelly *Garrow and Kelly*, above n 11, at 739.
- 41 *New Zealand Guardian Trust Company Ltd v Siemonek* [2007] NZCA 494, [2008] 2 NZLR 202 at [38] – [41].
- 42 CEF Rickett “Reviewing a Trustee’s Act, Omission or Decision under Section 68 of the Trustee Act 1956” [1990] NZ Recent Law Review 69.
- 43 They cite *Johns v Johns* [2004] 3 NZLR 202 (CA) at [49] in support of their view of what beneficially interested might include; see Kelly, Kelly and Kelly *Garrow and Kelly*, above n 11, at 743.
- 44 Kelly, Kelly and Kelly *Garrow and Kelly*, above n 11, at 740.
- 45 *Rossiter v Wrigley* HC Hamilton A105/80, 3 July 1989.
- 46 Rickett, above n 42, at 80.
- 47 Trustee Act 1956 (Qld), s 8.
- 48 Rickett, above n 42, at 80.
- 49 *Ibid.*
- 50 *Rossiter v Wrigley* HC Hamilton A105/80, 3 July 1989 at 33.
- 51 Rickett, above n 42, at 80.
- 52 *Re Havill* [1968] NZLR 217 (SC) at [223] and *Re WEL Energy Trust* [2002] 3 NZLR 826 (HC) at [36].
- 53 *Wendt v Orr* [2004] WASC 28 at [20]–[31], cited in Kelly, Kelly and Kelly *Garrow and Kelly*, above n 11, at 740.
- 54 Kelly, Kelly and Kelly *Garrow and Kelly*, above n 11, at 741.
- 55 Rickett, above n 42, at 69.
- 56 *Schmidt v Rosewood Trust Ltd* [2003] 2 AC 709 at [51] and [66].
- 57 Law Commission *The Duties, Office and Powers of a Trustee*, above n 10, at ch 4.
- 58 Law Commission *Perpetuities and the Revocation and Variation of Trusts: Review of the Law of Trusts Third Issues Paper* (NZLC IP22, 2011) at chs 4 and 5.

Chapter 2

Powers under the Trustee Act 1956

INTRODUCTION

- 2.1 Part 5 of the Trustee Act 1956 contains most of the powers conferred on the High Court by that Act. A number of other provisions in the Act also confer powers on the High Court or modify jurisdiction exercised under the Act.
- 2.2 This chapter examines the High Court's powers under the Act. The Commission invites submissions on any issues that may have arisen over these provisions. To avoid repetition with earlier Issues Papers only those provisions and issues that have not been canvassed in earlier papers are considered. The focus here is on the role of the court under each provision, although the Commission welcomes any further comments submitters may wish to make on any of the provisions.

POWERS CONFERRED ON THE HIGH COURT

- 2.3 "Court" is defined in section 2 of the Trustee Act to mean "the High Court". This means that the powers to grant relief or make orders under the provisions of the Act are reserved to the High Court. District Courts have an equitable jurisdiction under section 34 of the District Courts Act 1947 and can hear some claims in relation to trusts. However, they do not have jurisdiction to grant relief or exercise any of the powers under the Trustee Act as these powers have been expressly conferred on the High Court by statute.⁵⁹ The issue of whether courts other than the High Court should be able to exercise all or some of the powers under the Trustee Act is discussed in chapter 3.
- 2.4 A wide variety of unrelated powers are conferred on the court by different sections of the Act. The discussion below moves sequentially through those provisions (not yet canvassed in earlier Issues Papers) that raise issues.

- 2.5 The relevant provisions are:
- section 72 – Commission;
 - section 74 – Power to make a beneficiary indemnify for breach of trust;
 - section 75 – Barring claims and future claims; and
 - sections 77 to 79 – Payment of trust money to the Crown.
- 2.6 In addition, this chapter identifies all the other court powers in the Act that will need to be retained and re-drafted in contemporary terms. These are mentioned only briefly since they do not seem to raise any specific issues.

Section 72 – Commission

- 2.7 Under section 72 the court may authorise the payment out of trust property of a “commission or percentage” to a trustee of an amount that is just and reasonable for the person’s services before, during, or on termination of the administration of the trust. Payment of commission on the authority of the court under the section is one of the exceptions to the trustee’s duty to act gratuitously and not profit from trusteeship.
- 2.8 The terminology of “commission or percentage” used in the section is out of date and a replacement provision should use contemporary terminology and enable the court to approve payment of a reasonable fee or remuneration to any trustee.
- 2.9 However, the section raises a further issue. It currently lists eight factors that the court is required to have regard to when determining what payment would be just and reasonable:
- (a) the amount that has already been paid to any trustee of the trust;
 - (b) the extent and difficulty of the services rendered by the trustee;
 - (c) the liabilities to which the trustee is or has been exposed, and the responsibilities imposed on him;
 - (d) the skill and success of the trustee in administering the trust;
 - (e) the value of the trust property;
 - (f) the time and services reasonably required of the trustee;
 - (g) whether any commission that might otherwise have been allowed should be refused or reduced due to delays in the administration of the trust that were occasioned by or could have been prevented, by the trustee; and
 - (h) any other circumstances considered relevant.
- 2.10 An issue the Commission seeks feedback on is whether it is beneficial to retain this type of list to provide guidance.

Section 74 – Power to make a beneficiary indemnify for breach of trust

- 2.11 Where a trustee has committed a breach of trust at the instigation, request or with the written consent of a beneficiary, the court may indemnify the trustee by making an order impounding or confiscating all or any part of the beneficiary's interest in the trust estate. All of the beneficiary's entitlements may be confiscated in order to make good the loss but only where the beneficiary has instigated, requested, or consented in writing to a breach of trust. The right to confiscate a beneficiary's interest is subject to the discretion of the court.
- 2.12 Where beneficiaries have simply consented to a breach of trust, but have not done so in writing, section 74 cannot be relied on and they cannot be made to indemnify trustees. However, they cannot sue the trustees for any loss they suffer as a result of any breach to which they consented. In such circumstances the beneficiary is also liable to account to the trust for any profit he or she may have made from the breach of trust.⁶⁰
- 2.13 Section 74, as currently drafted, contains a very antiquated proviso stating that the court may make an order impounding the property "notwithstanding that the beneficiary may be a married woman restrained from anticipation". This proviso predates the significant legislative changes made in other areas of the law giving married women full and equal status under law so should be repealed.

Section 75 – Barring claims and future claims

- 2.14 The section confers powers on a trustee for the dual purposes of facilitating the prompt distribution of an estate and also for managing claims that the trustee considers ill-founded. Where a trustee has received a claim but is not prepared to pay it or agree to a compromise with the claimant, he or she can utilise section 75. Also, where the trustee anticipates a claim that has not been made yet, he or she can use section 75 to give notice to the prospective claimant.
- 2.15 Under section 75 the trustee may serve upon any claimant or potential claimant a notice requiring him or her to take legal proceedings (within three months from the date of service) to enforce and prosecute their claim through court proceedings. At the expiry of the notice period the trustee may apply to the court for an order barring the claim. The claimant or prospective claimant must be served with the application seeking to bar his or her claim.
- 2.16 Where the claimant is unable to then satisfy the court that the claim has been filed and is being pursued, the court may make an order:
- (a) barring the claim; or
 - (b) allowing the trust property to be dealt with without regard to the claim.

2.17 The court may alternatively extend the period for the applicant to file their claim. The court may impose such conditions and give such directions, including a direction as to the payment of the costs of the application, as it considers just. For the purposes of section 75, a claim or potential claim means any claim:

- (a) in respect of any estate or trust property;
- (b) against the trustee personally where the trustee is entitled to be reimbursed out of the trust fund;
- (c) under the Law Reform (Testamentary Promises) Act 1949; or
- (d) by anyone claiming as a creditor, or next of kin, or beneficiary.

Section 75 does not apply to any claim under the Family Protection Act 1955.

2.18 The circumstances in which section 75 can be used appear to be very broad. In *Public Trust v Vincent* the Public Trustee applied to the High Court for orders barring a number of proceedings the defendants had commenced in the District Court and Disputes Tribunal. The court concluded that section 75 was sufficiently broad to cover such claims.⁶¹

2.19 The Commission is not aware of any particular difficulties that have arisen over the interpretation and application of the provision by the courts, although the section has only been examined in a handful of cases. One issue that could be considered is whether more recent statutes, such as the Property (Relationships) Act 1976, should be included in the list.

Sections 77 to 79 – Payment of trust money to the Crown

2.20 An option for trustees, where beneficiaries cannot be located, is to pay the money to the Crown. Under sections 77 to 79 of the Act trustees may be relieved of their responsibilities as trustees by paying trust money or securities over to the Crown in accordance with the provision. Where trustees are in agreement the court's involvement is minimal.

2.21 Under section 77 trustees (or a majority of them) may:

- (a) file an affidavit in the nearest High Court registry giving particulars of the trust and beneficiaries; and
- (b) serve a copy of the affidavit on the Secretary to the Treasury; and
- (c) pay the money or transfer the securities to the Crown.

2.22 Where the majority of trustees wish to make use of the provisions but other trustees do not agree, the court may make an order requiring payment or transfer to the Crown. The court may also make an order where money or securities have been deposited at a bank or with a broker requiring that they are transferred to the majority of trustees so the trustees can then transfer them to the Crown. A receipt from the Treasury discharges the trustees and the money and securities are then administered by the Treasury.

- 2.23 Section 79 provides that an ex parte application may be made to the court for the payment or transfer of any money or securities held by the Crown under section 77. The Court may make any orders it thinks fit when resolving such an application.

Practice under the provisions

- 2.24 The Treasury advises that each year a number of trustees pay money or transfer securities to the Crown under the section. Most of the money that is paid to the Treasury to administer is paid over by the trustees of unit trusts or superannuation trusts when the trustees want to wind those trusts up. The Treasury also receives some money from solicitors who have been acting as trustees holding unclaimed money in their firm trust accounts. It seems the mechanism is not, however, currently used by the trustees of private trusts. This is likely to be because there are other options available when trustees wish to pay out such funds and beneficiaries cannot be found.
- 2.25 The Treasury will not accept a transfer of funds under the provision unless trustees are able, in their affidavit, to provide sufficient evidence that they have taken all reasonable steps to locate beneficiaries and pay out the funds.
- 2.26 The Treasury holds monies paid under section 77 in a trust account for six years. Section 78 requires Treasury to publish at the end of each financial year in the *Gazette* a statement of all money and securities held by the Crown under section 77. The Treasury's practice is to list the name of individual beneficiaries, where these are known, as well as the names of the funds and the amount being held. Where someone is able to establish a claim, the Secretary to the Treasury may pay or transfer the money or securities to that person under the section. The provision allows the reasonable costs and expenses of the Crown to be deducted before payment is made. The Commission understands though, that in practice, the Treasury does not make such deductions and all their administrative costs are funded by the Crown in the usual way as overheads through Vote Treasury appropriations.
- 2.27 Money that is not claimed and paid out during the six years that it is held in a trust account by the Treasury is then transferred to the Crown bank account as unclaimed money.
- 2.28 The Treasury advise that approximately two million dollars (\$2,023,500) is currently held on trust. Approximately \$250,000 was transferred from the trust account to the Crown bank account on 1 July 2011 as it had, at that date, been held for six years. The Treasury estimates that approximately 10 per cent of the trust money and securities that are paid to the Crown under these provisions are subsequently claimed and paid out to claimants. The remaining 90 per cent goes into the Crown account and is never claimed back.

- 2.29 A procedure of this kind would seem to provide a necessary final backstop for trustees where they are unable to distribute funds. Of some concern, perhaps, is the amount of money that is never claimed and is simply absorbed into the Crown account. It might be appropriate to consider whether more should be required to locate beneficiaries, such as publication of a directory of unclaimed funds on the web as well as in the *Gazette*.
- 2.30 The Treasury is currently under no obligation to invest or manage the funds it holds and is not required to pay any interest on money it has held when it is finally claimed. This is consistent with the approach taken in the Unclaimed Money Act 1951. Under that Act no claimant is entitled to interest on money when claimed from the Commissioner of Inland Revenue.⁶²

Should an affidavit always be required?

- 2.31 A further concern is that the process under section 77 requiring trustees to file an affidavit may be considered quite arduous in cases where the amount of money held on trust is very small. Treasury officials advise that they are occasionally contacted by solicitors whose trust accounts hold small sums of unclaimed trust money that they would like to pay over to the Treasury under the provisions. However, because the process under section 77 requires the solicitor to file an affidavit describing the particulars of the unclaimed funds before the Treasury can accept the money, the Treasury is unable to accept unclaimed funds from trustees in any other situation. The Commission considers that a simpler process, not requiring the expense of an affidavit, could well be appropriate for dealing with small sums of money.

Brief overview of other court powers in Act

- 2.32 The other court powers in the Act that will need to be retained and re-drafted in contemporary terms (not already discussed in earlier Commission Papers) follow. For completeness the Commission lists here also those provisions (discussed in *The Duties, Office and Powers of a Trustee*⁶³ and *Perpetuities and the Revocation and Variation of Trusts*)⁶⁴ that confer powers and functions on the court. Any further feedback from submitters on the role and powers of the court under these provisions is also welcomed.
- 2.33 The relevant provisions are:
- A power to order a partition – under section 14(6B) the court may, if satisfied that the partition of the real estate of a deceased person would be advantageous to those parties with an interest in it, order a partition (subdivision) or appoint arbitrators to effect a partition.
 - The court's supervisory role where a trustee exercises their power under section 15(1)(j) to appropriate property to pay out a legacy. After receiving notice any interested person may apply to the court to vary the proposed appropriation.

- Under section 24, if trustees wish to insure any property for full replacement value, they must either obtain the consent of any person entitled to the income or alternatively seek the consent of the court.⁶⁵
- The court has supervisory powers under section 32 to manage situations where a trustee has power to carry on the business of a deceased person.⁶⁶
- A power to give directions under section 35(4) where there is doubt as to what advertisements should be published by a trustee giving notice under the section advertising for claims before distributing property under a trust. (A general updating of section 35 should also provide for the giving of notice in ways other than advertising in newspapers.)
- Under the indemnity provision in section 38(2) the court may, on application, authorise the payment of a trustee expenses as the court determines are just in the circumstances.⁶⁷
- Trustees' powers under section 40, to apply income for the maintenance or education of an under aged beneficiary, are subject to, and may be varied by, court direction.⁶⁸
- Under section 41, the portion of capital that may be applied by a trustee to the maintenance or education of an under-aged beneficiary is limited to half the beneficiary's vested share or interest. If a trustee wishes to pay more he or she must obtain the consent of the court. A court order is also required before any payments can be made by the trustee in a manner that would prejudice other prior interests.⁶⁹
- The court may authorise the setting aside of income or profits of business for certain specified purposes under section 42A.⁷⁰
- Under section 46, the court has powers to discharge trustees and appoint replacements.⁷¹
- The court has powers under section 49 to appoint advisory trustees and under section 50 to appoint custodian trustees.⁷²
- Under section 51, the court may appoint new trustees where it is inexpedient or impractical for others to do this without the assistance of the court. The court does not normally use its power under section 51 where it is possible for an appointment to be made by others under section 43 of the Act.⁷³ A number of options for reforming current provisions regarding the appointment of trustees have already been canvassed.⁷⁴
- Sections 52 to 62 of the Act empower the court to make vesting orders. The core provisions governing vesting orders have been canvassed and feedback was invited on any problems.⁷⁵
- The power of the court to authorise dealings with trust property and variations of trust under section 64 and section 64A have also been discussed.⁷⁶

- A trustee may obtain directions from the court on points arising in the management of a trust under the procedure set out in section 66.⁷⁷
- Under section 70, the court may, if satisfied that a diligent search has been made, give judgment against a defendant trustee in his or her absence. The provision is occasionally used so remains necessary.⁷⁸
- Under section 71, the court has a power to order that the costs and expenses of any application for any order under the Act, or any costs and expenses arising under any court order (including the cost of any conveyance or assignment of property) are to be paid out of the trust, or to be apportioned between such parties as the court directs.
- The court has the power under section 73 to relieve trustee from personal liability where they have committed a breach of trust, so would be liable on a strict application of the law, but have acted honestly and in good faith.⁷⁹
- Section 76 provides the machinery for ascertaining the existence or whereabouts of unknown or missing claimants.⁸⁰ It is a long and quite impenetrable provision that essentially sets out a process for trustees to follow where beneficiaries cannot be ascertained. Under it the court may give directions where a trustee is uncertain about what advertisements to place to notify potential beneficiaries. The court also has broad powers under the section to approve distribution where beneficiaries cannot be traced. The process has been used in a few cases involving pension funds that have largely been distributed, but where a handful of outstanding beneficiaries cannot be located despite extensive efforts on the part of trustees.⁸¹ Retention of a mechanism of this type seems necessary.

QUESTION

Q4 What changes, if any, are needed to the powers of the court under the provisions discussed in this chapter?

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- 59 District Courts Act 1947, s 34(2).
- 60 N Kelly, C Kelly and G Kelly *Garrow and Kelly Law of Trusts and Trustees* (6th ed, LexisNexis, Wellington, 2005) at 732–836 [*Garrow and Kelly*].
- 61 *Public Trust v Vincent* HC Auckland CIV-2005-404-629, 19 February 2006.
- 62 Unclaimed Money Act 1951, s 11(5).
- 63 Law Commission *The Duties, Office and Powers of a Trustee: Review of the Law of Trusts Fourth Issues Paper* (NZLC IP26, 2011) [*Duties, Office and Powers of a Trustee*].
- 64 Law Commission *Perpetuities and the Revocation and Variation of Trusts: Review of the Law of Trusts Third Issues Paper* (NZLC IP22, 2011) [*Perpetuities and the Revocation and Variation of Trusts*].
- 65 See Law Commission *Duties, Office and Powers of a Trustee*, above n 63, at [5.3]–[5.6].
- 66 *Ibid*, at [5.38]–[5.40].
- 67 *Ibid*, at [1.53]–[1.55].
- 68 *Ibid*, at [5.55]–[5.67].
- 69 *Ibid*.
- 70 *Ibid*, at [5.43]–[5.47].
- 71 *Ibid*, at [4.40]–[4.42].
- 72 *Ibid*, at [5.50]–[5.54].
- 73 Kelly, Kelly and Kelly *Garrow and Kelly*, above n 60, at 458.
- 74 Law Commission *Duties, Office and Powers of a Trustee*, above n 63, at [5.55]–[5.67].
- 75 *Ibid*, at [4.45]–[4.53].
- 76 Law Commission *Perpetuities and the Revocation and Variation of Trusts*, above n 64, at ch 5.
- 77 See Law Commission *Duties, Office and Powers of a Trustee*, above n 63, at [5.65]–[5.67].
- 78 In *Bridgecorp Ltd (in receivership and in liquidation) v Turnbull* the first defendant had not been served by the plaintiffs with the proceedings but the plaintiff was able to proceed to have judgment entered against him by relying on section 70 of the Trustee Act 1956. Associate Judge Doogue was satisfied that a diligent search had been made for the first defendant and that he was a person who is being served ‘in the character of trustee’; *Bridgecorp Ltd (in receivership and in liquidation) v Turnbull* HC Auckland CIV-2008-404-6227, 18 February 2009 at [1].
- 79 See Law Commission *Duties, Office and Powers of a Trustee*, above n 63, at [3.18]–[3.27].
- 80 *Re Sheridan (deceased)* [1959] NZLR 1069 (CA) at 1075.
- 81 *Re UEB Industries Ltd Pension Plan* (1995) 1 NZSC 40,341.



Chapter 3

Jurisdiction of the District Courts

INTRODUCTION

- 3.1 District Courts are given by statute the same broad equitable jurisdiction as the High Court in respect of trusts. However, because District Courts do not have jurisdiction to exercise the powers granted by the Trustee Act 1956, they do not provide an effective forum for resolving lower value trust disputes.
- 3.2 This chapter considers whether changes should be made to expand the jurisdiction of District Courts in relation to trusts. An alternative option of extending the jurisdiction of the Family Court over family trusts is also canvassed in this chapter.

JURISDICTION CONFERRED BY DISTRICT COURTS ACT

- 3.3 District Courts have only statutory jurisdiction. Historically, the equitable jurisdiction of District Courts was limited to certain specified matters. Section 34 of the District Courts Act 1947 now gives District Courts full equitable jurisdiction within the monetary limits of section 29, except where that jurisdiction is regulated by statute.⁸²
- 3.4 Section 34 provides that:
 - (1) Subject to the provisions of this Act, the courts shall have—
 - (a) the same equitable jurisdiction as the High Court to hear and determine any proceeding (other than a proceeding in which the amount claimed or the value of the property claimed or in issue is more than \$200,000):

- (b) jurisdiction to hear and determine any proceeding for the dissolution or winding up of any partnership (whether or not the existence of the partnership is in dispute), where the whole assets of the partnership do not exceed in amount or value the sum of \$200,000.
 - (2) Where jurisdiction in respect of any proceeding or class of proceeding is, by virtue of any provision of any Act (not being section 16 of the Judicature Act 1908) that relates expressly to that proceeding or class of proceeding, exercisable by the High Court or any other court (not being a District Court), District Courts shall not by virtue of subsection (1)(a) or section 29(1) have the equitable jurisdiction of the High Court in respect of that proceeding or class of proceeding.
 - (2A) Notwithstanding subsection (2), the District Courts shall have the power to make orders pursuant to section 49 of the Administration Act 1969....
- 3.5 Section 29(1) of the Act sets the monetary limits for proceedings in District Courts:
 - (1) The courts shall have jurisdiction to hear and determine any proceeding where the debt, demand, or damages, or the value of the chattels claimed, is not more than \$200,000, whether on balance of account or otherwise: provided that the courts shall not, except as in this Act provided, have jurisdiction to hear and determine—
 - (a) any proceeding for the recovery of land; or
 - (b) any proceeding in which the title to any franchise is in question.
- 3.6 District Courts are granted by section 34(1)(a) of the District Courts Act “the same equitable jurisdiction as the High Court”, so long as “the amount claimed or the value of the property” at issue is no more than \$200,000. Specific qualifications are imposed on District Courts’ equitable jurisdiction by section 34(2). Where an Act (other than section 16 of the Judicature Act 1908, the provision conferring general jurisdiction on the High Court) has conferred equitable jurisdiction on the High Court (or any other court) over a proceeding or class of proceeding, then District Courts have no jurisdiction over such proceeding. Most significantly for our review, this provision means that the powers granted to the High Court by the Trustee Act cannot be exercised by District Courts.
- 3.7 Before turning to that issue, it is useful to examine section 34(1)(a) more closely and consider what jurisdiction District Courts have in this area. What does “the same equitable jurisdiction as the High Court” actually mean? The Commission suggests that the words can simply be given their natural meaning. District Courts have the same equitable jurisdiction as the High Court but only up to the specified monetary limit. Within those monetary limits the courts have the same equitable jurisdiction to supervise and intervene when necessary in trusts as the High Court.

- 3.8 The current section 34 was enacted in 1992 and replaced a list of specific matters that previously defined the District Courts' equitable jurisdiction. When the provision was introduced, the Minister of Justice said that it had become apparent that the equitable jurisdiction of the District Courts was not sufficiently wide and that to remedy this it "was therefore decided that the district courts should have the same equitable jurisdiction as the High Court, with some exceptions."⁸³
- 3.9 District Courts have jurisdiction to determine breach of trust claims within their monetary limits.⁸⁴ Included here are those cases where the court is being invited to review the exercise of a power or discretion by trustees.
- 3.10 As was discussed in chapter 1, the High Court has an inherent power to supervise the administration of trusts and control trustees. The High Court inherited from the courts of Chancery an inherent jurisdiction to supervise, and if necessary to intervene in, the administration of trusts.⁸⁵ This supervisory jurisdiction means the High Court can, in appropriate circumstances, remove trustees and modify or even revoke trusts.⁸⁶ There seems to be no case law on point, but it is unlikely that section 34(1)(a) would be found to have conferred these supervisory powers on the District Courts.
- 3.11 It is also appropriate to note here that the upper limit of \$200,000 that currently applies to the amount that can be claimed or the value of the property that can be at issue is, in practice, a significant barrier to trust litigation being undertaken in the District Court.⁸⁷ Even most modest family trusts are likely to have assets well in excess of that amount, so disputes where the amount at issue is less than this figure are likely to be rare in practice.

JURISDICTION UNDER THE TRUSTEE ACT

- 3.12 District Courts cannot exercise any powers under the Trustee Act. The Act gives exclusive jurisdiction to the High Court. Some inconvenience and difficulty is caused by this restriction. It might even be argued that the District Court's jurisdiction in respect of trusts is rendered ineffective because it is not able to make orders under the Act.

- 3.13 The problem is well illustrated by the Court of Appeal decision in *Morris v Templeton*.⁸⁸ In this case beneficiaries brought proceedings against a trustee in the District Court alleging that the trustee had breached his trust by investing funds in unauthorised securities. The District Court judge found for the applicants that the trustee had breached his trust, but then purported to exercise the discretion given to the High Court under section 73 of the Trustee Act and excuse the trustee from personal liability for losses suffered as a result of the breach. The beneficiaries appealed. Eventually the case reached the Court of Appeal, which held that “[t]he Legislature specifically reserved the power to grant relief under section 73 to the High Court”.⁸⁹ District Courts can hear claims for breach of trust under their equitable jurisdiction as provided for in section 34(1) of the District Courts Act but the Trustee Act reserves jurisdiction to grant relief under section 73 to the High Court so by virtue of section 34(2) the District Court has no jurisdiction.⁹⁰
- 3.14 Where a District Court makes an order against a trustee for breach of trust the trustee will have to then apply to the High Court for relief if the trustee wishes to invoke section 73 and avoid personal liability. This is not a satisfactory situation because two separate courts will have to consider the same salient facts and make determinations. It may also effectively force such breach of trust cases into the High Court notwithstanding that there are relatively modest sums involved purely to avoid a multiplicity of proceedings.⁹¹
- 3.15 In its report *Some Problems in the Law of Trusts* the Law Commission recommended addressing this issue by amending section 73 to include a further subsection requiring breach of trust claims to be removed to the High Court where the trustee, by his or her statement of defence, seeks relief under the section.⁹² This approach to the issue was adopted in the Trustee Amendment Bill 2007. When introduced the Bill included a clause to be inserted into the District Courts Act that provided for the automatic removal of the entire breach of trust proceedings from the District to the High Court in any case where section 73 of the Trustee Act was invoked.⁹³
- 3.16 The Select Committee rejected this approach in its report on the bill. Instead the Committee said:

We recommend giving District Courts jurisdiction over breach of trust cases within their monetary jurisdiction, by inserting new section 34(2A) into the District Courts Act 1947 (new clause 13). This is instead of the bill’s proposal that new section 45AA (clause 13) be inserted in the District Courts Act, requiring certain proceedings in a District Court to be removed to the High Court. Under the current Trustee Act, only the High Court has jurisdiction to relieve a trustee from personal liability for breach of trust. We also recommend amending section 73 of the Trustee Act (new clause 8A) to allow District Courts to transfer proceedings to the High Court if necessary because of complexity. We recognise that it is appropriate to have most such cases heard in District Courts, and having these cases heard in the High Court might result in delays and high costs for beneficiaries.

- 3.17 The Select Committee only considered jurisdiction under section 73 because this was the issue addressed by the Bill before it. It did not consider the broader question of whether District Courts should have jurisdiction under other sections of the Trustee Act.
- 3.18 Some commentators have expressed disagreement with the Select Committee's assertion "that it is appropriate to have most such cases heard in District Courts, and having these cases heard in the High Court might result in delays and high costs for beneficiaries".⁹⁴ Others have suggested that further consideration should be given to the issue of extending certain (if not all) Trustee Act and other statutory powers to the District Court.⁹⁵
- 3.19 The Trustee Amendment Bill 2007 as reported back by the Committee has not progressed. The question of what if any jurisdiction District Courts should have under the Act is consequently being looked at again by the Law Commission as part of this review.

EXTENDING THE JURISDICTION OF DISTRICT COURTS

- 3.20 Whether District Courts should have jurisdiction under legislation replacing the Trustee Act and, if only partially, in what areas, are significant issues for this review.

Should District Courts have jurisdiction under new trust legislation?

- 3.21 Arguments that can be made in favour of expanding the District Courts' jurisdiction under new trusts legislation centre on improving access to dispute resolution options. The equitable jurisdiction of District Courts in respect of trusts is ineffective unless they are able to exercise statutory powers over trusts. District Courts are not currently an effective forum for trust cases because they do not have jurisdiction to appoint new trustees, remove or replace trustees or deal with applications for variation or resettlement. They also cannot review the acts of trustees under section 68 where they are exercising a power under the Act. (As already noted, the upper limit to the District Courts' jurisdiction is also a practical barrier to commencing most trust cases in these courts – but that issue is well beyond the scope of this project.)
- 3.22 Since the Trustee Act came into force the jurisdiction of District Courts has expanded, in equity, as well as in other areas. As the monetary jurisdiction of the District Courts has increased, amendments have also broadened the scope of their jurisdiction under section 34. Subsection (2A) was, for example, inserted in 1996 giving District Courts the power to make orders under section 49 of the Administration Act 1969. As already noted, the current section 34 replaced a list of specific matters that previously defined the courts' equitable jurisdiction in 1992.

- 3.23 Given the general expansion of the courts' equitable jurisdiction during the years since the Trustee Act was enacted, it might therefore be argued that it is something of an anomaly that District Courts cannot exercise powers under the Trustee Act within their monetary limits. In other areas of law, for example the Property Law Act 2007, District Courts now have concurrent jurisdiction with the High Court under statute. However, other Acts, for example the Companies Act 1993, continue to reserve jurisdiction to the High Court.
- 3.24 It might also be argued that District Courts could provide a less costly and generally more accessible option for beneficiaries seeking to hold trustees to account in lower value disputes.⁹⁶ Similarly, in some situations where trustees need to apply to the High Court for directions or orders, the cost of proceedings might be reduced if applications could be made to the District Courts. For example, even a comparatively straightforward application to remove a trustee on grounds of incompetence or criminal fraud requires a High Court application. In many situations an application to appoint a new trustee is a relatively straightforward matter.
- 3.25 Litigating in the High Court is expensive. The fee structure for the High Court's civil jurisdiction is premised on it primarily hearing high value cases or those that raise complex issues of law. The filing fee for an application is presently \$1,329.20. There is also a concession rate proceeding fee of \$483.40, which is available for some applications under the Trustee Act. However, the Commission has been advised by practitioners that practices vary between different registries as to when this lower rate is applied. Hearing fees for the High Court are \$1,570.90 for each half day of court time.⁹⁷ In contrast, an application fee in a District Court is \$169.20 and hearing fees are set at \$906.30 for each half day.⁹⁸
- 3.26 The cost of legal representation probably differs less between the two courts. It has been suggested to the Commission by practitioners that the cost of representation will be similar regardless of whether cases are heard in the High or District Court. This is mainly because proceedings under the Trustee Act can often be undertaken in the High Court using the truncated, less costly originating application process. This process is not available in the District Courts so overall the cost of representation may remain similar, even where practitioners' charging rates are lower in the District Court.
- 3.27 While the differences in the cost of representation are less significant, the overall cost to litigants is higher in the High Court. Some commentators argue that the cost of High Court action may be reasonable where there are substantial assets and sufficient funds in the trust to meet them. However, many trusts in New Zealand have only modest assets (often the family home) and it seems anomalous that trustees can bring other claims (like one to enforce a contract) in a District Court for up to \$200,000, but an application to remove a trustee can only be made only in the High Court.⁹⁹
- 3.28 The question of whether applications could be more quickly resolved by the District Courts is much more difficult to assess.

- 3.29 Researchers at the Otago University Law Faculty recently conducted a preliminary investigation on the speed of resolution of civil cases in New Zealand. The study found that there was a dearth of New Zealand research in this area. Using data that measured the time it took for a subset of civil cases to progress through the system for the District and High Court, the study found that while a greater percentage of cases are resolved before being allocated a hearing in the District Court, those cases take on average 55 days longer to resolve than the same group of cases in the High Court. Where cases proceed to the point where a hearing is allocated cases take on average marginally less time (19 days) in the District Court than the High Court. Where there is more difference between the two is the percentage of High Court cases (16 per cent) that come within this bracket compared to the District Courts (only one per cent).¹⁰⁰ The reasons for this difference are not clear. It may be due to differences in the types of civil cases, the value of claims or the issues being litigated in each court.
- 3.30 Some trust practitioners have told the Commission that the High Court's civil procedures and also its case management processes are much better suited to resolving trust litigation than those currently in use in the District Courts. In particular, the availability of the truncated originating application process, effective case management processes, and the use of Associate Judges increase the court's efficiency and can reduce delay and cost.

Which powers should District Courts have?

- 3.31 If the jurisdiction of District Courts was extended under new trust legislation, then a further issue to consider is whether District Courts should simply be given concurrent jurisdiction with the High Court up to the monetary limits specified in the District Courts Act. Concurrent jurisdiction would allow applicants to continue to file in the High Court where they considered the circumstances made this more appropriate.
- 3.32 Giving the District Courts jurisdiction in all matters arising under the Act that fall within specified monetary limits is the more straightforward approach to reform.
- 3.33 However, an alternative option to consider would be to give the District Courts jurisdiction under some specific sections (such as the appointment and removal of trustees) but not others (such as those enabling variations to a trust).
- 3.34 If jurisdiction is limited to specific sections then the specific powers the courts should have would need to be identified. As noted above, the Select Committee report on the Trustee Amendment Bill 2007 only proposed giving District Courts jurisdiction under section 73. However, that was probably because jurisdiction under that specific section was the issue being dealt with in the Bill. The Committee was not considering the broader question of whether the District Courts should also have jurisdiction under the other sections of the Trustee Act.

- 3.35 The three specific areas where it has been suggested to the Commission that a lower level alternative to the High Court is most needed are:¹⁰¹
- (a) appointment and removal of trustees;
 - (b) decisions about whether or not trustees should release specific information to beneficiaries or not; and
 - (c) application for directions jurisdiction (currently under section 66 of the Act).
- 3.36 A disadvantage of only giving the courts certain powers would be that aspects of a trust case that come before a District Court may still raise issues that fall beyond the court's jurisdiction.

Should the Family Court have jurisdiction under new trusts legislation?

- 3.37 Another alternative that has been discussed by some commentators is to give the Family Court some jurisdiction (again concurrently with the High Court) under trust legislation.¹⁰² The Family Court might only have jurisdiction under some specific provisions.
- 3.38 The Family Court already has concurrent jurisdiction with the High Court under the Family Protection Act 1955 and it might therefore be appropriate for it, rather than the District Courts, to have jurisdiction in respect of family trusts. The Family Court also already sometimes considers aspects of trust law that arise in cases within its jurisdiction under the Property (Relationships) Act 1976.
- 3.39 However, a number of issues arise when considering the Family Court. Not all trusts are family trusts. Many trusts have a commercial component and significant numbers operate, as discussed in Part 3 of this paper, as trading trusts. The Family Court could not be considered an appropriate forum for disputes in respect of any of these types of trusts.
- 3.40 In addition, the Family Court does not have the substantive equitable jurisdiction of the District Courts. Section 11(1) of the Family Courts Act 1980 confers jurisdiction on the Family Court. Section 16 of that Act then applies the District Courts Act, with any necessary modifications, to Family Courts and Family Court judges. A line of High Court cases has confirmed that these provisions do not confer the District Court's substantive equitable jurisdiction under section 34 on the Family Court.¹⁰³ In the most recent decision the High Court stated that "further words are required to confer on the Family Court the civil jurisdiction of the District Court. Those further words are absent".¹⁰⁴ The Family Court has, under section 16 of the Family Court Act, the ancillary jurisdiction of a District Court under section 41 of the District Courts Act, so is able to give equitable relief where a matter is within its jurisdiction, but does not have jurisdiction to hear a cause of action founded in equity.¹⁰⁵

- 3.41 Unless it was first given a substantive equitable jurisdiction, the Family Court could not deal with the full range of trust cases. It cannot therefore be considered as an alternative forum, even for family trust cases, in the way the District Courts might. However, the Family Court could be given a limited jurisdiction to exercise powers under the Trustee Act where that was considered necessary to dispose of proceedings that were otherwise properly before it under other legislation (such as the Family Proceedings Act, Property (Relationships) Act, and Family Protection Act). The Commission would welcome feedback on whether this might be desirable, given the number and nature of trust issues that seem to have arisen in relationship property cases before the Family Court.¹⁰⁶
- 3.42 Finally, it should be noted that these issues in respect of the Family Court's jurisdiction are currently being considered as part of the broader Family Court Review being undertaken by the Ministry of Justice. The terms of reference require that review to specifically consider "the statutes best administered by the Family Court and the boundaries between the Family Court and the civil jurisdiction of the High or District Courts". *Reviewing the Family Court: A Public Consultation Paper* was issued by the Ministry in September 2011 and submissions will close on 29 February 2012.

Should the High Court retain exclusive jurisdiction?

- 3.43 The main argument for the High Court retaining exclusive jurisdiction is that trust law is a technical and specialist area involving issues of both legal and factual complexity. Considerable expertise at both the judicial level and representation level is required and this will more readily occur if jurisdiction is exclusively exercised by the High Court. In 2004 the Law Commission recommended that some areas of civil work, including trusts and administration, should continue to be heard exclusively or predominantly by the High Court because such cases can be complex.¹⁰⁷
- 3.44 The Scottish Law Commission has also recently taken this approach. It has said that in the interests of simplification there should be a single court to which all applications relating to trusts are made.¹⁰⁸ Some areas of trust jurisdiction, for example those around variation of the terms of the trust, confer significant discretion on the court. The Scottish Law Commission's view is that a consistent and principled approach across cases can best be achieved by allocating all cases to a single court.¹⁰⁹ This same argument applies in New Zealand.

- 3.45 Trust cases involving the exercise of powers under the Act make up only a small portion of civil cases currently dealt with by the High Court. They would make up an even smaller portion of the civil workload of District Courts. It might be argued that it is more efficient to have all these cases determined by judges who have a greater degree of familiarity with a particular area of law. If trust cases are concentrated in the one court, the level of expertise at managing and resolving such cases improves, which in turn can reduce court time and costs. Judges with greater familiarity with the subject matter comprehend the evidence and issues more readily. This ultimately leads to better decision-making because such judges are less likely to err in their decisions. Arguments of this kind are currently being made by some for greater specialism within the High Court.¹¹⁰
- 3.46 As already noted, some practitioners have suggested that the better case management processes that are evident in the High Court, together with the use of Associate Judges, allow that court to effectively manage and resolve most trust cases. The High Court is better placed to efficiently process and determine the full range of trust related applications, including relatively simple applications, in a reasonably efficient and timely manner.

Comment

- 3.47 There are clear advantages in having greater expertise develop in complex areas of law. However, other factors, such as cost and accessibility for litigants, also need to be considered. It is also very difficult to determine whether decision-making by the District Courts would be any better or worse than the High Court.
- 3.48 At this stage the Commission's perception is that there are mixed views within the judiciary and the legal profession on extending the District Courts' jurisdiction. There are likely to be many who would not support District Courts having greater jurisdiction over trust issues and many who would likely welcome it.

QUESTIONS

Q5 Should the High Court continue to have exclusive jurisdiction under new trusts legislation or should District Courts have concurrent jurisdiction (within their monetary limits)?

Q6 If District Courts have concurrent jurisdiction, should it be only under some provisions in the Trustee Act 1956? If so, which provisions?

Q7 What, if any, powers should the Family Court have under new trusts legislation?

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- 82 Brookers Online *Commentary - Civil Procedure: District Courts and Tribunals* at [DC34.01].
- 83 (5 May 1992) 525 NZPD 8177.
- 84 *Morris v Templeton* (2000) 14 PRNZ 397 (CA).
- 85 *Schmidt v Rosewood Trust Ltd* [2003] 2 AC 709 at [51] and [66].
- 86 Although the High Court retains these supervisory powers, they have long been displaced for all practical purposes by provisions in the Trustee Act 1956 governing the removal, appointment and replacement of trustees and statutory powers covering the revocation and variation of trusts.
- 87 The Commission will raise the issue of the upper limit of the District Court’s jurisdiction generally when it releases an Issues Paper early next year as a part of its reference to review the Judicature Act 1908 and consolidate courts legislation.
- 88 *Morris v Templeton* (2000) 14 PRNZ 397 (CA).
- 89 *Ibid* at [9].
- 90 *Ibid*.
- 91 Andrew S Butler (ed) *Equity and Trusts in New Zealand* (2nd ed, Thomson Reuters, Wellington, 2009) at 10 [*Equity and Trusts*].
- 92 Law Commission *Some Problems in the Law of Trusts* (NZLC R79, 2002) at [16].
- 93 See Trustee Amendment Bill 2007 (144-1), cl 13, as introduced.
- 94 One example being Tony Molloy QC “New Zealand: Cuckoos in the nest in an otherwise promising trust and investment jurisdiction” (2009) 201 *Offshore Online* 19 at 23.
- 95 Butler *Equity and Trusts*, above n 91, at 10.
- 96 Chris Kelly “Supervision of Trustees: Enforcement or Problem Solving” (LLM Thesis, Victoria University of Wellington, 2009) at 107.
- 97 High Court Fees Regulations 2001, sch.
- 98 District Courts Fees Regulations 2009, sch.
- 99 Kelly, above n 96, at 108.
- 100 Rachel Laing, Saskia Righarts and Mark Henaghan *A Preliminary Study on Civil Case Progression Times in New Zealand* (University of Otago Legal Issues Centre, Faculty of Law, 15 April 2011).
- 101 Submission of Greg Kelly Law Limited on *The Duties, Office and Powers of a Trustee: Review of the Law of Trusts – Fourth Issues Paper* (dated 12 October 2011).
- 102 For example see the discussion in Kelly, above n 96, at 108.
- 103 *Singh v Kaur* [2000] 1 NZLR 755 (HC); *Perry v West* HC Auckland M1331-SD00, 8 September 2000; *F v W* HC Wellington CIV-2009-485-000531, 16 July 2009; *Yeoman v Public Trust Ltd* [2011] NZFLR 753 (HC).
- 104 *Yeoman v Public Trust Ltd* [2011] NZFLR 753 (HC) at [28].
- 105 *Ibid*, at [27] and [29].
- 106 The trust issues that have arisen within the Family Court’s jurisdiction are discussed in an earlier paper; Law Commission *Some Issues with the Use of Trusts: Review of the Law of Trusts Second Issues Paper* (NZLC, IP20, 2010) at [3.22]–[3.41].
- 107 Law Commission *Delivering Justice for All* (NZLC R85, 2004) at 262.

108 Scottish Law Commission *Discussion Paper on Supplementary and Miscellaneous Issues relating to Trust Law* (SLC DP148, 2011) at 37.

109 Ibid.

110 Dr Tony Molloy QC has, for example, argued strongly for specialism cautioning that it is not reasonable to expect judges to be able to master all of the law. See Tony Molloy QC “Trust Busting” (paper presented to a forensic accounting conference in Auckland, May 2011) at 5.

Part 2

MECHANISMS FOR DISPUTE RESOLUTION





Chapter 4

A new mechanism for trust disputes resolution

INTRODUCTION

- 4.1 The law currently makes it difficult to for beneficiaries to hold trustees to account. Taking an action against a trustee in the High Court, which is currently the only practical option available to beneficiaries who are dissatisfied with the performance of a trustee's duties, is likely to be costly, complex and slow. These factors are likely to dissuade many beneficiaries from taking action against a trustee when, in fact, they may have had a well-founded case. As a result, some trustees that are not performing the duties which they owe beneficiaries are not being held to account and breaches of trust are not being put right.
- 4.2 This chapter explores whether any other option for trust disputes resolution, such as an ombudsman, tribunal, or commission, should be considered. While the cost of establishing such a mechanism is likely to mitigate against the adoption of any of them at this time, it is useful to set out their features and analyse what value they could add.

IS A FURTHER MECHANISM FOR TRUSTEE ACCOUNTABILITY NEEDED?

- 4.3 Some commentators consider that the existing arrangements for the supervision of trustees are no longer adequate given the rapid growth in the number of trusts in New Zealand in the last 20 years and the inevitability that problems will arise with some of these.¹¹¹ The fiduciary duties of trustees in a trust relationship are meaningful only if they can be enforced.

- 4.4 There are two main problems that this discussion of new dispute resolution mechanisms for trusts seeks to address. First, the High Court is relatively inaccessible as the only dispute resolution decision-maker for trusts. As discussed in chapter 3, District Courts are not able to exercise powers under the Trustee Act 1956 (“the Act”) so do not have the jurisdiction to, for instance, appoint a new trustee or replace an existing trustee,¹¹² authorise dealings with trust property,¹¹³ authorise variations of the trust,¹¹⁴ review the acts and decisions of a trustee,¹¹⁵ or relieve a trustee from personal liability.¹¹⁶ For the majority of situations requiring external intervention to resolve a problem with a trust, it is necessary for the case to go to the High Court.
- 4.5 In order for court proceedings to be warranted and to have a reasonable chance of success, the complaints against trustees must be at the most serious end of the spectrum. In a case of serious default by a trustee, it will be possible for a beneficiary to obtain a remedy through the court, although it is likely to involve expense and delay. Chris Kelly suggests that where breaches of trust are less serious, involve less financial loss, or the beneficiary simply wants to warn a trustee before the trustee goes too far, there are few appropriate, satisfactory solutions available.¹¹⁷
- 4.6 A second problem is that trust disputes are often not well suited to litigation, but beneficiaries have no other way of holding trustees to account. Trust disputes can often involve private matters and family relationships. Litigation can be a heavy-handed response to these types of issues. The adversarial approach is unlikely to improve, and may impair, family relationships.
- 4.7 Kelly considers that in this context the exclusive jurisdiction of the High Court in some trust matters is of increasing concern.¹¹⁸ He argues that the system needs a low key, early intervention warning and monitoring mechanism. Early intervention is preferable to allowing minor disputes to escalate. It allows more face-saving compromises and can limit damage to family relationships.¹¹⁹
- 4.8 However, it may be preferable to improve access to the courts, to clarify the courts’ powers and to improve the processes in the legislation so that there is less need to go to court. The cost of any alternative mechanism may be too high to be commensurate with the likely scale of the problem it will address.

PRINCIPLES FOR EVALUATING OPTIONS

- 4.9 If any mechanism is to be pursued, it should achieve the following:
- (a) *Accessibility* – dispute resolution should be accessible for beneficiaries. This means that it should not be too costly for those using it or lead to overly long delays in decisions being made or be too formal. It should allow for early intervention in a dispute.
 - (b) *High-quality decision-making* – the dispute resolution mechanism should encourage high-quality, legally sound decisions regarding the potentially complex areas of trust law and equity.

- (c) *Value* – any dispute resolution mechanism would also need to be cost-effective relative to the benefits that it will create and likely caseload. Consideration will need to be given to how much, if any, of the cost should be borne by the Government, and how much should be passed on to those who are using it.

A TRUSTS OMBUDSMAN

- 4.10 One option for improving access to trusts dispute resolution is to establish a trusts ombudsman. Chris Kelly has proposed that this alternative approach to the supervision of trustees is the best option for improving the accountability and quality of trustees. The option of a trusts ombudsman was also mooted by others in response to concern about the power of corporate trustees.¹²⁰ Under Kelly's proposal, this ombudsman would be able to investigate complaints against trustees, resolve disputes and provide guidance to trustees as to their legal duties.¹²¹
- 4.11 In Swedish the word "ombudsman" means "agent" or "representative" of the people.¹²² The role of an ombudsman is to investigate complaints from members of the public who feel they have been treated unfairly by an organisation. Traditionally ombudsmen investigate citizens' complaints about the public administration and make non-binding recommendations. The purpose of these public sector ombudsmen has been to provide a fast, effective and user-friendly method of providing public accountability for public institutions. A relatively recent development is the growth of ombudsmen for the private sector. Organisations and industries such as universities, the media, banks and hospitals have introduced ombudsmen.¹²³
- 4.12 New Zealand's public sector ombudsmen were introduced in 1962 and have become an important part of New Zealand's public administration and accountability structure. Their power and role are established by statute.¹²⁴ In addition, New Zealand has two private sector ombudsmen: the Banking Ombudsman and the Insurance and Savings Ombudsmen. Both of these are voluntary, industry-funded schemes with jurisdiction for loss of up to \$200,000, and are established by financial institutions to facilitate disputes within their industries.¹²⁵
- 4.13 The ombudsman concept has evolved and been adapted for different purposes in New Zealand. There are authorities that have similarities to an ombudsman but have had functions added to them or been given different emphases. The Health and Disability Commissioner,¹²⁶ Privacy Commissioner¹²⁷ and Human Rights Commission¹²⁸ are examples of positions or bodies with an ombudsman-like character.

Powers and role of a trusts ombudsman

- 4.14 The key features of an ombudsman seem to be the authority to make non-binding recommendations and the role of overseeing a sector or industry. Ombudsmen will commonly issue guidelines to improve the functioning of that industry or sector. Other features depend on how the role has been adapted for the context.
- 4.15 Kelly has suggested a trusts ombudsman could have some powers of the High Court, such as reviewing trustees' charges, but would not have other powers, such as being able to appoint or remove trustees or vest trust property. He suggests that the trust ombudsman's role would be to issue reports of an advisory nature. Most of the ombudsman's rulings would be non-binding but highly persuasive. Kelly suggests that the ombudsman could make binding decisions in three areas: the release of information to a beneficiary; reviewing trustees' charges; and the allocation of the costs of its investigation.¹²⁹ This would have the advantage of bringing a theoretically low cost resolution to matters that can cause much uncertainty. However, it is not clear that binding decision-making works well with the ombudsman's role in the context of trusts law.
- 4.16 The Commission's view is that, if established, it would be appropriate for a trusts ombudsman to have non-binding recommendatory power rather than binding powers. The role of an ombudsman should not undermine that of the courts. However, it would be important that the ombudsman's findings were highly persuasive so that in most instances they would be sufficient to resolve disputes. A jurisdictional limit, such as the \$200,000 threshold delineating the District Courts' jurisdiction, may need to be considered in order to restrict the seriousness of the complaints that could be determined by an ombudsman.
- 4.17 The principal activities of a trusts ombudsman under this model could include:¹³⁰
- (a) listening to and evaluating the viewpoint of the parties;
 - (b) providing mediation and advice services (to encourage all parties to see the view point of the others involved);
 - (c) explaining the obligations imposed by law and by terms of the trust deed or will;
 - (d) advising where, as a matter of law, a party was incorrect or had misunderstood the legal obligations imposed by the trust;
 - (e) advising what would be required to remedy any mistakes or inadequacies in trust administration; and
 - (f) attempting to achieve an agreement on a lawful way forward that would meet the legitimate needs and expectations of the parties.

- 4.18 This framing of the role of a trusts ombudsman is somewhat wider than other New Zealand ombudsman schemes. However, incorporating the skills of mediating and advising into the role could produce significant benefits, as long as the ombudsman's impartial position could be retained.
- 4.19 The trusts ombudsman could have an educative role by reporting annually or providing case notes about individual cases that could provide guidance for trustees. This would help to provide lay trustees with information on the requirements of their role and how the duties translate into practical administrative and management obligations. The trusts ombudsman or someone from the office of the trusts ombudsman could engage with the parties to a dispute in processes similar to arbitration or mediation.¹³¹ This may prevent a dispute becoming too adversarial in tone.¹³²
- 4.20 If an ombudsman is to have a mediation role, a method for gaining consent to any mediated arrangements from unborn and unascertained beneficiaries would also need to be considered. It may still have to be the court which provides consent on behalf of these beneficiaries or otherwise the ombudsman could have the power to appoint someone else to approve the arrangements on their behalf.
- 4.21 Kelly has suggested that there should be a right of appeal to the District Court (or High Court where the value contested is above \$200,000) against all determinations of a trusts ombudsman. There is a question of whether this would be appropriate where the ombudsman has made a recommendation. However, if a trustee was protected from liability when following a recommendation of the ombudsman, there is a strong case for allowing appeal rights. The legislation would need to clearly set out how the right of appeal would work and how an ombudsman's non-binding recommendations would interact with court decisions.

Evaluating the option of a trusts ombudsman

- 4.22 A trusts ombudsman would be a private sector rather than a public sector ombudsman because trusts are private arrangements and the costs of disputes are currently borne by parties rather than the Government or the public generally (although there is some public cost through trusts cases appearing before the courts). Because there is no unified trusts industry with a clear interest in providing an alternative dispute resolution mechanism to the courts, it is unlikely that impetus for a trusts ombudsman would arise in the private sector. The Government may consider that the need for improved decision-making and dispute resolution on trusts matters is significant enough and in the public interest, particularly of lay trustees and beneficiaries who otherwise have little chance of having their legal rights enforced, that it should establish a trusts ombudsman by legislation. Almost certainly there would be a need for government involvement and funding to establish a trusts ombudsman and possibly on-going government funding. It would be unlikely to work as a voluntary scheme because there would be limited incentive for trustees to sign up.

Advantages

- 4.23 A trusts ombudsman would avoid the formality of court proceedings. It would allow issues to be resolved speedily. The trusts ombudsman could become a specialist in trusts law, which would make its decisions or recommendations highly persuasive. It could ensure that disputes do not escalate to the extent that they require court intervention.¹³³ It may allow decisions on some issues, such as access to information by beneficiaries, without need for court involvement. The trusts ombudsman would be able to provide authoritative guidance to trustees, making it easier for them to carry out their role and improving the management of trusts by trustees.¹³⁴ Parties would be able to proceed without legal representation, meaning the process could be significantly cheaper. This mechanism would be available at an early stage in disputes.

Challenges

- 4.24 One of the main concerns about a trusts ombudsman relates to the legal authority of this role. Its establishment would necessarily require the divestment of some of the court's authority in looking at trust matters. Historically, the Chancery Court has had exclusive responsibility for the development and operation of the law of equity. While in New Zealand there is unified jurisdiction over common law and equity in the High Court, it would be understandable if there was disquiet amongst some of the legal profession and judiciary if equity were to become further removed from its roots and become the domain of a non-judge.
- 4.25 A further issue relating to a trust ombudsman's legal authority is that there are many areas of trusts law where the law is not firmly settled, such as the release of information to trustees. There are areas of trusts law where a trusts ombudsman would be required to reach a recommendation or decision without a clear precedent for how the case should be decided. It may be inappropriate for an ombudsman to be developing the law in this way and it may lead to many appeals, eroding the value of having an alternative mechanism.
- 4.26 However, there are some areas of the court's powers under the Act that are more settled or involve administrative, rather than decision-making, functions. There may be a stronger case for an ombudsman to be able to make binding rulings on these matters instead of those suggested by Kelly. Also, it may be the case that legal issues, such as the duty to inform beneficiaries, can be clarified and simplified as a result of reforms following this review. This may make it more appropriate for an ombudsman to decide these issues.
- 4.27 The fact that ombudsmen or similar authorities have not been introduced in comparable contexts, such as companies or contracts, should be considered. It could be argued that trusts are no more special than companies and that trusts issues should have to be taken before the courts as companies issues or contractual issues are.

- 4.28 One of the key issues that must be addressed in determining whether a trusts ombudsman is feasible is how it would be funded. The options are government funding, self-funding by those involved in the dispute, or funding by some sort of levy on all trusts. None of these options is straightforward.
- 4.29 Kelly envisaged that a trusts ombudsman could be mostly self-funding, with the party that is found to be at fault bearing the costs of the investigation. He proposes that a trusts ombudsman should have the discretion to make a binding ruling as to whether the trust fund, the trustees personally, the complainant or an advisory trustee, protector, appointer or other quasi-fiduciary should bear the costs.¹³⁵
- 4.30 In order to have an ombudsman who has a high calibre of experience and expertise, a relatively high-scale salary would need to be provided for the position. The salary of a District Court Judge is currently \$288,500.¹³⁶ If the salary is in this vicinity, it is difficult to see that an ombudsman's office could operate on a budget of less than \$500,000 annually when costs of staff, administration and overheads are taken into account. If there were 100 complaints per year, the fee per investigation would need to be \$5,000 to meet administrative costs. If the cost of investigations were fully passed on to parties this would mean that a complaint to the trusts ombudsman is not a cost-effective option, even in comparison with a High Court application. It could be argued, however, that if a trusts ombudsman is to have fairly wide-ranging tasks that have a beneficial effect for trustees, settlors and beneficiaries throughout New Zealand, that cost should not only be borne by parties to a dispute.
- 4.31 An alternative is for the Government to bear the costs of the trusts ombudsman. This raises the issue of whether the Government should have responsibility for trusts disputes or whether costs should be borne privately because trusts are private matters. Trust issues already cost the Government when disputes have to go to court. The Government appears to have an interest in having user-friendly trust law and administration. However, trusts are most often private matters that only advantage individuals or families.

- 4.32 Another method of funding a trusts ombudsman would be to levy all trusts. The other non-public service ombudsmen in New Zealand, the Banking Ombudsman and the Insurance and Savings Ombudsman, are funded by the industries in which they operate. Banks and insurance and savings companies opt in to the ombudsman scheme, pay levies and agree to be bound by decisions. This option presents difficulties in that currently there is no requirement for trusts to register, report or otherwise indicate to any regulatory body their existence, except the requirement for a tax return for income earning trusts to be filed with Inland Revenue. A mandatory levy, fee or duty on all trusts, either when they are established or annually, would only be possible if there were also registration requirements for trusts. This issue is discussed in chapter 9. If such a mechanism were in place, it could be argued that it is a justifiable charge on all trusts to fund a dispute resolution system to improve the operation of trusts in New Zealand. On the other hand, it could be a disincentive for people to settle trusts, which may be considered problematic. New Zealanders may instead choose to settle trusts off-shore.
- 4.33 In evaluating the option of a trusts ombudsman, it must be considered whether this approach solves enough of the current problems with trusts for it to be worthwhile. It is difficult to assess the potential case load of a trusts ombudsman. An ombudsman would provide greater accessibility to disputes resolution decision-making, and would do so in a less adversarial way. It could be established in a way that ensures high-quality decision-making, but this could add to the cost.

TRUSTS TRIBUNAL

- 4.34 Another option to improve trust dispute resolution is a tribunal. A tribunal could be established as an alternative to an ombudsman as a lower level decision-maker than the courts. It would have binding decision-making authority. Tribunals can be an option where there is a need for either a specialist decision-maker with expertise that a court cannot provide, or for a lower level, more informal and accessible decision-maker.
- 4.35 A tribunal could be given jurisdiction to make decisions on certain trust issues. It may need to have a jurisdictional limit, such as only being able to hear complaints where \$200,000 or less is at issue. The likely caseload of a trusts tribunal would be small compared with some tribunals.¹³⁷ However, there may be a sufficient number of cases that a tribunal would be warranted. There are existing tribunals that hear fewer than one hundred cases per year.¹³⁸ Where there is not a sufficient case load for a full-time tribunal, tribunals can sit on a part-time basis.

- 4.36 The Law Commission's study paper *Tribunal Reform* proposes a unified tribunal service that would unite a large number of tribunals, arranged into divisions, under the leadership of a Principal Tribunals Judge.¹³⁹ While it is unclear whether this proposal will be progressed in the future, it is certainly evident that establishing a tribunal within an existing administrative structure could be more cost-effective than a completely independent tribunal. The Ministry of Justice's Tribunals Unit is a possible location for a trusts tribunal.
- 4.37 *Tribunal Reform* sets out guidelines against which new tribunals can be considered in order to avoid tribunals being established indiscriminately without an eye to coherence or a principled structure.¹⁴⁰ One factor that should be considered is whether there are compelling reasons relating to subject-matter or process which mean that trusts matters are more suitable to a tribunal than a court.
- 4.38 In its 1989 report on tribunals, the Legislation Advisory Committee identified three factors for assessing whether the decision-maker under any new statutory scheme should be a court, a tribunal or an arm of government. These are:¹⁴¹
- (a) the characteristics of the function, together with the issues to be resolved and the interests affected;
 - (b) the qualities and responsibility of the decision-maker; and
 - (c) the procedure to be involved.
- 4.39 In trusts disputes, the function is adjudicative. However, the role also requires clarification of complex legal issues. It affects the rights and responsibilities of trustees, beneficiaries and settlors. The decision-maker is likely to need to be a judge, given the complexity and "judge-made" status of the law of equity. Because many trust disputes involve family arrangements, a formal court procedure is not necessarily the most helpful in trust disputes.

Evaluating the option of a trusts tribunal

- 4.40 A trusts tribunal could improve access to dispute settlement compared to the current situation. It is likely to be quicker, cheaper, more informal and less adversarial than the High Court. It would have a different role to an ombudsman. It could make binding decisions rather than recommendations, which may make it more effective at determining disputes. Educative, guidance and mediation functions would fit better with the functions of an ombudsman or commission (discussed below), although publicly available tribunal decisions would contribute to public education and guidance.
- 4.41 A tribunal would have the power to make legally binding decisions. At least one of the tribunal members could be a judge and this would imbue its proceedings with greater weight than a non-judicial ombudsman. The trusts tribunal would be able to build up specific expertise in the law of equity and trusts. This would address the concern that, as the courts are dealing with trust issues so seldomly, they are not building sufficient expertise in this area of law.

- 4.42 However, as discussed in relation to a trusts ombudsman, there is a concern that allowing a tribunal to make decisions on trusts would be delegating the court's decision-making authority, and the determination of complex questions of equity, too far. Some powers could be retained for the courts under legislation and there would be a right of appeal.
- 4.43 A trusts tribunal would require some government funding. Complainants or the trusts industry could be required to contribute in the same ways as discussed above for an ombudsman. One of the benefits of a tribunal, so long as it is administratively supported within an existing structure, such as the Ministry of Justice's Tribunals Unit, is that it can operate on a part-time basis and sit in response to its workload.

COMMISSION

- 4.44 Another option for improving the dispute resolution of trusts is to introduce a commission or authority for trusts. This option would have a different emphasis to an ombudsman or tribunal. Its role would be primarily overseeing the trusts industry. It could provide guidelines, supervise providers of trust services and include a mediation service. It could also produce a code of conduct or standards for regulating trusts and trustees.
- 4.45 Kelly posited a Trust and Estate Supervision Commission based on the Charities Commission as another option for improving trusts dispute resolution. He considered that the Commission could approve probate for deceased estates, provide advice and education to trustees, investigate complaints, decide whether to release trust documents and operate an optional register of trusts. A commission could have a wider and more flexible scope than an ombudsman. It could employ investigators to consider complaints, potentially on a part-time, as needed basis.¹⁴² While a commission would be able to achieve a wider range of purposes, a trusts ombudsman or tribunal is likely to have a stronger ability to ensure trustees comply with their duties.¹⁴³

CONCLUSION

- 4.46 Introducing an alternative dispute resolution mechanism for trusts could have a number of benefits, such as improving accessibility and education, and reducing formality and cost to individuals. Yet, in the current fiscal environment the cost could be considered prohibitive. New costs from such a scheme are unavoidable. It is likely that for now the best approach is to improve access to the courts in trust matters and improve the processes available under trusts legislation. The options of a trusts ombudsman, tribunal and commission do have merit, and, especially if trusts continue to be as prolific in New Zealand as they are now, they may warrant consideration at a later time. We are interested in views about the viability and desirability of these options.

QUESTION

Q8 What are your views on the dispute resolution mechanisms discussed in this chapter?

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- 111 Chris Kelly “Supervision of Trustees: Enforcement or Problem Solving” (LLM Thesis, Victoria University of Wellington, 2009) at 1 [*Supervision of Trustees*].
- 112 Trustee Act 1956, s 51.
- 113 Trustee Act 1956, s 64.
- 114 Trustee Act 1956, s 64A.
- 115 Trustee Act 1956, s 68.
- 116 Trustee Act 1956, s 74.
- 117 Kelly *Supervision of Trustees*, above n 111, at 104.
- 118 *Ibid*, at 108.
- 119 *Ibid*, at 106.
- 120 “Calls for better regulation of family trusts: Please sir, can we have some more... of our own money” *Sunday Star Times* 22 August 2008; Jacqueline Smith “Guardian Trust beneficiary worried about fund freeze” *New Zealand Herald* 6 August 2008.
- 121 Kelly *Supervision of Trustees*, above n 111, at 119 – 120.
- 122 Emily O’Reilly, Irish Ombudsman *Office of the Ombudsman – Ireland* < www.ombudsman.gov.ie > .
- 123 Steven Van Roosbroek and Steven Van de Walle “The Relationship between Ombudsman, Government, and Citizens: A Survey Analysis” (July 2008) *Negotiation Journal* at 289; O’Reilly, above n 122.
- 124 Ombudsmen Act 1975. Ombudsmen also have powers under the Official Information Act 1982, Local Government Official Information and Meetings Act 1987, Protected Disclosures Act 2000 and Crown Entities Act 2004.
- 125 Banking Ombudsman < www.bankomb.org.nz >; Insurance and Savings Ombudsman < www.iombudsman.org.nz > .
- 126 The Health and Disability Commissioner Act 1994 establishes the Office of the Health and Disability Commissioner; Health and Disability Commissioner < www.hdc.org.nz > .
- 127 Established under the Privacy Act 1993; Privacy Commissioner < www.privacy.org.nz > .
- 128 Established under the Human Rights Act 1993; Human Rights Commission < www.hrc.co.nz > .
- 129 Kelly, *Supervision of Trustees*, above n 111, at 138 – 140.
- 130 *Ibid*, at 134.
- 131 *Ibid*, at 123.
- 132 *Ibid*, at 133.
- 133 *Ibid*, at 119.
- 134 *Ibid*, at 120.
- 135 *Ibid*, at 121 – 122.
- 136 Judicial Salaries and Allowances Determination 2010, sch.
- 137 For a comparison of the caseload of a range of tribunals in New Zealand see Law Commission *Tribunals in New Zealand* (NZLC IP6, 2008) at 142 – 143.

138 For instance, the Student Allowance Appeal Authority, Land Valuation Tribunal, Customs Appeal Authority, Human Rights Review Tribunal and War Pensions Appeal Board (see Law Commission *Tribunals in New Zealand*, above n 137, at 142 – 143).

139 Law Commission *Tribunal Reform* (NZLC SP20, 2008).

140 *Ibid.*

141 Legislation Advisory Committee *Report No 3: Administrative Tribunals* (Government Printer, Wellington, 1989).

142 Kelly *Supervision of Trustees*, above n 111, at 146.

143 *Ibid.*, at 146 – 8.

Chapter 5

Alternative dispute resolution

INTRODUCTION

- 5.1 This chapter has so far looked at new dispute resolution mechanisms established by statute. The following discussion concerns a mechanism that may already be available in some trust deeds, involving individual arrangements rather than establishing an external structure. The utilisation of the commonly used techniques of alternative dispute resolution (ADR) may be used to handle trust disputes. ADR refers to a number of different processes, such as arbitration and mediation, which can be used to resolve disputes without recourse to the courts. Some trust deeds may provide for the use of ADR in trust disputes. There is nothing in the Act that makes this generally available, however. Amendments may need to be made to trust law to ensure that more trust disputes can be settled in this way.
- 5.2 The aim of arbitration and mediation is for the parties involved in the dispute to reach a settlement. In a mediation, a broker attempts to facilitate a negotiated settlement at some stage before a trial. Mediation negotiations are confidential and without prejudice.¹⁴⁴ In a successful mediation, the mediator will find the common ground between the positions of all parties and create a settlement that all parties can agree to.
- 5.3 Arbitration is a more formal process. It is regulated by the Arbitration Act 1996. Arbitrators make a final and binding decision, which is capable of enforcement.¹⁴⁵ Arbitrations have over time been used more frequently to deal with complex commercial disputes. This has resulted in a degree of procedural complexity. The Arbitration Act 1996 appears to be targeted at relatively high cost commercial dispute resolution.¹⁴⁶ This means that it is of limited use in most disputes relating to trusts.¹⁴⁷

APPLICATION OF ALTERNATIVE DISPUTE RESOLUTION TO TRUSTS

- 5.4 It has long been recognised, although possibly more so in other jurisdictions, that there are many benefits to settling trust disputes by ADR.¹⁴⁸ Resolving an issue through ADR rather than resorting to court action can save significantly on time and cost. ADR can achieve finality and confidentiality. Because of the often intensely personal nature of trust disputes, it is often preferable for the issues and feelings involved to be aired in a more private forum than a court.¹⁴⁹ Adversarial litigation is usually an expensive and crude method of resolving disputes. It has been described as “particularly brutalizing when applied to the most personal and emotionally charged areas of life: family relationships, private property and death.”¹⁵⁰ An advantage of mediation is that it can lead to a solution that meets the objectives of the parties without being limited by the legal principles and remedies available.¹⁵¹
- 5.5 Nevertheless, despite these considerable advantages of ADR in trust disputes, there are some substantive and procedural features of trust disputes that create challenges for applying ADR in this context. One of the main barriers to the use of ADR is the multipartite nature of trusts.¹⁵² Trusts commonly involve a number of beneficiaries with different interests. Some beneficiaries may be minors, incapacitated, unborn or unascertained.¹⁵³ This can make it difficult, or even impossible, to achieve universal agreement, which is usually necessary for an ADR settlement.
- 5.6 Trust disputes can be either external (third party disputes) or internal (trustee disputes and beneficiary disputes). For the external disputes not involving the beneficiaries, the trustees will usually have the power, either under the trust deed or in statute, to settle a claim through ADR.
- 5.7 The settlement of a trust dispute by a trustee will usually involve the exercise of a power to compromise either in the trust instrument or in statute. Section 20 of the Act provides the trustee with the power to compromise on “any debt, account, claim, or thing whatever relating to the trust or to the trust property”. This section provides a default power to compromise, which a trust deed may override. The trustee is not liable for any loss that results from any arrangement entered into as a part of this compromise as long as it is done in good faith.¹⁵⁴ This section is nearly identical to section 15 of the Trustee Act 1925 (UK). It is likely that section 20 of the New Zealand statute would be interpreted similarly to section 15 of the United Kingdom statute, about which it was held:¹⁵⁵

... section 15 is concerned with what may be called external disputes ... not internal disputes, where one beneficiary under the trusts is at issue with another beneficiary under the trusts.

- 5.8 Section 20 is, therefore, unlikely to be of assistance in the case of internal disputes between beneficiaries or between a trustee and beneficiaries. The power of settlement under current legislation will only be relevant in limited circumstances. In order for an ADR settlement to apply to internal trust disputes, it would be necessary for a trust deed to provide that ADR is to be used and to provide trustees with a power to settle in these situations. Where a dispute does involve beneficiaries in one of the internal trust disputes, it may be possible that all beneficiaries are ascertained and have legal capacity to agree to a settlement so as to conclusively decide all of the relevant trust issues.¹⁵⁶ However, it is common for some of the beneficiaries of a trust not to be ascertained or of full capacity. This makes it more difficult to produce a binding settlement.
- 5.9 It would be difficult to apply ADR to trust disputes where a trustee is unwilling to settle or to be involved in the dispute resolution process. In these situations ADR does not provide a viable alternative to court action.

OBTAINING CONSENT TO USING ALTERNATIVE DISPUTE RESOLUTION

- 5.10 The nature of ADR is that parties need to agree to be bound by the resulting settlement. A difficulty with trusts is that unascertained and incapacitated beneficiaries cannot enter into an agreement. Trusts are generally not considered to be a contractual relationship,¹⁵⁷ but a unilateral transfer of assets to a person prepared to accept the office of trustee for the benefit and on behalf of beneficiaries.¹⁵⁸ It can be argued that living, capable beneficiaries can be considered to have agreed to provision for ADR in trust instruments. One theory is that all beneficiaries of a trust settlement claim under or through the settlor, who is a party to the agreement with the trustee for ADR, and there is a deemed acquiescence from beneficiaries to the use of ADR as a condition precedent to benefitting from the trust.¹⁵⁹ Another view is that the equitable doctrine of election, which provides that no one shall claim both under and in opposition to the same instrument, means that beneficiaries who accept a benefit under a trust instrument must adopt the whole of it, including an ADR clause.¹⁶⁰
- 5.11 When it comes to unascertained and incapacitated beneficiaries, however, these theories do not apply. Under the current law there will need to be an application to the court to have a representative appointed who can consent to be bound by an ADR settlement on their behalf. If the interests of incapacitated or unascertained beneficiaries are to be affected by a dispute settlement, these beneficiaries need to be represented during the ADR process.¹⁶¹

Achieving a binding settlement

- 5.12 Under current law, it is likely that the court will have to approve a settlement reached through ADR in order for it to be binding on unascertained and incapacitated beneficiaries. The rule in *Saunders v Vautier*,¹⁶² under which beneficiaries who are together absolutely entitled to trust property may bring the trust to an end, or vary the trust under the extended version of the rule, may be used to approve a settlement reached by ADR. Under section 64A of the Act, the court may approve a variation on behalf of certain classes of beneficiaries including minors, incapacitated, unborn and unascertained, provided it is not to their detriment. The court's powers to approve variations enable the court to approve an agreement to submit a dispute to ADR and to approve any settlement agreement resulting from ADR. It may be possible for the court to use these powers to introduce mandatory ADR provisions into a trust and possible to include provision for virtual representation of incapacitated and unascertained beneficiaries.¹⁶³

Law reform

- 5.13 There are several approaches which could be taken to facilitate the use of ADR if it is considered that more emphasis should be placed on ADR as a method of trust dispute resolution.
- 5.14 An English Trust Law Committee Working Party and the Association of Contentious Trust and Probate Specialists has recently drafted a code for trust issues designed to encourage the use of mediation at any stage of a dispute, and particularly at an early stage.¹⁶⁴ They proposed that a representative of incapacitated or unascertained beneficiaries would be appointed by the court before the commencement of legal proceedings.¹⁶⁵ The Working Party considered that mediated agreements should continue to require the court's approval in order to protect the beneficiaries from lack of skill and experience in their advisers, to ensure that the lawyers receive only their proper costs and fees and to enable the other parties to obtain a valid discharge from the beneficiaries' claims.¹⁶⁶ Though originally expected to take effect as a pre-action protocol, the code has now been issued as part of a non-binding practice guide.¹⁶⁷
- 5.15 A more cost-effective and quicker approach is to empower the representative to enter into a compromise and discharge the claims of the beneficiaries he or she represents, without requiring that the court approve any such arrangements. The risk in this approach is that the incapacitated and unascertained beneficiaries may be poorly represented and the settlement may not adequately uphold their interests.

- 5.16 Is it possible to avoid recourse to the court? It would certainly be more cost-effective and faster if trust disputes could be resolved through ADR without the involvement of the court either to appoint representatives of incapacitated and unascertained beneficiaries or to approve the settlement. This could be achieved by a provision in the trust deed that appoints “virtual representatives” to make decisions that bind the incapacitated and unascertained beneficiaries. However, this does not appear to be that easy under current legislation. Hayton argues that a strong case can be made that arbitration does not amount to court proceedings, so that a trust deed allowing virtual representatives being involved in an arbitration does not oust the court’s jurisdiction if the arbitration occurs before legal proceedings have been commenced.¹⁶⁸ However, a compromise agreement, such as that resulting from a mediation, either before or after legal proceedings would oust the court’s jurisdiction to approve arrangements in order for them to bind incapacitated and unascertained beneficiaries. A mediated settlement would, therefore, only be binding after the representatives had been appointed by the court and the court had approved the arrangement.¹⁶⁹
- 5.17 In the United States virtual representatives can be used to reach binding settlements without court involvement. Legislation in a number of states enables virtual representation clauses in trust deeds to bind the interests of incapacitated and unascertained beneficiaries without the need for court approval.¹⁷⁰ These provisions generally provide that beneficiaries with largely coincident economic interests to those that would be held by unascertained or incapacitated beneficiaries can act as their virtual representatives. Another way they can work is to provide for the appointment of an independent special representative for these beneficiaries, which can be a better option as it reduces the risk of a court overturning a settlement due to a conflict of interest of a beneficiary who approved it on behalf of unascertained or incapacitated beneficiaries as well as him or herself.¹⁷¹ In order to protect against later claims by disgruntled beneficiaries, trust deeds need to state that the representatives are not liable to the persons they represented unless they acted dishonestly.
- 5.18 Statutory intervention can facilitate the use of ADR in trust disputes. Hayton has said:¹⁷²
- Clearly, legislation is needed to deal with the difficulties, with some procedure for independent non-conflicted representatives to be appointed at an early stage to look after the interests of minor, unborn and unascertained beneficiaries and to have full authority to agree to a mediated solution of the dispute. Provision also has to be made for financing and protecting from liability whomever are appointed as such representatives, it being necessary for reasons of time and cost to oust the need for the approval of the court to any agreed solution.
- 5.19 In Guernsey there has been statutory intervention to ensure that where an ADR settlement is authorised by a trust deed or the court and is signed by or on behalf of all parties, “the settlement is binding on all beneficiaries of the trust, whether or not yet ascertained or in existence, and whether or not minors or persons under legal disability”.¹⁷³

- 5.20 The majority of states in the United States give trustees the power to use mediation and arbitration to resolve trust disputes in a way that is similar to section 20 of the Act. A few states have gone further than this. Washington has adopted provisions as part of the Trust and Estate Dispute Resolution Act (TEDRA) that grants “any party the right to proceed first with mediation and then arbitration before formal judicial procedures may be utilized”.¹⁷⁴ TEDRA contains detailed directions for arranging mediations and arbitrations. ADR decisions and settlements may be appealed to the court. TEDRA allows parties to come to an agreement that may differ completely from what the settlor intended.¹⁷⁵ Because of this, TEDRA has been criticised in the United States as being too radical,¹⁷⁶ although permitting parties to override a settlor’s intention is not seen as surprising or undesirable in jurisdictions like New Zealand that apply the rule in *Saunders v Vautier*.¹⁷⁷
- 5.21 The Hawaiian legislation provides another example. In Hawaii, a beneficiary can make a request to the court that mediation be used to resolve the dispute. The court can also require mediation to be used. A criticism of Hawaii’s mediation system is that it requires that parties bear the cost of mediation, which make ADR a less attractive option¹⁷⁸

CONCLUSION

- 5.22 The Commission considers that the option of facilitating the use of ADR in trusts should be pursued. Relying on ADR could reduce the need for disputes resolution at a later stage. It makes disputes resolution accessible and low cost, and means disputes can be dealt with relatively privately and informally. There are some complex legal questions to be resolved before alternative disputes resolution can be widely used in trusts.

QUESTIONS

Q9 Should trusts legislation facilitate the use of alternative disputes resolution in trust disputes? Should it be available in every trust or only those that specifically provide for it in the trust deed?

Q10 Should legislation allow for trust deeds to provide for virtual representatives to bind unascertained and incapacitated beneficiaries to a settlement?

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- 144 David Hayton “Problems in attaining binding determinations of trust issues by alternative dispute resolution” < www.kozlaw.com > at 2 [“Problems in attaining binding determinations”].
- 145 Ibid, at 2.
- 146 Chris Kelly “Supervision of Trustees: Enforcement or Problem Solving” (LLM Thesis, Victoria University of Wellington, 2009) at 98 [*Supervision of Trustees*].
- 147 Ibid, at 99.
- 148 Paul Buckle “Trust disputes and ADR” (2008) 14 *Trusts & Trustees* 649 at 649.
- 149 Ibid.
- 150 Teresa R Peacocke “Arbitration and mediation of trust and probate disputes: Obstacles removed (or non existent)” (1 July 2008) < www.3storebuildings.com > at 1.
- 151 Kelly *Supervision of Trustees*, above n 146, at 97.
- 152 Buckle, above n 148, at 649.
- 153 Ibid.
- 154 Trustee Act 1956, s 20.
- 155 *Re Earl of Stafford Dec'd* [1978] 3 All ER 18 at 32 – 33.
- 156 Hayton “Problems in attaining binding determinations”, above n 144, at 1.
- 157 See Law Commission *Review of Trust Law in New Zealand: Introductory Issues Paper* (NZLC IP19, 2010) at 29 – 31.
- 158 Peacocke, above n 150, at 3.
- 159 Lawrence Cohen “The Arbitration of Trust Disputes” (1999) *Journal of International Trust and Corporate Planning* ITCP 7 at 203.
- 160 Peacocke, above n 150, at 4, citing *Re Macartney* [1918] 1 Ch 300 and *Cooper v Cooper* (1874) LR 7 JL 53 at 70.
- 161 Hayton “Problems in attaining binding determinations”, above n 144, at 2.
- 162 *Saunders v Vautier* (1841) Cr & Ph 240; 41 ER 482. See Law Commission *Perpetuities and the Revocation and Variation of Trusts: Review of the Law of Trusts – Third Issues Paper* (NZLC IP22, 2011) at 50 – 52.
- 163 Peacocke, above n 150, at 11.
- 164 “The ACTAPS Practice Guidance for the Resolution of Probate and Trust Disputes” < www.actaps.com > .
- 165 Ibid.
- 166 Ibid.
- 167 Ibid, preliminary note.
- 168 Hayton “Problems in attaining binding determinations”, above n 144, at 2.
- 169 Ibid, at 4 – 5.
- 170 Ibid, at 5.
- 171 Ibid, at 7.

- 172 David Hayton “Major trends in the trust world: Part 2” (2007) 2 PCB 122, at 126.
- 173 Trusts (Guernsey) Law 2007 (Guernsey), s 63.
- 174 Trust and Estate Dispute Resolution Act, RCW §11.96A.270 (USA).
- 175 Peacocke, above n 150, at 14.
- 176 For instance KM Elliott “ADR Gone Wild!: One State’s Experience with a Radical Trust and Estate Dispute Resolution Act” (2007) < works.bepress.com/kirsten_elliott/1 > .
- 177 Peacocke, above n 150, at 14.
- 178 *Ibid*, at 15, referring to the Supreme Court of Hawai’i, Hawai’i Probate Rules.

Part 3

TRADING TRUSTS



Chapter 6

Introduction to trading trusts

INTRODUCTION

- 6.1 It is important to view trading trusts in the context of the conventional historical and legal distinctions between a company and a trust.¹⁷⁹ In brief, the limited liability company was established as a way to protect those wishing to invest in commercial trading activities. The aim was to limit the risk taken by investors putting money into a sphere that would provide economic and social benefits.¹⁸⁰ In contrast, trusts are formed to enable a person to hold assets for the benefit of another, for reasons such as estate planning or protection of assets.¹⁸¹
- 6.2 Companies are entities in their own right and allow greater protection for the individual or individuals involved when their business incurs debts.¹⁸² They are governed by the Companies Act 1993, which provides the process for incorporation and the requirement for registration on the Companies Register.¹⁸³ The company name must end with the word “Limited”,¹⁸⁴ to warn potential creditors that the assets from which they may recover debts are limited to those of the company. The company name must be clearly stated in written communications and signed documents.¹⁸⁵ Unlike companies, trusts are not separate legal entities and there is no public register of trusts.¹⁸⁶ Trustees are also fully personally liable for their actions as trustees, though this can be limited through contract or the trust instrument. As observed in a recent article, “[h]aving regard to the nature of the relationship between trustee and beneficiary, it is plain that a responsible person is needed to manage assets on behalf of another.”¹⁸⁷

- 6.3 Trust structures have become increasingly popular for commercial purposes.¹⁸⁸ This chapter discusses a particular form of such a trust. Trading trusts are trusts under which the property is used to carry on business. They often have a structure that involves a company acting as a trustee, holding property on trust for certain beneficiaries, where the company has very few or no assets owned outright. The trust does not have a separate legal personality, so creditors contract with the company, and accordingly it is the company that is liable for trust debts including debts incurred in trade.
- 6.4 Such a structure can cause problems for creditors, particularly if the company that is a trustee becomes insolvent. Unsecured creditors must rely on the trustee's right of indemnity from trust assets to satisfy their claims, and there are many circumstances in which the indemnity may be impaired or unavailable altogether, potentially leaving creditors with no recourse. There are several areas of uncertainty in regard to insolvent corporate trustees. Another issue arising is whether beneficiaries of a trading trust require further protection in the event of breach of trust by the corporate trustee.
- 6.5 Other forms of trust are used in business as well. This chapter will not cover investment trusts, unit trusts, or statutory trustee companies.¹⁸⁹

WHAT IS A TRADING TRUST?

- 6.6 Although “ultimately no dogmatic structure restricts trading trusts”,¹⁹⁰ this section will set out some features that are commonly associated with trading trusts. Taking a wide definition, a trading trust is a trust that actively carries on business. It has been said that “the main characteristic of the trading trust is that the trust property is used in the conduct of business.”¹⁹¹ It is this feature that distinguishes a trading trust from an investment trust under which property held by a trustee is used for passive (or even active) investment.¹⁹²
- 6.7 The term “trading trust” is often used to describe a structure in which the trustee of a trust is a limited liability company, instead of a natural person.¹⁹³ This trustee can be referred to as a corporate trustee (or sometimes a trustee company).¹⁹⁴ The corporate trustee generally has few or no assets of its own aside from the trustee's right to indemnity out of trust assets. All the assets are held on trust for the beneficiaries. The trust is usually discretionary.¹⁹⁵ As the Law Commission stated in 2002:¹⁹⁶

There is established a trust, of which the sole trustee is a limited liability company. It is that company that trades, but the assets to which the company has title are beneficially owned by the beneficiaries of the trust, so that if the company fails the only assets available to the creditors of the company in liquidation are the trustee's right to indemnity out of such assets of the trust as may still be available.

- 6.8 In the recent New Zealand case of *Levin v Ikiua*, the term “trading trust” has been more narrowly defined to identify a business operated by an assetless company, in the capacity as a trustee for named beneficiaries.¹⁹⁷ There is an issue as to how trading trusts should be defined, which would need to be addressed if references to them were to be included in legislation. This is addressed in more detail in chapter 8 below.
- 6.9 According to Crossland, “two main species of corporate trustee abound for trading trusts”:¹⁹⁸ first, that of a single trust trustee, often trustee for one set of assets under one trust deed trading as a single business venture; and secondly, trustee companies set up by professional legal and accountancy firms that administer clients’ trading trusts. The issues addressed in this Part primarily concern the first type, but also touch on some problems raised by the second.¹⁹⁹
- 6.10 Trading trusts also need to be distinguished from “business trusts”, used principally as a means of succession planning (often in conjunction with family trusts) where the trust holds the shares in a company which owns the business assets.²⁰⁰

USE OF TRADING TRUSTS

- 6.11 The use of trading trusts as a commercial vehicle emerged during the 1970s, particularly in Australia, as an alternative to the use of a private company for the operation of a family business.²⁰¹ The first major corporate trustee case reached the High Court of Australia in 1979.²⁰² The subject began to receive academic attention from the early 1980s.²⁰³ Academic comment began to appear in New Zealand shortly afterwards.²⁰⁴ In its Preliminary Paper in 2002 the Law Commission considered that the use of trading trusts in New Zealand clearly seemed to be spreading.²⁰⁵ However, the Commission’s subsequent Report stated that submitters had responded that they had yet to encounter trading trusts or problems from their use. The Report stated “[t]his is understandable because use of trading trusts in New Zealand is not yet widespread, though it has begun.”²⁰⁶ With a few exceptions, trading trusts have received little judicial attention in New Zealand, especially at the appellate level; this may reflect “the relatively small value of many of these trusts, making protracted litigation uneconomical.”²⁰⁷
- 6.12 It is difficult to ascertain empirically the incidence of trading trusts at present in New Zealand, as the status of the company as a trustee is not required to be disclosed through the Companies Register. Accordingly, the Law Commission would be interested in views on whether trading trusts are in widespread use in New Zealand, and whether there are actual problems resulting from their use, including those identified in this Part.

Advantages of using a trading trust

6.13 The use of trusts in commerce has many advantages for those using them. Donovan Waters QC has said:²⁰⁸

It is well established that for trusts in the commercial area the elements of a trust that are most valued are asset segregation from the trustee's own assets, the flexibility the settlor has with a trust in creating beneficial interests, and the prophylactic manner in which the courts have interpreted and applied the fiduciary obligations of the trustee. In addition to statutory limited liability, the corporation also offers the element of asset segregation and consequent protection from the creditors of others; incorporating a fund of assets will confer this protection for those assets. ...

6.14 As a commercial vehicle, a trading trust in the particular form described above combines the advantages of a company, namely limited liability and separate corporate personality, with the advantages of a trust,²⁰⁹ for example, relative privacy and anonymity.²¹⁰

6.15 Dal Pont describes four main advantages to using a trading trust:²¹¹

- (a) avoiding the level of restrictive regulation and technical compliance requirements affecting companies,²¹² for example financial reporting obligations;
- (b) the discretionary trust allows for a more tax-effective distribution of business income across a range of beneficiaries;
- (c) the discretionary trust also offers flexibility in changing circumstances, particularly in selecting beneficiaries and the amount and timing of distributions;
- (d) since trust property is excluded from assets that can be used to satisfy the claims of creditors of the corporate trustee, the trading trust may be a useful mechanism for asset protection in case of insolvency. Distribution of accumulated income and capital reduces the assets available to creditors.²¹³

6.16 Corporate trustees carry certain advantages over natural persons. A key reason for having a corporate trustee is to protect individuals acting as directors from personal liability, because of the separate corporate personality of the company.²¹⁴ In that respect a trading trust is a preferable structure to such alternatives as partnerships or sole traderships.²¹⁵ Contracts with third parties are made in the name of the company, not in the names of the individual directors; it is the company not the directors who are liable. The same applies regarding liability for taxes, levies and statutory charges.²¹⁶

6.17 Another advantage of a corporate trustee is succession: even if the directors change, the company remains the trustee. The trust's assets can be held and where necessary registered in the name of the company, so no change to the title is needed in the event that the directors change.

6.18 In *Levin v Ikiua*, Heath J observed:²¹⁷

Because the use of an assetless corporate trustee has the potential to defeat the interests of genuine creditors of a company, there is (rightly) a healthy degree of cynicism surrounding its use. However, it is as well to remember that a trading trust may be used for legitimate purposes, without its directors or shareholders having any intention to defeat the rights of creditors with whom it does business. In each case the intention of those who settle the trust and trade through this commercial vehicle will need to be considered.

6.19 Thus, as is explored more fully below, some of the same features that make a trading trust structure attractive in a commercial setting, particularly limited liability and a separate legal personality, can carry significant disadvantages for other parties that might deal with them.

PREVIOUS LAW COMMISSION REVIEW OF TRADING TRUSTS

6.20 Trading trusts were addressed briefly by the Law Commission in 2002 in *Preliminary Paper 48: Some Problems in the Law of Trusts*.²¹⁸ This paper identified risks to unsecured creditors and risks to beneficiaries as the main concerns.²¹⁹ It also noted that it is probably the case that the trustee's right to indemnity out of trust assets may not be limited or excluded by the trust assets, but considered it preferable to put this beyond doubt.²²⁰

6.21 In its Report later in 2002, the Law Commission recommended that the following section be inserted into the Trustee Act:²²¹

Trading Trusts

- (1) In this section "trading trust" means a corporation (not being a trustee corporation or a Board incorporated under Part II of the Charitable Trusts Act 1957) which in the capacity of trustee of a trust carries on any trade or business; and "distribution" has the same meaning as is provided by the Companies Act 1993 section 2(1).
- (2) The directors of a trading trust will have the same obligation to the beneficiaries of the trust as they would have had if they and not the corporation had been the trustees of such trust.
- (3) No contract or arrangement purporting to reduce or remove the entitlement of the trading trust to be indemnified out of the assets of the trust shall be of any effect.
- (4) A trading trust may make a distribution to a beneficiary of the trust only if the same requirements as are prescribed by the Companies Act 1993 section 52 (relating to the solvency test) have been satisfied, and in the event of a breach of this provision, the directors and officers of the trading trust will be under the same criminal liability and the same personal liability to make repayment as are directors of a company under the Companies Act 1993 sections 52(5) and 56.

- 6.22 The following section discusses some of the reaction to the Commission's proposals. Some submitters responded to the Preliminary Paper stating that trading trusts were not in widespread use or causing problems.²²² The Commission put forward its recommendations in the Report nonetheless, it stated, in order "to prevent the occurrence in New Zealand of difficulties of the type that have been encountered in Australia before they actually happen."²²³ In 2007, an external reviewer engaged by the Ministry of Justice to review the Commission's proposed changes to the Trustee Act considered that since the 2002 Report the use of trading trusts had become more common in New Zealand. However, the reviewer too was unaware of any significant difficulties resulting from their use.²²⁴
- 6.23 On the proposal to treat the directors as having the same obligations to beneficiaries as if they were the trustee, in (2) of paragraph [6.21] above, submitters were divided but some saw merit in such a provision.²²⁵ Others who were against the proposal commented that it would be a very significant change that would disregard legal form and blur the distinctions between trustees and directors.²²⁶ Some considered that the law already adequately protects beneficiaries, in that directors may be liable for dishonest assistance in a breach of trust or knowing receipt of trust funds, and no case had been made out that there was a need to extend the liability of directors any further.²²⁷ Hart considered that the potential exposure for directors would be too great under the proposed provision, in light of the obligations already owed including their fiduciary obligations, and those under the Companies Act.²²⁸ The change could discourage people from acting as directors of a corporate trustee carrying on business.²²⁹
- 6.24 All of those who submitted on the issue supported the proposal to put beyond doubt that a trustee's entitlement to indemnity may not be excluded by the trust instrument, in (3) of [6.21] above.²³⁰ Many commented that this was likely already to be the law in New Zealand.²³¹
- 6.25 Submitters who commented were generally not in favour of the proposal to apply the solvency test in section 52 of the Companies Act to distributions by a trading trust to its beneficiaries, in (4) of [6.21] above. There were concerns that the requirement would put too great a burden on trustees. Hart considered this proposal to be "not unreasonable" as it prevented the trustee from reducing its assets to such an extent that it was incapable of meeting its commercial obligations.²³² However, he noted that the personal liability for directors would be harsher under the proposed provision than under section 56(1) of the Companies Act, which provides the ability to recover the distribution from the shareholder. The external reviewer was concerned that the proposed restriction on distributions would impose significant transaction costs on trustee companies such as trustees of unit trusts, and also considered that the "very brief cross-reference technique" created uncertainty about how the rules relating to distributions would apply.²³³

- 6.26 Two additional proposals referred to in the Preliminary Paper were not included in the final Report:
- Providing in statute that no corporation aggregate with limited liability may be appointed as an express trustee other than a trustee corporation. This was described in the paper as maybe “too big a sledgehammer”.²³⁴ Several submitters disagreed with the proposal.²³⁵ Some were of the view that the corporate structure was appropriate to manage personal risks and no objections could be made to the company acting as a trustee;²³⁶ thin capitalisation concerns could be raised in respect of many corporates in New Zealand, irrespective of any trust involvement.²³⁷
 - Requiring disclosure by a company that was a trustee that this was its status. The Commission considered this was perhaps insufficient to put potential unsecured creditors on guard.²³⁸ Most submitters did not comment on this point, although one did note the importance of notifying creditors that they were dealing with a trust. The submitter suggested that there could be a positive obligation on trustees to put any contracting party on notice that they are dealing with a trust, so that contract negotiations could proceed on a transparent basis.²³⁹
- 6.27 Ultimately, as a result of the concerns raised by the external reviewer, no provisions on trading trusts were included in the Trustee Amendment Bill 2007. In any case the Bill itself did not progress and the Law Commission subsequently received a much broader reference on the law of trusts, so trading trusts fall to be considered again under the current review. Due to the brevity of the discussion in the 2002 Preliminary Paper and Report, this chapter has looked afresh at the issues and possible options, but does refer back to the 2002 options and submissions received where relevant.

OVERVIEW OF ISSUES WITH TRADING TRUSTS

- 6.28 In 1982, Australian authority on trust law, Professor Ford, said of trading trust that the “fruit of this union of the law of trusts and the law of limited liability companies is a commercial monstrosity”.²⁴⁰ He considered it had considerable scope for frustrating creditors, and the potential to undermine the utility of the company as an entity through which business is carried on.²⁴¹ Heath J has recognised the choice of a company as trustee as counter-intuitive:²⁴²

... trust law has developed on an underlying expectation that a settler would want a responsible trustee to be appointed, to protect the interests of the beneficiaries. A solvent trustee can be sued if he or she were to commit a breach of trust. However, a trading trust is premised on the opposite assumption: namely it is preferable to trade through a corporate trustee with limited liability and no assets other than the right of indemnity.

6.29 The Law Commission has identified some potential problem areas stemming from the use of trading trusts but, as indicated above, is uncertain about whether these problems are arising in practice in New Zealand. The problems fall into four categories:

1. Definitional issues: whether and how a trading trust should be defined;
2. Issues for beneficiaries: in the event of a breach of trust, a corporate trustee may have insufficient assets to compensate the beneficiaries, so the beneficiaries may need to try to claim against the directors directly, which may be difficult;²⁴³
3. Issues in insolvency, including the liquidation of a corporate trustee; the payment of the liquidator's fees and expenses from trust assets; the priority of creditors on liquidation; and the application of the insolvent transaction regime;
4. Issues for creditors: while creditors will know if they are dealing with a limited liability company from the company name, they may not be aware that if company is a trustee of a trust; the corporate trustee's main or only asset will often be its indemnity against the trust assets, which can disadvantage creditors if the indemnity is limited or not available, or if assets have been distributed to beneficiaries.

6.30 The following two chapters discuss these areas in more detail along with some possible options for reform. However, it should be emphasised that the Commission recognises trading trusts can be a legitimate commercial vehicle, and is not suggesting that their use be prohibited. The issue is more one of whether there is any possible misuse or uncertainty that needs to be addressed by specific statutory measures.

QUESTIONS

Q11 Are trading trusts in widespread use in New Zealand?

Q12 Are there any actual problems resulting from the use of trading trusts, including those identified in this Part?

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- 179 Paul Heath “Bringing Trading Trusts into the Company Line” [2010] NZ L Rev 519 at 519–522.
- 180 *Ibid.*, at 520. See also the long title to the Companies Act, which states at (a) that it is an Act: “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.”
- 181 Heath, above n 179, at 521.
- 182 *Salomon v Salomon* [1897] AC 22 (HL) and Heath, above n 179, at 520.
- 183 Companies Act 1993, ss 11–14.
- 184 Or “Tapui (Limited)”: see Companies Act 1993, s 21.
- 185 Companies Act 1993, s 25.
- 186 On the registration of trusts, see further ch 8.
- 187 Heath, above n 179, at 523.
- 188 Law Commission *Review of Trust Law in New Zealand: Introductory Issues Paper* (NZLC IP19, 2010) at [2.43]–[2.45] and [2.67]–[2.72].
- 189 Trustee company legislation will be addressed in the third stage of the Law Commission’s Review of the Law of Trusts project.
- 190 GE Dal Pont *Equity and Trusts in Australia* (Thomson Reuters, Rozelle (NSW), 2011) at [27.10].
- 191 *Ibid.*
- 192 Andrew S Butler (ed) *Equity and Trusts in New Zealand* (2nd ed, Thomson Reuters, Wellington, 2009) at 416 [*Equity and Trusts*].
- 193 This in itself is not a new development: companies have always been able to act as trustees; unless the trust instrument prevents the appointment of a corporation, a corporation may act as trustee: Trustee Act 1956, s 48.
- 194 This is distinct from a trustee company under the Trustee Companies Act 1967.
- 195 Heath, above n 179, at 523.
- 196 Law Commission *Some Problems in the Law of Trusts* (NZLC R79, 2002) at 14.
- 197 *Levin v Ikiua* [2010] 1 NZLR 400 (HC) at [97], affirmed [2010] NZCA 509.
- 198 Kaley J Crossland “Unsecured creditors and the ‘Uncorporation’: issues with trading trusts post Global Financial Crisis” (2011) 17 *Trusts and Trustees* 185 at 188–189.
- 199 Such companies will also be addressed in the third stage of the Law Commission’s Review of the Law of Trusts, which will look at the Trustee Companies Act 1967.
- 200 Law Commission *Review of Trust Law in New Zealand: Introductory Issues Paper* (NZLC IP19, 2010) at [2.72].
- 201 *Levin v Ikiua* [2010] 1 NZLR 400 (HC) at [96].
- 202 *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 (HCA) [*Octavo*].
- 203 See HAJ Ford “Trading Trusts and Creditors’ Rights” (1981) 13 *MULR* 1; BH McPherson “The Insolvent Trading Trust” in PD Finn *Essays in Equity* (Law Book Company, Sydney, 1985) 142; HAJ Ford and IJ Hardingham “Trading Trusts: Rights and Liabilities of Beneficiaries” in PD Finn *Equity and Commercial Relationships* (Law Book Company, Sydney, 1987) 48.

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- 204 See for example AW Lockhart “Trading Trusts: An Examination of Trustees’ Liability and Creditors’ Rights” (1985) 5 AULR 313.
- 205 Law Commission *Some Problems in the Law of Trusts* (NZLC PP48, 2002) at 9.
- 206 Law Commission *Some Problems in the Law of Trusts* (NZLC R79, 2002) at 14.
- 207 Peter Moore “Trading Trusts: Law and Policy” (February 2008) at 1.
- 208 D Waters “The Trust in a Changed and Yet Changing World” [2008] JITCP 205 at 230–231.
- 209 Butler *Equity and Trusts*, above n 192, at 416.
- 210 Greg Kelly *Law of Trusts* (looseleaf ed, LexisNexis) at [2.12] [*Law of Trusts*]; Lockhart, above n 204, at 328.
- 211 Dal Pont, above n 190, at [27.15]. Endorsed in *Levin v Ikiua* [2010] 1 NZLR 400 (HC) at [102].
- 212 Moore, above n 207, at 2.
- 213 *Law of Trusts*, above n 210, at [2.12].
- 214 Butler *Equity and Trusts*, above n 192, at 417.
- 215 Moore, above n 207, at 2.
- 216 Pravir Tesiram “Contracting as a Trustee: Liability to Creditors and the Use of Private Trust Companies” (paper presented at New Zealand Law Society Trusts Conference, May 2005) at 168.
- 217 *Levin v Ikiua* [2010] 1 NZLR 400 (HC) at [101].
- 218 Law Commission *Some Problems in the Law of Trusts* (NZLC PP48, 2002) at [23]–[25].
- 219 *Ibid*, at [23]–[24].
- 220 *Ibid*, at [25].
- 221 Law Commission *Some Problems in the Law of Trusts* (NZLC R79, 2002) at [29].
- 222 See Law Commission *Some Problems in the Law of Trusts* (NZLC R79, 2002) at [29]; submission of Chris Kelly, Public Trust on *Preliminary Paper 48: Some Problems in the Law of Trusts* (submission dated 15 March 2002) at 5.
- 223 *Ibid*, at [28].
- 224 David Goddard QC “NZLC 79 – ‘Some Problems in the Law of Trusts’ – Implementation” (Draft Memorandum prepared for Ministry of Justice, 6 May 2007) at 2.
- 225 Submission of the Institute of Chartered Accountants of New Zealand (ICANZ) on *Preliminary Paper 48: Some Problems in the Law of Trusts* (submission dated 21 March 2002), at 10.
- 226 Submission of Pravir Tesiram on *Preliminary Paper 48: Some Problems in the Law of Trusts* (submission dated 21 March 2002) at 3.
- 227 Goddard, above n 224, at 2–3 and *ibid*, at 3. See further discussion in paragraphs [8.2]–[8.5].
- 228 John Hart “Trading Trusts” (paper presented to New Zealand Law Society Trusts Conference, 2003) at 158.
- 229 *Ibid*.
- 230 Submission of Chris Kelly, above n 222; ICANZ, above n 225; and Tesiram, above n 226
- 231 Submission of Tesiram, above n 226, at 4.

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- 232 Hart, above n 228 at 160; also mentioned by Goddard, above n 223, at 5.
- 233 Goddard, above n 224, at 5.
- 234 Law Commission *Some Problems in the Law of Trusts* (NZLC PP48, 2002) at [25].
- 235 Submission of the New Zealand Trustees Association on *Preliminary Paper 48: Some Problems in the Law of Trusts* (submission dated 15 March 2002).
- 236 Submission of the Property Law Section, New Zealand Law Society on *Preliminary Paper 48: Some Problems in the Law of Trusts* (submission dated 12 March 2002) at 3.
- 237 Submission of ICANZ, above n 225, at 9.
- 238 Law Commission *Some Problems in the Law of Trusts* (NZLC PP48, 2002) at [25].
- 239 Submission of ICANZ, above n 225, at 9.
- 240 HAJ Ford “Trading Trusts and Creditors’ Rights” 13 *Melb UL Rev* 1 at 1.
- 241 *Ibid.*
- 242 *Levin v Ikiua* [2010] 1 NZLR 400 (HC) at [115].
- 243 Butler *Equity and Trusts*, above n 192, at 416.

Chapter 7

Creditors and trading trusts

INTRODUCTION

- 7.1 This chapter outlines some potential issues arising for creditors dealing with trading trusts. First, it discusses the point that creditors may not know that a company with which they are dealing is acting as a trustee and that its assets are mainly held on trust. Secondly, issues for creditors are outlined stemming from the trustee's right of indemnity and creditors' reliance on that indemnity. Unsecured creditors will usually need to utilise the trustee's right to indemnity from trust assets if the trustee has insufficient assets of its own to meet its debts. Creditors can be left with no recourse if the right of indemnity is not available.
- 7.2 A number of options for reform are outlined, some of which could work in combination. The options include ways to inform creditors that a company is acting as a trustee; preventing the exclusion of the trustee's indemnity via the trust instrument; other means of strengthening creditors' access to the trustee's indemnity; providing creditors with direct recourse to the trust assets; and the liability of directors of a company that is acting as a trustee. A final option is to retain the status quo and not introduce any new measures for trading trusts. If a strong case cannot be made that there is a problem requiring intervention and that one or more of the other suggested options will address the problem, retaining the status quo may be the best approach.

CREDITORS NOT AWARE OF THE TRUST

- 7.3 The first main issue in relation to trading trusts is that creditors may be unaware that they are dealing with a trust. The creditors may therefore assume that assets are held both legally and beneficially by the company, when in fact they are held on trust and the company itself has very limited assets, which may affect the creditor's prospect of recovering their debt. This is a circumstance that may arise with other trusts where it is not clear that property is held on trust by the trustee, but it is more significant here because the trust is actively involved in carrying on business.
- 7.4 A submitter in 2002 stated that they saw specific problems "where creditors have no idea that they are dealing with only a trustee company."²⁴⁴ Blanchard J has also commented extrajudicially on the lack of transparency in trusts, and queried whether trustees ought to be required to reveal the existence of the trust.²⁴⁵ The Commission has been informed by the Insolvency and Trustee Service that they have encountered at least one case where creditors have thought they were dealing with a company but where the assets were in fact held on trust.²⁴⁶ This issue was also raised by another submitter in 2002.²⁴⁷
- 7.5 Without disclosure of the fact that the company is acting as trustee, the creditor is not aware of the need to take greater precautions to protect its position, such as requiring security, guarantees, or making enquiries about the nature of the trust arrangement, the authority of the trustee to incur liabilities, the status of the trustee's right to indemnity, and the value of the company's assets owned outright. There is also an argument to be made that if there continues to be no disclosure requirement, widespread use of the trading trust structure could impact on the integrity of the Companies Register as it would only show an incomplete picture of the company.

Option 1: Disclosure of trustee status to creditors

- 7.6 The company could be required to disclose that it acts as a trustee for a trust in respect of which it carries on business in New Zealand. This would allow creditors to be informed of the nature of the entity with which they are dealing, so that they can take steps to protect themselves against the attendant risks. Disclosure would only need to be in a brief format, so that it is easy to comply with. Disclosure requirements would be limited to those companies acting as trustees of trusts that "carry on business" and would not affect passive trusts that happen to have a corporate trustee. "Carrying on business" is an established term that is used in relation to overseas companies which could readily be adapted for this context.²⁴⁸

- 7.7 Disclosure could be effected by one of several means. A register of trusts could potentially address this issue. Registration of trusts is discussed in chapter 9, including the option of a register for trading trusts only, at [9.45]–[9.47]. Alternatively, rather than creating a separate register for trusts, disclosure of the company’s status as a trustee could be made public through the Companies Register, via the Annual Return.²⁴⁹ This would be likely to require an amendment to the Companies Act 1993, as well as the subordinate legislation containing the information required by the Annual Return. There would be a potential time-lag, however, if a trust commences trading some months before the trustee’s Annual Return is due. In our view it would be more prudent to require the trustee to make disclosure prior to the trust “carrying on business”.
- 7.8 Potential difficulties with this proposal include:
- (a) inconsistency with existing Companies Register disclosure requirements: there is no requirement to disclose other risks to solvency, such as leasing of assets or indebtedness;
 - (b) the effect of the disclosure requirement on the overall scheme of the Companies Act: disclosure about the fact that a company is acting as a trustee of a trading trust would be novel, and outside the matters that are usually recorded on the Companies Register;
 - (c) in practice, creditors may not use the Companies Register to check the status of the company.
- 7.9 Instead, disclosure could be effected by other means, such as a positive obligation on the director(s) of the company to inform creditors and prospective creditors that the company is acting as a trustee. A suggestion along these lines was made in a submission in 2002.²⁵⁰
- 7.10 Another option would be a requirement for disclosure that a company is acting as a trustee on company documents, and perhaps contracts entered into, in the same way that the company name must be displayed on all written communication and documents issued by or signed by the company that create a legal obligation.²⁵¹ A submitter in 2002 favoured adopting this practice, so that any literature from the trust or company contained “___ Trust trading through ___ Limited”.²⁵²
- 7.11 A comparable proposal was mooted in Australia in the mid-1980s, at the same time as other reforms aimed at trading trusts, but did not go ahead, due to concerns that the likely cost and uncertainty of the proposal outweighed the possible benefits.²⁵³ However Gardiner, writing in 1987, considered that the proposal had “continuing merit as an additional protective measure for creditors and is worthy of reconsideration”;²⁵⁴ again in 2004 Cooper agreed that “[i]n retrospect, this was a salutary package and should have proceeded”.²⁵⁵

- 7.12 The lapsed proposal was to impose an additional obligation upon corporations and their directors to advertise their representative status by noting on any relevant documentation²⁵⁶ that the corporation was acting as trustee of a trust, in order to put prospective creditors on notice of the nature of the entity with which they might transact. Indeed this proposal went further than mere notification, and proposed also that a person would not be taken to have constructive notice of the terms of a trust merely because there had been a notification of its existence.²⁵⁷ The intention was to prevent the need for creditors to insist on reviewing the trust deed before dealing with a trustee, or at least to protect those who did not do so from having a presumption of knowledge raised against them.²⁵⁸
- 7.13 Either of these options might be more effective in informing a prospective creditor than disclosure through the Companies Register, as they do not require the intermediary step of the creditor actively checking the Register to obtain notification. There is a further question to consider of what the consequences should be, if any, for failing to disclose trustee status to a creditor, which could involve personal liability for the director, or the commission of an offence, as was the case under the Australian proposals.
- 7.14 The problem remains with all of the options discussed that even if creditors do learn that the company involved is a trustee, they may not make any further inquiries as to the company's assets or indebtedness, or inspect the trust deed. It follows that perhaps disclosure of trustee status by itself is insufficient, and a statement should also be given about assets held on trust and any restriction or exclusion of the trustee's indemnity in the trust deed.²⁵⁹ Disclosure of more detailed information of this nature would probably not be practical on business correspondence and would be best achieved through the Companies Register or informing the creditor directly. The greater the extent of the disclosure required, the more onerous it would be for corporate trustees to comply with; more extensive disclosure would also reduce the privacy currently afforded to trust arrangements.
- 7.15 Finally, disclosure about trustee status and potentially other relevant information is still likely to be insufficient in and of itself in protecting creditors, especially unsophisticated ones who do not appreciate the implications of dealing with a trustee. Disclosure would probably need to be considered in conjunction with other possible reform options.

LIABILITY OF A TRUSTEE AND THE RIGHT OF INDEMNITY AGAINST TRUST ASSETS

Liability of a trustee

- 7.16 A trust is not a legal entity; the trustee is the legal owner of the trust property.²⁶⁰ Therefore, a trustee is personally liable for all liabilities incurred in performing the trust, including debts to third parties.²⁶¹ This personal liability subsists unless there is a clause in the contract with the third party limiting the personal liability of the trustee; liability can be limited to the trust assets.²⁶² Clear and unambiguous words are needed for the court to accept that a trustee's personal liability has been excluded. Limitation of liability through the trustee's contract with a third party is distinguishable from any clause in the trust deed that limits the trustee's liability to the trust assets, as the clause in the trust deed only applies between the trustee and the beneficiaries, not between the trustee and third parties.²⁶³ However, any clause in the trust deed still has implications for creditors looking to recover their debt by way of subrogation to the trustee's right of indemnity.

Trustee's right to indemnity

- 7.17 Because the trustee administers the trust property for the benefit of the beneficiaries and not the trustee themselves, it is the beneficiaries who bear the liabilities incurred in performing the trust. Accordingly, the trustee has an indemnity against the trust assets to satisfy debts properly incurred under the trust. There are two aspects to this indemnity:²⁶⁴
1. where the trustee expends their own funds properly for trust expenses, they are entitled to be reimbursed from trust assets, often referred to as a right of recoupment; or
 2. the trustee may pay trust liabilities directly out of the trust assets, a right of exoneration.
- 7.18 The liabilities must be properly incurred to be covered by the right of indemnity. If a trustee has acted improperly in incurring the liabilities, they will not be entitled to indemnity from the trust assets.²⁶⁵ The trustee's right of indemnity is recognised both in the common law²⁶⁶ and in section 38(2) of the Trustee Act 1956. Butler states that section 38(2) "essentially reflects the trustee's right of indemnity as set out in the case law and does not derogate from it".²⁶⁷ The section provides:

A trustee may reimburse himself or pay or discharge out of the trust property all expenses reasonably incurred in or about the execution of the trusts or powers; ...

7.19 The trustee's right to indemnity from the trust assets, whether by way of reimbursement or exoneration, creates an equitable interest in both the capital and income of the trust. There is some confusion over the nature of this interest and whether it creates a lien or charge.²⁶⁸ There is a lien or charge only in the sense that a court may order the sale of assets to enable the trustee to discharge its liability; a charge involves agreement between the parties to give the charge, whereas a lien may arise in other ways.²⁶⁹ The interest has the following features:²⁷⁰

- it has priority over claims of beneficiaries and third parties;²⁷¹
- it arises by operation of law so it is not subject to the Personal Property Securities Act 1999;²⁷²
- it remains attached to trust assets even if the trust assets leave the possession of the trustee;²⁷³
- since it is equitable, not possessory, even if a trustee is removed from office, it will remain attached to the trust assets (and may remain so if the replacement trustee distributes the trust assets to the beneficiaries);²⁷⁴
- where the right arises because the trustee has personally discharged the liability or intends to do so, it can be sub-charged or assigned by the trustee;²⁷⁵ and
- again where the trustee has used its own money to meet the liability, it is an asset of the trustee that passes to the Official Assignee in liquidation or bankruptcy (unlike the trust assets).²⁷⁶

7.20 The trustee's right to an indemnity for liabilities properly incurred in carrying out the trust extends beyond the trust property. It is enforceable in equity against the beneficiaries where the beneficiaries have capacity, have accepted beneficial ownership of the trust property knowing the relevant assets were held by the trustees, and can together terminate the trust at any time.²⁷⁷

Subrogation of creditors to trustee's right of indemnity

- 7.21 Unsecured creditors of a trustee do not have a direct claim against the trust assets, unlike secured creditors who have a claim through their security. It is the trustee that is personally liable for debts properly incurred in the administration of the trust. Therefore the primary claim for creditors is against the trustee personally, not the trust assets. Creditors may recover from the trustee directly if the trustee has sufficient assets, other than assets that are held on trust. However, if the trustee has few or no assets of its own that are available to satisfy the creditor's debts, then the creditor must look to the trust property through subrogation. Subrogation is the process by which one person, in this case the creditor, is put in the place of another, here the trustee, so that the trustee's right of indemnity from trust assets is used to satisfy the creditor's debt.²⁷⁸ The purpose of the right of subrogation is to avoid the injustice of a beneficiary receiving a windfall from credit given to the trustee that has not been repaid.²⁷⁹ This is of particular relevance in the context of trading trusts, as the corporate trustee of a trading trust may have very few or no assets that are not held on trust.
- 7.22 There is some uncertainty about whether a creditor can exercise their right of subrogation where the trustee is not in liquidation or bankruptcy. In *Levin v Ikiua* Heath J stated that because the creditor's primary right is against the trustee personally, recourse to the trust assets through the right of indemnity would only be needed if the trustee had insufficient funds to satisfy the debt.²⁸⁰ However there is also authority to suggest that a creditor can assert its subrogation right where the trustee is not in liquidation or bankruptcy if the trust is under the administration of the court; where the trustee consents and the action does not prejudice others; or where the creditor can show that proceedings against the trustee for recovery has been or is likely to be fruitless.²⁸¹
- 7.23 A creditor's subrogation to the trustee's right of indemnity is entirely derivative. This means that the creditor cannot be placed in a better position than the trustee: if the trustee's right of indemnity is impaired, then the creditor's subrogation claim is likewise impaired.²⁸² This is an important issue for unsecured creditors if they are relying on the subrogation right for recovery purposes.²⁸³

Circumstances in which right to indemnity may be impaired

- 7.24 There are a number of ways in which the trustee's indemnity may be impaired. There is also the possibility that the trustee may not have properly incurred the liability in the first place, and so would not be entitled to an indemnity in respect of that liability. Creditors may have no knowledge of unrelated circumstances that impair the trustee's right to indemnity. This may effectively provide a windfall to beneficiaries and creates unfairness for creditors. If a trustee enters into a contract in any of the following circumstances, they will not have an indemnity, and consequently the creditor's ability to subrogate to the indemnity will also be denied:

- (a) if a trustee lacks the capacity to enter into the contract, under the powers in the trust deed or the general law;
 - (b) if a trustee has the power to enter into the contract but lacks the authority to do so, because a necessary procedure was not complied with (for example an insufficient number of trustees entered into the contract);²⁸⁴
 - (c) if a trustee is in breach of duty in entering into the contract, for example the duty to act in the best interests of the beneficiaries as a whole.²⁸⁵
- 7.25 The trustee's right to indemnity, and the creditor's derivative subrogation right, can also be impaired through cross-claims by the beneficiaries. If a trustee has caused a loss through breach of trust, the trustee will be liable to the trust for the amount of that loss. The trustee's indemnity will be reduced by the amount owed to the trust fund from the trustee's breach.²⁸⁶ This type of impairment is temporary and is remedied once the trustee provides compensation for the breach. Notably, if the trustee properly incurs a liability to a creditor, but there is a cross-claim by beneficiaries, the trustee's indemnity (and the creditor's subrogated right) will still be reduced even if the cross-claim is wholly unrelated to the contract with the creditor, and even if the cross-claim arose after the contract was entered into.²⁸⁷
- 7.26 To take a simplified example, if a trustee owed a creditor \$100,000 under a contract properly entered into, the trustee would ordinarily be entitled to an indemnity for that entire amount from the trust assets. The creditor could subrogate to the trustee's indemnity for the \$100,000 it is owed under the contract. But this would not be the case in the following situations:
1. If the trustee lacked the requisite capacity or authority to enter into the contract, for instance if the trust deed did not permit making such contracts, or an internal requirement was not met, or the trustee was acting in breach of trust in entering into the contract, the trustee would be denied the benefit of the indemnity, so the creditor could not rely at all on the indemnity to recover its debts.
 2. If the trustee (before or after entering into the contract) committed unrelated misconduct, such as misappropriating trust funds, or neglect of trust assets, that resulted in a \$30,000 loss to the trust estate, the trustee would be liable to compensate the trust estate for this amount. The trustee's indemnity would be reduced by the amount the trustee owed the estate, so the available indemnity that the creditor could access would be \$70,000.

Exclusion or limitation of the right of indemnity

- 7.27 Settlers commonly seek to modify the trustee's right to indemnity in the trust deed itself. There seems to be general agreement that the trustee's right of indemnity against the beneficiaries can be excluded by the trust deed, but the position is less clear regarding limitation or exclusion of the right of indemnity against trust assets. The indemnity is important to unsecured creditors: they will be significantly prejudiced if it is limited or excluded entirely, since they cannot rely on subrogation to satisfy their claims if the trustee cannot meet the liabilities personally.
- 7.28 There is some debate about the extent to which the trustee's right to indemnity can be excluded or limited by the trust instrument. One view is that the indemnity can be limited or even excluded entirely.²⁸⁸ The alternative view is that it may not be excluded because "the right of indemnity from the assets is an incident of the office of trustee and inseparable from it".²⁸⁹
- 7.29 The position has not been conclusively determined by a court in New Zealand and nor is it clear from the statutory scheme. In the Trustee Act, section 2(5) permits a settlor to modify "powers conferred on the trustee" by the legislation. The key question is whether the statutory right to indemnity in section 38(2) is a power of the trustee;²⁹⁰ if it is a power then it falls within section 2(5) and may be excluded. Writing extrajudicially, Heath J considers that the right of indemnity is likely to be something that cannot be the subject of exclusion or modification by the trust instrument.²⁹¹ He acknowledges that the wording of section 38(2) may suggest that it is a "power" because the section expressly authorises the trustee to reimbursement in respect of all expenses reasonably incurred in execution of the trusts or powers; such authorisation must necessarily create a "power" for the trustee to do those things.²⁹² But the wording of section 38(2) could suggest that it is a "right".²⁹³ Heath J has stated:²⁹⁴
- I consider it likely that, because the opening words of s 38(2) refer to a qualified ability to reimburse or to pay or discharge expenses "in or about the execution of the trusts or powers", the legislature must have intended to draw a distinction between the right to an indemnity and the exercise of powers to which it may relate.
- 7.30 Heath J also observed that it seemed wrong in principle that a settlor could exclude the right of indemnity where to do so would be to the detriment of the trustee exercising stewardship over the trust assets.²⁹⁵ Further, exclusion of the right was at odds with wanting a responsible trustee to carry out the trust, and there would be no protection against loss for someone accepting an appointment as a trustee. He queried rhetorically, "what would be the purpose of excluding the right in indemnity, other than to render nugatory the claims of creditors against the corporate trustee itself?"²⁹⁶

- 7.31 The view of the authors of *Equity and Trusts in New Zealand* is that the right can be limited but not excluded entirely, as the trustee's right to indemnity is an essential part of trusteeship; a trustee will be unable to properly exercise its discretions for the benefit of the beneficiaries if it has no right to indemnity for liabilities from the trust assets.²⁹⁷ If a corporate trustee with little private equity lacks a right to indemnity, when trust liabilities are incurred, this means that the company will invariably be insolvent.²⁹⁸ On whether the trustee's indemnity in section 38(2) can be excluded, the authors consider it only arguable that the trustee's right of indemnity can be considered a power for the purposes of sections 2(4) and 2(5).
- 7.32 Tesiram argues that an absence of an indemnity will not be a disincentive for natural person trustees to exercise their discretions properly, and indeed they may act more cautiously where personal liability will attach. Although it may be a disincentive for corporate trustees, this arises from the limitation of liability of the corporate entity, which is not the case for natural persons.²⁹⁹ His view is that the more compelling policy argument against permitting exclusion or modification of the indemnity is that:³⁰⁰
- ... because creditors can only access trust assets by way of subrogation to the trustee's right of indemnity (unless they are secured creditors) the right of indemnity is very much part and parcel of a trustee's office and inseparable from it.
- 7.33 Tesiram considers that it is difficult to see section 38(2) as providing a power that can be modified or excluded pursuant to sections 2(4) and 2(5); powers are generally either dispositive powers or those relating to the administration of the trust, and indemnities are neither.³⁰¹ He thinks that there is no basis for excluding the application of section 38(2) and that attempts to do so are likely to be ineffective.³⁰²
- 7.34 Heydon and Leeming of *Jacob's Law of Trusts* and Dal Pont of *Equity and Trusts in Australia* both disagree with the notion that the right of indemnity is so intrinsic to the nature of a trust that its exclusion would undermine the trust's existence.³⁰³ Dal Pont argues that if this were so, one would expect it would be clearly signalled in statute, while instead in four Australian jurisdictions statutory exclusion is permitted outright. He considers that the right of indemnity is not of the same nature as the other "core" elements of a trust.³⁰⁴ Heydon and Leeming agree that (save for statutory intervention) the right at general law may be excluded, even though this may gravely prejudice creditors' rights if the trustee is impecunious.³⁰⁵ Those authors note that there are many other circumstances in which the rights of a creditor of a trading trust are equally gravely prejudiced, and that if a provision excluding the trustee's indemnity is inserted into the trust instrument for the purpose of defrauding creditors, other remedies might be available to the creditor.³⁰⁶

- 7.35 In trustee legislation in Australia, the position varies from jurisdiction to jurisdiction: in Queensland the statutory right to indemnity cannot be excluded by the trust instrument; this is also likely to be so in the Australian Capital Territory, New South Wales, and South Australia; in the other jurisdictions the legislation contemplates that the right can be excluded or modified by the trust instrument.³⁰⁷
- 7.36 In 2002 the Law Commission considered that the right of indemnity probably could not be excluded or limited.³⁰⁸ There is still no authority in New Zealand stating the position with certainty, but overall the balance of commentary appears to say that it probably cannot be excluded totally. The question that follows is whether this position should be stated in legislation.

OPTIONS FOR REFORM

Strengthening the creditor's derivative claim through the trustee's right to indemnity

Option 2: Providing in statute that the right to indemnity cannot be modified or excluded

- 7.37 In 2002 the Law Commission recommended that the Trustee Act be amended to make it clear that the right to indemnity was not capable of being modified or excluded.³⁰⁹ There was widespread support from submitters when this was proposed in the Preliminary Paper. There is the opportunity to consider this proposal again. Such an amendment would bring New Zealand into line with the Australian states that also share this position. It would bring certainty to an issue that is currently undecided, but which several New Zealand commentators consider is likely to be the case already.³¹⁰ It would provide some protection for unsecured creditors whose only means of accessing the trust assets is by way of subrogation to the trustee's right of indemnity.
- 7.38 A drawback of this proposal is that it restricts the settlor's ability to settle the terms of the trust as they wish, and the trustee's freedom to accept a trusteeship without indemnity rights. Not all Australian jurisdictions have chosen to legislate in this way, and indeed some have provided for the opposite and allow indemnities to be excluded completely. Additionally, this change in itself does not address all the ways in which the trustee's indemnity can be impaired. Creditors may still find themselves unable to rely on the right to indemnity if, for example, the trustee has committed a breach of trust and caused a loss to the trust assets.

- 7.39 There is an issue as to whether any legislative change in this area should apply to trusts generally, or only to trading trusts. If it is desirable only to target trading trusts, there are further difficulties as to how to appropriately restrict the provision.³¹¹ There is also a transition issue of whether such a change should be prospective only; this issue arises in relation to all of the reform options raised.

Option 3: Enhancements to creditors' subrogation right

- 7.40 Even if the trustee's right to indemnity cannot be excluded by the trust instrument, risks remain for creditors contracting with a trustee, as the indemnity can be impaired in a number of ways (because the trustee lacked the capacity or authorisation to enter into the contract, or was in breach of its equitable duties in doing so, or the trustee is indebted to the trust).
- 7.41 To address these issues, the Trust Law Committee³¹² in England proposed several reforms be provided for in legislation. The first was that where a trustee is indebted to the trust for reasons unconnected with a contract with a creditor, this indebtedness should not prevent the creditor from being indemnified out of the trust fund, although it may prevent the trustee from exercising their right of indemnity to the extent of the indebtedness.³¹³
- 7.42 Secondly, subject to any contrary intention in the trust instrument, where a trustee's entry into a contract with a creditor was in breach of the trustee's equitable duties, this should not prevent the creditor having a right of indemnity out of the trust fund unless the creditor was dishonest.³¹⁴ The Committee had considered that checking whether the trustee will be in breach of duty by contracting with the creditor is "the most difficult and unsatisfactory" barrier facing the creditor wishing to rely on the trustee's right of indemnity.³¹⁵ The Committee considered it "not far short of astonishing" that the creditor's ability to recover depends on the trustee not acting negligently; this effectively requires the creditor to ensure that the trustee is not in breach of trust, and makes it assume some form of fiduciary duty to the trust and its beneficiaries.³¹⁶
- 7.43 Notably, the Trust Law Committee elected not to recommend a proposal introducing an "indoor management" type rule that creditors could rely on to assume that trustees were acting with the requisite capacity and authorisation, instead "preserving a sufficient distinction between trusts and companies."³¹⁷ The Committee considered that it was legitimate to expect the creditor to investigate whether the contract was within the capacity and authorisation of the trustee.³¹⁸ A reason for the Committee's position against an indoor management rule may be because it could be said that in cases where a trustee did not have the requisite capacity or authority to enter into a liability, a trustee's right of indemnity never arose in the first place, so it would be inappropriate to create or validate it via a rule. This is compared with cases involving breaches of trust, where the indemnity did come into existence, and is simply being preserved for the creditor's benefit.³¹⁹

7.44 But New Zealand need not necessarily follow the view of the Trust Law Committee regarding the need for an “indoor management” type rule for trusts. The authors of *Equity and Trusts in New Zealand* propose a scheme giving creditors priority over beneficiaries, where the creditor can assume the trustee is not in breach in incurring the liability, regardless of beneficiary cross-claims and attempts to limit or exclude the trustee’s right of indemnity (unless the creditor has knowledge of these circumstances).³²⁰

7.45 This option could provide that the creditor can rely on the trustee’s right of indemnity despite the trustee’s lack of capacity or authorisation, breach of trust, indebtedness to the trust resulting in a cross-claim, or a limited or excluded right of indemnity in the trust deed, unless the creditor is aware of these matters. It may be appropriate to cover some or all of these ways in which the indemnity can be impaired. This would ensure that the trustee is insulated against circumstances about which it has no knowledge but which may prejudice the creditor’s ability to subrogate to the trustee’s indemnity.

Direct recourse to trust assets

7.46 It can be argued that the option canvassed above by the Trust Law Committee, along with any reforms preventing the exclusion of the trustee’s right to indemnity by the trust instrument, do not go far enough. Tjio criticises the Trust Law Committee proposals for being concerned with enhancing a creditor’s subrogation rights only, rather than creating direct claims on the trust fund.³²¹ He considers that the focus on addressing weaknesses in the creditor’s right of subrogation is misguided.³²² Donovan Waters QC has echoed the concern that the “weakness” of the trust in many common law jurisdictions is that the trust creditor only has access to the trust assets when the (otherwise insolvent or bankrupt) trustee is entitled to indemnity.³²³ He considered that there is mounting pressure to introduce statutory reform introducing limited liability for trustees and direct access for creditors to the trust assets.³²⁴

Option 4: Giving trustees the power to grant charges for creditors over trust assets

7.47 An option to consider is providing in legislation for trustees to have the power to grant fixed or floating charges over trust assets for the benefit of third party creditors, enabling them to have a direct claim against trust assets (subject to any contrary intention in the trust instrument). As proposed by the Trust Law Committee in England,³²⁵ this could be a default rather than a mandatory provision. The charge avoids the need for creditors to rely on the trustee’s right to indemnity and circumvent the problem of unrelated indebtedness of the trustee by making this immaterial to creditors.³²⁶

- 7.48 This approach effectively partitions the assets of the trust so that it is treated as a de facto separate entity.³²⁷ It would not remove the need for the creditor to examine the terms of the trust deed to check that there is no restriction on the trustee's ability to grant security over trust assets; most trust deeds that are professionally drafted contain express clauses rather than relying on default provisions.³²⁸
- 7.49 The authors of *Equity and Trusts in New Zealand* express doubt about the practicality of this proposal, and note that unless a default position was created whereby a charge was granted automatically, this approach would not assist the many creditors who would not be aware of the need to negotiate such a charge from the trustee.³²⁹ It may be that a reform of this kind would only assist the types of creditors who were likely to seek security anyway.

Option 5: A right of direct recourse to trust assets

- 7.50 A more straightforward but perhaps more radical option would be to provide for creditors to have direct recourse to trust assets, without needing to rely on the trustee's right of indemnity. Providing for a direct claim on the trust assets in certain circumstances would avoid the unfairness of the creditor being deprived of the ability to recover because the trustee's right to indemnity is impaired, for example due to the trustee's unrelated indebtedness, and the beneficiaries receiving a windfall benefit.
- 7.51 Direct recourse to the trust assets may already be available, although it is not clear what approach New Zealand courts would take. A creditor might have a claim against the trust fund in unjust enrichment, to the extent that the trust fund is benefited at the expense of a creditor.³³⁰ A direct claim is also possible where the trust instrument provides for the trust fund to be liable.³³¹ The contract between a creditor and a trustee may be construed as giving the creditor a direct claim against the trust fund, through implication, if the contract provides that the trustee is not to be personally liable but that the creditor is to look to the trust fund to satisfy the claim.³³²
- 7.52 Alternatively, a more narrow construction of such a provision is that the trustee's own property is exempt but the creditor is not given a direct claim against the trust fund, and still must rely on the trustee's right to indemnity to access the trust assets.³³³ Even if there is such a contractual provision to rely on, the creditor must still ensure that the contract is within the capacity of the trustee.³³⁴ Where the contract states that the trustee is not to be personally liable, the tendency in the United States is to construe the contract as giving a creditor a direct right of recourse to the trust fund, whether or not it specifically provides for this.³³⁵

7.53 The United States has seen the emergence of a doctrine of “direct access to the trust assets” or “binding the trust estate”.³³⁶ The courts and academics appear to agree that “a trustee can and should be permitted to exclude all personal liability, and that an unsecured trust creditor can and should be able to access directly the trust estate despite this, free of the clear accounts rule.”³³⁷ This is illustrated in the relevant sections of the Restatement of the Law of Trusts³³⁸ as well as the Uniform Trust Code.³³⁹ The second Restatement states that a trust creditor is permitted direct access to trust property in certain circumstances:³⁴⁰

- (a) where the trustee is entitled to exoneration (that is, indemnity) (section 268);
- (b) where the trust estate has benefited (section 269);
- (c) where the terms of the trust provide for the liability of the trust estate (section 270);
- (d) where the contract binds the trust estate (section 271);
- (e) other situations where it is equitable to permit satisfaction (section 271A): the commentary on this section observes that this principle has emerged as a modern trend that has “gradually become established.”³⁴¹

7.54 The revised version of the Restatement appears as though it will simplify the position considerably. Halbach states:³⁴²

Trusts Third can be expected to reverse the position of previous Restatements of Trusts by providing that third parties’ suits against trustees normally result in a judgment against the trustee in a representative capacity (that is, one “against the trust”).

7.55 The draft of the third Restatement provides in section 105 that a third party may assert a claim against a trust for a liability incurred in trust administration by proceeding against the trustee in the trustee’s representative capacity, whether or not the trustee is personally liable.³⁴³ Section 106 states that a trustee is personally liable on a contract only in certain circumstances: if the trustee committed a breach of trust; if the trustee’s representative capacity was undisclosed and unknown to the third party; or if the contract so provides.³⁴⁴ Thus, the starting point is that the creditor is given a direct claim against the trust assets, unless certain circumstances are met – the opposite of the approach taken in the second Restatement, where the scenarios involving direct access to the trust assets were still expressed as the exceptions. D’Angelo observes that now, while a trustee in the United States can assume personal liability, the contract must expressly state this, which is the reverse of the Australian (and New Zealand) position.³⁴⁵

7.56 The prospective change in the Restatement is in line with section 1010 of the Uniform Trust Code, headed “Limitation On Personal Liability of Trustee”, which provides:

- (a) Except as otherwise provided in the contract, a trustee is not personally liable on a contract properly entered into in the trustee’s fiduciary capacity in the course of administering the trust if the trustee in the contract disclosed the fiduciary capacity.
- (b) ...
- (c) A claim based on a contract entered into by a trustee in the trustee’s fiduciary capacity ... may be asserted in a judicial proceeding against the trustee in the trustee’s fiduciary capacity, whether or not the trustee is personally liable for the claim.

7.57 On this point, *Scott and Ascher on Trusts* comments:³⁴⁶

Third parties who contract with the trustee are permitted ... to assert their claims directly against the trust estate ... In short then, though there remain some instances in which the trustee is personally liable, such as when the contract so provides or when the trustee fails to disclose that the trustee is acting on behalf of the trusts, [section 1010] generally relieves the trustee of personal liability on contracts entered into on behalf of the trust estate.

7.58 This change is very significant for creditors contracting with a trustee, as it shifts the risk of dealing with an insolvent or misbehaving trustee from the creditor to the trust estate.³⁴⁷ Such a shift is said to be appropriate because “the trust is the ‘enterprise’ that has generated the contract” and should therefore bear the costs of performing the contract; additionally, the choice of trustee is within the settlor’s control, and it is manifestly unfair for a third party to bear the consequences of a poor choice of trustee by the settlor.³⁴⁸

7.59 Provision could be made in legislation in New Zealand for creditors to have a direct claim against the trust assets in certain circumstances. This would not necessarily need to entail change to the current law on trustee liability. Enabling creditors to take a claim against the trust assets via a legislative provision could be drafted so that the claim is available independently of the trustee’s right of indemnity. In this way the provision would circumvent the problems arising where a creditor cannot satisfy their debt because the trustee’s indemnity is impaired.

7.60 Against the advantages for creditors that such a reform might provide, it could be argued that permitting direct access to the trust assets would cut across basic contractual and equitable principles (such as trustees’ personal liability). It could also result in two “classes” of unsecured trust creditor, depending on whether or not they were able to make a direct claim, which could lead to unfairness.³⁴⁹ The interests of beneficiaries also need to be considered if the creditors are able to access trust assets. Overall, this type of reform might disincentivise the use of a trading trust structure if the trust assets are no longer protected from the reach of creditors, a consequence which may or may not be desirable.

- 7.61 A question arises about the circumstances, if any, in which a direct claim should be permitted. There was support in a submission to a previous Issues Paper for allowing a direct claim on the trust assets where the relevant liability is incurred for the benefit of the trust as a whole, although it was acknowledged that it would not assist creditors in an insolvency situation.³⁵⁰ This proposal is in line with section 269 of the second Restatement.
- 7.62 D'Angelo thought that the circumstance referred to in section 271 of the second Restatement, where a contract that provides that a trustee is not personally liable can be taken as implying that the trust estate will carry the liability, might be palatable in Australia. This concept did not involve a radical departure from current trust and equity principles.³⁵¹ In contrast, he thought the concept in section 271A, that a direct claim is permitted where it is equitable to do so, conferred altogether too broad and too discretionary jurisdiction on the courts.³⁵² Certainly section 271 “involves a less precise concept of equity”;³⁵³ it may be challenging for the courts to apply and create uncertainty for parties.

Option 6: Liability of directors of trading trusts

- 7.63 Another option to consider for protection of creditors is the liability of directors of a corporate trustee. Directors contract on behalf of the company, and it is the company, a separate legal entity, that is liable for repayment of any liabilities incurred. Creditors are clearly vulnerable if the corporate trustee is a limited liability company with only nominal capital assets.³⁵⁴ At present, the directors of a company that is a trustee are subject to the same obligations as the directors of any company; as Heath J has said:³⁵⁵

A company is a company is a company. Whether a company is a trustee or operating on its own behalf, it remains a company subject to statutory, common law and equitable rules.

A director is a director is a director. A director of a company owes the same duties to a company, whether the company is a trustee or operating on its own behalf.

- 7.64 Directors of corporate trustees are accordingly subject to the directors' duties in the Companies Act 1993. Directors must ensure that distributions of the company's wealth are not made unless the company is solvent:³⁵⁶

For the creditor who does not know that it is trading with an assetless corporate trustee, the protection against the suffering of loss lies in the duties owed by directors to the company, breach of which will enable liquidators to recover sufficient moneys to meet creditors' claims; assuming the directors are themselves solvent and are able to pay in full. On the other hand, if the directors consider carefully the company's financial position and make a decision on reasonable grounds that creditors would not be prejudiced by any distribution they make, they will not be held personally liable for any distribution to beneficiaries.

- 7.65 In particular, sections 131, 135, 136 and 137 of the Companies Act will apply. Section 131 imposes a duty on directors to act in good faith and in the best interests of the company.³⁵⁷ Section 135 prohibits directors causing or allowing the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors. Section 136 prohibits a director from agreeing to a company incurring an obligation unless the director reasonably believes the company will be able to perform the obligation required. Section 137 requires a director, when exercising or performing duties, to exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances, taking into account the nature of the company and the decision, the position of the director and the nature of responsibilities undertaken by him or her. In addition, sections 344–350 of the Property Law Act 2007 prevent dispositions of property with intent to defraud creditors.
- 7.66 A director who breaches their duties to the company may be liable to the company for any losses the company suffers, and on liquidation a liquidator or creditor can bring an action against a director to recover losses suffered by the company as a result of the director's breach of duty. A director of a corporate trustee may even be in a more precarious position than a director of an ordinary company, if the corporate trustee has limited assets of its own.³⁵⁸ Depending on the availability of the trustee's right to indemnity and the value of the trust assets, a director may well be liable for reckless trading under section 135 or incurring an obligation without reasonable grounds to believe that the company will be able to perform the obligation under section 136.
- 7.67 If the company has been placed in liquidation, then the creditor, liquidator or shareholder can apply for an order under section 301(1) for repayment of money or property to the company's assets or to the creditor directly, if a director has misapplied money or property, or acted negligently or in breach of trust or duty in relation to the company. However, orders in favour of an individual creditor under section 301 are limited.³⁵⁹
- 7.68 In *Levin v Ikiua* two directors of a corporate trustee were found to be in breach of their duties to the company in making distributions to beneficiaries once they were aware of a claim by a creditor, so that distribution was likely to result in loss to the creditor. The directors were ordered to pay to the liquidators the amount distributed.³⁶⁰ It was said the breaches could be on the basis of breach of fiduciary duty or the principle in *Nicholson v Permakraft (NZ) Ltd*,³⁶¹ being the duty of the director not to authorise distribution of the assets of the company for the benefit of third parties to the detriment of a person known to be a creditor.³⁶²
- 7.69 The question is whether these obligations impose sufficient constraints on directors of corporate trustees in trading trust structures, or whether the liability of directors should be extended. The Commission would be interested in views on this. If it was desirable to impose further liability on directors, the next question is how this is best achieved. It is likely that any reform would require an amendment to the Companies Act.

7.70 In 2002 the Commission recommended providing that a trading trust may make a distribution to a beneficiary of the trust only if the requirement in section 52 of the Companies Act (the solvency test) have been satisfied, and applying the same criminal and personal liability to directors in the event of breach of this provision as are found in sections 52(5) and 56.³⁶³ Submitters to the Preliminary Paper were generally not in favour of this proposal, as discussed in paragraph [6.25]. In light of concerns raised by submitters about the shorthand importation of the test in section 52 and the lack of support for this option, it is proposed not to pursue it further, but the Commission is open to submitters' views to the contrary.

7.71 In Australia the main legislative development to protect creditors dealing with trading trusts has been in relation to directors of corporate trustees; a similar provision could be adopted in New Zealand. Section 197 of the Corporations Act 2001 (Cth) applies where a corporation incurs a liability while acting or purporting to act as a trustee. Subsection (1) provides that directors are personally liable for debts incurred by the company where the company does not have an indemnity out of the trust assets. The section provides:³⁶⁴

197 Directors liable for debts and other obligations incurred by corporation as trustee

- (1) A person who is a director of a corporation when it incurs a liability while acting, or purporting to act, as trustee, is liable to discharge the whole or a part of the liability if the corporation:
 - (a) has not discharged, and cannot discharge, the liability or that part of it; and
 - (b) is not entitled to be fully indemnified against the liability out of trust assets solely because of one or more of the following:
 - (i) a breach of trust by the corporation;
 - (ii) the corporation's acting outside the scope of its powers as trustee;
 - (iii) a term of the trust denying, or limiting, the corporation's right to be indemnified against the liability.

The person is liable both individually and jointly with the corporation and anyone else who is liable under this subsection.

Note: The person will not be liable under this subsection merely because there are insufficient trust assets out of which the corporation can be indemnified.

- (2) The person is not liable under subsection (1) if the person would be entitled to have been fully indemnified by 1 of the other directors against the liability had all the directors of the corporation been trustees when the liability was incurred.

...

7.72 This section was first introduced in 1986.³⁶⁵ 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.³⁶⁶ One aim was that the imposition of personal liability on directors would have the effect of discouraging the insertion into trust deeds of provisions limiting or excluding the company's right of indemnity from trust assets. It was also intended to encourage trust deeds to be drafted so as to minimise or eliminate the possibility that a trustee would be in breach of trust.³⁶⁷ The basis was that it is reasonable to encourage all directors of companies acting as trustees to ensure that the company does not enter into trust deeds which deny creditors access to trust assets to meet liabilities incurred by the company.³⁶⁸ As Cooper has described:³⁶⁹

The archetype of the mischief sought to be addressed is the situation where a creditor is owed money by a corporate trustee with a \$2 share capital and either the terms of trust or the conduct of the trustee deny the creditor access to the trust assets via subrogation to the trustee's right of indemnity.

7.73 In the event, litigation involving section 197 has been limited. There has been little commentary and there was no significant judicial consideration of its predecessors.³⁷⁰ A significant issue with the interpretation of section 197 arose in 2003 following a decision of the South Australian Full Court in *Hanel v O'Neill*,³⁷¹ *Hanel* was the first time that the section had been considered. The version of section 197(1)(b) at that time did not contain the text from "solely because of ..." onwards, or subparagraphs (i) to (iii). The note after paragraph (b) read ambiguously, "This is so even if the trust does not have enough assets to indemnify the trustee". The majority in *Hanel* interpreted section 197(1) as saying that a director of a corporate trustee will be liable for liabilities incurred by the trustee, merely because there are insufficient trust assets to meet them, even if the trustee has a legal right to indemnification. The majority decided that insufficiency of assets meant that the corporate trustee was not "entitled" to be fully indemnified, thereby triggering liability under section 197(1). They concluded that Parliament, when rewording the section in 1999, had intended to reverse the previous position that an insufficiency of assets, by itself, did not mean that a director would be taken not to be entitled to be fully indemnified. The decision was criticised by subsequent courts and commentators³⁷² who considered the interpretation to be incorrect. The problem was the major expansion of directors' personal liability that effectively treated directors of corporate trustees as guarantors of any liability entered into on behalf of the trust.³⁷³

7.74 The decision in *Hanel* was soon overridden in 2005 by an amendment that replaced subsection (1) and the accompanying note with the current wording set out in paragraph [7.68].³⁷⁴ There appears to have been no further judicial consideration of section 197 as amended. The Second Reading of the amending Bill indicated that it would "address concerns that have arisen" after *Hanel*, "restore the long-standing interpretation of section 197" and "clarify the circumstances in which directors or corporate trustees are liable to discharge a liability incurred by the corporation, acting in its capacity as trustee".

- 7.75 The revised section 197 is still not without its difficulties. The drafters of the amendment elected to list the circumstances of extinguishment or limitation of the right of indemnity, in subparagraphs (i) to (iii), rather than leaving the question to be determined by the general law.³⁷⁵ Austin and Ramsay have pointed out that due to the amendments, a director would not be liable if the trustee's right of indemnity is lost for a reason other than those listed.³⁷⁶
- 7.76 Lang Thai considers that the section is unacceptable for several reasons. While directors in Australia can be held liable under the insolvent trading provisions in section 588G of the Corporations Act 2001, section 588H offers four defences. Directors being sued under section 197 have no similar defences, so directors of trustee companies are treated more harshly under section 197.³⁷⁷
- 7.77 Thai is also concerned that section 197 leaves open the potential for abuse by directors of certain trustee companies, especially smaller ones, if the company has a full indemnity or a limited but reasonably extensive indemnity under the trust deed, but the director ensures that the trust has insufficient funds to fulfil the company's right of indemnity.³⁷⁸ He advocates a legislative provision requiring the directors of trustee companies to discharge all company debts and out of pocket expenses before proceeding to distribute the balance of trust funds to the beneficiaries.³⁷⁹ He also considers that there should be a requirement for a trustee company to publicly document the extent to which the trustee company is legally entitled to indemnity (through lodgement of the trust documents with the Australian Securities and Investments Commission).³⁸⁰ Thai further comments that he would like to see reincorporated into section 197 the defence provision protecting "innocent directors" which was found in the section prior to its rewording in 2000.³⁸¹
- 7.78 If New Zealand were to incorporate a provision based on section 197 of the Australian Corporations Act 2001 into legislation (albeit with improved drafting), this reform would negate the effect of any limitation or exclusion of the trustee's right to indemnity in the trust deed by shifting liability to the directors. The need for such a provision would be reduced if legislation were introduced providing that the right to indemnity cannot be excluded in the trust instrument. A provision similar to section 197 might have a similar effect by incentivising trustees to ensure that trust deeds do not restrict the right of indemnity. It would also provide another avenue of protection to creditors in the event of a breach of trust or ultra vires conduct by the trustee.
- 7.79 Nonetheless, there are clearly many issues arising from the introduction of a provision such as section 197, including those highlighted in Australia. Moreover, such a change would not by any means provide a full guarantee for repayment of creditors; repayment as a matter of personal liability would depend on the available asset base of the directors. However, it might focus the attention of directors on their conduct and right to indemnity if their personal liability is affected. A New Zealand equivalent section could cover the same circumstances of exclusion or limitation of the right of indemnity as listed in section 197(1)(b)(i) to (iii), or could define the scope of this more widely or narrowly, or leave it to be determined by the courts under a general provision.

- 7.80 There remains a question about how to deal with directors distributing assets to beneficiaries so that, while the company may be indemnified against trust assets, there are no assets available to fulfil the company's right of indemnity. The interaction of a new section with the existing Companies Act provisions, particularly the directors' duties, would need to be considered. There may be legitimate concerns about the impact that such a section would have on the willingness of persons to act as directors of corporate trustees, if their personal liability were expanded; extra costs may be incurred in indemnity insurance. The availability of appropriate defences would need to be addressed. There is also an issue as to whether the section ought to apply to all trusts (as the Australian provision does) or to certain trusts only.
- 7.81 The Commission would be interested in views on whether statutory intervention is necessary to hold directors of corporate trustees liable to creditors, and if so, in what circumstances liability should attach.

Option 7: Retain the status quo

- 7.82 A further option would be to retain the status quo and make no changes in relation to creditors dealing with trading trusts. This is the preferred option if the difficulties for creditors caused by trading trusts are not sufficiently serious, widespread or identifiable to warrant intervention. A fundamental argument against reform is that the types of issues raised by trading trusts are no different to risks ordinarily faced by unsecured creditors looking to do business with a company that is not a trustee, for example that the company's assets are subject to a charge. It could be said that a creditor always runs the risk that the party they are contracting with will not be able to meet their obligations, whether that party is an individual person, a corporate trustee, or an ordinary company. On this view there is no compelling reason to set the trading trust structure apart and apply additional rules to assist creditors who have failed to take security.
- 7.83 Under the status quo, existing trust and company law obligations would continue to apply to corporate trustees and their directors. This approach places the risks of dealing with an assetless corporate trustee mainly with the third party looking to contract with it, although the corporate trustee and its directors would still be bound by duties under the Companies Act and the Fair Trading Act 1986. Creditors would continue to have their primary claim against the trustee personally, and rely on the trustee's right of indemnity to recover their debts if the trustee has insufficient assets. Creditors would bear the risk that the indemnity is not available, possibly leaving them with no recourse to have their debt satisfied. It would be open to settlors to exclude the right to indemnity via the trust instrument and trustees to accept the position with this limitation (although it is as yet unclear in New Zealand whether such a provision would undermine the existence of the trust).

7.84 The current position puts the onus on the creditor to protect their position, either by taking security, or by establishing for themselves the extent of the trustee's indemnity, whether it is limited or excluded by the trust instrument, and whether the trustee is acting within its capacity and authority in entering into the contract. Smaller or less sophisticated creditors may be constrained in their ability to obtain such protections, due to lack of awareness about the need for them or limited negotiating power.

SUMMARY

7.85 A number of options have been outlined in this chapter. They are as follows:

- Option 1: Disclosure of a company's status as a trustee, for example through the Companies Register or through business documents.
- Option 2: Preventing the exclusion in the trust instrument of the trustee's right to indemnity from the trust assets.
- Option 3: Strengthening the creditor's access to the right to indemnity, for instance providing that the creditor can still rely on indemnity from the trust fund irrespective of whether the trustee acted in breach of trust in incurring the liability or was otherwise indebted to the trust fund.
- Option 4: Giving trustees the power to grant charges for creditors over trust assets.
- Option 5: Providing creditors with direct recourse to trust assets in some situations.
- Option 6: Providing for liability of directors of companies acting as trustees for trust liabilities in some situations.
- Option 7: Retaining the status quo.

7.86 There are also other options that have not been put forward. The possibility of restricting whether limited liability companies can act as express trustees did not receive a favourable response during the 2002 review and so has not been taken further in this chapter. Other options that have not been explored include requiring a minimum paid-up capital for companies acting as trustees, and the proposal put forward in 2002 to apply the solvency test to distributions to beneficiaries.³⁸²

7.87 Finally, submitters to a previous Issues Paper in the present review suggested that it would be useful for trusts legislation to clarify certain matters relating to the liability of trustees, the trustee's right to indemnity, the subrogation of creditors and the exclusion of the right of indemnity.³⁸³ These relate to trading trusts but also apply in trust law more broadly. The general principles have been set out above at paragraphs [7.16] to [7.36]. The Law Commission is interested in views on whether it would be beneficial to clarify these matters in legislation. It would not be intended to change the common law, but only to restate the essential principles in legislation. It would still be open for settlors to vary the position in the trust instrument.

QUESTIONS

Q13 Do you consider that there are problems for creditors dealing with trading trusts?

Q14 Do you support any of the options for assisting creditors dealing with trading trusts, either alone or in combination?

Q15 Do you consider that it would be beneficial to restate in legislation the essential principles of any of the following areas of the common law (as they apply generally, not only to trading trusts):

- a. that a trustee assumes personal liability unless there is an express contract to the contrary;
- b. a trustee's right to indemnity out of trust assets;
- c. how and subject to what, if any, conditions can a trustee's rights to indemnity be exercised;
- d. the circumstances in which creditors can be subrogated to a trustee's right of indemnity; and
- e. exclusion of the right of indemnity.

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- 244 Submission of Reeves Middleton Young on *Preliminary Paper 48: Some Problems in the Law of Trusts* (submission dated 4 March 2002), at 1.
- 245 Peter Blanchard “Towards a modern law of trusts” (paper presented to New Zealand Law Society Trusts Conference, 2001) at 8.
- 246 Meeting with Grant Slevin, Insolvency and Trustee Service and Ministry of Economic Development, 7 September 2011.
- 247 See para [6.26].
- 248 See Companies Act 1993 (NZ), s 332
- 249 Companies Act 1993 Regulations 1994.
- 250 Submission of the Institute of Chartered Accountants of New Zealand (ICANZ) on *Preliminary Paper 48: Some Problems in the Law of Trusts* (submission dated 21 March 2002), at 9.
- 251 Companies Act 1993, s 25.
- 252 Submission of Reeves Middleton Young, above n 244, at 1.
- 253 Proposed new s 504B was to be introduced by the Companies and Securities Legislation (Miscellaneous Amendments) Bill (No 2) 1984, but was not proceeded with: see Explanatory Paper to the Companies and Securities Legislation (Miscellaneous Amendments) Bill 1985 (Exposure Draft 2), June 1985, at [484]–[485].
- 254 DG Gardiner “Trading Trusts and Straw Trustees (Principles and Problems Reconsidered)” (1987) 3 QIT Law Journal 17 at 44.
- 255 Jeremy Cooper “Piercing the ‘veil of obscurity’ – the decision in *Hanel v O’Neill*” (2004) 22 C&SLJ 313 at 316.
- 256 Defined widely under proposed s 504A to include business letters, statement of accounts, invoices, orders for good or services, official notices and bills of exchange.
- 257 Proposed sections 504A and 504B.
- 258 Cooper, above n 255, at 317.
- 259 Lang Thai “Recent amendment to section 197 – is it acceptable?” (2006) 14 Insolv LJ 22 at 34.
- 260 GE Dal Pont *Equity and Trusts in Australia* (Thomson Reuters, Rozelle (NSW), 2011) at [23.120].
- 261 *Ibid*; *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 (HCA) at 367.
- 262 *Muir v City of Glasgow Bank* (1879) 4 App Cas 337.
- 263 See Vicki Amundsen “The trustee’s liability – limited to assets or not?” New Zealand Tax Updater (CCH, 23 April 2009) at 1; *Sovereign Homes Ltd v Meurant* HC Auckland CIV-2006-404-7394, 15 May 2007.
- 264 Andrew S Butler (ed) *Equity and Trusts in New Zealand* (2nd ed, Thomson Reuters, Wellington, 2009) [Equity and Trusts] at 442; Dal Pont, above n 260, at [23.120].
- 265 *Re O’Donoghue* [1998] 1 NZLR 116 (HC).
- 266 For instance *Re Johnson* (1880) 15 Ch D 548.
- 267 Butler *Equity and Trusts*, above n 264, at 444.
- 268 Bill Patterson “Trustees’ indemnities, equitable liens, subrogation and caveats – has the law taken a wrong turn?” (paper presented to New Zealand Law Society Trusts Conference, 2011) at 287–289.

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- 269 Ibid, at 287–288.
- 270 Butler *Equity and Trusts*, above n 264, at 446–447.
- 271 *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 (HCA); *Re Johnson* (1880) 15 Ch D 548 at 552.
- 272 Personal Property Securities Act 1999, s 23(b).
- 273 *Jennings v Mather* [1902] 1 KB 1 (CA).
- 274 *Rothmore Farms v Belgravia* (1999) 2 ITELR 159.
- 275 Butler *Equity and Trusts*, above n 264, at 446; *Custom Credit Corp Ltd v Ravi Nominees Pty Ltd* (1992) 8 WAR 42; *Niak v Davidson* HC Dunedin CP15/98, 2 June 1999.
- 276 *Levin v Ikiua* [2010] 1 NZLR 400 (HC) at [112]; although Ford considers that it should not be treated as a proprietary interest: see para [8.28].
- 277 Butler *Equity and Trusts*, above n 264, at 131, citing *Hardoon v Belilios* [1901] 1 Ch 342. However, the precise limits of the indemnity described above are not entirely certain, for instance whether the creditor’s subrogation right applies to the trustee’s right of indemnity against the beneficiaries: see Butler at 444–445.
- 278 *Levin v Ikiua* [2010] 1 NZLR 400 (HC) at [120].
- 279 Ibid, at [119].
- 280 Ibid, at [121].
- 281 Butler *Equity and Trusts*, above n 264, at 448; *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 (HCA).
- 282 Dal Pont, above n 260, at [27.25].
- 283 Butler *Equity and Trusts*, above n 264, at 449.
- 284 Ibid.
- 285 Trust Law Committee (UK) “The Rights of Creditors Against Trustees and Trust Funds” (Report, 1999) at [3.9] [“Report on Rights of Creditors”].
- 286 Butler *Equity and Trusts*, above n 264, at 450.
- 287 Ibid.
- 288 *RWG Management Ltd v Commissioner of Corporate Affairs* [1985] VR 385 per Brooking J; however, this case was decided in the context of the Victorian Trustee Act which allows for the exclusion of indemnities); *Re German Mining Co* (1854) 43 ER 415 per Turner J; HAJ Ford and IJ Hardingham “Trading Trusts: Rights and Liabilities of Beneficiaries” in PD Finn *Equity and Commercial Relationships* (Law Book Company, Sydney, 1987) 48.
- 289 BBH McPherson “The Insolvent Trading Trust” in PD Finn *Essays in Equity* (Law Book Company, Sydney, 1985) 142. See also *Kemtron Industries Pty Ltd v Commissioner of Stamp Duties* (QLD) (1984) 15 ATR 627 (QC) at 634.
- 290 Paul Heath “Bringing Trading Trusts into the Company Line” [2010] NZ L Rev 519 at 528.
- 291 Ibid, at 530.
- 292 Ibid, at 528.
- 293 Ibid, at 529.

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- 294 Ibid.
- 295 Ibid, at 530.
- 296 Ibid.
- 297 Butler *Equity and Trusts*, above n 264, at 455–456.
- 298 Ibid, at 456.
- 299 Pravir Tesiram “Contracting as a Trustee: Liability to Creditors and the Use of Private Trust Companies” (paper presented at New Zealand Law Society Trusts Conference, May 2005) at 160.
- 300 Ibid.
- 301 Ibid, at 161.
- 302 Ibid.
- 303 JD Heydon and MJ Leeming *Jacobs’ Law of Trusts in Australia* (7th ed, LexisNexis, 2006) at [2106] [Jacobs]. The authors state that the notion “lacks a foundation in logic” but do not elaborate further.
- 304 See Law Commission *The Duties, Office and Powers of a Trustee: Review of the Law of Trusts Fourth Issues Paper* (NZLC IP26, 2011) at ch 1 [Duties, Office and Powers of a Trustee]; Dal Pont, above n 260, at [23.155].
- 305 *Jacobs*, above n 303, at [2106].
- 306 Ibid.
- 307 Dal Pont, above n 260, at [23.155].
- 308 Law Commission *Some Problems in the Law of Trusts* (NZLC R79, 2002) at 13. [*Some Problems in the Law of Trusts*]
- 309 Ibid, at 14.
- 310 For example Heath, above n 290, at 530.
- 311 See para [8.32].
- 312 The Trust Law Committee was set up in 1994 under the auspices of King’s College London, comprising legal academics and practitioners who conduct research to analyse weaknesses in trust law and ways of improving it. It has produced consultation papers and reports on various areas of trust law including the rights of creditors against trustees and trust funds. The Committee worked with the United Kingdom Law Commission to develop the Trustee Act 2000.
- 313 Trust Law Committee “Report on the Rights of Creditors”, above n 285, at [3.4] and [10.2].
- 314 Ibid, at [10.3]. “Dishonest” is meant in the sense established by *Royal Brunei Airlines v Tan* [1995] 2 AC 378.
- 315 Ibid, at [3.9].
- 316 Ibid, at [3.9]; Hans Tjio “Lending to a Trust” (2005) 19 TLI 3 at 11.
- 317 Ibid, at [3.8].
- 318 Ibid, at [3.5]–[3.6].
- 319 Tjio, above n 316, at 19.
- 320 Butler *Equity and Trusts*, above n 264, at 463.
- 321 Tjio, above n 316, at 19.

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- 322 Ibid, at 20.
- 323 Donovan Waters QC “The Future of the Trust – Part II” (2007) 14 *Journal of International Trust and Corporate Planning* 1 at 12.
- 324 Ibid at 11–12.
- 325 Trust Law Committee “Report on the Rights of Creditors”, above n 285, at [3.1] and [10.1].
- 326 Ibid, at [3.1].
- 327 Tjio, above n 316, at 14.
- 328 Ibid.
- 329 Butler *Equity and Trusts*, above n 264, at 462–463.
- 330 Trust Law Committee “Rights of Creditors Against Trustees and Trust Funds” (Consultation Paper, April 1997) at [2.30] [“Consultation Paper on Rights of Creditors”].
- 331 Ibid, at [2.31]–[2.32].
- 332 Ibid, at [2.33]–[2.36].
- 333 Ibid, at [2.35].
- 334 Tjio, above n 316, at 19.
- 335 Ibid. See American Law Institute *Restatement of the Law, Second, Trusts* (2nd ed, 1959) at s 271.
- 336 See Nuncio D’Angelo “The unsecured creditor’s perilous path to a trust’s assets: Is a safe, more direct US-style route available?” (2010) 84 *ALJ* 833 at 848–854.
- 337 Ibid, at 854.
- 338 Restatements of the law are produced by the American Law Institute. These are not statutes and do not have the force of law (unless accepted by the courts of a state) but are highly authoritative, and seek to collect and summarise the law and sometimes resolve ambiguities: D’Angelo, above n 336, at 848. The second Restatements were published in 1959; since then further revisions have been carried out and the draft has been approved, but the relevant volumes of the third Restatement have not yet been published.
- 339 A Uniform Trust Code, covering express trusts, was developed by the National Conference of Commissioners on Uniform State Law, and is intended to provide a default statute. See s 102 (Scope) and Comment, and Comment on Article 1. It was promulgated in 2000 and updated in 2005, and has now been accepted in some form in 24 states, with three more in the process of introducing it in 2011: see < www.nccusl.org/ > Legislative Fact Sheet: Uniform Trust Code. Once enacted in a state, it becomes part of the law of that state: see D’Angelo, above n 336, at 848.
- 340 *Restatement of the Law, Second, Trusts*, above n 335.
- 341 Ibid, at s 271A, comment a.
- 342 Edward C Halbach “Uniform Acts, Restatements, and Trends in American Trust Law at Century’s End” (2000) 88 *California Law Review* 1877 at 1883.
- 343 American Law Institute *Restatement of the Law, Third, Trusts* (Tentative Draft No 6, 2011) at s 105.
- 344 Ibid, at s 106.
- 345 D’Angelo, above n 336, at 849.
- 346 Austin Wakeman Scott, William Franklin Fratcher and Mark L Ascher *Scott and Ascher on Trusts* (5th ed, vol 4, Wolters Kluwer, 2007) at 1875–1876.

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- 347 Ibid, at 1877.
- 348 Ibid, at 1879.
- 349 D'Angelo, above n 336, at 857.
- 350 Submission of Taylor Grant Tesiram on *Review of Trust Law in New Zealand: Introductory Issues Paper* (submission dated 28 February 2011) at 8.
- 351 D'Angelo, above n 336, at 855.
- 352 Ibid, at 854.
- 353 JD Merralls "Unsecured Borrowings by Trustees of Commercial Trusts" (1993) 10 Aust Bar Rev 248 at 257.
- 354 D'Angelo, above n 336, at 774.
- 355 Heath, above n 290, at 537.
- 356 Ibid, at 539.
- 357 See for example the director of a corporate trustee found liable under s 131 in *Vance v Lamb* HC Wellington CIV-2007-485-343, 2 December 2008.
- 358 Paul Heath and Michael Whale *Heath and Whale on Insolvency* (online looseleaf ed, LexisNexis) at [46.5(f)].
- 359 See *Insolvency Law & Practice* (online looseleaf ed, Brookers) at [CA135.06(3)] and [CA301.08(3)]; *Mitchell (t/a D L Mitchell Plumbing & Drainage) v Hesketh* (1998) 8 NZCLC 261,559.
- 360 *Levin v Ikiua* [2010] 1 NZLR 400 (HC) at [138]–[147]. Confirmed by the Court of Appeal in [2010] NZCA 509 at [73].
- 361 Ibid, at [146].
- 362 Ibid, at [139] and [142], citing *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242 (CA).
- 363 Law Commission *Some Problems in the Law of Trusts* (NZLC R79, 2002) at 14.
- 364 Corporations Act 2001 (Cth), s 197. Subsections (3) to (5) respectively provide that this section does not apply to a liability incurred outside Australia for a foreign company, a registrable Australian body outside its place of origin, or to an Aboriginal and Torres Strait Islander corporation.
- 365 The provision was originally introduced as s 229A of the Companies Codes through the Companies and Securities Legislation (Miscellaneous Amendments) Act 1985 (Cth) in March 1986. Subsequently the Corporations Law replaced the Codes and the provision was renumbered to s 233. Then in the Corporations Act, brought in in 2001, the provision was replaced with s 197 and some changes in wording were made.
- 366 Explanatory memorandum at [277].
- 367 Ibid, at [280].
- 368 Ibid.
- 369 Cooper, above n 255, at 315. See also Second Reading Speech by Mr Lionel Bowen, Attorney-General, on the Companies and Securities Legislation (Miscellaneous Amendments) Bill 1985, House of Representatives, Weekly Hansard, No 14, 1985, at 1923.
- 370 Thai, above n 259, at 22–23.
- 371 *Hanel v O'Neill* [2003] SASC 409 at [67].

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- 372 *Edwards v Attorney-General (NSW)* (2004) 60 NSWLR 667 at [142]–[152]; *Saffron Sun Pty Ltd v Perma-Fit Finance Pty Ltd (in liq)* (2005) 65 NSWLR 603 at [31]; *RJK Enterprises Pty Ltd v Webb* [2006] 2 Qd R 593; *Intagro Projects Pty Ltd v Australia and New Zealand Banking Group Ltd* (2004) 183 FLR 462 at [61]–[63]. Cooper, above n 255; Thai, above n 259.
- 373 Dal Pont, above n 260, at [27.40].
- 374 Corporations Amendment Bill (No 1) 2005, introduced in June 2005.
- 375 RP Austin and IM Ramsay *Ford's Principles of Corporations Law* (14th ed, LexisNexis Butterworths, 2010) at [20.170].
- 376 *Ibid* at [20.170].
- 377 Thai, above n 259, at 32–33.
- 378 *Ibid*, at 33.
- 379 *Ibid*.
- 380 *Ibid*, at 34.
- 381 *Ibid*.
- 382 See para [7.70].
- 383 Submission of Vicki Ammundsen, Ayres Legal on *Review of Trust Law in New Zealand: Introductory Issues Paper* (submission dated 28 February 2011) at 3; Submission of Taylor Grant Tesiram, above n 350, at 8.

Chapter 8

Beneficiaries, insolvent corporate trustees and definitions

LIABILITY TO BENEFICIARIES

- 8.1 There is a question about the rights of beneficiaries of a trading trust. The position of a beneficiary under a trading trust is the same as it is in any other trustee-beneficiary relationship. In the event of a breach of trust, the beneficiaries may have a claim against the company, assuming liability has not been excluded by the trust instrument.³⁸⁴ However, if the company has insufficient assets of its own with which to compensate the beneficiaries, pursuing remedies against the company will be pointless.³⁸⁵ The beneficiaries may therefore need to try to claim against the individuals responsible for causing the company to breach the trust, generally the directors of the company.
- 8.2 Claiming against the directors is more difficult than bringing a claim against the corporate trustee, because there is no direct fiduciary relationship between the directors of corporate trustees and the beneficiaries of the trust for which the company is a corporate trustee.³⁸⁶ Trustees owe a direct fiduciary duty to beneficiaries, and directors owe a duty to the company. But directors are not automatically liable to beneficiaries for the actions of a corporate trustee, including breaches of trust committed by the company.³⁸⁷ The position has been described thus:³⁸⁸

It is the company which is trustee, not the individual members or officers of the company. While directors owe a fiduciary duty to their company, it is not consistent with the acknowledged separateness of the corporate entity that they should share the responsibilities owed by the corporate trustee to the beneficiaries.

- 8.3 However, directors may be liable to beneficiaries based on other claims.³⁸⁹ Where the corporate trustee has committed a breach of trust, a director may be liable for providing dishonest assistance in that breach of trust. *Equity and Trusts in New Zealand* states that “[i]n a corporate trading trust where directors play an active decision-making role it will not be difficult to prove assistance by them in the breach of trust”,³⁹⁰ by showing either active assistance or passive participation in not objecting to the actions that were in breach of trust.³⁹¹
- 8.4 The test for whether the director was acting dishonestly is objective: although there is no leading case in New Zealand on this issue, the authors of *Equity and Trusts in New Zealand* consider that the law was probably settled in *Barlow Clowes International Limited v Eurotrust International Limited*.³⁹² The question is whether, given the director’s knowledge of the relevant facts, their participation in the breach of trust was objectively dishonest, with no requirement that they realise that they were acting dishonestly.³⁹³ However, negligence alone by the director will not amount to dishonesty.³⁹⁴
- 8.5 Another possible claim beneficiaries may have is in knowing receipt. Such liability is “receipt-based”.³⁹⁵ If a director receives trust property in breach of trust, they are liable to return that trust property to the trust. Otherwise the director might be liable for unjust enrichment. Another possibility is that that director may be liable as a *trustee de son tort* (literally, a trustee of his own wrong).³⁹⁶ This arises when a person assumes the position of trustee, without being properly appointed, and proceeds to administer the trust and control the assets, as if he or she were a trustee.³⁹⁷ It appears that no claim against a director as a *trustee de son tort* has yet been brought successfully in a reported case in New Zealand.³⁹⁸
- 8.6 There is also the possibility of other claims such as through an indirect fiduciary duty, or “dog-leg” claim. This is the idea that liability may be indirectly attributed to the directors of a corporate trustee. The directors owe a duty of care to the company; if breached this creates a chose in action against the directors, which is trust property that may be available to the beneficiaries.³⁹⁹ However, most of these heads of liability are uncertain, being untested in New Zealand, and unlikely to succeed except in limited circumstances.
- 8.7 In 2002 the Law Commission was concerned with the risks to beneficiaries of a trading trust: if the business fails, the beneficiaries’ only recourse is against an assetless trustee. For protection of beneficiaries, the Commission recommended an extension to the liability of directors. It proposed that there should be imposed on the directors of the trust company the same obligations to beneficiaries to which they would have been subject if they personally had been the trustees.
- 8.8 This recommendation received little comment from submitters but those who did comment were divided. Some considered that the law adequately protects beneficiaries already through the existing heads of liability referred to above,⁴⁰⁰ and that extending liability in the way recommended would discourage third parties from acting as directors of corporate trustee companies. Others saw some merit in such a “direct look through” for beneficiaries.⁴⁰¹

- 8.9 The Commission is not aware of whether problems in relation to beneficiaries of trading trusts are arising in practice in New Zealand. The Commission is interested in hearing views on this issue. Unless a particular concern is demonstrated, there does not seem to be a need for reform. However, the Commission again invites comments on the option of imposing the same obligations on directors as they would have had if they, and not the corporate trustee, had been the trustees of the trust. The Commission also invites any alternative proposals if reform is needed in this area.

INSOLVENT CORPORATE TRUSTEES

- 8.10 There are several issues and areas of uncertainty regarding trading trusts in the context of insolvency. These include:
- (a) whether a corporate trustee should be liquidated;
 - (b) the entitlement of the liquidator to fees and expenses from trust assets;
 - (c) the distribution of assets and priority of creditors on liquidation;
 - (d) the application of the insolvent transaction regime to trust creditors; and
 - (e) the removal and replacement of a corporate trustee on liquidation, which was addressed in Issues Paper 4.⁴⁰²
- 8.11 As indicated above, the Commission is interested in whether these are merely potential problems, or whether they have resulted in practical difficulties in New Zealand. The issues listed above will be described briefly in turn.

Liquidation of a corporate trustee

- 8.12 The issue of whether an insolvent corporate trustee should be liquidated has come under scrutiny by the courts on several occasions. It was also raised as requiring consideration by a submitter to an earlier Issues Paper.⁴⁰³ If a corporate trustee becomes insolvent, the company may be put into liquidation, either by a shareholder's resolution or by the Court on the application of a creditor, in the same way as any company would ordinarily be put into liquidation.⁴⁰⁴ Particular problems are created when a company, set up by solicitors or accountants to provide trustee services, is the corporate trustee for multiple trusts, usually family trusts for clients of the practitioner. Such companies are commonly assetless.⁴⁰⁵ If the corporate trustee incurs liabilities (perhaps unknowingly), the question arises as to whether the corporate trustee should be liquidated, and this decision affects not just one but many trusts.

- 8.13 In *Commissioner of Inland Revenue v Chester Trustee Services*⁴⁰⁶ in 2002 the Court of Appeal considered whether an insolvent corporate trustee should be placed in liquidation. Chester was the corporate trustee of 35 trusts that had no assets other than its rights of indemnity. The Commissioner of Inland Revenue had issued a statutory demand against Chester in respect of GST liability incurred by two of the trusts. If Chester was put into liquidation it would have to resign in relation to all the other trusteeships, which would be very costly. The Court of Appeal decided that Chester should be liquidated nonetheless, as an insolvent company is generally unfit to act as a trustee, and the result was consistent with general company law policy and trustee law. This position was reflected in section 51(2) of the Trustee Act 1956.
- 8.14 The High Court case of *Newmarket Trustees Ltd v Commissioner of Inland Revenue* involved a corporate trustee that was acting as the trustee of 118 trusts, in addition to a trust that incurred GST and income tax liability. The Commissioner applied to liquidate Newmarket Trustees. Associate Judge Bell considered that there was a prima facie case for liquidation, as the corporate trustee had incurred liabilities and had failed to comply with a statutory demand. However, the Court decided to dismiss the application to liquidate the company. The impact of the liquidation on the other 118 trusts was a relevant consideration, along with the fact that the corporate trustee had no assets to realise for the benefit of creditors, so no benefit would arise from ordering the liquidation. The Commissioner has been granted an extension of time to appeal to the Court of Appeal against the decision in the High Court.⁴⁰⁷
- 8.15 The Public Issues Committee of the Auckland District Law Society Inc has released a public issues paper on the *Newmarket Trustees* case, encouraging practitioners operating trustee companies to ensure that “a corporate trustee is used only for the single trust for which it was established, or at most only for those trusts established for the same client.”⁴⁰⁸
- 8.16 The trusts involved in these cases are somewhat different in structure and purpose from trading trusts as referred to elsewhere in this Part. There may be a need for trusts legislation to provide more guidance on when a corporate trustee should be liquidated. These issues may be dealt with in more detail in Stage Three of the Commission’s review of trusts law, when the trustee companies legislation will be examined, but submitters’ preliminary views would be welcome.

Fees and expenses of liquidators

- 8.17 An area of some uncertainty relating to corporate trustees is whether a liquidator is entitled to recover their fees and expenses from trust assets.⁴⁰⁹ This was raised by a previous submitter⁴¹⁰ and has also been the subject of a series of conflicting cases in Australia.⁴¹¹ The position in New Zealand appears to be that the liquidator's expenses and remuneration can be paid from the trust assets.⁴¹² There is also the policy consideration that it would be difficult to find liquidators willing to act as such if their costs could not be recovered from trust assets.⁴¹³ Without the actions of an insolvency administrator the trust beneficiaries would not receive a distribution.⁴¹⁴
- 8.18 The expenses relating to the administration of the trust can be recovered from the trust assets, but the general expenses of administering the estate, unrelated to the administration of the trust, cannot come from trust assets, as they are private liabilities.⁴¹⁵ Nonetheless, where the liquidator acts reasonably to identify which are trust assets and which are not, those costs are recoverable.⁴¹⁶ The court has an inherent jurisdiction to allow remuneration and payment of expenses for the administration of trust property by a receiver or liquidator.⁴¹⁷
- 8.19 In Australia the courts have taken a "very technical" approach, holding in some cases that the liquidator had no right to apply trust assets for any purpose except to administer the trust property and to discharge trust debts.⁴¹⁸ Overall the position is less clear but is generally consistent with that in New Zealand.⁴¹⁹ The Australian cases are based on the liquidator's costs and expenses being recovered under the trustee's right of indemnity; if there is no right of indemnity, then it may be that the liquidator cannot recover their costs and expenses from trust assets.⁴²⁰ Some time ago the Australian Law Reform Commission proposed extending the trustee's right of indemnity to include not only trust debts and liabilities, but also the costs associated with the winding up of the company (where the assets of the company are not sufficient to cover those costs).⁴²¹ However, this would not assist in clarifying whether the costs can be recovered when the indemnity is not available. The position of the liquidator in New Zealand does not seem to be similarly vulnerable: it has been held that the ability of a liquidator to recover costs comes from equity and is not related to the position of trustee, so the ability of the liquidator to recover costs will not be lost because of illegality or breach of trust by the trustee.⁴²²
- 8.20 No cases in New Zealand have yet addressed a corporate trustee which has as its only business the administration of a trust. In this situation in Australia the general expenses of winding up are able to be recovered from the trust assets, as they are necessarily related to the administration of the trust,⁴²³ and it is likely that the same approach would be taken in New Zealand.⁴²⁴

- 8.21 It may be useful to clarify in trusts legislation the position in New Zealand regarding who bears the costs of liquidation, to resolve uncertainty for liquidators about whether they will be able to have their expenses met from the trust assets; costs relating to general administration versus administration of the trust; the relevance of the trustee's right to indemnity; and the situation regarding general expenses where a corporate trustee has the administration of a trust as its only business. Views on this are invited.

Distribution of assets and priority of creditors on liquidation

- 8.22 Further issues arise in the case of insolvency of a trading trust regarding the distribution of assets and priority of creditors. A corporate trustee of a trading trust may have both trust creditors and non-trust creditors. Trust assets cannot be used to satisfy private non-trust debts. There is a distinction to be drawn in different situations involving funds recovered using the trustee's right of indemnity. When a trustee has personally paid a trust debt, they are entitled to recover the amount from the trust assets, through the right of recoupment. The recouped funds are the trustee's own money and are therefore available to liquidators and non-trust creditors. However, when a trustee seeks to have liabilities paid directly out of the trust assets, through the right of exoneration, those funds can only be applied to trust liabilities.⁴²⁵
- 8.23 Where an insolvent trustee has insufficient assets to satisfy the claims of all creditors, the question arises as to the order and priority for payment of the claims. The general assets of the trustee (if any) will be distributed in accordance with the statutory preferential creditor regime in sections 312 to 313 and Schedule 7 of the Companies Act 1993. A key issue is whether the preferential creditor regime will apply to the distribution of the trust assets. The statutory regime does not apply to trust property of an individual trustee, which will be distributed according to equitable principles of the courts.⁴²⁶ When liquidating a corporate trustee, again trust property will not be subject to the statutory regime, but the liquidator may exercise the right to indemnity and divide the results of that among creditors.⁴²⁷ One view is that the preferential regime is likely to apply to assets recovered through the right of indemnity as they are assets of the company.⁴²⁸
- 8.24 The Supreme Courts of South Australia and New South Wales have held that the statutory preferential regime will apply to trust assets recovered via the right of indemnity on liquidation of a corporate trustee.⁴²⁹ The basis for these decisions is that liabilities incurred by a corporate trustee in trade are the corporate trustee's liabilities, so creditors of the company are to be paid in the order of the statutory regime.⁴³⁰ This is subject to the principle described above that trust property (from the trustee's right to indemnity) cannot be applied to satisfy the general debts of the company; they can only be applied to the payment of trust creditors.⁴³¹

- 8.25 Not all agree that the statutory preferential regime should apply to trust assets. McPherson J (writing extrajudicially) has argued that it is incorrect for the Australian statutory regime to apply to division of trust assets among trust creditors in the winding up of a corporate trustee, and that the regime applies only to assets that are beneficially owned by a company and are available for division amongst the creditors generally.⁴³² He argued that priorities should be fixed by the court; such an approach would traditionally mean that the trust creditors would be paid on a *pari passu* basis (ranking equally without preference) after the costs of realising the assets and the costs, charges and expenses of the trustee have been paid.⁴³³ A differing view is that trust creditors should be paid in the order in which their claims arose, based on the equitable principle that the prior in time is the better equity.⁴³⁴
- 8.26 Views are sought on whether the application of the preferential creditor regime (or an alternative regime) to corporate trustees should be provided for in legislation.

Application of insolvent transaction regime to trust creditors

- 8.27 A further question is whether the insolvent transaction provisions apply to transactions made with trust creditors. These provisions are “designed to enable the liquidator to set aside transactions into which the company entered before liquidation so that money is restored to the company to ensure all creditors are treated equitably.”⁴³⁵ The particular focus is on sections 292 (insolvent transactions) and 298 (transactions for excessive or inadequate consideration) of the Companies Act. Sections 293 (voidable charges), 297 (transactions at undervalue) and section 348 of the Property Law Act 2007 (dispositions of property made with intent to prejudice a creditor) are also relevant.
- 8.28 In *Octavo* the High Court of Australia held that the voidable preference provisions in Australian legislation did apply to dispositions of trust property, so payments made by the corporate trustee prior to liquidation could be recovered from recipients and made available to the liquidator for distribution.⁴³⁶ This was based on the view that the trustee’s right of indemnity out of trust property was a proprietary right that could be exercised by the liquidator on behalf of the company’s creditors. Ford has criticised this proprietary view of the right of indemnity as incorrect;⁴³⁷ he considers the right of indemnity to be merely a “power over the trust property” that is a “fiduciary power”.⁴³⁸

- 8.29 This issue has not yet been determined in a court in New Zealand. In *Levin Heath J* left open the question of whether *Octavo*⁴³⁹ would apply in this country. However, he held that section 298, involving transactions for excessive or inadequate consideration, did not apply to property held on trust. Section 298 was directed at company assets, not distribution of trust property to its beneficial owners; the Court of Appeal accepted, however, that there was a proprietary interest in the property distributed to beneficiaries to the extent of the trustee's right of indemnity.⁴⁴⁰ When directors of a corporate trustee distribute trust property to beneficiaries knowing that trust debts would remain unpaid, the creditors' protection is that the directors are liable for any loss resulting.⁴⁴¹ In contrast, section 292 could be used to reclaim property that was held on trust, but has been disposed of to give a preference to one trust creditor over others.⁴⁴² If money had been paid out to a beneficiary under the insolvent circumstances referred to in section 292, the property could be reclaimed for distribution to trust creditors (but not to non-trust creditors, until trust creditors had been paid in full).⁴⁴³
- 8.30 Another view is that the voidable transaction regime will not apply to payments made to beneficiaries unless the payment was made to the beneficiary as a creditor. For instance, if a trustee has credited an amount to a beneficiary's account with the trust, payments debiting the beneficiary's account would constitute a payment to the beneficiary as a creditor, this transaction would be very likely to be caught under the regime.⁴⁴⁴
- 8.31 The Commission would like to know whether submitters agree that some or all of the insolvent transaction provisions apply to corporate trustees and trust creditors, and whether it would be useful to clarify this in legislation.

DEFINITIONAL ISSUES

- 8.32 With all of the options considered in this Part, the question arises as to whether they should apply only to trading trusts, or more widely to other types of trusts. If targeted legislative provisions are necessary to address any problems caused by trading trusts, there is a preliminary issue as to whether and how the term "trading trust" should be defined in legislation, although to a large extent the necessity and form of any definition depend on what problems are identified with trading trusts and how they are proposed to be remedied. In 2002 the Law Commission recommended certain provisions applying only to trading trusts, and accordingly put forward a legislative definition as follows:⁴⁴⁵

"trading trust" means a corporation (not being a trustee corporation or a Board incorporated under Part II of the Charitable Trusts Act 1957) which in the capacity of trustee of a trust carries on any trade or business ...

- 8.33 This definition covers the corporate nature of the trustee and the requirement for the corporation to be carrying on business, two of the key features referred to in chapter 6. However, there is no agreement about precisely what a trading trust is, since trading trusts do not necessarily follow any particular structure, and the term can be used in a wide or narrow sense. Concerns were expressed about the scope of application of the definition proposed in 2002: it was considered too broad as it would catch a wide range of corporate trustees, such as trustees of unit trusts.⁴⁴⁶ This would have undesirable consequences such as in relation to insurance costs.⁴⁴⁷ Some submitters to the Preliminary Paper in 2002 did not support any codification of a distinction between trading trusts and other types of trusts.⁴⁴⁸ There is also the problem that a definition of a trading trust may “struggle to stand the test of time.”⁴⁴⁹
- 8.34 If a definition were required, one possibility would be to adapt the 2002 definition to incorporate a list of express exclusions of certain corporate trustees that are intended to fall outside the definition, such as trustees of unit trusts.

QUESTIONS

Q16 Are there problems arising in relation to beneficiaries of trading trusts?

Q17 Is any reform necessary relating to beneficiaries of trading trusts, and if so, in what way? Do you consider that directors of corporate trustees should have the same obligations to beneficiaries as if they personally were the trustees?

Q18 Are the problems arising from insolvent trading trusts correctly identified?

Q19 Do any of the issues referred to regarding insolvent trading trusts require legislative clarification or reform?

Q20 Can the term “trading trust” be defined adequately in legislation? If so, what form should the definition take?

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- 384 For a full discussion of trustee exemption clauses, see Law Commission *The Duties, Office and Powers of a Trustee: Review of the Law of Trusts Fourth Issues Paper* (NZLC IP26, 2011) at ch 3 [*The Duties, Office and Powers of a Trustee*].
- 385 HAJ Ford and IJ Hardingham “Trading Trusts: Rights and Liabilities of Beneficiaries” in PD Finn *Equity and Commercial Relationships* (Law Book Company, Sydney, 1987) 48 at 58.
- 386 Andrew S Butler (ed) *Equity and Trusts in New Zealand* (2nd ed, Thomson Reuters, Wellington, 2009) at 422 [*Equity and Trusts*].
- 387 *Bath v Standard Land Company Ltd* [1911] 1 Ch 618. *Ibid*, at 421.
- 388 Ford and Hardingham, above n 385 at 58; see also *Salomon v Salomon* [1897] AC 22.
- 389 For further discussion of the liability of directors, including other heads of liability not covered here, see Chris Kelly and Greg Kelly “So you want to be trustee” (paper presented to New Zealand Law Society Trusts Conference, 2009) at 52–54.
- 390 Butler *Equity and Trusts*, above n 386, at 423.
- 391 *Ibid*; *Royal Brunei Airlines v Tan* [1995] 2 AC 378.
- 392 *Barlow Clowes International Ltd v Eurotrust International Ltd* [2006] 1 All ER 333 at [15].
- 393 Butler *Equity and Trusts*, above n 386, at 423–424.
- 394 *Ibid*, at 425.
- 395 *Twinsectra v Yardley* [2002] 2 AC 164 at [105].
- 396 Butler *Equity and Trusts*, above n 386, at 426.
- 397 *Ibid*; Ford and Hardingham, above n 385, at 64.
- 398 Butler *Equity and Trusts*, above n 386, at 426.
- 399 See *HR v JAPT* [1997] PLR 99; but see *Gregson v HAE Trustee* [2008] EWHC 1006 (Ch); Chris Kelly and Greg Kelly “So you want to be trustee”, above n 389, at 53.
- 400 For example, Submission of Pravir Tesiram on *Preliminary Paper 48: Some Problems in the Law of Trusts* (submission dated 21 March 2002) at 3; John Hart “Trading Trusts” (paper presented to New Zealand Law Society Trusts Conference, 2003) at 158.
- 401 For example, Submission of the Institute of Chartered Accountants of New Zealand (ICANZ) on *Preliminary Paper 48: Some Problems in the Law of Trusts* (submission dated 21 March 2002) at 10.
- 402 See Law Commission *The Duties, Office and Powers of a Trustee*, above n 384, at [4.3]–[4.32].
- 403 Submission of Vicki Amundsen, Ayres Legal on *Review of Trust Law in New Zealand: Introductory Issues Paper* (submission dated 28 February 2011) at 3.
- 404 Paul Heath and Michael Whale *Heath and Whale on Insolvency* (online looseleaf ed, LexisNexis) at [46.5(c)].
- 405 *Ibid*, at [46.1].
- 406 *Commissioner of Inland Revenue v Chester Trustee Services Ltd* [2003] 1 NZLR 395 (CA).
- 407 *Commissioner of Inland Revenue v Newmarket Trustees Ltd* [2010] NZCA 291.
- 408 Public Issues Committee, Auckland District Law Society Inc “Independent Trustees, Corporate Trustee Companies and the Need for Good Governance – the Newmarket Trustees Lesson” (Public Issues Paper, 1 August 2011) at 4–5.

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- 409 *Heath and Whale on Insolvency*, above n 404, at [46.5(e)].
- 410 Submission of Ammundsen, above n 403, at 3.
- 411 See *Re Byrne Pty Ltd* [1981] 1 NSW 394; *Re Enhill Pty Ltd* (1982) 7 ACLR 8; *Re Suco Gold Pty Ltd* (1983) SASR 99.
- 412 Kaley J Crossland “Unsecured creditors and the ‘Uncorporation’: issues with trading trusts post Global Financial Crisis” (2011) 17 *Trusts and Trustees* 185 at 210. *Heath and Whale on Insolvency*, above n 404, at [46.5(e)].
- 413 *Butler Equity and Trusts*, above n 386, at 460.
- 414 *Re Suco Gold* (1983) SASR 99.
- 415 *Heath and Whale on Insolvency*, above n 404, at [46.5(e)].
- 416 *Re Newsmakers International Ltd (In Liq)* HC Napier N153/86, 24 February 1994.
- 417 *Re Secureland Mortgage Investments Ltd (No 2)* (1988) 4 NZCLC 64,266 (HC).
- 418 Michael Whale “Insolvent Trading Trusts” (paper presented to 9th Annual LexisNexis Corporate Insolvency Conference, Auckland, March 2010); *Re Byrne Pty Ltd* [1981] 1 NSW 394.
- 419 *Heath and Whale on Insolvency*, above n 404, at [46.5(e)]; 13 *Coromandel Place v C L Custodians Pty Ltd (In Liq)* (1999) 17 ACLC 500.
- 420 It is suggested this is the case in *Heath and Whale on Insolvency*, above n 404, at [46.5(e)].
- 421 Australian Law Reform Commission Report No 45: *General Insolvency Inquiry* (vol 1, 1988) at [265].
- 422 *Re National Pacific Securities Ltd (In Rec and In Liq)* (1991) 5 NZCLC 67,332 at 67,340. Compare some saying the entitlement to recover is because the liquidator is performing the duties of the trustee: see Crossland, above n 412, at 210.
- 423 13 *Coromandel Place v C L Custodians Pty Ltd (In Liq)* (1999) 17 ACLC 500; *Re Suco Gold Pty Ltd* (1983) SASR 99.
- 424 Michael Whale *Trust Insolvency* (paper presented to New Zealand Law Society Trusts Conference, 2009) at 114–115.
- 425 *Butler Equity and Trusts*, above n 386, at 461; *Heath and Whale on Insolvency*, above n 404, at [46.5(d)].
- 426 *Levin v Ikiua* [2010] 1 NZLR 400 (HC) at [113].
- 427 *Ibid*, at [118].
- 428 Paul Heath and Michael Whale “The Big Insolvency Debate: Trust Busting and the Impact of Insolvency” (paper presented to Accountants’ Trust Conference, Auckland, May 2001) at 21–23.
- 429 *Re Suco Gold Pty Ltd* (1983) SASR 99; *Heath and Whale on Insolvency*, above n 404, at [46.5(d)].
- 430 *Re Suco Gold Pty Ltd* (1983) SASR 99; Michael Whale “Insolvent Trading Trusts” (paper presented to 9th Annual LexisNexis Corporate Insolvency Conference, Auckland, March 2010) at 5.
- 431 *Re Suco Gold* (1983) SASR 99.
- 432 BH McPherson “The Insolvent Trading Trust” in PD Finn *Essays in Equity* (Law Book Company, Sydney, 1985) 142 at 154.
- 433 *Ibid*, at 154–155.

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- 434 Daryl R Williams “Winding Up Trading Trusts: Rights of Creditors and Beneficiaries” (1983) 57 ALJ 273 at 277.
- 435 Paul Heath “Bringing Trading Trusts into the Company Line” [2010] NZ L Rev 519 at 533.
- 436 *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 (HCA).
- 437 HAJ Ford “Trading Trusts and Creditors’ Rights” (1981) 13 MULR 1 at 26. But see McPherson, above n 432, at 157.
- 438 *Ibid.*
- 439 *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 (HCA).
- 440 *Ibid.*, at [82]; [2010] NZCA 509 at [53]–[54].
- 441 *Ibid.*, at [83].
- 442 Heath, above n 435, at 536. See also *Heath and Whale on Insolvency*, above n 404, at [46.5(g)].
- 443 *Ibid.*, at 536–537.
- 444 Whale, above n 430, at 5.
- 445 Law Commission *Some Problems in the Law of Trusts* (NZLC R79, 2002) at 14.
- 446 David Goddard QC “NZLC 79 – “Some Problems in the Law of Trusts” – Implementation” (Draft Memorandum prepared for Ministry of Justice, 6 May 2007) at 5.
- 447 *Ibid.*
- 448 For example, Submission of ICANZ, above n 401, at 9.
- 449 *Ibid.*

Part 4

REGULATION OF TRUSTS





Chapter 9

Registration and reporting requirements

INTRODUCTION

- 9.1 The registration of trusts is an option that has been suggested to us on several occasions and warrants some consideration. Submitters on the Law Commission's earlier Issues Papers on the review of the law of trusts have raised a trust register or other regulatory requirements, in particular in discussing their "wish list" for the law of trusts and measures to counteract the negative impacts of the abolition of gift duty. Some media attention has been given to the possibility that a register for trusts will be introduced.⁴⁵⁰ A natural progression of a registration approach is to impose reporting requirements.
- 9.2 These options involve the increased regulation of trusts. Wholesale registration requirements have been introduced in few countries. Because such a step necessarily involves increased compliance costs and a departure from historical and overseas norms, there would need to be good reasons for introducing a register and reporting requirements.
- 9.3 This chapter examines possible problems which appear to have arisen from the lack of regulatory requirements for trusts in New Zealand, how these issues have been addressed overseas and evaluates options for regulation of trusts that could be considered here. The option of a register discussed in this chapter applies only to express trusts.

CURRENT REGULATION OF TRUSTS IN NEW ZEALAND

- 9.4 At present there is very little regulation of trusts in New Zealand. While incorporated charitable trusts are required to be registered and charities can register in order to obtain tax benefits, there is no register for inter vivos or testamentary trusts. In respect of incorporated charitable trusts, the registration is the process that establishes such a trust as a corporate body. As trusts do not have legal personality, there is not the same necessity for a registration system.
- 9.5 There are also no reporting requirements for these trusts other than the requirement for income earning trusts to submit a tax return to the Inland Revenue. Up until 1 October 2011, the gift duty requirements meant that a settlor of a trust that still owed a debt for the settlement of trust property was required to submit an annual gifting return to show that the gift of the portion of the remaining debt did not exceed the threshold above which gift duty had to be paid. This created a de facto reporting requirement for a number of trusts. Gift duty has now been abolished. New legislation, discussed in paragraphs [10.24] – [10.31], provides some requirements for trust service providers to obtain, verify and retain records of the beneficial ownership and control of trusts.

WHY MIGHT A REGISTER BE NEEDED?

Lack of a central repository of information about trusts

- 9.6 It could be considered problematic that there is no official means of recording the existence of a trust.⁴⁵¹ A trust is a relationship between a settlor and trustee. But it is a relationship that has specific legal consequences for those involved and for third parties interacting with it. Similar types of legal relationship, such as companies, limited partnerships and incorporated charitable trusts, are required to be publicly registered and acknowledged. There is high per capita trust usage in New Zealand.⁴⁵² Trusts therefore must be having an impact on the financial situation of a significant proportion of New Zealanders, whether through having their assets transferred to trusts or by being beneficiaries or potential beneficiaries of trusts. Furthermore, a large number of New Zealanders are under obligations as trustees.
- 9.7 Despite this, the Government has little ability to assess even basic information about how trusts are used and how they affect the financial position of those involved. This may hinder the Government's ability to respond to any problems relating to trusts or their effects and means government policy could result in inefficiencies and unintended consequences. The Ministry of Social Development has expressed its concern about the lack of annual reporting or accounting requirements for trusts and a central repository of knowledge regarding the existence of trusts.⁴⁵³

- 9.8 A requirement to register basic information about a trust would mean information on the numbers of trusts and who was involved in them would be retained. However, anything more substantial than this would require extensive reporting requirements as well.

Lack of transparency

- 9.9 It could be argued that there is a lack of transparency about the existence and use of trusts. Whether a trusts register and reporting requirements can alleviate this depends on the nature of the register and regulations.

Beneficiaries

- 9.10 An issue that has been raised is that some beneficiaries may not know that they are beneficiaries of a trust and they have no ability to find this out.⁴⁵⁴ Trustees are under a duty to inform beneficiaries of information relating to the trust, including taking reasonably practicable steps to inform beneficiaries of the trusts in their favour.⁴⁵⁵ Beneficiaries are generally the only persons with standing to challenge the performance of a trustee's duty and without the beneficiaries having knowledge of the trust there is no one to hold trustees to account.⁴⁵⁶ However, this concern may not be best addressed by a register. Other options, such as clarifying the trustees' obligations to inform beneficiaries, are being considered in this review.⁴⁵⁷

Third parties

- 9.11 Third parties, including potential creditors, may be unaware that they are contracting with trustees as opposed to the legal and beneficial owner or a company. In the case of a trading trust there are no or very few assets with which to meet obligations. A third party may be at greater risk of becoming an unpaid creditor than it realises or has been able to factor in to the risks of the transaction.
- 9.12 Blanchard J commented extrajudicially on the lack of transparency in 2002. He queried whether trustees ought to be required to reveal the existence of the trust. He described the problem thus:⁴⁵⁸

Where, in my view, the unrevealed trust can mislead is when you are dealing with someone who appears to have assets making them credit worthy but upon bankruptcy is found to be holding them in trust for family members. Trusts are easy to spot when the legal ownership is held by a trust corporation or by several persons whose names include a solicitor or accountant ... then you know there is a trust which may be protecting assets. But if I contract with Mr and/or Mrs Bloggs on the strength of their apparent asset position, am I not entitled to think that assets I see vested in their names alone are their beneficial property, not held in trust so as to be unavailable to meet obligations to me?

- 9.13 Blanchard J considered that there was a “misuse of trust law when concealment of this kind is practiced.” A register of trusts is a possible response to this issue, although it relies upon creditors checking the register in order for them to get the information, which would then enable them to seek greater protections and guarantees regarding the transaction with the trust. Chapter 6 raises more direct options for disclosure when a trading trust is contracting with third parties. It is arguable that the responsibility should lie with potential creditors to properly check the nature of the entity with which they are doing business and to take appropriate precautions.

Lack of accountability

- 9.14 Because there is currently no way of obtaining information about individual trusts, there may be a lack of accountability in how trustees are managing trusts. A beneficiary may hold a trustee to account, but in many cases this is unlikely to happen either because beneficiaries are unaware of what the law requires of trustees or because the primary beneficiaries are the settlor, who may also be a trustee, and his or her close family members.
- 9.15 There are certain management requirements trustees should meet, such as keeping account of trust property, recording trustees’ decisions and meeting tax obligations. The beneficiaries may not notice or be concerned about these requirements not being met. However, it may not be in the interest of the public or the Government for trusts to be poorly managed. There are benefits for settlors in transferring their assets to a trust and for beneficiaries in having an interest in trust property. It may result in unfairness if these trusts continue to generate these benefits when the day to day management requirements have not been met. Submitters have expressed concerns about this.⁴⁵⁹
- 9.16 Currently there is no way of identifying trusts that are not operating as they should unless problems result in litigation. Registration and reporting obligations would only address these problems if a significant amount of information about individual trusts was made publicly available and a process for monitoring compliance and enforcing obligations were established. Such monitoring and enforcement processes would significantly add to costs.

Abolition of gift duty

- 9.17 There is the potential for the abolition of gift duty, from 1 October 2011, to exacerbate any problems with a lack of records of trusts.⁴⁶⁰ The annual gift duty return meant that where a trust still owed a debt, settlors and trustees had to meet or at least to consider the state of a trust at least once annually in order for settlors to forgive the portion of the debt that the trust continued to owe.⁴⁶¹ Gift duty has ensured some documentary record of assets that have been transferred to a trust each year. There is concern that the abolition of gift duty will result in a loss of key information on trusts.⁴⁶²

- 9.18 In the Regulatory Impact Statement on the Taxation (Tax Administration and Remedial Matters) Bill, Inland Revenue noted that the removal of gift duty and its associated compliance costs could be expected to lead to more instances of gifting to trusts, which may in turn lead to an increase in the number of trusts established in New Zealand.⁴⁶³ They commented that there are “broad concerns across government and the private sector regarding the uses of trusts and their lack of regulation” but that these concerns should be dealt with independently of gift duty. They referred to the Law Commission’s review as an opportunity to consider new forms of regulation, such as a central trust register and the compulsory filing of annual trust accounts.⁴⁶⁴ Submitters have expressed concern about the effect of the repeal of gift duty on trust management and record keeping.⁴⁶⁵

Assessment of the problem

- 9.19 A number of distinct issues have been raised, which could support a case for further regulation of trusts. It needs to be considered whether these do in fact pose a problem that is in need of reform. There is a perception among some that trusts are causing unfairness in various ways, and that greater transparency about how property is held will reduce the ability of people to “hide” property in trusts and gain advantages because of this. A register has been suggested in answer to this concern. However, it is arguable whether a register would achieve these aims. The extent to which registration and reporting requirements for trusts would address the perceived problems depends on the nature of the register and requirements.
- 9.20 The options for registration are detailed below following a discussion of how trusts are regulated overseas. A minimal register and reporting obligations are unlikely to achieve much, yet more extensive reporting requirements may greatly increase the obligations on trustees and the costs of administering trusts for the sake of only a small number who misuse trusts. The compliance costs of introducing a registration requirement would be high. An annual reporting requirement would mean time and expense for every trust in New Zealand. Fees for registration would be an additional cost. On top of this, the administrative costs for introducing a registration requirement and maintaining a register would be considerable.

OVERSEAS APPROACHES

- 9.21 The regulation of trusts is approached differently in different countries. It seems that New Zealand has some of the least regulation and lowest information collection requirements for trusts of any comparable country.

Scotland

- 9.22 The Scottish Law Commission raises the question of whether Scottish trust deeds should be required to be registered in the Books of Council and Session or in a new register of trusts. They comment that the relative simplicity of the trust as a legal concept and its consequent utility in a wide range of contexts would be undermined if the steps necessary to constitute a standard trust became too formalised. They express the provisional view that no more than a written declaration of trust should be required to establish a trust. They note that there are advantages of registration, but that they are reluctant to add a further formality and expense to the constitution of a valid trust.⁴⁶⁶
- 9.23 The Commission also discusses registration of trusts in the context of what is known in Scotland as “truster-as-trustee” trusts, trusts where the settlor becomes the sole trustee. They are treated somewhat differently to other trusts because they are the exception to the rule that a declaration of trust does not have to be constituted in writing.⁴⁶⁷ There is a particular risk with this type of trust that the trust could be set up without the knowledge of anyone other than the settlor and beneficiary and without any indication to a third party that the property which constitutes the trust fund has been moved “from the [settlor’s] private patrimony to his trust patrimony and is therefore no longer available to his personal creditors.”⁴⁶⁸ The Scottish Commission raises the question of whether, because of their potential for abuse, these types of trusts should be registered in a public register such as the Books of Council and Session. They see some force in the argument that registration should be required for these trusts.⁴⁶⁹

Australia

- 9.24 Unlike New Zealand, Canada and the United Kingdom, Australia requires that all trusts are registered with its Tax Office regardless of whether they earn income. All trusts are required to lodge annual tax returns unless the Tax Office advises them otherwise.⁴⁷⁰ Some Australian states require stamp duty to be paid for every declaration of trust.⁴⁷¹

Canada

- 9.25 In Canada there is no legal requirement for trust service providers to collect information on the settlor, trustees and beneficiaries, although this would normally be done in practice anyway. There is no system of central registration of trusts and no legal requirements for record-keeping. There are registration and information provision requirements in the case of trusts that also fall within the definition of “financial entity” and trusts that are required to lodge a tax return. Trusts that must make returns to the Canadian Revenue Agency are required to provide specific information on the name of the trust, type of trust, amounts of income and property, including foreign property and personal details of those administering the trust, and a copy of the trust deed. This information is not available for other government purposes and is not publicly available.⁴⁷²

United Kingdom

- 9.26 There are no general registration requirements for trusts in the United Kingdom. As with most jurisdictions, trusts that earn income or make capital gains are required to file a tax return.⁴⁷³ Trustees must notify the Revenue and Customs Office when a new trust that will receive income or make capital gains is established, or a trust that previously did not do either of these begins to do so. The Money Laundering Regulations 2007 (UK) impose responsibilities on providers of services in relation to the formation, operation and management of trusts. These provide for registration, information and record-keeping requirements for these providers.⁴⁷⁴

United States

- 9.27 State jurisdictions in the United States have chosen not to regulate trusts in the way that other corporate vehicles are regulated. United States authorities have confirmed that this is because in the United States a trust is viewed essentially as a contractual agreement between two private persons. This means that there are no registration requirements, other than tax filing requirements for trusts that earn income.⁴⁷⁵

Cayman Islands

- 9.28 There is no central reporting requirement for trusts in the Cayman Islands. Neither is there a register of all trusts. Provision of trust services is a regulated activity and there is a regulatory regime for trust service providers, which makes them subject to recordkeeping, due diligence and other requirements.⁴⁷⁶ Trust service providers must keep records of all trusts, which can be accessed by a regulator. The requirements on trust service providers mean that information on the beneficial ownership and control of trust property is readily accessible by the authorities when there is suspected criminal activity, but less so for other purposes.⁴⁷⁷

Jersey

- 9.29 The legal arrangements for trusts in Jersey are similar to those in the Cayman Islands. A regulated trust service provider approach is used to address the anti-money laundering issues. Those involved in business as a trustee conduct a “regulated activity” under the Proceeds of Crime (Jersey) Law 1999. This means that professional trustees are subject to registration requirements, although there are no general requirements for the registration of a trust.⁴⁷⁸

Singapore

- 9.30 There is no general register for trusts in Singapore. Trustee companies and trust company service providers are required to collect and maintain records of information on the beneficial ownership and control of trusts.⁴⁷⁹ Recently, the Council of the Law Society of Singapore has issued a practice direction requiring lawyers to also take measures to obtain information on the beneficial ownership of trusts for which they are acting or doing business.⁴⁸⁰ Singapore has concentrated more rigorous regulatory requirements on business trusts, which it has considered to be more high risk. Business trusts are a form of collective investment set up as a trust structure. It is a hybrid bearing elements of both companies and trusts. Under the Business Trusts Act, measures that seek to safeguard investors rights by promoting transparency and establishing the duties of trustees and directors are in place. These include a public registers of beneficiaries and trustee-managers.⁴⁸¹

OPTIONS

Option 1 – Status quo

- 9.31 One option is to continue not to impose any registration or reporting requirements for trusts. This approach would not be out of line with other comparable jurisdictions, where there is a pattern of regulating trust advisors and professional trustees, which is discussed in chapter 10, while keeping trusts relatively anonymous and unregulated.

Advantages

- 9.32 An advantage of the current situation is that there are minimal regulatory costs for those establishing trusts and acting as trustees, especially following the repeal of gift duty. Furthermore, the low level of regulation of trusts means that there is a perception that trusts are not encumbered by “red tape” or bureaucratic requirements. Trusts are currently dealt with in an environment that protects confidentiality, privacy and anonymity. These can be seen as strengths that encourage private and commercial arrangements through trusts.

- 9.33 It is not clear to what extent the perceived problems discussed earlier in this chapter are in fact having an impact. If these are not significant, there is less impetus for altering the status quo. As is discussed in chapter 10, there is now a series of statutes regulating the financial advice and service provision sector. It can be argued that these provide sufficient checks and information on the trusts that could be at risk of being used for criminal purposes, and for the protection of beneficiaries.

Disadvantages

- 9.34 The weaknesses of the current system are that it does not address the perceived problems discussed earlier. There is arguably a lack of sufficient information about the use of trusts in New Zealand to accurately inform government policy in areas such as taxation and government assistance to those in need. There are only limited ways in which trustees can be held to account for carrying out their duties. The harm arising from trusts that are not being administered properly may not be negatively affecting the beneficiaries, but there may be harm to the Government or third party creditors. Without a registration and reporting system in place, the Government cannot impose record-keeping and other administrative requirements on trusts and there can be no independent gauge of whether a trust is being administered properly.

Option 2 – Register

- 9.35 A register of trusts would involve a mandatory requirement on either settlors or trustees to provide information to a government agency. This would need to be information sufficient to identify the trust and at least basic information about the parties and property involved. This would be a significant departure from the current position.
- 9.36 The type of information that is required to be registered would depend on the purpose of the register and to whom the information is going to be made available. It has been suggested to us that a register should at least record the name of the settlors, trustees and beneficiaries (both fixed and discretionary).⁴⁸² It must be acknowledged that because of the structure of many New Zealand trusts there may be difficulty in defining who the settlors and beneficiaries are in some trusts. Trusts can set up wide classes of beneficiaries and there is a spectrum of interests that those who may stand to benefit from a trust may have. This is particularly the case in relation to Māori Land Trusts, which have on average 88 beneficial owners per title of Māori land and often many beneficiaries that are unaware of their interest. Sometimes the nominal settlor of a trust is unrelated to those responsible for giving assets to the trust. Persons other than the settlor may settle property on a trust. These factors could make it difficult for this information to be registered.

- 9.37 The registration function would need to be housed in a government agency, such as the Ministry of Economic Development, which administers the Companies Register. There may need to be a registrar of trusts. In order for the register to continue to have accurate information there would need to be on-going obligations on trustees to update the register when details change or to provide an annual return that verifies details.
- 9.38 There would need to be consequences for failing to register or for supplying incorrect information. Whether an enforcement mechanism, such as a civil penalty, would be sufficient, or whether loss of official recognition as a trust is an appropriate measure would need to be considered.
- 9.39 An approach involving a register of trusts could take one of several forms. It could be relatively closed and non-searchable. It could be a searchable, public register. It could be limited only to certain types of trusts, such as trading trusts.

Options for types of register

Closed register

- 9.40 If the option of a closed register was instigated, the information would only be available to be searched by limited parties for limited purposes. The agency responsible for the register could use it to ensure that trustees were meeting the requirement to make an annual return. Some statistics and general information about trusts could be made available to the Government for other purposes, which could be used to guide policy, but it is unlikely that this would include information on individual trusts. The main reason why a closed register would be chosen instead of a searchable register would be to maintain the privacy and confidentiality of trust arrangements.
- 9.41 This type of register could create some benefits in regard to keeping trustees accountable for their duties. They would be required to make some type of annual return which would mean they would have to turn their attention to the trust and their obligations at least once per year.
- 9.42 A closed register would achieve more limited goals than a more open register. It would not create as much transparency of the ownership and control of property, inform beneficiaries of their interest in a trust, or allow creditors to check whether they are contracting with a trustee. The costs of establishing a register for trusts would be considerable and need to be weighed against its potential benefits. As the Government would be the primary benefactor of such a register there is less of a reason to pass the costs on to those involved in trusts than there would be if the benefits accrued also to the public, beneficiaries and creditors.

Searchable public register

- 9.43 Another version of a register is one that is open for anyone to search and find out some details about individual trusts. In addition to general statistics on trusts to help guide policy development, government agencies could access information about individual trusts, which may help with assessing applications for government assistance. The public register would allow potential creditors to determine that they are entering commercial arrangements with a trustee on behalf of a trust. It would allow people to find out whether they are beneficiaries of a trust. This would be similar to the model that is used for the companies register or the registers for charities or incorporated societies.
- 9.44 This type of register would result in reduced privacy, confidentiality and anonymity for settlors, trustees and beneficiaries. This arguably removes one of the key reasons why trusts are used. Those who are particularly concerned to keep their arrangements private may seek to establish trusts offshore rather than in New Zealand. It could result in the use of nominal settlors and other practices to ensure information remains private. As with the closed register there would be significant costs in establishing and maintaining the register. The cost to the Government could be offset by charging a fee to be able to search the register.

Register for trading trusts only

- 9.45 A register for trading trusts is one option for addressing the issue of the trustee status of a company not being disclosed to a creditor. This type of register is directed at those trusts that can be seen as more risky, that is those that engage in commercial arrangements with others, rather than applying to all trusts. A searchable register of trading trusts could allow potential creditors to find out if the company they are dealing with is a trust and whether property is held for beneficiaries in the company's capacity as trustee. This would allow a creditor to take greater precautions to protect its position. However, the register would only be effective at this if the creditor searched the register. It would afford no assistance to a creditor who accepts the contracting company at face value without conducting any further investigations. Arguably it should be the creditor's responsibility to inquire into the background of companies with which they contract.
- 9.46 Because the ambit of a register of trading trusts would be narrower than a general register of trusts, the loss of privacy and anonymity would be less widespread compared to a general register. However, for trading trusts there would be a significant change with trust information becoming publicly available. Registration for trading trusts would achieve fewer purposes than a wider register.
- 9.47 Chapter 7 discusses other options for addressing the concern regarding the disclosure of a company's trustee status to creditors, which may be more appropriate ways of addressing issues arising with trading trusts.⁴⁸³

Reporting requirements

- 9.48 It is also worth considering what the reporting requirements should be. These could be in the form of an annual return that trustees are required to submit to the appropriate government agency.
- 9.49 KPMG has made several suggestions about the type of reporting requirements for trusts that could be included in legislation:⁴⁸⁴
- financial statements – lodging annual financial returns with a trusts registrar, and adoption of accounting standards that disclose transactions, distributions, assets and liabilities, either as a sealed disclosure or open for public viewing;
 - tax return – including balance sheet information for trusts which derive no taxable income;
 - declaration to an appropriate government agency of distributions made by the trust;
 - declaration of assets – an annual declarations of gifts made to trusts and property held by the trust.

Role and powers of a registrar

- 9.50 Any system of registration would need an administrative body to receive information about trusts and to manage a register. It is likely that a trusts registrar would be appointed to have the responsibility for maintaining the register. The effectiveness of a register depends on how actively a registrar manages the information. Legislation would need to set out the extent to which the registrar could take action when a trustee was not meeting their registration and reporting requirements. Part 20 of the Companies Act 1993, which establishes the Registrar of Companies, could be a useful model for a registrar in the trusts context. The Registrar of Companies has the functions of registering documents and maintaining a register, and may inspect the documentation provided and request further documentation.

Analysis of register option

Advantages

- 9.51 The benefits of a register and reporting requirements would depend on what is required and what will be done with the information. Trusts are a significant part of the legal and economic landscape in New Zealand. The trusts industry of those providing trustee services and advice is important to the New Zealand economy. New Zealanders appear to be more attached to trusts than people in comparable countries. As the number of trusts grows, there has been increased litigation and interaction with other areas of government policy. Unlike other legal and economic structures, such as companies or land titles, there is very limited regulation of trusts.
- 9.52 As discussed above, a register could make information about individual trusts available to government agencies, beneficiaries and potential creditors (if it is an open register). This would create greater transparency regarding the financial and legal position of individuals and companies, and could allow beneficiaries to identify the trusts in which they have an interest.⁴⁸⁵ A register of trusts would open the door for greater regulation of the administrative requirements imposed on trustees and measures to be taken if these are not met, although this would require a body to be responsible for the monitoring and enforcement of trustee obligations.
- 9.53 A register of trusts provides a mechanism for charging a fee or levy on trusts, which would introduce a way of requiring the trusts industry to bear the costs of structures that could be put in place to assist all persons with trusts, such as a trusts ombudsman or tribunal. A trusts register would formalise the process of creating a trust. This would provide the ability to educate those involved in what their roles are at the time that the trust is established.⁴⁸⁶ This is particularly important for lay trustees. It may also mean in some cases that trusts are entered into more cautiously and with full understanding of their effect.
- 9.54 A further argument for the registration of trusts is that trusts are commonly used in a way that is similar to companies. Companies are subject to considerable regulation and public reporting requirements. Company directors are on public record and are accountable to shareholders. It can be argued that similar standards should apply to trusts.⁴⁸⁷ Donovan Waters QC notes that the call for public registration of trusts in the way that companies are registered is likely to become more strident as non-common law jurisdictions consider the introduction of domestic trusts.⁴⁸⁸ He states:⁴⁸⁹

In common law jurisdictions, as one can see in investor magazines and newspaper business columns, the perception grows that the trust and the corporation are very much look-alike modes of property management. Why should rules for the protection of third parties dealing with directors be in existence for corporations, but not for those dealing with trusts? ... [Those from civil law jurisdictions] are taken aback by the presence of such extensive remedies, while at the same time no mandatory public registration is imposed. There is no registration under the common law property model that will protect either the third party stranger doing business with a trustee, or the creditors whether of the trustee himself or of the wrongful recipient of trust property.

- 9.55 Requiring trustees to submit annual returns containing information that reflects how a trust is being administered may increase the likelihood that trusts will be managed correctly. It would provide the opportunity for trustees to be kept accountable for some of their duties as trustees by means other than the beneficiaries taking a court action against them. Much of the information that would likely be included in a reporting requirement should be collected and recorded by trustees anyway, as part of their duties as trustees.
- 9.56 Reporting requirements would increase the transparency of trusts in New Zealand. It could provide a mechanism for knowing how much wealth is held in trusts and in what forms. If the reported information were made available to other government agencies, it would allow them more information with which to assess applications for government assistance.

Disadvantages

- 9.57 Requiring trusts to be registered would be a fundamental change to the regulation of trusts in New Zealand. Registration would make trusts a less private arrangement. How much so depends on whether the register is publicly searchable. Much of the value of trusts rest on the private nature of the arrangement it offers and the flexibility to create and vary trust relationships. A trust register would mean that the existence and some of the details of trust arrangements would be notifiable and possibly publicly available. Trusts in New Zealand are diverse in structure. Many are complex and depart markedly from the traditional format of settlor, trustee and beneficiary with a vested interest. Discretionary trusts are the norm and, in consequence, it can be difficult or impossible to state who the beneficiaries are or what their beneficial interest is. It can also be difficult to define who the settlor is in some trusts. A requirement to register the names of settlors, trustees and beneficiaries may sit uneasily with the discretionary, flexible nature of trusts in New Zealand. There may be practical problems with the requirement to provide particular details of those involved in a discretionary trust.

- 9.58 Registration would create an additional regulatory requirement for trusts, something that can be seen as impeding business and commercial practice. Registration would inevitably create increased compliance costs for those with trusts. It is likely that a registration fee would be necessary. If an annual return is required, it is likely that professional trustees, lawyers or accountants, whose fees must be paid, will be involved in preparing these. The repeal of gift duty was motivated by a desire to reduce compliance costs which outweigh the revenue collected.⁴⁹⁰ The point has been made to us that it is important that further measures for trusts do not replicate the compliance costs that were found to be unsatisfactory and unnecessary in relation to gift duty.⁴⁹¹ The initial registration of the hundreds of thousands of existing trusts is likely to be a complex and costly process and may not be worthwhile. It may be exceedingly difficult or even impossible to enforce a registration requirement on existing trusts because there is no complete record of trusts currently.
- 9.59 Imposing reporting requirements on trusts would further increase compliance costs. It may require the involvement of a professional trustee, lawyer or accountant where this otherwise would not have been considered necessary. The satisfactory fulfilment of trustees' duties to manage a trust and keep full records may mean that little additional work is required to satisfy the reporting requirements or it could create additional trustee obligations to what already exist in the law of trusts. This may be unnecessary if it is considered that there is not a problem with how trusts are being managed.
- 9.60 Reporting requirements for all trusts would be treating large and small trusts alike. The size of trusts can vary considerably with many simply holding a family home and nothing more on behalf of "mum and dad" settlor-trustees, and others managing multi-million dollars' worth of assets and investments. It may not be appropriate for all trusts to have the same reporting requirements. Many trusts are not income earning. Should these be required to submit the same types of returns as those that are?

Regulation through service providers

- 9.61 Another option for regulating the trusts industry is to impose regulatory requirements on trust service providers, those who advise people about establishing trusts and those who act as professional trustees. Rather than seeking information about individual trusts, this option would oblige trust service providers to educate those entering trust relationships properly, to keep accurate records and gather information, and to provide a high standard of service. This option is discussed in greater detail in the chapter 10.

A record-keeping provision

- 9.62 An option for addressing concerns about accountability and the management of trusts, without resorting to a register or requirements to submit information to a registrar, is to include in trusts legislation a provision setting out the basic record-keeping requirements for trustees. This would be intended to restate rather than amend the law, and would not be designed to increase trustees' obligations. It would clarify, particularly for lay trustees, what information needs to be held. The information would not need to be submitted to a registrar and the trust would not need to be registered.
- 9.63 It is suggested that this provision could require trustees to keep copies of:
- the trust deed;
 - any variations made;
 - minutes of decisions made by trustees;
 - contracts entered into; and
 - accounts.
- 9.64 While it may be considered obvious to some that such information should be held, there is concern that not all trustees are aware of these obligations. A provision like that suggested would make this clear and would help to ensure that thorough records are held for all trusts, which in turn may make it easier for beneficiaries to receive this information⁴⁹² and hold trustees to account.

QUESTIONS

Q21 Is the introduction of a trusts register warranted? Why or why not? If so, what type of register should be introduced?

Q22 Do you think that a record-keeping provision in the form suggested would be useful? Why or why not?

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- 450 Rob Stock “Lifting of trust veil mooted” *Sunday Star Times* 3 October 2010; Rob Stock “Gift duty bonus comes at high price” *Sunday Star Times* 7 November 2010.
- 451 Submission of New Zealand Trustee Services on *Review of the Law of Trusts in New Zealand: Introductory Issues Paper* (submission dated 29 November 2011) at 13.
- 452 Law Commission *Some Issues with the Use of Trusts in New Zealand: Review of the Law of Trusts – Second Issues Paper* (NZLC IP20, 2010) at [2.1] – [2.7].
- 453 Submission of Ministry of Social Development on *Some Issues with the Use of Trusts in New Zealand: Review of the Law of Trusts – Second Issues Paper* (submission dated 22 July 2011).
- 454 Submission of Martin Riley, Stirling Tax Services on *Some Issues with the Use of Trusts in New Zealand: Review of the Law of Trusts – Second Issues Paper* (submission dated 17 June 2011).
- 455 See Law Commission *The Duties, Office and Powers of a Trustee: The Review of the Law of Trusts – Fourth Issues Paper* (NZLC IP20, 2010); David Hayton, Paul Mathews and Charles Mitchell (eds) *Underhill and Hayton: Law Relating to Trusts and Trustees* (17th ed, LexisNexis Butterworths, Bath, 2006) at [60.10].
- 456 Submission of Martin Riley, above n 454.
- 457 Law Commission *The Duties, Office and Powers of a Trustee: The Review of the Law of Trusts – Fourth Issues Paper* (NZLC IP20, 2010) at ch 2.
- 458 Peter Blanchard “Towards a modern law of trusts” (paper presented to New Zealand Law Society Trusts Conference, 2001) at 8.
- 459 Submission of New Zealand Trustee Services, above n 451.
- 460 The Taxation (Tax Administration and Remedial Matters) Act received Royal Assent on 29 August 2011.
- 461 See Rob Stock “Gift duty bonus comes at high price”, above n 450.
- 462 *Ibid.*
- 463 Inland Revenue RIS – Taxation (Tax Administration and Remedial Matters) Bill < www.taxpolicy.ird.govt.nz > at 18.
- 464 *Ibid.*, at 19.
- 465 Submission of Vicki Ammundsen, Ayers Legal on *Some Issues with the Use of Trusts in New Zealand: Review of the Law of Trusts – Second Issues Paper* (submission dated 31 March 2011) at 3. Submission of Ministry of Social Development, above n 453.
- 466 Scottish Law Commission *Discussion Paper on the Nature and the Constitution of Trusts* (SLC DP133, 2006) at 38.
- 467 Requirements of Writing (Scotland) Act 1995, s 1(2)(a)(iii).
- 468 Scottish Law Commission, above n 466, at 40.
- 469 *Ibid.*, at 41.
- 470 Australian Tax Office < www.ato.gov.au > .
- 471 For instance, in Victoria A\$200 in stamp duty must be paid when a trust is settled < www.sro.vic.gov.au > .
- 472 FATF *Third Mutual Evaluation on Anti-Money Laundering and Combating the Financing of Terrorism: Canada* (FATF/OECD, 2008) < www.fatf-gafi.org > at 251 – 253.

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- 473 FATF *Third Mutual Evaluation on Anti-Money Laundering and Combating the Financing of Terrorism: United Kingdom* (FATF/OECD, 2007) < www.fatf-gafi.org > at 238.
- 474 Society of Trust and Estate Practitioners *Trust Reporting Systems – An International Comparison* (STEP, 2010) at 11.
- 475 FATF *Third Mutual Evaluation on Anti-Money Laundering and Combating the Financing of Terrorism: United States of America* (FATF/OECD, 2006) < www.fatf-gafi.org > at 237 and 239.
- 476 Caribbean FATF *Mutual Evaluation/Detailed Assessment Report Anti-Money Laundering and Combating the Financing of Terrorism – Cayman Islands, Ministerial Report* (CFATF, 2007) < www.cfatf-gafic.org > at 129.
- 477 Ibid.
- 478 International Monetary Fund *Jersey: Financial Sector Assessment Program Update – Detailed Assessment of Observance of AML/CFT* (IMF, 2009) < www.imf.org > at 178 – 179.
- 479 FATF *Mutual Evaluation Second Follow-Up Report: Anti-Money Laundering and Combating the Financing of Terrorism – Singapore* (FATF/OECD, 2011) < www.fatf-gafi.org > at 20.
- 480 Ibid, at 22.
- 481 Ibid, at 20.
- 482 Submission of Ministry of Social Development, above n 453.
- 483 See paras [7.6] – [7.15].
- 484 Submission of KPMG on *Some Issues with the Use of Trusts in New Zealand: Review of the Law of Trusts – Second Issues Paper* (submission dated 7 April 2011).
- 485 Submission of Martin Riley, above n 454.
- 486 Submission of Cash Flow Doctors on *Some Issues with the Use of Trusts in New Zealand: Review of the Law of Trusts – Second Issues Paper* (submission dated 10 January 2011).
- 487 Submission of Martin Riley, above n 454.
- 488 D Waters “The Future of the Trust – Part II” (2007) 14 *JITCP* 1 at 10.
- 489 Ibid, at 10 – 11.
- 490 *Inland Revenue Regulatory Impact Statement*, above n 463, at 1.
- 491 Submission of KPMG, above n 484, at 10 – 11.
- 492 The duty of trustees to provide beneficiaries with information regarding a trust was discussed in Law Commission *The Duties, Office and Powers of a Trustee*, above n 455, at ch 2.



Chapter 10

Regulation of trust service providers

INTRODUCTION

- 10.1 Another issue the Commission has examined as part of its review is whether there is a need for additional regulation of those providing services to trusts. Some groups providing professional services to support trusts, such as lawyers, financial advisers and accountants, are regulated, but others are not.
- 10.2 This chapter considers whether all service providers should be regulated. It examines the policy objectives of such regulation, describes New Zealand's current regulatory arrangements and the problems that can arise. The chapter also looks at the regulatory regimes overseas jurisdictions have adopted and considers the options for additional regulation of trust service providers.

POLICY OBJECTIVES

- 10.3 Regulation necessarily imposes costs as well as restraints on individual freedoms. In a democratic society that values individual freedom, regulation that limits the circumstances under which people are free to engage in different commercial activities must be justified. Consumer protection regulation prescribing particular standards or qualities can be justified where the goods or services in question carry risks. It may also be justified in markets for complex services to ensure that they work fairly and efficiently and to address information asymmetries.

Consumer protection regulation

- 10.4 Regulation can prescribe particular standards or qualities of service. Where the consumption of goods and services carry risk, more intensive regulation may be justified. In some industries, such as those manufacturing medicines or preparing food for sale, regulation aims at eliminating risk. In others, including most service markets, consumer protection regulation seeks to moderate rather than eliminate risk, or seeks to achieve the appropriate balance of risks between different parties to a transaction.
- 10.5 Consumer protection regulation is aimed at ensuring that consumers of services have adequate information, are treated fairly, and have adequate avenues for redress. The main regulatory tools used in consumer protection are disclosure requirements and conduct regulation. Disclosure regulation includes a general prohibition on false and misleading statements. Conduct regulation specifies standards of conduct as well as sanctions for breaches of regulatory standards.

Information asymmetry

- 10.6 For a market to function competitively, consumers and service providers both need to be well informed. However, the problem of information asymmetry will arise when one party to a transaction has relevant information that the other does not. When accessing some types of complex advisory services consumers can lack (and cannot efficiently obtain) the knowledge, experience or judgement required to make well informed decisions. Information asymmetry exists when disclosure alone (consumer protection) is not sufficient to address the imbalance. No matter how much information the consumer is given by the service provider they will not be able to make an effective choice.
- 10.7 Regulation addresses this problem by substituting the judgement of a third party for that of the consumers. This is effectively what registration and licensing regimes purport to do. The competence of doctors, lawyers, financial advisers and many other occupational groups providing services to the public is assessed and monitored for the benefit of consumers by an occupational authority or a publically funded regulator. The authority or regulator has the necessary knowledge, experience and judgement to assess the specialist services. Only providers who can meet an appropriate qualification and practice standard are registered or licenced. Consumers are then able to choose between service providers who have been assessed and licensed.

Objectives of regulation

- 10.8 The policy objectives behind greater regulation of trust services are therefore to:
- protect the interests of the consumers of these services; and
 - to address information asymmetries in the market,
- by ensuring that all providers of services met a certain standard.

- 10.9 Regulation that improved the quality of services and reduced the risks and costs of substandard services would also enhance confidence in the trust sector.

CURRENT REGULATION

- 10.10 New Zealand already has regulatory regimes applying to professional groups providing trust administration and advisory services. Lawyers, chartered accountants and financial advisers are all regulated. Trustee companies are also subject to regulation. However, the existing regimes do not extend to cover everyone providing services in this sector.

Lawyers

- 10.11 New Zealand lawyers are regulated by the New Zealand Law Society under the Lawyers and Conveyancers Act 2006. All lawyers must meet certain educational and professional standards before they can be registered and are able to practice law. Once registered, they are required to act in accordance with rules of conduct and client care that have been made by the New Zealand Law Society, and approved by the Minister of Justice.⁴⁹³ These rules are binding and provide guidance around the boundaries within which a lawyer may practise.
- 10.12 The rules, based on the fundamental obligations of lawyers, include being independent in providing regulated services to clients, acting in accordance with fiduciary duties and duties of care, and protecting the interests of clients.⁴⁹⁴ Lawyers who fail to meet these standards can be disciplined and ultimately can be removed (struck off) from the register and excluded from practising law.

Chartered accountants

- 10.13 Accountants are not regulated per se. In fact, anyone can call themselves an accountant and offer services as such. However, to be a chartered accountant a person must be a member of the New Zealand Institute of Chartered Accountants and be subject to the Institute's regulatory standards. Chartered accountants are a self-regulated professional group. Members are required to undertake mandatory professional development training, are bound by the Institute's code of ethics and are required to adhere to professional standards adopted by the Institute. They are also subject to disciplinary procedures and a client complaint system.
- 10.14 This self-regulating model leaves it to the public to choose between accountants who are registered chartered accountants and those who are not.

Trustee Companies

- 10.15 Trustee companies are those companies listed in section 2 of the Trustee Companies Act 1967 as trustee companies for the purposes of the Trustee Companies Act 1967, the Trustee Companies Management Act 1975 and the Trustee Companies Management Amendment Act 1978.⁴⁹⁵ Trustee companies act as the trustees of private trusts and also carry on business as trustees for holders of debt securities, statutory supervisors as regards participatory securities, trustees of unit trusts and superannuation schemes, and statutory supervisors for retirement villages.
- 10.16 Each trustee company is incorporated under the Companies Act and has the powers and responsibilities conferred by that Act, and by its private enabling Act and its constitution.⁴⁹⁶ The conduct of business by trustee companies is regulated. For example, restrictions are imposed on the remuneration that may be charged for different services and trustee companies are required to disclose the administrative charges imposed in respect of group investment funds.
- 10.17 A review of the legislation governing trustee companies will be undertaken by the Commission during stage three of this project. Issues and problems with the legislation governing trustee companies will be considered at that stage.⁴⁹⁷

Financial advisers

- 10.18 Financial advisers and financial service providers are regulated by the Financial Advisers Act 2008 and the Financial Service Providers (Registration and Dispute Resolution) Act 2008. The regime mainly covers individuals and companies who provide core financial services such as financial advice, banking, credit, financial guarantees and securities. However, the regime also encompasses some functions undertaken by trustee companies and others providing advice to trusts.
- 10.19 All financial advisers and financial service providers must be registered on a public register called the Financial Service Providers Register. Only registered advisers can proffer the financial services covered by the regime. The regime requires all financial advisers to exercise the level of care, diligence and skill of a reasonable financial adviser when providing financial adviser services. An obligation not to engage in misleading or deceptive conduct and to comply with disclosure obligations when providing personal retail services also apply to all advisers and entities registered under the regime. Stricter, more tailored obligations are imposed on advisers and financial service providers who wish to provide certain types of financial products.
- 10.20 Financial advisers must meet a higher standard to be licensed as authorised financial advisers or (in the case of corporate bodies) qualifying financial entities before they can lawfully advise on certain financial products. In addition to the requirements outlined above they must comply with the terms and conditions imposed on their licence and their code of professional conduct.

- 10.21 Lawyers and chartered accountants who provide financial advice do not have to be on the register or meet authorisation requirements if they do this as part of their normal business as a lawyer or accountant. They are covered by the regulatory regimes already discussed. Trustee companies are exempt when providing any services otherwise covered by the regime in the ordinary course of providing legal or financial services relating to the preparation or drafting of wills and estate management and administration. However, in practice these companies all provide these services in other contexts as well, so all of them are registered under the regime anyway.
- 10.22 The Financial Markets Authority (FMA) is the regulator for the regime. It registers financial advisers and imposes terms and conditions on the licenses for authorised financial advisers and qualifying financial entities. The FMA is also responsible for monitoring compliance with the regime and, when necessary, taking enforcement action.

Other relevant legislation

- 10.23 Two other Acts are also relevant to an overview of existing regulation.

Securities Trustees and Statutory Supervisors Act 2011

- 10.24 All trustees and statutory supervisors of publicly issued equity, debt and participatory securities, all trustees of unit trusts and Kiwisaver schemes, and all statutory supervisors of retirement villages are required to comply with and become licensed under the Securities Trustees and Statutory Supervisors Act 2011.⁴⁹⁸ The regime came into force on 1 October 2011.
- 10.25 The Act introduced a licensing regime for these trustees and statutory supervisors. They will be required to file regular reports with the FMA. The Act also gives the FMA powers to oversee the performance of trustees and statutory supervisors.

Anti-Money Laundering and Countering Financing of Terrorism Act 2009

- 10.26 From 30 June 2013 trust service providers and trust companies will be required to maintain records and report against anti-money laundering measures contained in the Anti-Money Laundering and Countering Financing of Terrorism Act 2009. The Act applies to all “reporting entities”. A reporting entity is partially defined in the Act but also includes a person or class of persons declared by regulations to be a reporting entity.⁴⁹⁹ Regulations have now been made declaring certain financial advisers and trust and company service providers to be reporting entities.⁵⁰⁰

- 10.27 Providers of trust services and trustee companies come within the ambit of the definition of “trust service providers” under these regulations, so will be required to comply with the regime as reporting entities from 30 June 2013. Authorised financial advisers and qualifying financial entities are also reporting entities under regulation.⁵⁰¹ Lawyers and chartered accountants are excluded from the definition if they carry out the relevant trustee services in the course of their business as lawyers or accountants.⁵⁰²
- 10.28 The objective of the regime is to detect and deter money laundering and terrorism financing and bring New Zealand into line with the international standards for anti-money laundering and countering the financing of terrorism. It is also intended to contribute to public confidence in New Zealand’s financial system.
- 10.29 Briefly the Act requires all reporting entities to:
- (a) undertake an assessment of the money laundering and terrorism financing risks facing their business;
 - (b) appoint a compliance officer;
 - (c) design and implement procedures and controls for vetting and training staff, undertaking due diligence and account monitoring of clients and record keeping; and
 - (d) report suspicious transactions.
- 10.30 Reporting entities will be under an obligation to verify the identity of all their clients and to establish the identity of the beneficial owner of any assets. They must also review and monitor their client information. The FMA will monitor reporting entities and enforce the Act for financial advisers and trustee companies and service providers.
- 10.31 The regime is not intended to regulate the general quality of services. However, the record-keeping and reporting requirements, together with the oversight of the FMA, may indirectly have a positive influence on the quality of services.

Coverage is incomplete

- 10.32 To summarise, regulatory regimes apply to lawyers, chartered accountants, financial advisers and trustee corporations. The Securities Trustees and Statutory Supervisors Act introduced a licensing regime for trustees and statutory supervisors of unit trusts and retirement villages. In addition, from 30 June 2013 the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 will impose anti-money laundering reporting requirements on trust service providers and trustee companies and corporations.
- 10.33 This leaves a group of trust service providers who are not regulated.

- 10.34 There are companies in the market providing administrative and advisory services to trusts and trustees in competition with lawyers, accountants, trustee corporations and registered financial advisers that are not regulated trustee corporations. They may also not be caught by the financial advisers' regime. There are also individuals who are not covered by the existing regimes who are acting as advisers.
- 10.35 These unregulated advisers provide their services as an alternative and in competition with trustee corporations and regulated professional advisers. Given they are claiming similar specialist skills and expertise, should they also be similarly regulated to protect the consumers of such services?
- 10.36 It should be noted that most of these companies and individuals will come within the definition of trust service providers used in regulations made under the Anti-Money Laundering and Countering Financing of Terrorism Act. They will consequently be reporting entities for the purposes of that Act when it comes into force and will be required to comply with the anti-money laundering reporting requirements. The only area that is not therefore covered by regulation in respect of this group concerns the quality of services. There is no requirement at present for this group to be registered or licenced in order to provide services. There is no requirement that services meet certain standards as there are for other groups. They are also not required to be a party to a binding dispute resolution scheme.

Professional or paid trustees

- 10.37 Paid trustees who are not lawyers, chartered accountants, or financial advisers also fall outside the current regulatory regimes discussed above. There are clear differences between individuals who act as trustees for reward and other trustees who act in that capacity privately as a result of a personal relationship with a settlor. Professional trustees provide their services because they are paid to do so. Where trustees act as such in the course of business for reward they hold themselves out as having special skills and expertise. They are also in a position to obtain indemnity insurance. In *The Duties, Office and Powers of a Trustee* the Commission discussed, in some detail, the differences between the standard of care applied to professional and lay trustees.⁵⁰³
- 10.38 Whether paid trustees should also be considered to be trust service providers in the same way as advisers is less clear. As discussed in the earlier paper, the office of trustee carries with it specific duties and liabilities. Trustees are already subject to standards of care and personal liability for their actions. Where trustees breach their duties, beneficiaries have remedies, although as was discussed in Parts 1 and 2 of this paper, those remedies are probably inadequate and need to be supplemented. However, whether people who claim to have specialist skills and expertise and seek appointment as paid trustees should also be regulated as trust service providers to protect consumers establishing trusts should also be considered.

SCALE OF ANY PROBLEM

- 10.39 The practices of unregistered and unregulated service providers and the quality of services they provide are very difficult to gauge. The nature and quality of the trust services being provided or the extent to which there are problems is not generally monitored. Without a registration system it is even difficult to assess the number of unregulated providers operating.
- 10.40 The Ministry of Economic Development has indicated that it considers that any gap in occupational regulation is very small. Anecdotal feedback provided to the Commission by others during the review also indicates this. Some submitters have suggested that the quality of trust and trustee services is quite variable and a few have provided anecdotes about unqualified or inexperienced advisers. However, these have mainly concerned lawyers or chartered accountants who “dabble” in trust work, sometimes with insufficient understanding of the relevant law and practice. Most examples given have concerned poorly drafted trust deeds and/or the use of outdated precedents, which can result later in problems and costs. These types of problems do not indicate a significant regulatory gap, and illustrate the importance of continuing professional development rather than the case for additional regulation. In the case of chartered accountants and lawyers there are already complaint and disciplinary mechanisms available for dealing with any serious breaches of their duty of care.
- 10.41 One trustee service provider has, in its submission to the Commission, raised concerns that many trusts are not being actively managed or administered by lay trustees who do not understand their role as trustees, keep poor quality records, and fail to separate trust and personal assets.⁵⁰⁴ Such reports are concerning, however they mainly concern trusts administered and managed by lay trustees rather than paid trustees providing services.
- 10.42 The Commission has heard relatively few anecdotes about the quality of services provided by paid trustees and trust advisers. Most anecdotes conveyed to the Commission concern advisers establishing trusts cheaply using off-the-shelf trust deeds. Unfortunately precedents can be poor and the result can be trust structures that are inadequate and poorly designed for the needs of the client. The problems are not normally apparent until a later time when other advisers are consulted. A survey undertaken by the Society of Trust and Estate Practitioners (STEP) in the United Kingdom in relation to the unregulated will-writing market found similar types of problems around competence and integrity. However, the scale of the problem identified by STEP seems to be significantly larger than any there may be in New Zealand in respect of trusts. Among many other issues, the STEP survey identified the problem of trusts sometimes being established unnecessarily, or being unnecessarily complex, or having poorly crafted or unworkable provisions.⁵⁰⁵

- 10.43 Poor quality advisory services and poorly crafted trust deeds do impose significant costs on trustees and beneficiaries. However, regulatory regimes also involve significant costs. If the problems are not significant then additional regulation may not be warranted.

OTHER JURISDICTIONS

Introduction

- 10.44 It is useful, in weighing up the options, to consider how these issues have been addressed in other jurisdictions.
- 10.45 Many other jurisdictions regulate those providing trust advisory services. There are variations, however, in the scope and coverage of the regimes that have been adopted between different jurisdictions. Some only regulate specialist trust companies, while others regulate a broader group of professional service providers.⁵⁰⁶
- 10.46 At the international level the Offshore Group of Banking Supervisors issued in 2002 its statement of best practice, *Trust and Company Service Providers – Statement of Best Practice*. The statement has since been endorsed by FATF, the IMF and OECD and sets out what is now an internationally accepted statement of best practice in this area. Many overseas jurisdictions subscribe to the statement of best practice.

Australia

- 10.47 Trustee companies are regulated in Australia but other trust service providers are not. The Corporations Legislation Amendment (Financial Services Modernisation) Act 2009 recently extended and adjusted the financial services regime in the Corporations Act 2001 to cover “traditional trustee company services”. These are defined to include acting as a trustee or otherwise administering or managing a trust. Trustee companies need an Australian financial services licence to operate. They come under the supervision of the Australian Securities and Investments Commission. Trustee companies are subject to certain requirements, including:
- compliance with general conduct standards, including the requirement to deal with beneficiaries efficiently, honestly and fairly, manage conflicts of interest and ensure that their representatives are appropriately trained and qualified in relation to the provision of traditional trustee services;
 - trustee companies need to have suitable dispute resolution arrangements (both internal and external) if they provide traditional trustee services to retail clients; and

- trustee companies are subject to enforcement provisions in relation to false and misleading statements and engagement in dishonest, misleading or deceptive conduct.

United Kingdom

- 10.48 In the United Kingdom trust services are subject to anti-money laundering regulation. Trust service providers are covered by the Money Laundering Regulations 2007. All trust service providers (if not exempt from the regime) must be registered with a supervisory body under the regime. Those that are not already under the supervision of the Law Society or a professional accountancy body or the Financial Services Authority must register and be supervised by the Department of Revenue and Customs. The Money Laundering Regulations impose obligations on those covered by the regime to establish and maintain appropriate and risk sensitive policies and procedures relating to customer due diligence, reporting and record keeping, internal control, risk assessment and management, the monitoring and management of compliance.
- 10.49 Professions such as solicitors and accountants providing trustee services are also subject to professional competence and standards regulation.

Isle of Man, Guernsey, Jersey, and the Cayman Islands

- 10.50 The Isle of Man, Guernsey, Jersey and the Cayman Islands all regulate trust service providers under their respective financial services regimes.⁵⁰⁷ Although the specific range of trust services regulated within each jurisdiction differs slightly, the key features of the regimes are the same.
- 10.51 All trust service providers covered by the regimes are required to hold a licence and only licence holders can provide the services. Each regime has a regulatory authority that licences service providers and maintains a public register. The regulatory authorities can impose mandatory conditions on the licences they issue.
- 10.52 The regulatory authority in each jurisdiction is also responsible for monitoring compliance with the regulatory framework and where necessary enforcing it. The regulatory authorities have developed best practice guidance for trust service providers. They also undertake routine inspections to assess compliance, and provide some advice and support to licence holders. Licenced providers are required by the different regimes to act with due skill, care and diligence in carrying on their regulated activities. They must also have adequate systems and controls in place and be able to demonstrate their effectiveness.

OPTIONS FOR REFORM

Option 1 – No further regulation

- 10.53 The financial advisers' regime, current professional regulation and the anti-money laundering legislation together cover most of those providing services in the market. The regulatory "gap" is relatively modest and it might therefore be appropriate to wait until the new regimes have bedded in and reassess the situation. One option is to do nothing further and simply leave it to the market to moderate the standard of services that fall outside these regimes.
- 10.54 Unregulated providers will have to compete with those covered by the financial advisers' regime now as well as the regulated professionals. The public therefore do have the option of choosing regulated service providers.
- 10.55 Professional trustees and advisers who fall outside existing regulatory regimes can form self-regulating associations.
- 10.56 Within this option steps might also be taken to promote a code of best practice for professional trustees, advisers and trust administrators.

Option 2 – Registration and regulation

- 10.57 The alternative option is to regulate and require trust service providers to be registered and meet certain statutory standards of conduct set by a regulatory authority. Such a regime could also be extended to cover paid or professional trustees.
- 10.58 This option would either include a professional body or association as regulator or a state authority which would undertake the task of registration, monitoring and enforcement. Within the legislative framework the regulator would set competence and good practice standards and would enforce these. The regime would also need a mechanism for resolving complaints about service providers.
- 10.59 If this option is favoured, then one approach might be to extend the coverage of the financial advisers' regime to bring in a wider group of trustee companies and trust service providers. The regime could, for example, be extended to cover all trust service providers and companies providing trustee services, rather than only some of these as at present. This would essentially be the same broader group who will be required to comply with the reporting requirements imposed by the Anti-Money Laundering and Countering Financing of Terrorism Act from June 2013.

- 10.60 Extending the reach of the financial advisers' regime is consistent with the approach taken in many overseas jurisdictions where a broader group of trustee companies and trustee service providers are currently regulated under equivalent financial markets regulation. However, being a trust adviser or professional trustee is different than being a financial service provider. Although some financial services may be involved, trustees have wider duties in relation to the beneficiaries and trust property. Those advising trustees would need to be competent across this broader range of functions also. Some changes would be needed to accommodate them within the financial advisers' regime. There would obviously be additional costs associated with extending that regime in this way. The Commission has not attempted to quantify these.
- 10.61 The alternative approach would be to enact a new and separate regime specifically for professional trustees and trust service providers.
- 10.62 It should be acknowledged that the costs associated with the introduction of a registration regime could be significant, even if it were implemented as an extension of the existing financial advisers' regime. There would be the compliance costs for providers associated with obtaining and maintaining their registration. In addition there would be the cost to the state of establishing the registration and enforcement mechanisms, running registration systems, and developing appropriate regulatory standards. These would be more significant if a separate regime was considered necessary.

Comment

- 10.63 As has already been noted, there is little information (other than the few anecdotal examples mentioned) available to indicate whether unregulated trust service providers are a real problem, or merely a potential problem. Without such evidence it is difficult to make the case for regulatory intervention in this area. At this stage the Commission's view, based on feedback and its research to date, is that the problems in this area are not extensive or significant. It is unlikely therefore that the benefits of regulating would justify the cost.
- 10.64 It seems appropriate, however, to continue to monitor the situation. It will take time before the impact of recent amendments to the financial advisers' regime and the Anti-Money Laundering and Countering Financing of Terrorism Act can be properly assessed. These changes are likely, even without any further extension to the financial advisers' regime specifically to trust service providers, to address many of the problems over unqualified advisers working in the sector.

QUESTIONS

Q23 Should trust service providers be registered and regulated? Which of the options do you favour and why?

Q24 Should any regime for trust service providers also extend to paid or professional trustees?

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- 493 Lawyers and Conveyancers Act (Lawyers: Conduct and Client Care) Rules 2008.
- 494 Lawyers and Conveyancers Act 2006, s 4.
- 495 Trustee Companies come within the definition of a “trustee corporation” for the purposes of the Trustee Act and may be appointed as sole trustee under that Act. The companies currently listed are Trustees Executors Limited, AMP Perpetual Trustee Company NZ Limited, PGG Trust Limited, New Zealand Permanent Trustees Limited, and The New Zealand Guardian Trust Company Limited.
- 496 *Laws of New Zealand Trusts* (online ed) at [718].
- 497 An outline of the Commission’s review programme for trusts is contained in Law Commission *Review of Trust Law in New Zealand: Introductory Issues Paper* (NZLC IP19, 2010) at [1.7].
- 498 The Securities Act 1978 requires all public issuers of debt and equity securities to appoint a trustee and the issues of other participatory securities to appoint statutory supervisors. The Unit Trusts Act 1960 similarly requires that a trustee be appointed in respect of a unit trust, and the Retirement Villages Act 2003 requires retirement villages to appoint a statutory supervisor.
- 499 Anti-Money Laundering and Countering Financing of Terrorism Act 2009, s 5.
- 500 Anti-Money Laundering and Countering Financing of Terrorism (Definitions) Regulations 2011.
- 501 *Ibid*, r 16.
- 502 *Ibid*, r 20.
- 503 Law Commission *The Duties, Office and Powers of a Trustee - Review of the Law of Trusts Fourth Issues Paper* (NZLC IP26, 2011) at [3.13].
- 504 Submission of New Zealand Trustee Services on *Review of the Law of Trusts in New Zealand: Introductory Issues Paper* (submission dated 29 November 2011) at 13.
- 505 Society of Trust and Estate Practitioners (STEP) “STEP Policy Briefing January 2011 – Cowboy Will Writing: Incompetence and Dishonesty in the UK Wills Market” (2011) Society of Trust and Estate Practitioners < www.step.org > .
- 506 Society of Trust and Estate Practitioners (STEP) “STEP Policy Briefing January 2010 – Trust Reporting Systems – An International Comparison” (2010) Society of Trust and Estate Practitioners at 2 < www.step.org > .
- 507 See Financial Service Act 2008 (IM); Regulation of Fiduciaries, Administration Business and Company Directors, etc (Bailiwick of Guernsey) Law 2000; the Financial Services (Jersey) Law 1998; and the Caymans under the Banks and Trust Companies Law (2009 Revision).

Appendices





Appendix A

Consultation list

The Law Commission has consulted with the following during the review of the law of trusts:

- Auckland Energy Trust Board
- Ayres Legal
- David Bigio
- John Brown
- Chapman Tripp
- United Kingdom Law Commission
- Glaistor Ennor Solicitors
- Anthony Grant and Richard Green
- Inland Revenue
- KPMG
- Legal Services Agency
- Māori Land Court
- Ministry of Economic Development
- Ministry of Justice
- Ministry of Social Development
- Anthony Molloy QC
- New Zealand Law Society
- New Zealand Trustee Services
- Office of the Official Assignee
- Professor John Prebble

- Price Waterhouse Coopers
- Reserve Bank of New Zealand
- Scottish Law Commission
- Taylor Grant Tesiram
- The Treasury

We are grateful for their contribution.

Appendix B

Questions

Q1 Should there be a statutory provision setting out the grounds for the court to intervene in the exercise of a discretion by trustees (in other words, should an amended version of section 68 be retained?)

Q2 On what grounds should the Court be able to review and interfere with the exercise of a trustee's discretion?

Q3 Should the Court's power to intervene be extended to cover trustees' actions, omissions and decisions when they exercise a power under a trust instrument as well as under the Act?

Q4 What changes, if any, are needed to the powers of the court under the provisions discussed in chapter 2?

Q5 Should the High Court continue to have exclusive jurisdiction under new trusts legislation or should District Courts have concurrent jurisdiction (within their monetary limits)?

Q6 If District Courts have concurrent jurisdiction, should it be only under some provisions in the Trustee Act 1956? If so, which provisions?

Q7 What, if any, powers should the Family Court have under new trusts legislation?

Q8 What are your views on the dispute resolution mechanisms discussed in chapter 4?

Q9 Should trusts legislation facilitate the use of alternative disputes resolution in trust disputes? Should it be available in every trust or only those that specifically provide for it in the trust deed?

Q10 Should legislation allow for trust deeds to provide for virtual representatives to bind unascertained and incapacitated beneficiaries to a settlement?

Q11 Are trading trusts in widespread use in New Zealand?

Q12 Are there any actual problems resulting from the use of trading trusts, including those identified in Part 3?

Q13 Do you consider that there are problems for creditors dealing with trading trusts?

Q14 Do you support any of the options for assisting creditors dealing with trading trusts, either alone or in combination?

Q15 Do you consider that it would be beneficial to restate in legislation the essential principles of any of the following areas of the common law (as they apply generally, not only to trading trusts):

- a. that a trustee assumes personal liability unless there is an express contract to the contrary;
- b. a trustee's right to indemnity out of trust assets;
- c. how and subject to what, if any, conditions can a trustee's rights to indemnity be exercised;
- d. the circumstances in which creditors can be subrogated to a trustee's right of indemnity; and
- e. exclusion of the right of indemnity.

Q16 Are there problems arising in relation to beneficiaries of trading trusts?

Q17 Is any reform necessary relating to beneficiaries of trading trusts, and if so, in what way? Do you consider that directors of corporate trustees should have the same obligations to beneficiaries as if they personally were the trustees?

Q18 Are the problems arising from insolvent trading trusts correctly identified?

Q19 Do any of the issues referred to regarding insolvent trading trusts require legislative clarification or reform?

Q20 Can the term "trading trust" be defined adequately in legislation? If so, what form should the definition take?

Q21 Is the introduction of a trusts register warranted? Why or why not? If so, what type of register should be introduced?

Q22 Do you think that a record-keeping provision in the form suggested in chapter 9 would be useful? Why or why not?

Q23 Should trust service providers be registered and regulated? Which of the options do you favour and why?

Q24 Should any regime for trust service providers also extend to paid or professional trustees?

