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By email to trusts@lawcom.govt.nz

Dear Ms Clifford

REVIEW OF THE LAW OF TRUSTS - PREFERRED APPROACH

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on the Law Commission's Preferred Approach Paper on the *Review of the Law of Trusts* (Issues Paper 6). The Law Society greatly appreciates the filing extension allowed by the Law Commission. As the Law Commission is aware, those drafting the Law Society's submission discussed proposal 9 in detail, and in particular, how the current law and the proposal relate to each other and interact with other proposals.

2. In responding to Issues Paper 6, the Law Society refers to its five previous submissions on the Issues Papers that the Law Commission has released as part of its Trusts Law Review:

   - Introductory Issues Paper (Issues Papers 1), submission dated 23 March 2011
   - Some Issues with the Law of Trusts (Issues Papers 2), submission dated 3 May 2011
   - Perpetuities and the Revocation and Variation of Trusts (Issues Papers 3), submission dated 22 July 2011
   - Duties, Office and Powers of a Trustee (Issues Papers 4), submission dated 9 November 2011
   - Court Jurisdiction, Trading Trusts and Other Issues (Issues Papers 5), submission dated 7 March 2012.

3. Where proposals made in Issues Paper 6 have been raised and commented on by the Law Society in earlier issues papers, and are not expressly addressed in this submission, the earlier submissions represent the Law Society's views. We also note that the Law Society met with Commissioner McLay and others in February 2013 and discussed aspects of Issues Paper 6 at length. We do not cover all that material again in this submission, but wish to highlight a few areas in particular.

4. As noted during that meeting, there are a number of issues where members of the drafting committee have divergent views. As this is likely to be a reflection of the views held by the wider profession, in relation to those issues, the Law Society is unable to make particular recommendations.

Proposal 5: Conduct Duties and Proposal 6 Mandatory Conduct Duties

5. The question of codification of trusts is controversial. The courts have been reluctant to exhaustively spell out trustees' duties, so as not to create law which cannot be applied to situations which have not yet been considered. Setting out trustees' duties in statute, even on a principle-based approach, carries the risk of crystallising the law in a way that is less than ideal.

6. Setting out trustees' duties as proposed would also be difficult and complicated, and could make the law hard to understand due to the interplay between conduct duties, mandatory duties, and default duties. The legislation could also be difficult to implement in practice, as drafters of trust deeds would be uncertain as to the extent the duties were able to be modified.

7. Spelling out trustees' duties in legislation also runs the risk of inadvertently changing the common law. For example, the proposed conduct duty in proposal 5(1)(a), that a trustee must act honestly and in good faith for the benefit of the beneficiaries of a trust, is an important principle and may not always be considered properly in practice. However, making it into a conduct duty, which cannot be modified, may well cause problems for trustees in relation to how this duty interacts with the rest of trust law. If a trustee is looking to exercise a power to add beneficiaries under an express power in a trust instrument, the trustee will have a problem, no matter what the trust deed says. Similarly, a trustee will have a problem if a trust deed directs an investment that is clearly a bad idea for beneficiaries when the trustee comes to make the investment.

8. The interaction between different types of duties is also complicated. The conduct duty in proposal 5(1)(b) (trustee to exercise such care and skill as is reasonable in the circumstances) seems to apply to all trustee duties, as opposed to just duties of investment or management.

9. The statutory duty of care in the English Trustee Act 2000 applies to investing, appointing agents, insuring, etc. The Irish Trustee Bill 2008 proposes a wider duty of care and the legislation in British Columbia appears to as well. However, this wider duty of care may be going too far, particularly with the interplay between the various types of duty currently proposed by the Commission.

10. One effect of the current proposals for the duty of care and the interplay between duties would be to make a trustee subject to a duty to exercise reasonable care in carrying out a trustee duty that had previously been absolute. Therefore, the proposal may lower the required standard from one of absolute compliance to one of exercising reasonable care.

11. Another effect would be to make a trustee subject to a statutory duty of care when exercising a dispository power. Currently, trustees can dispose of property from a trust, and subject to following the law defining what a trustee may or may not do, the court will not interfere based solely on the merits of the trustee's decision. Introducing a statutory duty of care introduces a new rule into this already complex area of law. And when coupled with the proposals for more transparent accountability arising from the statutory duty to inform and the statutory right for a beneficiary to ask for trustee decisions to be reviewed, it may well expose trustees to the risks and uncertainties of their decisions being open to challenge on this additional ground.

12. Therefore, the Law Society recommends a half-way house approach, setting out the "core" trustees' duties in an operative provision and in a very general and non-prescriptive way, such

as providing that trustees must act in good faith and honestly. It may also be helpful to set out the mandatory content duties, as in proposal 6, which should not be able to be limited or excluded under the trust deed.

13. Any provision should then go on to say that this does not limit the common law and that trustees have other duties (such as those in proposal 7(1)(a)), which could be listed by way of example in non-operative provisions.

14. Any statutory duty of care could provide that when carrying out investment functions (and related management functions), a trustee must exercise reasonable care and skill having regard to their special knowledge or experience, and whether they are paid.

15. Following that, the new Act could say that these duties, other than mandatory conduct and mandatory content duties, can be modified by the terms of the trust (the duty to inform is discussed separately below).

16. This would impact on the proposals preventing exclusion or modification of mandatory trustees' duties but this consequence will be less problematic than extensive codification of trustees' duties as proposed. Codification of duties will result in problems as the duties are already complex and overlap. The law must be flexible enough to allow it to develop to deal with new situations. On the other hand, exclusion of trustee liability problems is limited to particular instances.

Proposal 8: Avoiding the consequences of a breach of trust

17. Whilst providing for mandatory trustees' duties appears initially to be an elegant way of dealing with limitation or exclusion of trustees' duties or duty modification issues, it will likely cause problems in practice.

18. The Law Society suggests it would be better to adopt a simpler approach and provide that liability for a trustee's dishonesty or recklessness (in the subjective sense) cannot be excluded or limited and a trustee will not be entitled to an indemnity from the trust fund for the consequences that follow.

19. Any provision must consider the possibility of all the beneficiaries of a trust agreeing to the trustee being indemnified from the trust fund for a specific exercise, or purported exercise, or for refusal or failure to exercise a trustee power or trustee action.

20. As indicated, it will be too problematic to deal with duty modification clauses. Whilst it is correct that a response by some draftsperson might be to look to exclude certain trustees' duties to get around the prohibition on exclusion of liability, this is unlikely to be a significant problem in practice. It would be far better to deal with the question of excluding or limiting trustee liability in a simple way.

21. The application of these provisions in relation to existing trusts must be considered in detail. An adequate transition period would allow existing trustees to be given sufficient opportunity to consider whether to resign.

22. The Law Society agrees with proposal 8(5) (to retain an equivalent of section 73 of the Trustee Act 1956). See page 10 of the Law Society's submission on Issues Paper 4.

Proposal 9: Duty to inform

23. The duty to inform was discussed in detail by the Law Society in response to Issues Paper 4. As noted in that submission, there is a lack of clarity as to what the current law requires in terms of the duty to inform.

24. The Law Society understands two duties are proposed: (i) a duty to actively notify (as set out in proposal 9(3)); and (ii) a duty to inform on request (as set out in proposal 9(1)).

25. Proposal 9(5) implies that the duty to actively notify a qualifying beneficiary of the existence of their interest and right to request information (proposal 9(3)) can be excluded by the terms of the trust but the duty to provide information on request (proposal 9(1)), which is part of the mandatory duty to account, cannot be so excluded. Mandatory duties are discussed above.

26. The Law Society agrees with the proposal that the duty to provide information on request (proposal 9(3)) is the type of duty which as a general proposition should not be able to be excluded as part of the wider obligation to account to beneficiaries. The duty to provide information on request is qualitatively different than the duty to actively notify.

27. However, there may be circumstances in which a trustee could perhaps justifiably not provide information even on request (e.g. a beneficiary acting for improper purposes against the interests of the trust as a whole) and this possibility may require some further development by the Commission.

28. The extent to which a duty to actively notify ought to be able to be excluded is a more vexed question and there is no perfect answer to it. As a matter of principle, it seems wrong that there should be an ability to exclude without providing further guidance (see paragraph 30 below).

29. However, settlors may view the ability to exclude the duty to actively notify to be beneficial, in circumstances where trusts involve factors like those identified in Proposal 9(2)(b)(ii). Even if there were a statutory prohibition on excluding a duty to actively notify, it is likely trust deeds will be drafted in such a way to get around such a statutory prohibition.

30. With that in mind, there are three options:

    (a) prohibit the exclusion of the duty to actively notify for new trusts (which will probably result in the issue being worked around in trust deeds by settlors who wish to do so); or

    (b) allow settlors to exclude the duty to actively notify for certain designated beneficiaries but not all beneficiaries; or

    (c) allow trustees to take various factors into account when determining if information can be withheld such as the age, attributes and circumstances of the beneficiary (as well as those in Proposal 9(2)(b)(ii)) and allow trustees to apply to the court for an order that trustees do not have to actively notify or set out requirements for notification. This would allow the court to decide whether active notification to a beneficiary might have adverse consequences for the beneficiary or the beneficiaries as a whole. The trustees should also be entitled to seek advice from the Public Trust about the matter.

31. The Law Society is aware that there are differing views on the extent to which legislation should provide for active notification and provision of information. For instance, some

practitioners consider that the provisions could make it clear how often the disclosure of information is required and allow trustees to apply to the court for an order that the trustees do not have to supply information, or an order about how often the trustees need to supply information. However, other practitioners believe that such a provision would be unnecessary.

32. The Law Society notes that whatever legislative approach is adopted, care must be taken to ensure that the rules are consistent with similar jurisdictions and other statutory developments, so as not to discourage the establishment of trusts in New Zealand by creating overly onerous obligations on trustees.

33. Further, notwithstanding the extent of the provisions in the legislation, if the proposals are to apply to existing trusts (and the Law Society notes paragraph 3.75 of the Law Commission's paper seems to suggest they will not) transitional provisions in relation to the duty to actively notify and provide information for existing trusts will be required. The Law Society recommends a five year transition period to allow trustees of existing trusts to make the necessary arrangements.

34 Proposal 9(4)(a) defines a beneficiary with a vested or contingent interest as a qualifying beneficiary. There is a possibility that the phrase "contingent interest" may be confusing, in particular in relation to whether it includes a discretionary beneficiary. The Law Society recommends that contingent interests should be clearly described as contingent property rights.

35. The Law Society uses the term "contingent interest" in this submission to mean a contingent property right (whether determinable or not) such as that typically held by a final beneficiary.

36. A particular difficulty some trustees may face revolves around the remoteness of some contingent interests. A trustee should not be required to seek out and inform a beneficiary of the trust if the beneficiary has a very remote contingent interest. Therefore the "real prospects" test as set out in proposal 9(4)(b) should apply to contingent beneficiaries as well.

37. The Law Society recommends that proposal 9(1) should require a request for information to be in writing.

Proposal 33: Disclosure of trustee status

38. The Law Society discussed the proposal to require a company, when acting as a trustee of a trust, to clearly describe its status as such, in its submission on Issues Paper 5 at questions 12 and 14. However, it is noted that the onus is on the party who receives such disclosure of the status of the corporate trustee, to satisfy itself of such important matters as the corporate trustee's authority to enter into the transaction and the credit and other commercial risks associated with trading with the trustee.

Proposal 34: Liability of directors for trust liabilities

39. The Law Society is concerned about whether the proposal to amend the Companies Act to provide for the liability of directors of companies acting as trustees for trust liabilities will make a significant change to the risks for directors of corporate trustee companies as (in such a case), a director would be likely to have breached their "ordinary" duties under section 135 of the Companies Act.

40. Specifically, it is noted that a breach of trust causing an indemnity to be impaired can occur:
    (a) before the particular transaction giving rise to the debt is entered into; or
    (b) at the same time as the particular transaction giving rise to the debt is entered into (and it is suggested that this is probably what section 197 of the Corporations Act is aimed at); or
    (c) after the particular transaction giving rise to the debt is entered into.

41. The pre-existing breaches or later breaches can occur because of trustee conduct totally unrelated to the transaction giving rise to the debt. Such a breach is relevant because the trustee indemnity is impaired by way of a set-off (and the trustee has to make up for all breaches before it is entitled to claim under its indemnity).

42. It is suggested that the wording of section 197 is likely to catch a director under scenario (a) or (b) (whether inadvertent or not). However, it is suggested that it will not catch a director under scenario (c) - but section 135 of the Companies Act would do so.

43. The next issue is that the wording of section 197 appears to make the director liable for the face value of the debt. This may not be the case in the case of a breach of section 135 – where the courts may (and do) look at various factors to determine the amount of a director's liability – which will often be less than face value of the debt, particularly for inadvertent breach.

44. As a result, it appears to follow that, to get the same outcome under section 197 as would be achieved under section 135 either the Court would need to make an adjustment (downwards) of liability under section 197 or an adjustment (upwards) under section 135. This seems illogical and brings in an element of arbitrariness (why should there be a distinction simply because the director in question is governing a corporate trustee?). Another point of difference that has been suggested is that of the so-called starting point for determining director liability – with the present state of section 135 requiring the courts to make a (difficult) decision about the point at which, and extent that, the losses that flowed from the directors' conduct should be factored into the other losses and gains incurred by the company.

Proposal 35: Appointment of a liquidator or receiver of a trust

45. It is noted that providing for the appointment of a trust liquidator/receiver was an option raised in discussion with the Law Society during a meeting with the Commission in March 2012. A non-exhaustive series of responses to the points raised by the Commission of the issues to be determined includes the need to:

    (a) limit the range of applicants to creditors, in the same manner as for other entities, rather than some sort of open-ended scope for other parties to apply;
    (b) identify the test for making such an appointment (the Law Society having previously proposed the grounds as being that it was just and equitable to do so), perhaps with the addition of sufficient guidelines to aid certainty;
    (c) identify that the jurisdiction to hear the applications is limited to the High Court;
    (d) clarify the powers of the receiver or liquidator, including realising assets or terminating a trust under the supervision of the court;

(e) specify priorities – perhaps as an add-on to mirror the general principles in company/insolvency legislation; and

(f) clarify the scope for the payment of fees of the liquidator/receiver from the trust assets.

Proposal 36: Liability of directors to beneficiaries

46. The Law Society does not support proposal 36 for the reasons set out in its comments to question 17 in Issues Paper 5. It is noted that the comments in Issues Paper 6 in relation to section 27 of the Unit Trusts Act are likely to be overtaken by the enactment of the Financial Markets Conduct Bill. The Bill takes the approach (in clause 130) that the manager of a registered managed investment scheme established under a trust deed has the same duties and liability in the performance of its functions as manager as it would if it performed those functions as a trustee, within the context of the wider civil liability scheme of the Bill.

Proposal 37: Insolvent corporate trustees

47. The Law Society supports the proposed review of specific areas of insolvency legislation. It is noted, however, that the court already has the power to appoint liquidators in respect of trust assets of bankrupt trustees by virtue of the Judicature Act 1908, on the basis that section 17A of that Act allows the court to appoint a liquidator to take charge of the assets of an "association" which includes an unincorporated body of persons and includes trustees of a trust.[1]

Relationship property proposals

Proposal 59: Section 182 of the Family Proceedings Act 1980

48. The Law Society supports the amendment in proposal 59 to extend the application of section 182 of the Family Proceedings Act to de facto couples. However, the Law Society continues to support the reform of both the Family Proceedings Act 1980 and the Property (Relationships) Act 1976 in order to achieve a single set of provisions relating to trusts in the relationship property context. The Law Society refers in particular to the comments made on page 12 of its submission on Issues Paper 2.

Options for Comment – Which, if either, of the following options do you favour for the Property (Relationships) Act 1976, and why?

49. The Law Society recommends option 2 is adopted (a review of the Property (Relationships) Act 1976 should be undertaken to determine whether there are circumstances (not currently addressed by the provisions of that Act) where dispositions to trusts should be set aside, to better give effect to the equal sharing regime in that Act).

50. The Law Society refers in particular to the comments made on pages 11 and 12 of its submission on Issues Paper 2.

Transitional Provisions

51. The Law Society does not support the establishment of two distinct regimes, one for existing trusts and one for trusts created after the enactment of any legislation. It will, however, be important for any legislation to be very specific as to how it relates to existing trusts. As

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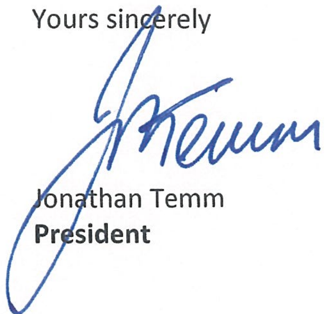
1 *BNZ v Rowley & Skinner [2012] NZCA 351*

mentioned above, a period of five years is recommended as a suitable transition period before amended law applies to existing trusts.

Conclusion

52. This submission has been prepared by the Law Society's Property Law Section and Family Law Section. If you wish to discuss this submission, please contact the Property Law Section Manager, Jennifer Chowaniec (04 463 2991 or jennifer.chowaniec@lawsociety.org.nz).

Yours sincerely



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