

LIABILITIES

John Hart, Barrister

Notes...

Lindsay: I'm pleased to introduce John Hart, an Auckland Barrister who specialises in trust and tax law and advises on international cross border trust and tax planning. John was the founding Chairman of the New Zealand branch of the Society of Trust and Estate Practitioners (STEP), a worldwide professional association promoting knowledge, education and higher professional standards amongst its members.

John, what do trustees need to think about for managing liabilities?

John Hart: Lindsay, the starting point is that trustees are personally liable for any obligations they enter into in their capacity as trustees. Trusts are not like company situations where directors are sheltered behind a corporate vehicle. Trustees always have to keep in mind that if they sign up to a commitment or other obligation as trustees, even though they may supposedly have the benefit of a right of indemnity out of trust assets, they're legally on the hook for anything they've committed to.

So, take an example where you're an independent co-trustee of the ABC Trust with a co-trustee (who was also the settlor of the trust) and you have both signed a contract to buy some real estate for the trust. It may have been at the instigation of the settlor/co-trustee who has said they will provide the money to complete the purchase for the trust. Let's then say there are not enough funds to pay the deposit or to complete the settlement and the contract goes into default. It's the trust and the trustees that are in default, not the settlor/co-trustee.

What can happen in that sort of scenario is the vendor selling the property can choose to chase the trustees jointly or individually for damages or to complete the contract. In that scenario the so called "independent trustee" can't say "look don't sue me, I'm just an independent trustee". All trustees are "on the hook" (or liable), for any obligations that a contract has put upon them.

The ABC Trust scenario highlights a few issues – trustee liability, trust liabilities and how trustees work together. If you're a trustee of a trust, you need to know your co-trustees very well and what they're up to. You certainly would not want to delegate authority to them to sign documents on your behalf. You also need to be confident about the resources or assets of the trust. You would also want to include in such a contract a clause to limit your liability as a trustee (so your liability was limited to the assets in your hands from time to time as trustee of that particular trust).

Lindsay: So trustees have a serious role that shouldn't be taken

lightly, especially if they may be personally liable for trust debts. I worry when trustees tell me their co-trustee has brought in some documents for them to sign and they just signed them because the co-trustee said “it’s all okay”.

John: Exactly. As a trustee you have to know what you’re doing and if you don’t, you shouldn’t sign anything without understanding what it is you’re signing up to, or at least getting some legal advice.

Trustees have a bunch of quite burdensome obligations. Trustees have obligations to act in good faith, to act fairly and reasonably, impartially and not with any self-interest. Trustees also have an obligation to invest prudently which comes back to what assets the trust might end up buying. They also have to be even-handed with the beneficiaries. Now that doesn’t mean all beneficiaries have to be treated alike or equally, but certainly the interests of all beneficiaries do need to be considered.

These obligations that I’ve just described could be called internal obligations. They’re obligations that look inwards to the trust. They’re liabilities which relate more to the obligations trustees have towards the beneficiaries of the trust or how the trustees conduct themselves in managing the trust.

Internal liabilities are essentially the flip side of what I’d call external obligations which are like the obligations in the ABC Trust example. External obligations involve liability looking outwards to external parties like the obligations you would have under a contract. Another example would be obligations on trustees as owners of commercial real estate where there may be statutory obligations under the Building Act, the Resource Management Act or a raft of other legislation.

Sometimes external obligations can cause problems for trustees because they can’t always limit their liability for potential claims or impositions under those types of statutes. That leads on to another issue which we can talk about in a little while and that’s about the advantage of using a corporate trustee in some trusts to protect individual trustees from the kind of liabilities which can’t be contracted out of, like the statutory liabilities I’ve just described.

Lindsay: John, internal obligations and external obligations are a good way to look at trustee liability. Do you have an example where trustees have had to pay trust debts personally?

John: There have been a number of recent cases where trustees have gotten into strife and been faced with personal liability. It’s generally been in situations involving commercial or residential real estate and often in a property development context. It’s very easy to be casual as a trustee and think that the trust isn’t carrying on a business or taxable

activity when in fact it is.

A number of the cases involve trustees who have incurred a substantial liability to the Inland Revenue Department (IRD) for GST or income tax. The IRD has then asked an independent trustee to pay the trust tax or GST debt which they have had to do personally, from their own resources. They might then look at recovering it back from their co-trustees and that's not always easy.

Whilst in a good case a trustee would be indemnified out of the trust assets, if the trust ends up with no assets, if the assets have been distributed, or if a settlor/co-trustee has no assets behind them, a co-trustee in that situation could easily be left sitting personally exposed to the claimants.

Lindsay: You've just described situations where a third party like IRD will look to where they've got the best chance of getting their money back. Do they chase all the trustees, some or just one?

John: I think in a lot of situations, unless there's a specific contractual provision stating otherwise, the liability of the trustees is joint and several to use the legal phrase. What that means is that the creditor can pursue one trustee and not others, or they can choose to pursue all trustees. Typically people with the deepest pockets tend to get chased rather than someone with no assets. So this becomes a risk factor especially for independent trustees. Trustees can't take their roles lightly.

Lindsay: Are there any other points around managing liabilities that you'd like to touch on? What other sorts of risks can arise for trustees and where does using an indemnity come in?

John: Trustees always need to think about how they limit their risk and liability. As I mentioned before, you can put a clause in a contract to limit the trustees' liability to the assets of the trust. Those clauses are definitely a good idea in contracts of any substance so you most commonly see them used in bank loan agreements and guarantees, that type of thing. It's absolutely essential for trustees to have these clauses in those types of documents and contracts.

I also think it is highly desirable for the trustees to get a competent lawyer to cast an eye over them. It doesn't take a lot of time and it's important because the clauses used by banks are highly variable. From a trustee perspective, some clauses used by banks are good and some clauses are terrible. Trustees should get good legal advice as there's no point having a false sense of comfort if the bank has used a clause that doesn't robustly limit your liability. That's the first point.

You raised the point about indemnity. Sometimes you may be asked

to do something as a trustee which has an element of risk, for example, to make a trust investment in an asset like shares in a private family company. From a strict prudent person approach, that might not be seen as an ideal trust investment in an ideal world as prudent trustees would likely invest in a lower risk diversified investment portfolio. That would be a situation where the trustees seek an indemnity.

Another area of potential risk is where trustees need to treat beneficiaries differently. Take a situation where you have three children who are expected to be the ultimate beneficiaries of the trust and for some reason the settlor considers one to be an inappropriate recipient. Maybe one is a bit of a spendthrift so you're asked to favour two beneficiaries and disfavour one. There may be very good reasons for doing that and while I'm not suggesting that it's a breach of trust, the trustees may feel that if there's scope for a dispute to arise in the future, they may want to seek additional comfort of an external indemnity as part of the decision making process.

An indemnity from an external party like the settlor may not be worth a lot if all the settlor's valuable assets are all held in trust. However, there may be an opportunity to ask for an indemnity from other parties who have assets to back the indemnity up – it could be another trust, a family company or the beneficiaries who are asked to indemnify the trustees. It's a matter of looking to see who might be willing to indemnify the trustees. A lawyer can advise how this is best achieved.

Lindsay: From what you're saying, indemnities are more likely to be used where trustees are required to make significant decisions or undertake major transactions where there could be some risk to the trustees for the decision they are required to make. Those events would be a good signal to get legal advice on what risks could exist for the trustees and how they can best be reduced.

John: Yes, absolutely. Another area that comes to mind is in the relationship property context if there's a relationship dispute involving a common trust between the two spouses. An independent co-trustee could get themselves into strife if they are seen to favour one spouse or the other. It's very important in a scenario like that for the trustee to be even-handed and remain independent.

In some particularly acrimonious disputes, the trustees may need to ask the Court to give them directions on how they should act and trustees might also be thinking about whether they should resign as trustee. The answer to that probably depends on how the trust is structured because I personally would not want to resign as a trustee if it played into the hands of one or other of the spouses (for example, if I resigned and it enabled one spouse to act in a harsher way than they might have had I still been in a trustee role). While resignation may be an option, you need to take care.

Lindsay: And that brings us back to the obligations you mentioned earlier, about acting in good faith, acting fairly and reasonably, impartially and not with any self-interest. As an independent trustee you have a really important role to ensure the trust keeps running as well as can be.

John: Exactly. The independent trustee can act as a check and balance on the conduct of the other trustees who may be much closer to the issues because the trust's been established for their family. The trustee's job is to actively participate with their co-trustees in the management of the trust. There's a danger if you partially delegate your functions to a co-trustee, human nature being what it is, things can slide and go very badly.

Lindsay: You touched on corporate trustees. Can you give a quick over view on what a corporate trustee is and when you might use one?

John: Any standard company can act as a trustee provided the trust deed permits it to and most modern trust deeds do. A corporate trustee structure may be an option to provide an extra layer of protection because, for the time being at least, directors of a corporate trustee don't have a direct fiduciary obligation to the trust beneficiaries. There are two approaches to using corporate trustees.

The first would be a situation where the Smith family wants to set up a trust and decide to establish a company called "Smith Family Trustees Limited" to be the sole trustee. The directors of that company might be some of the Smith family members plus an independent person. So in this example, it's a standalone corporate trustee.

The other approach is where Mr and Mrs Smith act personally as trustees in their personal names. However, a company is established to act with Mr & Mrs Smith as independent trustee. If Mr Jones was asked to be an independent trustee, Mr Jones could set up a company called "Jones Trustees Limited" to be independent trustee. In this situation the three trustees of the Smith Family Trust are Mr and Mrs Smith and Jones Trustees Limited as independent trustee. Either option is fine.

There may be a number of benefits. One is that you've got limited liability to trust creditors. If there are ever changes of individuals like an independent trustee wants to resign, that person can come out as a director and a new director goes in. This means you don't have to change legal title to trust assets, which is convenient. Aside from the added external protection to trust creditors, you don't have a direct duty as an individual to the trust beneficiaries. So in a situation where the trust beneficiaries were disgruntled with how the trust had been handled, in a claim situation where there is a corporate trustee being

used, they would sue the corporate trustee, not individual trustees.

Lindsay: Thanks John. I think it's important to remember that whether you're acting personally as a trustee or using a corporate structure, the points you made earlier about good trusteeship, doing the job properly, treating it as a job, still apply.

John: It does because if you think you're hiding behind a corporate trustee and there's a disaster or something goes wrong with the trust, you've still got reputational damage, you've still got costs of defence, you've got risk to relationships with people involved because they'll be unhappy with how things have gone. You also can't discount the possibility of some crusading Judge in the future deciding to lift the corporate veil and allow beneficiaries to sue the individuals behind a company. It's still about good practice and good risk management and doing the job properly.

Lindsay: What recommendations do you have as good practices for trustees around liabilities?

John: If you can't do the job properly or you don't want to do it properly, don't be a trustee. Then there are the things we've talked about up in terms of limitation clauses and contractual documents and the possible use of indemnities. Trustees need to adopt good process and practices and get the basics right about actively managing their obligations and running their trusts properly as trustees.

I'd recommend trustees meet and review the trust annually. If they can't meet physically, at least talk on the phone or communicate by email. Review things like the financial statements, how investments have performed and the current positions of the beneficiaries.

Trustees shouldn't delegate to co-trustees unless they have absolute faith in them (and there's an issue about whether trustees are permitted to delegate under the trust deed).

Finally, trustees need to get good advice on matters they don't understand or where they have issues to deal with.

Lindsay: John, thank you very much for your insights and I think a nice way to end would be to come back to your suggestion that trustees think about their liabilities as either internal or external obligations. If people want to contact you, they can email you at john.hart@tax-trusts.com.

John: Thanks Lindsay.