Michael Dineen, Partner, Buddle Findlay, Auckland
Collapsing Collective Investment Vehicles - A New Zealand Perspective

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Michael Dineen
Partner
Buddle Findlay
Auckland

COLLAPSING COLLECTIVE INVESTMENT VEHICLES: INSOLVENCY OF TRUSTS AND MANAGED INVESTMENT SCHEMES – UNCERTAIN TERRITORY FOR LENDERS AND LAWYERS

Background – the Current Investment Climate

1. It is certainly topical right now to be considering the insolvency of collective investment vehicles. In the last 6 months we have seen[168]:

   Citigroup Inc. suspending investor withdrawals from a London-based US$500 million credit hedge fund to give it a chance to "stabilise";

   Bear Sterns (in its last days) closing a hedge fund that had invested nearly US$1 billion in asset-backed securities;

   Knight Capital Group Inc. liquidating two poorly performing hedge funds and returning their assets to investors;

   DB Zwirn & Co LP liquidating two of its largest funds involving US$4 billion in assets after investors tried to redeem approximately half of their investments;

   Peloton Partners telling investors that its Peloton ABS Master Fund was to be liquidated;

   GO Capital Asset Management suspending investor withdrawals from its €600 million Global Opportunities Fund for one year for liquidity reasons;

   Polar Capital Holdings plc closing three funds after a 11% fall (US$400 million) in assets under management; and

[168] "*Hedge Funds Stagger Through First Quarter '08*", Lipper HedgeWorld, Chicago, *Alternative Investment Quarterly*, First Quarter 2008.

Pardus Capital Management suspending investor withdrawals due to declining values of its holdings in order "to protect the funds and their investors from external short-term pressure".

2. The low water mark had been set ten years ago with the collapse of the hedge fund Long-Term Capital Management. Founded in 1994, its capital by early 1997 had risen to US$4.7 billion. The markets then turned horrifyingly against it, triggered by Russia defaulting on its bonds in August 1997. LTCM lost virtually all of its capital and was bailed out by a consortium of banks arranged by the Federal Reserve so as to avoid a failure that could have threatened the global financial system[169].

3. By these standards, problems in New Zealand are insignificant:

in March 2008 ING NZ froze withdrawals from its Diversified Yield and Regular Income Funds indefinitely, with NZ$520 million of retail investors' money at stake. The funds had invested in CDOs and CLOs in the USA and Europe. While the value of the Funds' investments had declined heavily due to the absence of buyers, there is considerable optimism that the underlying credit quality of the loans is such that over time they will be largely repaid and the two funds will return to something like their previous value;

in early April 2008 TOWER announced that its NZ$220 million MortgagePlus Fund was to be liquidated after TOWER decided, among other things, that it was "uncompetitive" in the current interest rate environment. It is not clear how long it will take to wind the fund up[170], but a first payment of 10% to investors was made in May and further distributions are expected quarterly; and

in July 2008 Canterbury Mortgage Trust suspended withdrawals owing to "an unprecedented number" of withdrawal requests, leaving its 5,000 investors unable to withdraw their investments totalling NZ$250 million until at least March 2009[171].

4. The problems for managed funds represent only the tip of the investing iceberg. As is well known, other products and institutions around the world[172] and in New Zealand have had their problems. As far as New Zealand is concerned, in the last two years we have seen more than 20

[169] For the full story see "*When Genius Failed – The Rise and Fall of Long-Term Capital Management*", Roger Lowenstein, Random House 2000.
[170] On the TOWER website investors are told the fund is being wound up "as quickly as possible".
[171] CMT is telling investors their quarterly interest payment due in October 2008 will still be paid, although the amount might be lower than expected. Since the fund is a group investment fund the reference to paying "interest" is incongruous.
[172] The collapse late last year of Britain's fifth largest mortgage lender Northern Rock, the rescue earlier this year of Bear Sterns by JPMorgan Chase after intervention by the Federal Reserve, and the more recent and ongoing 'rescue of the rescuers' Fannie Mae and Freddie Mac have all been widely publicised.

finance companies either put in receivership, reach an arrangement with creditors or stop lending and withdraw their prospectuses. In addition other, more sophisticated, debt products have been in the news - the Australian manager of PINs Securities has been placed in voluntary administration and is now to be wound up, with considerable uncertainty for noteholders in terms of what and when they will be paid, and Macquarie New Zealand Fortress Notes have traded for some time at less than half of their face value and although they now have improved financing facilities available they will not be paying investors interest for some time173.

5. So what are collective investment vehicles and what is the nature of "insolvency" when applied to them?

Collective Investment Vehicles in New Zealand

6. Collective investment vehicles take many forms. They can be companies, partnerships, limited partnerships and trusts. Basically they are just vehicles which enable a group of investors to invest together, often in an aggregated way which would not be available to them each individually. They also have different names in different jurisdictions – they can be called unit trusts, mutual funds, investment trusts, open-ended investment companies, unit investment trusts, closed-end funds and any number of variations on those themes. Some would say they include superannuation schemes and life insurance products but this paper will deal with unit trusts and their lesser known colleagues, group investment funds174.

7. Group investment funds are a creature of statute. Section 29 of the Trustee Companies Act 1967 allows trustee companies (Trustees Executors, NZ Guardian Trust, Perpetual Trust and Public Trust) to establish group investment funds. This was effectively a statutory authorisation to trustee companies to mix trust funds, thereby aggregating investments and enabling enhanced returns to their beneficiaries. However, during the 1970s and 80s it became fashionable for trustee companies to create group investment funds as an external managed fund for retail investors.175

[173] Four years, according to the *National Business Review* (1 July 2008). The new loan does not require asset sales if their value declines.
[174] Superannuation schemes and life insurance products have their own statutory regimes and it would seem that most of the problems with superannuation schemes have arisen not because of any kind of insolvency but exactly the opposite – what to do with the surplus. One could also include securitisation vehicles here, since trusts are invariably used in their structuring, but the end investor is almost always holding a debt instrument, rather than a unitised interest in any trust.
[175] It is questionable whether they were ever intended to be used for this purpose but there were advantages, often tax-related, in creating retail GIFs instead of unit trusts.

8. The units in retail group investment funds are “participatory securities” for the purposes of the Securities Act 1978 and their offer to the public is regulated by the participatory securities regime in that Act. Although similar in nature, they are not unit trusts and they are considered to be a “trustee’s fund” rather than a “manager’s fund” as is the case with unit trusts. In other words, it is the trustee which is primarily responsible for their creation and management, as well as custodianship of the assets, although the investment management and administration responsibilities are often contracted out.

9. However, most collective investment schemes in New Zealand are unit trusts established under the Unit Trusts Act 1960. This Act was subsequently considered insufficiently rigorous for the protection of investors and it is now necessary for offerings of units in unit trusts to comply with the Securities Act requirements as well[176]. There is a separate regime within the Securities Act dealing with unit trusts.

10. The unit trust is, as mentioned previously, considered to be a “manager’s fund” in the sense that the manager, who will be independent of the trustee, makes all investment decisions relating to the scheme[177]. The trustee’s responsibility is to hold and protect the assets of the fund for investors, although the trustee does have an obligation, implied in trust deeds by section 12 of the Unit Trusts Act, not to act on any direction of the manager to buy or sell an asset of the trust if in the trustee’s opinion the proposed purchase or sale is “manifestly not in the interests of the unit holders”. This “power of veto”[178] is seldom used.

11. A discussion of unit trusts would not be complete without a brief reference to the “PIE” (portfolio investment entity) regime introduced in April 2008, by way of amendment to the Income Tax Act 2007. While unit trusts were fashionable in the 1980s, it soon became apparent that they suffered from something of an uneven playing field in terms of their tax treatment. Because by their very nature they bought and sold assets as investments, they were subject to tax not only on the income derived from their assets but also on any capital gain made on the sale of their assets. This is to be compared with the normal situation of an investor in New Zealand who would not be subject to capital gains tax unless he or she was a trader in those assets or had specifically bought the asset with the intention of reselling it.

[176] *Securities Act 1978* and *Securities Regulations 1983*.
[177] Unlike in Australia, there is no ‘responsible entity’ regime in New Zealand so each unit trust must have a trustee and a manager. Under section 4 of the *Unit Trusts Act*, the manager must post a bond of $40,000 with the Crown to secure the due discharge of its obligations before it can act as manager.
[178] So described by Durie J in *Re Flat Rock Forests Trust* [2000] 3 NZLR 207.

12. After many years' lobbying, this uneven playing field has now been sharply tilted the other way – through the introduction of the PIE regime. Now, subject to compliance with the detailed PIE criteria contained in the Act, investors in a managed fund which is a PIE pay a final tax of 30 cents in the dollar on their income from the fund. Since the top marginal tax rate in New Zealand is 39 cents in the dollar, managers of unit trusts and other managed funds have been quick to comply with the PIE regime[179] to give investors on the top marginal rate an effective 9 cents in the dollar tax saving on the income from their investment.[180]

Liability of Unit Trustees

13. Section 24 of the Unit Trusts Act deals with the statutory liability of a trustee of a unit trust and provides as follows:

> "The trustee of a unit trust and the manager thereof shall each have the same duty to observe care and diligence in the performance of its duties as any other trustee, and shall each be entitled to the same indemnities and relief as any other trustee.
>
> Any provision in a trust deed governing a unit trust or any other instrument shall be void so far as it would have the effect of –
>
> > Exempting the trustee or manager or any director or officer of the trustee or manager from liability for breach of trust where it or he fails to show the degree of care and diligence required of it or him in that capacity, having regard to the provisions of the trust deed and the powers, authorities, or discretions conferred thereby:
> >
> > Indemnifying the trustee or manager or any such director or officer from any such liability."

14. So the trustee is not to be exempted from, or indemnified against, liability for breach of trust where it fails to show the degree of care and diligence required of a trustee. Trustees invariably seek to be exempted from liability as much as possible and it has become standard for unit trust deeds in New Zealand to provide that the trustee is liable only where the

[179] Indeed the difficulty in converting the TOWER MortgagePlus Fund (see paragraph 3(b) above), which is a group investment fund, into a PIE is stated by TOWER to be one of the reasons for winding it up.

[180] Traditional issuers of debt securities in New Zealand, such as banks, have been quick to take advantage of the PIE regime as well. Most of the banks in New Zealand have now created "cash PIEs" in order to protect their depositor base, so that depositors who previously invested in debt securities issued by their bank now invest in units in a PIE (often managed by a subsidiary of their bank), thereby effectively receiving a higher return on their "deposit". Anecdotal evidence is that the IRD is "surprised" that banks and other issuers of debt securities have reacted in this manner.

liability is attributable to its "own wilful act, gross negligence or wilful default"[181], or wording to similar effect.

15. This provision is then invariably accompanied by wording to the effect that it does not limit the trustee's statutory "duty of care and diligence and vigilance in carrying out its duties…."[182]. It is also a requirement of the Securities Regulations that a unit trust prospectus state the extent if any to which the trustee is indemnified by the trust.

16. Given the extent of these indemnities and exemptions, one might be forgiven for wondering how a trustee under a unit trust can be liable to anyone for anything, unless it has been grossly negligent or has wilfully defaulted in its obligations. The answer is that liability can arise in a number of different ways:

by entering into contracts on behalf of the trust; and

through statute.

Contractual Liability

17. Quite often it is the trustee rather than the manager who will enter into a contract on behalf of a unit trust. Most unit trustees will be careful to obtain legal advice on any significant or sizable contracts entered into on behalf of the trust. Unit trustees and their lawyers are unlikely to forget to include in any such contract a provision limiting the liability of the trustee to the assets of the trust[183].

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[181] While "gross negligence" has become the standard, there is considerable debate about the distinction between "negligence" and "gross negligence" and indeed whether there is any distinction at all – see *Wilson v Brett* (1843) 11M & W 113, *Pentecost v London District Auditor* [1951] 2 ALL ER 330, *Armitage v Nurse* [1998] Ch 241, *Walker v Stones* [2001] QB 902, *Barraclough v Mell* [2005] EWHC 3387 (Ch), [2006] WTLR 203, *Baker v JE Clark & Co (Transport) UK Limited* [2006] EWCA Civ 464 and the New Zealand case of *Rickard & Ors v The Council of New Zealand Veterinary Association Inc.* (High Court, 1 October 1987, Greig J). Also see the comments made by the New Zealand Law Commission in its report entitled *Some Problems in the Law of Trusts: Report 79* (NZLC R79, April 2002) which recommended the introduction of such a distinction in New Zealand in relation to the liability of trustees. The Government responded to this recommendation by noting that it was controversial and therefore required further investigation. To date, no such recommended legislative action has been taken.

[182] This approach could be criticised as resulting in something of a drafting shambles and it could well be a challenge for any judicial mind tasked with having to work through it. Nevertheless, it has become the 'standard' approach.

[183] The form of the limitation clause is a topic in itself. Each bank in NZ seems to have its own clause and every lawyer has his or her own opinion on all of those clauses. There are often lengthy negotiations between a bank and the NZ Law Society on that bank's standard form limitation clause. The limitation tends to be ineffective to the extent the trustee has been in breach of trust caused by his or her "wilful default or dishonesty" but there is seldom any sign of the "grossly negligent" wording enjoyed by the lucky corporate trustees. Essentially these clauses are up for negotiation on all the larger transactions. For a case where a trustee was held personally liable, despite being described as a trustee, because there was no proper limitation wording see *NZHB Holdings v Friedlander & Ors* (High Court Auckland, 10 June 2004).

18. The main contractual liability of a unit trustee will arise through borrowing. Indeed it is here where most true cases of "insolvency" of unit trusts will arise.

19. Although there are no strictly legal limitations, it has traditionally been the case with New Zealand unit trusts that the ability of the manager to 'gear up' the trust is severely limited. Although it will be the manager's decision to borrow, it will be the trustee who enters into the loan agreement, at least in the capacity of 'borrower'. Traditionally the type of trust most likely to borrow would be a property trust, and normally trustees at the time of preparing the trust deed would limit the amount of borrowing in a property trust to a fairly low level. Whereas banks and other property lenders are prepared to lend well in excess of the traditional 70% or so of valuation[184], corporate trustees have successfully sought to limit property trusts to a loan to valuation ratio of about 35%. Unit trusts investing in other types of property do from time to time have borrowing facilities available but they tend to be for liquidity rather than gearing purposes.

20. Thanks to the relatively low levels of gearing in unit trusts in New Zealand, there have been few instances[185] of trusts being insolvent in the sense that they are unable to pay their creditors. Nevertheless, it is worth mentioning in a paper such as this the remedies available to a lender to a unit trust. These remedies are much the same as the remedies available to a lender to a company. Although the unit trust is not a separate legal entity for general legal purposes[186], a lender to a unit trust (or more correctly a lender to the trustee as borrower) will, subject to the terms of the trust deed[187], be able to take security directly over the assets, eg. by way of mortgage, and more generally by way of a general security interest (equivalent under the PPSA[188] regime to what used to be called a debenture or, in Australia, a fixed and floating charge). The remedies available to a secured lender by way of enforcement of its securities granted by a unit trustee are the same as those available to a lender to

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[184] Market commentators considered it an eye-opener when lending institutions started going to 90% of valuation but as we all know the excesses of the last decade or so have seen loans granted at 100%, and even higher than that, of valuation.

[185] Few, but not none. The Flat Rock Forests Trust, a unit trust, had receivers appointed by Countrywide Bank in 1998 and its manager was put into liquidation. This was a case of assets declining in value (or perhaps more correctly being bought at an overvalue) and the bank acting to recover its loan. There was no return to unitholders.

[186] For tax purposes, however, a unit trust is treated as a company.

[187] While it is undoubtedly good practice for the lender to check the terms of the trust deed to ensure the borrowing is within the trustee's powers and that the borrowing is for a proper purpose, lenders will take some comfort from section 22 of the *Trustee Act 1956*. This provides that where a trustee grants a mortgage, the mortgagee's interest will not be impeachable "except on the ground of fraud, or be affected on the ground that no case has arisen to authorise the mortgage, or that the power was otherwise improperly or irregularly exercised" – although the trustee can still be liable to the "person damnified" for its improper actions.

[188] *Personal Property Securities Act 1999.*

any other corporate entity[189], i.e. mortgagee sale, appointment of a receiver, and enforcement of rights personally. In addition there are various remedies available under the Unit Trusts Act to unitholders which are not generally available to creditors[190].

21. Lending can sometimes be on an unsecured basis, although this is rare. In this situation the lender will depend heavily on the trustee's right to be indemnified out of the trust fund[191], and the loan agreement will incorporate a number of covenants by the trustee in relation to this right of indemnity , in particular maintaining that right at all times and not doing anything which could cause that right to be lost[192].

22. Trustees these days have to take special care as a result of the increasing sophistication of financial products. This is especially so in unit trusts investing in derivative contracts where the 'asset' can also have a liability linked to it. Often the ill-informed trustee can find that what he thought was an investment ends up costing the trust a substantial sum.

Statutory Liability

23. It has always been a concern for trustees and their advisers that they can assume liability in certain circumstances by operation of law. In the absence of a contract, the trustee has no way of limiting its liability. Most often a statutory liability will arise associated with the holding by the trustee of an asset. For example, by holding land the trustee can be liable:

for the payment of rates; and

under statutes such as the Building Act 1991 and the Resource Management Act 1991 which can impose strict liability for certain offences[193].

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[189] Note that under the PPSA a general security interest can be taken from any type of entity, including an individual, which was not the case under previous law.

[190] For example the power to remove the manager (s19), the right to appoint inspectors (s21) and rights against delinquent directors of the manager (s27).

[191] Section 38(2) of the *Trustee Act* allows a trustee to reimburse himself from the trust fund for all expenses reasonably incurred in the execution of the trusts or powers. The trust deed will invariably repeat this right and go further to allow the payment of fees to professional trustees. For what is reasonable and what is not, see Hammond J in *O'Donoghue v Farmer* [1998] 1 NZLR 116.

[192] Special care should always be taken when lending unsecured to a trust, not the least to satisfy the lender that the trustee has the power to borrow, that the borrowing is for a proper purpose and that the trustee is not in breach of trust. A loss of the trustee's right of indemnity through a wilful or other serious breach of trust could obviously be catastrophic for the lender. Unsecured lenders will not be protected by s 22 of the Trustee Act (see note 20 above) which only applies to powers to sell, exchange, lease or mortgage.

[193] The RMA, for example, imposes both civil and criminal liability on the owner of land and in some cases (where it can be said they personally contributed to the relevant act or omission) its directors. Local authorities can issue abatement notices requiring action to be taken to ensure compliance with the Act or conditions of a plan or consent, and the Environment Court can issue enforcement orders requiring or restraining certain action. Criminal liability can arise in certain circumstances, such as the accidental release of contaminants. Although these are strict liability offences, local authorities tend to

24. Obviously trustees, like any other property owners, will seek to monitor and minimise any potential liabilities they have in these circumstances such as through environmental audits prior to purchase, but clearly it is possible in extreme cases for trusts to become insolvent if their assets are insufficient to meet these liabilities. Many trustee companies will use a nominated subsidiary company to hold real property assets in an attempt to shield the trustee company itself, and its directors, from these statutory liabilities. Often the directors of the subsidiary will be officers of the manager rather than of the trustee, with the trustee having ultimate control of the company through a carefully drafted constitution. However it is yet to be seen if these attempts at protection will survive judicial scrutiny.

What is the "insolvency" of a managed fund?

25. Obviously insolvency can arise in different ways. The most obvious case is an inability to meet debts as they fall due, ie. cashflow insolvency. Because of the nature of a managed fund, which in most cases is an investing rather than a trading vehicle, an inability to pay creditors will most often arise where the creditor is a lender. This suggests that debt is the main insolvency danger for trustees, and in normal market conditions this may well be right.

26. However, as we have seen recently, the other main cashflow danger to a managed fund is an unanticipated and unusually high demand from investors for redemptions. The reasons for investors wanting to withdraw can be many and varied. For example, if the fund starts to decline in value, more investors will want to withdraw their units and this can lead to a serious "run" on the fund, in some cases to an extent which exceeds the fund's liquidity to enable it to pay them out. On the other hand, the reason for the run on the fund can have no relationship at all with its performance or the underlying soundness of its assets. Indeed, the very recent plight of Canterbury Mortgage Trust[194] is a good example of this – it seems that certain investors in the Trust are wanting to get their investments out simply because of current conditions in the financial markets, in particular in the finance company sector.

Suspension of withdrawals

27. It is here that collective investment schemes have developed a way of managing this type of cashflow insolvency which is not normally[195]

be sensible when prosecuting them, often adopting a 'scattergun' approach at first but then gradually releasing from the proceedings those not personally responsible for the breach.

[194] See paragraph 3(c) above.

[195] Actually in some debt issues, capital or mezzanine debt in particular, the issuer does have the right, and indeed in certain circumstances the obligation, under the trust deed to suspend certain payments such as interest.

available to the issuers of debt securities. To combat potential cashflow insolvency arising from high demand for withdrawals, managed funds around the world have developed[196] suspension rights whereby the manager can suspend withdrawals in certain circumstances. The trust deed may set out the circumstances in which, and the time for which, the suspension is effective but essentially the suspension rights will allow the manager to suspend withdrawals so as to protect the interests of the existing unitholders generally and in particular to avoid diminution in unit value through the need to sell assets at unfavourable prices, often in a declining market, in order to fund withdrawals. There can be constraints and conditions on the manager's ability to suspend and the trustee will often have a role.

Winding-Up

28. The other form of insolvency is of course balance sheet insolvency, ie. the trust's liabilities exceed the value of its assets. However, unless there are creditors (for example an unusually high level of borrowing) it will seldom be the case that the trust will be insolvent. The trust's net assets, and the unit value, may decline to virtually nil, but the fund itself will not be insolvent on a balance sheet basis. This is almost unheard of in New Zealand because of historically conservative debt levels.

29. The option is always open to the manager, in this type of scenario as well as where the manager considers there is no real future for the fund[197], to wind it up. Normally the trust deed will provide that the manager will have the right to wind up the fund after a period of notice to unitholders, and the unitholders themselves will have the right through an extraordinary resolution to vote to wind the fund up. On a winding-up of the fund, the net assets after payment of all creditors are paid pro rata to the unitholders.

Conclusion

30. The ability to suspend withdrawals, combined with historically low debt levels in New Zealand unit trusts, has resulted in very few truly "insolvent" unit trusts and invites the conclusion that "insolvency", when applied to unit trusts in New Zealand , is something of a misnomer. However in true cases of insolvency, the territory for the trustee, lenders, other creditors and unitholders is perhaps not as 'uncertain' as one might first think.

[196] This has not always been the case. Unit trusts in the late 1980s in New Zealand sometimes did not provide for there to be a suspension on withdrawals of units – indeed they often provided that the manager was under no obligation to repurchase or redeem units.
[197] As, for example, happened with the TOWER MortgagePlus Fund (see paragraph 3(b) above).