LENDING TO MANAGED INVESTMENT SCHEMES

Lender, Custodian and Trustee Issues

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INTRODUCTION

The focus of this session is lending to Managed Investment Schemes ("**MIS**") and issues for Lenders, Trustees and Custodians.

At first sight given the differences in terminology and governing legislation one might conclude that the New Zealand and Australia situations are quite different. However, while there are some important differences in terms of registration, licensing and governance, the issues for lenders and trustees are somewhat similar.

Daniel Marks' paper will focus primarily on the Australian perspective and this paper will consider some of the issues which arise with reference to Unit Trusts in the New Zealand jurisdiction.

There are some other forms of "collective investment" in New Zealand – a number of which are specifically excluded from the definition of Unit Trust in the Unit Trusts Act 1960 ("**UT Act**"). These mainly include interests in Group Investment Funds established by Corporate Trustees under the Trustee Companies Act, the Public Trust's Common Fund, Friendly Societies, Superannuation Funds and Share Purchase Schemes. For the purposes of this paper, these have been excluded given that the Unit Trust structure is the most common in New Zealand and Australia. There is some overlap between the two but many of the issues are relevant to both the Australian and New Zealand situation.

The paper will cover the following general areas:

- Registration and Licensing
- Roles of the Manager and Trustee
- Powers and Duties – Manager and Trustee
- Liability issues
- Covenants
- Custody

Collective investment schemes involve the pooling of individual investors' funds into a single vehicle which invests in various types of assets across the investment spectrum, and are generally in the form of unit trusts.

MIS came into force 1 July 1998 under the Managed Investments Act ("**MIA**") Australia and are incorporated into chapter 5C of the Corporations Act 2001 (Cth). The most significant change was the replacement of the separate roles of the trustee and manager with the single role of the Responsible Entity, ("RE").

The RE has the dual role of "trustee" and "manager". It must be an Australian public company holding an Australian Financial Services licence to act as an RE, and the Act specifies minimum net tangible asset requirements.

In New Zealand the principal governing legislation is the Unit Trusts Act 1960 ("**UT Act**").

Unit Trusts are defined in section 2 of the UT Act and result from the creation of an express trust constituted under the trust deed. They require the appointment of a separate manager and trustee. The manager initiates the trust. Property is made subject to the trust by the terms of the UT Act, and must be vested in the trustee .

The manager is charged with management and the day-to-day administration of trust property pursuant to the UT Act and the Trust Deed. The trustee has less to do with administration but assumes a "watchdog" role.

Pursuant to Section 7 of the UT Act, offerings in Unit Trusts are also subject to the provisions of the Securities Act 1978,and Regulations.

REGISTRATION AND LICENSING

The Corporations Act in Australia contains requirements for registration and licensing. A managed investment scheme must be registered with the Australian Securities and Investment Commission ("**ASIC**") where:

- the scheme has 20 or more members; or
- the scheme is promoted by a person who was in the business of promoting Managed Investment Schemes.

A managed investment scheme does not need to be registered if interests issued in the scheme are "excluded issues" within the meaning of Section 66 of the Corporations Law.

No such distinction occurs in New Zealand but the Securities Act recognises a distinction between sophisticated and unsophisticated investors, by virtue of section 3(2) which specifically excludes certain offerings from general offers to the public.

All registered schemes in Australia require:

- appointment of an RE, and custodian if the net tangible assets of the scheme are less than $5m
- a constitution which must contain all matters as prescribed by the Act – (it is effectively the RE regime version of a Trust Deed for the benefit of the investors in the scheme);
- a compliance plan setting out how the RE will manage the scheme to comply with the law and the scheme's constitution. If less than half the Board of Directors of the RE are not external then the RE must have a compliance committee which must have at least three members. The principal role of the compliance committee is to ensure compliance with the constitution, the law and the compliance plan, report breaches to the RE and ultimately ASIC if the RE fails to act in relation to breaches;
- registration is effected by lodging a signed copy of the constitution and compliance plan with ASIC[1].

The UT Act permits the manager to apply to the court to remove the trustee. The Minister may remove the trustee where the trustee was appointed by the Minister pursuant to section 5 of the UT Act.

The manager may also be removed by the court on the application of any unitholder, the Minister or the Trustee. A meeting of unitholders may also remove the manager.

The registration, licensing and governance requirements for unit trusts are contained in sections 1-8 of the UT Act. There are some differences between the two regimes, principally, that the MIA regime is quite detailed in terms of governance and regulation with quite specific duties imposed on both the RE and its directors, officers and employees. One of the most important differences in my view is that the RE performs the role of both manager and trustee ,whereas in NZ the roles are separate.

[1] Managed Investment Schemes – An Outline Simone Desmarchelier – Findlaw Australia – www.findlaw.com.au/articles

Importantly, the UT Act also imposes liability on the manager for its acts and omissions in the performance of its duties, as if it were a trustee.

The trust property must be vested in the trustee or one or more nominated persons of the trustee or in one or more nominees of a nominated person of the trustee but the trustee remains jointly and severally liable with that person for performance of obligations. Under section 3(4) of the UT Act, the manager and the trustee cannot be the same "persons" or controlled by the same "persons". Nor can the nominee be controlled by the same "person". Nor can the manager be a "nominee".

The manager must be a company within the meaning of the Companies Act that is a reporting entity within the meaning of the Financial Reporting Act 1993 or an exempt company under the "Financial Reporting Act" that complies with the Act as if it were a reporting entity.

The manager is required to provide to the Crown a bond, from a surety acceptable to the Crown, of $40,000 to secure the performance of its obligations, for each unit trust of which it is the manager. One could query the relevance of this in the current managed funds environment.

Trustees must be either a trustee corporation within the meaning of the Trustee Companies Act 1967 or a company or bank approved for that purpose by the Minister.

The Trust Deed must be approved by the Registrar of Companies and a copy lodged with the District Registrar.

In contrast with the MIA, there are no requirements for a constitution or a compliance committee.

The governance and regulation is via the somewhat "more general" provisions of the Act and the detail of the Trust Deed which it has been argued by some, is preferable to the single RE regime, because of the perceived" added value" from an investor's perspective of having a separate manager and trustee. This is a moot point.

The Act includes implied provisions under section 12 in all unit trust deeds perhaps the most significant of those being the so-called veto provision, section 12(1)c which states that the trustee shall not act on the direction of the manager to acquire or dispose of property where the trustee is of the opinion (conveyed in writing to the manager) that the transaction "is manifestly not in the interests of unitholders". However I am not aware of this having been used in practice, particularly as managers and trustees will often agree "investment guidelines" which some would argue would imply some "prior approval" of investments by the trustee making it difficult to "veto" a particular investment later.

Section 121(a) requires the manager to "use its best endeavours" to ensure the unit trust is carried on in a "proper and efficient" manner.

The Act also contains provisions for the appointment of one or more inspectors to investigate and report on the affairs of a unit trust and its manager. I am only aware of one situation in NZ where this has occurred and this was the Flat Rock Forests case[2].This was a case concerning the fiduciary responsibilities of managers of unit trusts and the appointment of an inspector pursuant to S21 of the UT Act .This case is discussed later in the paper under "Manager's Powers and Duties"

[2] Re Flat Rock Forests Trust [2000] 3 NZLR 207

There are "notional" penalties for failure to provide information to the inspector by officers or agents at the company which is the manager of the unit trust.

The UT Act also contains provisions for the appointment of a temporary manager and gives the court the power to remove the manager on the application of the trustee or a unitholder.

The trustee may cause the manager to be removed if it certifies it would be in the interests of unitholders and the unitholders also have that power if they convene a meeting under the Act.

On the question of liability, both the trustee and the manager have the same duties to observe care and diligence in the performance of their duties as any other trustees but are also entitled to the same indemnities and relief as any other trustee.

Provisions in trust deeds indemnifying the trustee or manager or any officer or director of each from liability for breach of trust where they fail to show the degree of care and diligence required of them in that capacity, shall be void.

TRUSTS

Notwithstanding the differences in legislative background and registration requirements, "MIS" in New Zealand and Australia contain one important common element and that is that they are both trusts.

The concept of the trust has been around since the middle ages.

Essentially a trust is:

> "*An equitable obligation, binding a person (the trustee) to deal with property over which he has control (the trust property) for the benefit of persons (the beneficiaries) any one of whom may enforce the obligations.(Underhill, Law of Trusts and Trustees 14th ed 1987 p1)*
>
> *A trust is not a legal entity separate from the trustees and beneficiaries, rather it is collection of rights and obligations.*
>
> *It is not a contract because it is enforceable by two persons who may not be party to it ie. the beneficiaries.*
>
> *The trust property is vested in the trustee.*
>
> *As a fiduciary – the trustee must adhere to the duties imposed on him as trustee. Therefore the trustee must act in good faith and for proper purposes.*[3]"

Whilst it is not the purpose of this paper to provide a detailed discussion on the law of trusts and trustees; it is important to understand the fundamentals of the concept of a trust in considering issues which arise when lending to trusts. The key issues in this area arise from the concept of trust and I think the important distinction between the quite specific and regulated MIS regime in Australia and the more "general" trust regime under the UT Act in New Zealand.

In a paper dated 8 September 2004[4] Diccon Loxton referred to the "Three Nots" as principles to bear in mind whenever lenders and other creditors are considering dealing with trusts:

(a) **A trust is not an entity**: From a Lender's perspective the important point to note is that creditors of trusts do not have direct access to trust assets, unless they are secured. Importantly although the trustee is entitled to be reimbursed and indemnified out of the trust assets when contracting with external parties it incurs personal liability.

(b) **A trust is not designed for business**: Trusts were created for quite different purposes than business.

(c) **Trust law does not favour creditors**: Company law has developed to provide some balance between the interests of shareholders and creditors and allow those dealing with companies to be afforded a measure of protection. For example the "indoor management" rule in Turquand's case, and the "previous " limitations of the "ultra vires" rule which has effectively been superseded by statutory provisions. The same cannot necessarily be said for trust law. Consequently creditors dealing with trustees cannot make assumptions about the trustee's compliance with its' powers or duties. (Diccon Loxton's paper contains a good discussion on these points.)

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[3] Lending to Trust Funds in the 90s, Rodney Stone – Paper presented to Banking and Finance Conference July 28, 1992
[4] Lending to Responsible Entities of Managed Investment Schemes, Diccon Loxton, Partner Allens Arthur Robinson – Presented in Sydney on 8 September 2004 at the Corporate Insolvency and Restructuring Forum (www.aar.com.au/pubs/pdfinsol/pap 08 Sept 04)

THE ROLE OF THE MANAGER AND TRUSTEE

The Role of the Manager

The manager's role is governed by the provisions of the UT Act and the Trust Deed and, it could be argued by reference to the common law given the specific statutory impositions of fiduciary obligations on the manager under section 3(2)c of the UT Act.

The manager's principal role in a Unit Trust is to effectively manage the business of the trust and subject to any other provisions of the Act. Section 3(2) of the UT Act:

(a) vests the power of management of investments and trust property in the manager;

(b) gives the manager the function of issuing and offering units to the public for subscription;

(c) imposes fiduciary obligations on the manager.

The manager must also comply with the "general compliance" provisions of the Act in relation to filing Accounts, Trust Deed amendments, sending accounts to unitholders etc.

These functions will be supported by detailed powers and functions in the Trust Deed. Whilst the manager is primarily responsible for the "day-to-day business of the trust" it will be the trustee who enters into lending arrangements and who will assume primary liability for the obligations under the documentation.

One of the practical issues which arises on a daily basis within Unit Trusts is the relationship between "the Trust", the manager and the trustee and in particular the relationship of an agent and principal. The relationship of an agent and principal may be defined as a fiduciary relationship which exists between two persons, one of whom (the principal), normally in this context the trustee, expressly or impliedly consents to the other (the agent) normally the manager, acting on its behalf, and the agent so consents to act[5].

In my experience this agency-principal relationship is not well understood by many managers and I suspect trustees and counterparties. For example, often managers will enter into borrowing or security arrangements with third parties without any prior reference to the trustee notwithstanding any requirement in the trust deed to obtain trustee approval, and that the lender will ultimately require the trustee to execute the borrowing or security arrangements.

Managers of property trusts will often if not always be reluctant to enter into a sale and purchase agreement but at the same time will undertake significant commitments on behalf of the trust for equity and other investments and borrowing. Where bank or other borrowing is to be undertaken, the trustee involvement will be mandatory, because that is the legal position and the trustee owns the assets.

[5] R Stewart "Unit Trusts" – Legal Relationships of Trustee, Manager and Unitholders (1988) C&SLJ, 269,271

The Role of the Trustee

The role of the Trustee in a Unit Trust is not too different to the general role of the trustee with which you will all be familiar.

The principal provisions in the UT Act relating to the trustee cover who may be appointed, custody of assets, removal and oversight of the manager's activities in a general sense.

All the "usual" law relating to trustees is equally applicable and the trust deed will contain all the operational and monitoring provisions as well as the specific powers and duties.

The trustee must at all times:

- adhere to and carry out the terms of the trust;
- act impartially between beneficiaries;
- exercise reasonable care;
- act for proper purpose and in good faith;

The trustee's principal role in unit trusts is to hold the trust property and, monitor the manager's activities, and do all those things which a trustee of any trust does, and with all of the "usual" duties and obligations.

POWERS OF MANAGER AND TRUSTEE

Trustee's Powers and Duties

Trustees powers and duties are derived from the trust deed, common law and the legislation namely the UT Act, Securities Act, and the Trustee Act.

Generally these powers include the power to:

- invest;
- carry on business;
- borrow; (this is of paramount importance from a lenders' perspective)
- give guarantees;
- mortgage and lease; and
- grant security over trust assets.

Under the UT Act the Trustee has an overriding power to refuse to carry out a transaction proposed by the manager if the Trustee considers that the transaction is manifestly not in the interests of the unitholders.

It is important for anyone contemplating lending to a trust that they consider whether the proposed transaction is permitted within the terms of the trust.

Lenders must also ensure that the trust was properly settled and does not infringe the law against perpetuities.

Typically lenders will require representations and warranties from the trustee normally contained in the certificate from the trustee or in the case of corporate trustees from the directors of the trustee that the trustee company can enter into the proposed borrowing transaction and the documents, and that the signatories are authorised.

Lenders to trusts will have constructive notice of the trust where they are aware that the borrower is a trustee and should review the trust deed as a matter of good practice, to ensure that the trust deed empowers the trustee to enter into the transaction.

Again in my experience, lenders often do not do this.

The trustee also has the overlay of fiduciary duties to act honestly without conflict and to act diligently and prudently. Again from the perspective of dealing with trustees the importance of lenders ensuring the activity is within trustees powers is important to avoid the possibility of the lender being liable as a constructive trustee.

It is common practice for New Zealand Unit Trusts to contain borrowing limitations and the trustee should ensure these are complied with to avoid potential liability for breach as a result of its standard indemnity from trust assets becoming void by reason of the trustee's negligence in not ensuring compliance with the borrowing limits. It is probably a matter of good practice for the lender to satisfy itself on this as well.

Manager's Powers and Duties

Although the UT Act specifies some of the manager's powers and duties these will mostly be contained in the Trust Deed. In a comparative sense the UT Act contains much less detail than the Corporations Law in this respect. Modern drafting will ensure the Trust Deed is as wide as possible to cover the many and varied situations encountered.

Property trusts will often be entering into significant borrowing for development or purchases.

Notwithstanding the wide powers given to managers in Trust Deeds, it is important to note that the trustee is ultimately responsible. We often see provisions in Unit Trust Deeds where the manager can direct the trustee to enter into a transaction or borrowing arrangement. The trustee will still be liable and should be aware of its general duties, powers and obligations in complying with any direction, and should consider refusing to act on directions if it considers that entering into the transaction would be in breach of the provisions of the trust deed, or any of its general trustee duties.

It is worthwhile looking in more detail at the Flat Rock[6] case in relation to the manager's powers and duties as the case concerns the power to appoint an inspector under section 21 of the UT Act, and is also about the fiduciary obligations of the manager of a unit trust.

The facts of the case briefly, are that Mr and Mrs Hatch invested in the Flat Rock Forests Trust (FRF Trust). The asset value subsequently declined and eventually became worthless. Mr and Mrs Hatch and other investors in the FRF Trust applied to the Court under S21 of the UT Act for the appointment of an inspector to investigate and report on the affairs and management of the trust on the grounds that the cause of the failure of the FRF Trust had not been disclosed to investors ,and there were suspicions that the management was inadequate or improper. It was contended by those opposing the application that before an inspector could be appointed the applicants had to pass a strict threshold test analogous to that applied to applications for investigations under the Companies Act 1955.

The court held that its' discretion was not circumscribed by the thresholds in S168 and169 of the Companies Act 1955 (not repeated in the Companies Act 1993), and that unitholders had a proprietary beneficial interest in the particular assets of the unit trust, thereby creating a direct interest in the way these assets were managed, and, importantly that managers of unit trusts had fiduciary responsibilities which are closely aligned to those of trustees under the Trustee Act 1956, where there was an automatic right to full accounting. An investigation could be ordered without a suggestion of misconduct.

The Court decided that an order for the appointment of an inspector was appropriate.

LIABILITY

There are a number of issues which arise here.

It is a well established principle that the trustee is personally liable for trust debts[7]. But a trustee also has an implied right of indemnity out of trust assets for liabilities properly incurred in carrying out its duties as trustee[8]. Therefore so long as the trustee has acted within the terms of the Trust Deed, the trustee is entitled to be indemnified out of the Trust Assets. Where the trustee has acted outside the terms of the

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6 Supra
7 Royal British Bank v Turquand (1855) 5 El&Bl 248; 119ER 418
8 VacuumOil v Wiltshire (1945)72 CLR319 at 324 per Latham J and at 335-336 pw Dixon J

trust deed, creditors dealing with trustees cannot rely on the "indoor management rule", as they can when dealing with a company.

This principle is important particularly for corporate trustees as the mere fact that the trustee is a corporation will not help if the trustee has acted outside powers of the Trust Instrument.

From a creditor's perspective no protection will be afforded the creditor where the trustee was not empowered to borrow.

It is common practice to seek to limit the personal liability of the trustee to the assets of the trust and it is most unlikely that a corporate trustee would enter into any borrowing transaction without such a limitation. Trustees have sought to limit their liability to the maximum extent possible, in some cases seeking indemnity even in the case of negligence by limiting the description to "gross negligence". My view is that there cannot be degrees of negligence. Either you are or you are not.

A recent UK case, the Concord case[9] considered the circumstances in which a trustee can seek and rely on an indemnity.

The case involved a bond issue where the trustees attempted to accelerate repayment on the occurrence of a disputed event of default. Briefly;

> Under the Trust deed the trustee could on direction of a specified percentage of bondholders, issue an acceleration notice on the occurrence of an event of default, subject to the trustee being indemnified to its satisfaction.
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> The issuer disputed the existence of an event of default and before accelerating, the trustee sought an indemnity against exposure to damages if it turned out there was no event of default.
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> The bondholders refused and the court ruled that the trustee could not insist on it "unless the risk is more than a mere fanciful one". It was held that the indemnity could only cover the legal costs likely to be incurred in an unsuccessful defence by the issuer, of the acceleration notice.
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> The judgment said:
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> - the obligation of the trustee to accelerate bonds is not dependent on the trustee being able to uphold the validity of acceleration against the issuer; and
> - in the absence of any contractual understanding to the contrary or negligence, by the trustee the trustee is not at risk of incurring liability to the issuer in damages for loss caused by invalidly accelerating bonds and is not entitled to an indemnity to cover that.

The "traditional" clause limits the trustee's liability to the assets of the trust which in the case of an unsecured lender would effectively cause it to lose its right of access to the assets of the trust or any recourse to the trustee if the trustee's creditors was in breach of trust.

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[9] Concord Trust v Law Debenture Trust Corporation plc [2005] UK HL (28 April 2005)

Unsecured Creditors

The lender may have recourse to the trustee through the right of indemnity from the trust assets where it is properly incurring liabilities in its capacity as trustee. But, the lender has no direct access to the trust fund.

However, if the trustee is acting beyond its powers the trustee is not indemnified in respect of the liability and in an extreme case a lender may find itself a constructive trustee in relation to the loan monies.

The lender cannot have any greater rights against the trust assets than the trustee but in these situations relies on a right of subrogation against the trustee's indemnity.

From the unsecured creditor's perspective reliance on the trustee's right of indemnity out of the trust assets is the key imperative. The difficulty for the unsecured creditor is that reliance on this "right of subrogation" is in the trustee's hands. Thus if the trustee commits any action which causes it to lose its right of indemnity then the creditor will be "left high and dry", so to speak and will not be able to seek reimbursement from the trust assets.

A further problem is the so-called" clear accounts rule". Where a trustee has committed a breach of trust it can only claim indemnity from the trust fund after making good any loss to the trust[10]. This means that creditors dealing with the trustee may be affected by other transactions not related to that being undertaken. A creditor may be acting in good faith with the trustee without knowledge of the potential impact of previous impropriety.

In the RWG Management case[11] the clear Accounts Rule was confirmed but Brooking J took the view that a balance should be struck between the amount owed to the trust and the amount due to the trustee under its indemnity with the trustee being able to recover to the extent it is in "credit".

In another case[12] the courts suggested that the trustee will not lose its right to indemnity where the incurring of the liability and the breach of trust are unrelated. [These comments were obiter.]

Notwithstanding the above comments, the unsecured creditor's position is somewhat tenuous and as such, prospective creditors should take appropriate steps look at trustee's powers, loan purpose, application of monies etc.

Secured Creditors

The position of secured creditors is preferable to that of unsecured creditors. If security is taken over the trust assets then the lender will have direct recourse to those assets subject "as always" to some provisos. The lender should ensure that the security is valid. This goes to the validity of the trust and its proper formation, certainty of property and beneficiaries.

The essential difference between the secured and unsecured creditor is that the unsecured creditor may be exposed to a multitude of issues arising from breaches of trust in relation not only to the lending transactions but to other dealings by the trustee of which it has no knowledge.

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[10] Re Firth (1902) 1Ch342 at 345 where the Court said that the creditor had no access to the trust assets unless the trustee had a clear account and therefore a right to be indemnified.
[11] RWG Management Ltd v CCA (Victoria) (1985) V385 at 399
[12] Staff Benefits Pty Ltd [1979] 1 NSWLR

On the other hand the secured creditor's risk profile is somewhat less being restricted primarily, subject to the abovementioned exceptions, to the specific lending transaction it is entering into.

An interesting debate on trustee liability is developing in the UK. A consultation paper published by the UK Law Commission proposed that courts should be able to effectively override the exclusion clauses where reliance on them would be inconsistent with the terms of the trust.

In a discussion on the question of trustee liability Jane Borrows and Eoin Gillen[13] argue that the UK Law Commission proposals on preventing trustees from limiting their liability should not apply to capital markets trustees. Rather the provision of a flexible regulatory framework would be preferable to a regime which if the Law Commission's proposals are adopted could have negative implications for UK financial markets because it might become very difficult to get anyone to act as a trustee.

Whilst the discussion does not relate specifically to MIS, the fundamentals of liability and trustees' duties are the same. Interestingly, in the UK the role of a note trustee is more in the nature of an administrator notwithstanding its fiduciary duties. This contrasts with the position in New Zealand and Australia. Although again there has been an increasing tendency to limit trustees' duties, discretions and obligations, particularly in note issues and subordinated debt issues.

Moodys has challenged the reduced role of trustees with particular reference to securitization transactions and said that it would consider a downgrade in ratings if it considers that the trustee was not acting in a stringent supervisory capacity. It is generally accepted that a trust deed is not a contract, see earlier in this paper because it is enforceable by persons who may not be a party to it ie. the beneficiaries.

In an article in Butterworths Journal of International Banking and Financing Law[14] Martin Hughes argues that a trust deed could be a contract and that has implications for trustees' exemption clauses. He states in relation specifically to the role of note trustees in the UK "*The trust is created by the vesting in the trustees the benefit of the issuer's covenant to pay, which it holds on trust for the bondholders, but at the same time the parties to the trust deed, the issuer and the trustee, exchange a variety of promises which causes a contract to exist*".

Often for New Zealand unit trusts no separate contract for the management of the trust will exist but the specifics aspects relating to management remuneration etc. will be contained in the Trust Deed.

The question of trustee liability presents a number of issues from the more traditional limitation to the restriction of duties under documents. There is to some extent a tension between the requirements of the beneficiaries, the lenders and the trustee. As Hughes points out in his article "*the trustee's right to sit on its hands in the absence of a satisfactory indemnity – invariably an express term of any trust deed – provides real protection to the trustees*". Whilst this is true and common process in relation to bond issues, the argument is not so simple for unit trust lending transactions.

Greater demands from lenders and the shared fiduciary responsibilities of managers and trustees under Unit Trusts present specific challenges – the manager is responsible for the "business of the trust" the trustee is the ultimate "responsible person" and both will seek to limit their exposure in any lending transaction.

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[13] Is the UK wrong about trustee liability? – Jane Borrows Eoin Gillen – IFLR/September 2004 pp1218

[14] More Good News than Bad for Bond Trustees – Martin Hughes – White Case, Butterworths Journal of International Banking and Finance Law – September 2004, p310

COVENANTS

In my experience there is often a "tussle" regarding covenants. This arises primarily because of the different interests and roles. As we have noted, the manager is responsible for the day-to-day business of the trust and will initiate any borrowing or other transaction the trust is to undertake. However the trustee will usually be the borrower. Conventional loan documents will require numerous covenants, representations and warranties from the borrower. This of course is standard lending practice. The problem which arises is that because the trustee is not involved in the day-to-day management of the trust many of the issues covered by the covenants, representations and warranties may not be within the trustee's knowledge.

The solution in the writer's view is that the manager should be party to the loan documents and give the covenants, representations and warranties. This would place a greater degree of accountability on managers than perhaps is usually the case where the documents having been "agreed" are passed to the trustee for execution. The trustee will however normally be happy to warrant as to the due establishment of the trust, the ability of the trustee under the trust deed to enter into the transaction and to due execution of the loan and any security documents by the trustee.

CUSTODY

The role of the custodian in Unit Trusts is somewhat different between the Aus/NZ situation. The Corporations Act requires the appointment of a separate custodian whose principal role is to hold the trust assets as a bare trustee.

Under the UT Act there is no requirement to appoint a separate custodian as the obligation to hold the assets rests with the trustee who may, and often does appoint a separate custodian. Prior to a June 1998 amendments to the Act the custodian had to be the trustee's nominee company which presented practical difficulties for trustees especially when dealing with global portfolios. In a practical sense the provision was honoured in the breach. The subsequent change to the Act removed this restriction enabling trustees to appoint external custodians. This is a practical necessity given the diversity of investment options available. Corporate Trustees will want to be dealing with reputable global custodians given that the trustee is ultimately responsible for the actions of the custodian.

Generally custodians will want a lien over the trust assets against fees and will certainly want to limit their liability. Otherwise I do not think the custodial issues are too different.

NOMINEE COMPANIES

Invariably in New Zealand the trustee will not have assets registered in its own name but will use a subsidiary nominee company, mainly to separate the ownership of assets from other assets in its name, and separate the activities of the particular trust from the trustees' own operations.

Assets will usually be held in a Nominee Company and the manager will have the authority either expressly by virtue of the provisions of the UT Act or the Trust Deed and a more general delegation, pursuant to investment guidelines, to freely undertake transactions on behalf of the trustee within the specified parameters of the general investment policy and guidelines subject to the oversight of the trustee. Generally this works well in practice providing the underlying documents make it very clear what is to happen for example if the manager wishes to undertake borrowing on behalf of the trust. Sometimes this is necessary to cover short term positions on settlements and the like.

One area which has given rise to particular issues is that of real property owning unit trusts. As noted it is a requirement of the UT Act that the assets be in the name of trustee. However from the perspective of day to day activities of the trust whether it be engaged in buying, selling, developing or leasing property this presents difficulties.

Having the assets in the trustee's nominee company is not without problems because the trustee will then need to appoint directors of that company who will usually be employees of the corporate trustee and it is not uncommon, to be presented with a stack of documents to sign which requires all the usual representations and undertakings that a director would usually give. The trustee will have its limitation as a trustee and will usually carry Directors and Officers insurance and provide an" indemnity" to the employee to cover any liability arising from its employee's actions in relation to the trust.

Unfortunately it is not that simple because as you know while the indemnity may afford some measure of protection there may well be situations where the employee director could incur personal liability under general corporate law.

The professional trustee acting in this capacity should take the proper advice and ensure that when entering into such documents that the subject transaction is within the trust powers.

From a practical perspective notwithstanding sound drafting and appropriate advice ,trustees let alone their employees do not get paid for taking unnecessary risks and trustees have therefore sought ways to mitigate this risk.

One solution which works well where there are a number of properties in the trust is to have a nominee company which is the holding company for all the trust property companies. Each property is owned by a separate company. The trustee provides the directors for the holding company and appoints the directors of the property owing subsidiaries. These will usually be senior executives of the Manager.

The constitutions of the companies are restricted to certain activities which can be carried out without the consent of the trustee. In some cases the reporting provisions of the Trust Deed have been amended to enable the Trustee to more effectively monitor the activities of the property owning companies. A key point is ensuring an appropriate description of matters which must be referred to the trustees before implementation.

As the shareholder the trustee has the ultimate veto power in that it can remove the directors

Directors of Corporate Trustees

A final point worth mentioning is that directors of trustee companies have an additional overlay of director responsibility because as well as their normal director's duties they have the additional responsibilities imposed on them in their trustee capacity, and they may be liable for debts incurred where the trustee has no right of indemnity. It would be an interesting "can of worms" where there was an employee director of a trustee nominee company, a lending enforcement and no indemnity because of a breach of trust.

An interesting and controversial decision[15] which has attracted adverse comment on the issue of liability of Directors of Corporate Trustees was given by the Full Court of South Australia.

The decision gave strong support to section 197(1) of the Corporations Law which makes directors of trustee corporations liable for debts and other obligations incurred by the corporation as trustee, if the Corporation cannot discharge the liability and is not entitled, or there are insufficient assets to be fully indemnified against the liability out of trust assets.

Briefly the facts of the case were that Daroko Pty Ltd was the trustee of Daroko Unit Trust and Mr Hanel was the sole director of Daroko Pty Ltd. The trust deed contained an adequate trustee indemnity provision.

Mr O'Neill owned premises of which Daroko was the tenant under a fixed lease. Daroko failed to pay rent and quit the premises two years before the lease expired. Prior to this, it distributed all of its income to its unitholder Forcett Pty Ltd in its capacity as trustee of a trust connected with Mr Hanel and as a consequence Daroko Unit Trust had no funds or assets to pay the rent.

Daroko found a sub-tenant to takeover the lease on the same terms but the landlord rejected this offer and got judgment against Daroko for approximately $23,000 being damages for early termination. Daroko did not pay. O'Neill claimed that Forcett as a beneficiary of the Daroko Unit Trust was liable to indemnify Daroko and sought an order under section 197(1) of the Corporations Act that Hanel was liable, as Daroko's sole director, to pay the judgment. The Magistrate gave summary judgment against Hanel on the grounds of section 197(1). The Court of Appeal (Debelle J dissenting) decided that a director of a corporate trustee will be liable individually and jointly with the corporation and other directors, for liabilities incurred by the trustee if there are insufficient trust assets to meet them, even if the trustee has a legal right to indemnification but the trust itself has no assets.

As Cooper[16] notes the decision in Hanel if correct, has significant implications for directors with potentially much wider liability, costs of insurance, and potential impact on all directors of corporate trustees.

He also suggests directors could be protected from section 197(1) in the Trust Deed other than where "dishonest intentions/or reckless conduct is involved". Although other possible solutions might involve using an SPV to hold trust assets, legislative reform is probably the most efficacious solution.

Happily for New Zealand trustees there is no equivalent legislation in New Zealand and I understand that there are strong efforts being made in Australia for legislative reform.

CONCLUSIONS

Although there are differences between the Australian and New Zealand situation, many of the issues are similar, with the Corporations Law being more prescriptive in terms of the detail on governance and regulation than the UT Act.

The respective rules for RE Trustee and Manager are subject to the general overlay of trustee law.

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[15] Hanel v O'Neill (2003) 48 ACSR 378; (2004)22 ACLC 274; [2003] SASC409. For an excellent discussion on this case see also "The Liability of Directors of Corporate Trustees" and the decision in Hanel v O'Neill, Jeremy Cooper Partners, Blake Dawson Waldron, Melbourne – on http://cclsr.law.unimelb.edu.au/researchpapers University of Melbourne Centre for Corporate Law and Securities Regulation published by University of Melbourne with permission from Lawbook Co. Diccon Loxton opcit

[16] J Cooper Opcit

It might also be argued that the MIS regime has slightly more "draconian" provisions than the UT Act in terms of penalties. There are issues for trustees both in terms of liability of the company and their directors. In New Zealand because there is a separate manager and trustee, this can give rise to problems with covenants when entering borrowing arrangements. This does not arise in Australia because there is only one entity.

Specific care will need to be taken in relation to the power of the trustee to enter into any borrowing arrangement especially if the borrowing is to be unsecured. Although again in a practical sense such borrowing is generally more likely to be secured.

There are some fundamental "ground rules" which apply when lending to trusts and these rules are also relevant in the MIS context. Trusts are different to companies and lenders particularly unsecured lenders should take specific care when lending to trusts and MIS.

The MIS regime is probably more "creditor friendly" than the New Zealand situation given the tighter regulatory environment. The manager of a unit trust has fiduciary duties by virtue of the UT Act and the writer suggests it would be appropriate to managers to be party to loan documentation particularly in relation to covenants, representations and warranties.

Notwithstanding the general rights of trustees to be indemnified from the trust assets, there are situations where the "right" to indemnity might be lost to the trustee and as a consequence trust creditors.

There are also issues for directors of corporate trustees and potential pitfalls for employee directors of nominee companies of the trustee.

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