

A Trustee's Guide to Litigation Pitfalls

By Kate Davenport QC &
Lama Almoayed

Kate Davenport QC practices at Bankside Chambers in Auckland and has extensive experience at litigating issues arising out of trustee's obligations and is a contributing editor to LexisNexis Law of Trust. Lama Almoayed is a junior barrister at Bankside Chambers.

It is often a surprise for lawyers, who have cheerfully assumed the role of a trustee, to realise how easily they can be exposed to litigation risk. This is particularly true for those who accept the role as independent trustee for private clients.¹ Marriages all too frequently crumble and the disgruntled children of earlier marriages can make life difficult for trustees. This short article addresses some of the pitfalls which a prudent trustee should consider and (hopefully) avoid.

Here are some things that you might like to consider before agreeing to become a trustee.

1. What is in the trust deed?

This might seem self-evident however many trustees do not acquaint themselves with the terms of the trust.² A common form of trust are those benefiting a large class of discretionary beneficiaries that give trustees wide powers. However, older trusts sometimes limit the powers of trustees, limit classes of beneficiaries, or prevent trustees from charging for their time or making decisions which benefit themselves (which is potentially tricky if a trustee is also a beneficiary)³. The lesson to be learned is: know the trust before you make any decision, in order to prevent problems cropping up later.

2. Know who you are dealing with and what pitfalls you might face

It is very important that you understand exactly who the potential beneficiaries of the trust are. If the trust has a husband and wife as settlors, and the primary beneficiaries are the couple and their children, understand what their needs might be, ask what will happen in the (hopefully unlikely) event that the couple separate. Do they have a joint power of appointment?⁴ What will happen if they cannot agree on what is to happen to the trust

¹ Often for a husband and wife, or for a surviving spouse where there are children from earlier marriages.

² See too Trustee Act 1956, section 2(4) and (5); *Hallows v Lloyd* (1888) 39 Ch D 686, 691 per Kekewich J.

³ The Court of Appeal in *Clayton v Clayton* [2015] 3 NZLR 293 note at [46] that it is well established that a person can be both settlor and trustee of a trust, and both trustee and a beneficiary of a trust.

⁴ This is a potential pitfall for solicitors when establishing trusts. In *Kilkelly v Arthur Watson Savage Legal* (HC, Invercargill, CIV-2006-425-148) (2007) a family trust was created for asset protection purposes. Mr and Mrs Kilkelly were the trustees, and the primary objective of the trust was to provide for Mr and Mrs Kilkelly and their daughter. After separation, Mr Kilkelly used his status as the sole appointer to remove Mrs Kilkelly as trustee. Mrs Kilkelly argued that she thought that her and her husband would have equal power and control as trustees and she did not realise that there was no joint power of appointment. The Court held that if Mrs Kilkelly had received appropriate independent advice about the implication of Mr Kilkelly's sole power of appointment and removal, she would not have entered into the transaction upon the same terms, or would have refused to cooperate on the formation of the trust and the transfer of relationship assets to the trust. See too *X v X* [2007] NZFLR 502.

on separation?⁵ Will they both agree to resign in these circumstances and allow the independent trustee to appoint someone else with him or her to administer the trust property for the benefit of the estranged couple and their children? All too frequently independent trustees of “family trusts” can end up taking the side of one spouse over the other. This should be avoided at all costs. If in doubt as to what to do, seek advice.

3. Consider the indemnity clauses and what protection they offer

Many trustees now opt to become trustees through a trustee company, giving them protection from potential exposure to litigation, but a trustee should ensure that the indemnity extends not only to the trustee personally, but also the directors of any trustee company. Remember, an indemnity clause may not cover breach of trust.⁶

Understand what the debt position of the trust is and your potential exposure. Can the trust service its debts? What indemnities have been given to previous trustees? Trustees should be aware of a recent decision that says that trustees (including former trustees) can caveat the title of trust property to protect their indemnity.⁷

Some trust deeds provide for a majority decision of trustees but this has potential risks too – in what circumstances is a majority decision not permissible?⁸ For example, does it cover sale of all trust assets? Check that any land owned is unencumbered or if not, understand the extent of any mortgages secured over the land.

4. Has the trust been well managed?

Family trusts which own property now require an IRD number. A prudent new trustee should ask to look at the accounts and understand the financial position of the trust. This can be particularly important when dealing with clients who have had more than one marriage and where there is likely to be competition for the financial resources of the

⁵ *Buckeridge v Buckeridge, McKenzie and SHB Trustees Ltd* [2015] NZHC 2231 [16 September 2015]; Mr Buckeridge applied to the Court to have Ms Buckeridge removed as trustee of the Trust. Since separation, Ms Buckeridge failed or refused to respond to any attempts by Mr Buckeridge to manage the Trust and deal with the Trust property. The Court made an order to remove Ms Buckeridge as trustee. See also in *Potter v Duffy* [2015] NZHC 544.

⁶ The law as outlined in *Armitage v Nurse* [1998] Ch 241 allows exemption clauses to be used to exempt a trustee for liability for a breach of trust as long as the trustee acts in good faith and in the honest belief that he or she is acting in the best interests of beneficiaries. See also AS Butler and DJ Flinn, *What is the Least That We Can Expect of a Trustee? Exclusion of Trustee Duties and Exemption of Trustee Liability* [2010] NZ L Rev 459.

⁷ *Official Assignee v Menzies* [2011] BCL 195. Judge Bell accepted that an equitable lien, with its associated power to have the property the subject of the lien sold, came within the property and powers of the bankrupt under s 42 of the Insolvency Act 1967. His Honour observed that a trustee’s liability must be the subject of an order that there is a caveatable interest in land. He found that there was a caveatable interest arising out of an equitable lien. This case and its reasoning has been criticized in some subsequent academic writing.

⁸ In *Cadman v Visini* (HC, Auckland, CIV-2009-404-007925, 30 May 2011), breach of trust was argued when the trustees issued proceedings without the unanimous decision of all three trustees. The Court held that a clause allowing majority decisions in the event of disputes or differences between trustees could not apply here, where Mr Wood was not aware of the matter and did not express differing views.

trust between children of different marriages or a subsequent spouse and children of the previous marriage(s).

It is important to ensure that the trust has up to date financial records and a trust minute book that records all resolutions and decisions made by the trustees (even the ones which are simple family husband and wife trusts).⁹ Beneficiaries can inspect these records but frequently only ask to do so when relationships with trustees are strained.

5. **Duties of trustees**

As a trustee you have three immutable duties which you cannot escape. A duty to act in good faith, to act honestly, and to act in the best interest of the beneficiaries.¹⁰ Do not forget, however, that if you are a lawyer you have overriding professional obligations. For example, under the Financial Transactions Reporting Act 1996, trustees must report any unusual trust settlements or transactions. A professional trustee must also be aware of the customer due diligence (CDD) requirements under section 11(1) of the Anti-Money Laundering and Countering Finance of Terrorism Act 2009.¹¹

6. **What does the settlor want?**

Ask the settlor(s) for a memorandum of wishes.¹² Discuss with them the circumstances in which following their wishes might not be possible. If a memorandum of wishes is not to be followed, trustees need to make sure that they document the reasons for it.

7. **You are expendable!**

Trustees often overlook the fact that if all the beneficiaries are legally competent and in agreement, or if there is only one beneficiary, then the beneficiaries may wind up the trust without reference to the wishes of the settlor or the trustees.

⁹ Westlaw NZ Online, *Working with Trusts* (Thomson Reuters, New Zealand) at 5.5 “Trustee Administrative Procedures”.

¹⁰ *Armitrage v Nurse* [1998] Ch 241. See also AS Butler and DJ Flinn, *What is the Least That We Can Expect of a Trustee? Exclusion of Trustee Duties and Exemption of Trustee Liability* [2010] NZ L Rev 459.

¹¹ According to the Department of Internal Affairs’ Financial Integrity Team, the key starting point is asking “does the professional trustee have authority to act on behalf of the customer, more than 25% ownership, or effective control?” If the answer to any of these questions is yes, there is a need to do CDD. Professional trustees may meet the beneficial ownership threshold as a result of their inclusion in the legal ownership of the customer. See at http://www.dia.govt.nz/diawebsite.nsf/wpg_URL/Services-Anti-Money-Laundering-AMLCFT-News-and-Information#1.

¹² Note that a letter of wishes that was signed by all the adult beneficiaries was held to have amended the terms of the trust and granted the wife part of the trust property in *Re Turino Consolidated Ltd Retirement Trust* [2008] JRC 100.

8. But you do matter!

Trustees have an obligation to act personally and unanimously.¹³ They are accountable to the beneficiaries of the trust and required to account to them for the proper administration of the trust.¹⁴ This means that as trustee, you need to be more than a sleeping partner – you need to actually make decisions and participate in the trust’s administration. Don’t accept the word or assurances of the other trustees.

9. Litigation

A trustee can become involved in litigation in two ways: either as the hapless bystander of a fight between two other trustees (often former spouses or de facto partners) in which the trust has become paralysed by the inability of the trustees to agree and application to the Court is necessary,¹⁵ or where the decisions of the trustees are challenged. In the first case, the trustee(s) might wish to apply to the Court for directions or interim orders, including removal of trustees. This way the trust may continue to function.

The High Court has powers under the High Court Rules to preserve any trust property if this is a subject of concern in any High Court litigation.¹⁶

10. If in doubt – apply to the Court

Trustees can seek directions from the Court under section 66(1) of the Trustee Act 1956 concerning any property subject to the trust or for directions in respect of the administration of the trust.¹⁷ Trustees can also apply to the Court under section 64 of the Trustee Act to authorise dealings with trust property and variations of trust.¹⁸

¹³ Unless the Trust gives the trustees the right of a majority decision. *Luke v South Kensington Hotel Co* (1879) 11 Ch D 121; *Pilkington v Inland Revenue Commissioners* [1962] 3 All ER 622; *Duncan v McDonald* [1997] 3 NZLR 669 AT 679; *Niak v Macdonald* [2001] 3 NZLR 334 at [16]; *Rodney Aero Club Inc v Moore* [1998] 2 NZLR 192.

¹⁴ AS Butler and DJ Flinn, *What is the Least That We Can Expect of a Trustee? Exclusion of Trustee Duties and Exemption of Trustee Liability* [2010] NZ L Rev 459 at 465.

¹⁵ *X v X* [2007] NZFLR 502.

¹⁶ Judicature Act 1908, Schedule 2, HCR 7.55 “Preservation of Property”.

¹⁷ *Neagle v Rimmington* [2002] 3 NZLR 826 concerned an application by a former trustee, Ms Neagle, to the Court for directions. Differences arose between Ms Neagle and the other trustees as to the nature and extent of their rights and obligations as trustees. The Trustees censured Ms Neagle three times for her conduct as a trustee. Ms Neagle sought orders and directions under section 66 of the Trustee Act 1956. The Court held that section 66 was designed to remove doubts as to the propriety of a course of action being contemplated by the trustee. It had no application to past or historical actions of the trustee. Directions given under section 66 were required to direct trustees on how to proceed in a contemplated situation, where the facts were clear and no breach of trust was alleged. In this case, there were substantial factual disputes and implicit allegations of breach of trust.

¹⁸ In *Rocket Surgery Limited v Goodwin* [2012] NZHC 2752 the Court held it was empowered by section 64 of the Trustee Act 1956 to authorise a range of dealings with trust property. Section 64 was held to have a broader purpose than section 64A and authorises a broader approach on the part of the Court.

11. If your decisions are challenged: Consider a Beddoe Application

If trustees are in doubt about whether to defend or bring proceedings, they can make a Beddoe Application to the Court for directions.¹⁹ The trustees disclose all the strengths and weakness of their case, often by providing counsel's opinion. They lay the case in support of their actions before the Court and the material is read only by the Court. The Court may approve the trustees defending litigation brought against them or support them bringing proceedings themselves. The order will normally provide that the trustee may recover costs and expenses incurred from the trust itself.

12. What do we have to disclose?

The documents that a trustee must give a beneficiary, and the documents that the beneficiary may obtain during the discovery process may differ. A beneficiary is entitled to receive information concerning the proper records of the trust, titles of the trust property, nature and content of their beneficial interest and accounts.²⁰ Beneficiaries are not necessarily entitled to any other documents.²¹ In litigation however, further documents may be ordered to be discovered.

I have seen many cases where refusal to provide records has aroused suspicion in beneficiaries and led to proceedings being issued to remove the trustees. In my view, if at all possible, trustees should be open with the beneficiaries. By this I do not mean that you necessarily need to make the beneficiaries part of the decision-making process, but beneficiaries should be generally informed about the workings of the trust. Too much secrecy engenders distrust.

¹⁹ *Re Beddoe, Downes v Cottam* [1893] 1 Ch 547; *Woodward v Smith* (2014) 3 NZLR 525 at [27].

²⁰ The Court in *Furness v Public Trustee* [1921] 40 NZLR 898 at 901-902 held that if the trustees fail to keep appropriate financial accounts, the Court will allow prime accounting records such as bank statements or books, cheque books, receipt books and other documents belonging to the trustee to be inspected. *Armitrage v Nurse* [1998] Ch 241; *Foreman v Kingstone* [2004] 1 NZLR 841 at [82]-[85]; *Burrows v Walls* (1885) 43 ER 859 per Lord Cranworth LC at 866; *Low v Bouverie* [1892] 1 Ch 68 per Lindley LJ at 99; *White v Lady Lincoln* (1803) 32 ER 395 per Lord Eldon at 397.

²¹ In *Breakspear v Ackland* [2008] EWHC 220 (Ch) the Court considered the question of whether beneficiaries of a discretionary trust have a right to see a letter of wishes. The trustees refused the request on the grounds that the letter was confidential, its disclosure could lead to family discord and that the beneficiaries had no entitlement to disclosure. The Court identified that the general principle that beneficiaries are ordinarily entitled to see trust documents is subject to the qualification that trustees are not required to disclose their reasons for exercising discretionary dispositive powers as the process is inherently confidential. Such confidentiality exists largely for the benefit of the beneficiaries. Letters of wishes are provided to assist trustees in the exercise of their discretion; they assist in the exercise of discretionary powers, an inherently confidential process, and the starting position is that they are confidential. In the circumstances, however, the trustees intended to seek the court's sanction for a scheme of distribution of the trust fund, and the wish letter was a key document to be taken into account by the trustees and relevant to the court's approval of the scheme. The risk of family division occasioned by disclosure was then outweighed by the requirement to give the claimants a proper opportunity to address the Court on the question of sanction, thus disclosure was ordered. The Court in *Foreman v Kingstone* [2004] 1 NZLR 841 stated that in New Zealand a fundamental duty of trustees was to account to the beneficiaries for the administration of the trust. Also, a court should always be mindful of the trustees' fundamental duty to inform beneficiaries of their rights, which must carry with it the right for the beneficiaries to inspect documents of the trust from which their rights may be deduced.

13. Some recent cases of interest to trustees

The Supreme Court has heard the appeal in *Clayton v Clayton* and its decision is awaited. This decision should resolve issues relating to circumstances in which there can be an illusory trust, and whether there is a distinction between an illusory trust and a sham trust.

The Court of Appeal in *New Zealand Maori Council v Foulkes*²² highlighted the importance of accountability for trustees; a trust will only have to reimburse a trustee for any *reasonable* costs incurred.²³ The Court also found that the power to appoint new trustees is of a fiduciary nature because the subject matter of the power is the office of the trustee, that office lies at the core of the trust and the office carries fundamental obligations to act in the best interests of the beneficiaries.²⁴ As such, this power could not be delegated to a third party, must not be exercised for a collateral purpose, and it didn't matter that the party exercising the power was not a trustee, it was the object and purpose of the power that was decisive.²⁵

It's also helpful to note the principles of interpretation that apply when the terms of a trust are unclear. This was discussed by the High Court in *Re McCaw Lewis Trustees (No 4) Limited*.²⁶ The Court held that similar principles apply to the construction of trust deeds as apply to the construction of contracts.²⁷ These principles were set out by the High Court in *Bulley v Attorney-General*.²⁸

In conclusion:

A trustee has significant obligations to beneficiaries. It is not a role that should be assumed without proper due diligence and a clear understanding of a trustee's duties and responsibilities.

²² *New Zealand Maori Council v Foulkes* [2015] NZCA 552.

²³ The Court finds, at [33], that the trust paying legal costs exceeding \$2 million was unacceptable. It was wrong to expect a deserving beneficiary to bear the cost of unproductive litigation, when the parties should have acted in a responsible, cooperative and cost efficient manner.

²⁴ At [22].

²⁵ At [22].

²⁶ *Re McCaw Lewis Trustees (No 4) Limited* [2014] NZHC 2627 at [19].

²⁷ At [19].

²⁸ *Bulley v Attorney-General* [2012] NZHC 615.