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TrustLaw

This newsletter is produced by Brookfields' Trusts and Management Services Team. The articles will keep you up to date on recent cases and information in the fields of trusts management and asset planning. Should you have any queries on the content of any of these articles, please contact a member of the team (details over).

Trusts - When Things Go Wrong

Black clouds are looming on the economic horizon and as a consequence many trustees may need to consider whether their trust will withstand the storms.

Asset protection and asset accumulation or growth are arguably the main reasons for forming trusts in New Zealand. But trusts are not immune to the vagaries of the economy and markets. Even if the trust has:

- a regular income stream from investments (shares, property, cash);
- holds both income and non income producing assets;

things can still go wrong and the trust assets can be vulnerable to attack.

Common Situations

The most common situations that will cause problems are:

- excessive borrowings;
- a drop in asset values;
- the trust assets have been used as security for the company/personal borrowings of a beneficiary, or the person who established the trust;
- guarantees given by trustees to secure the beneficiary's company/personal loans;
- loss of income stream from the beneficiary's company or settlor's own earnings;
- loss or reduction of an income stream from trust assets.

A Typical Scenario

Regrettably these situations will tend to occur together. In a typical example a family trust will hold:

- a residential property lived in by trust beneficiaries;
- a beach house used by the trust beneficiaries;
- shares in the family company

The trustees owe nothing on either the home or beach house. However, loans to the family company from the bank are secured by way of mortgages over the two trust properties and an unlimited liability guarantee from the trustees.

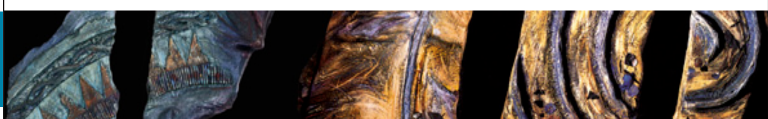
What happens if the company loses a major contract and is unable to meet loan repayments? The bank calls in its security and unless the loans can be refinanced or renegotiated, the trustees may have a limited time to repay or refinance the loans elsewhere. Failure to do something may mean that the properties can be sold by the bank as mortgagee.

The trustees may then be forced to quickly sell either one of both the properties to avoid a mortgagee sale. The full value of the property may not be realised. The trustees are now the owners of a trust fund that has been seriously depleted. The company shares have little or no value and the trust properties have been sold to pay non-trust borrowing.

The Aftermath

The original decision of the trustees to provide a guarantee to the Bank for the company's borrowings from the Bank has been their undoing.

Trustees, when making decisions relating to the trust fund, must always consider that they are holding the trust fund for the benefit of a number of beneficiaries not just the settlor/s.



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At this point some questions arise, and may be questions which are asked by beneficiaries:

1. Why did the trustees provide the guarantee in the first place?
2. The trustees are shareholders of the company and must sign resolutions for all major transactions – this includes borrowings. Did the trustees consider the purposes of the borrowing adequately and the capacity of the company to cope with borrowings?
3. Did the trustees monitor their liability under the guarantee, for example at annual meetings of the company and by reviewing the company's financial statements carefully each year?

Case Law

This issue was discussed in a UK case where it was held that where a trustee holds a controlling shareholding in a company, then the trustee has a duty to monitor the activities of the company and should, as the need arises, exercise the shareholder voting rights. Where a trustee fails to adequately supervise the company directors and the trust fund suffers a loss in value, then the trustee may become subject to a claim from the beneficiaries. In this case the trustee was held personally liable to make good the loss that had been suffered.

Lessons and Guidance for Trustees

Should the trust assets have been used to secure the company's borrowings? Was the trustees' decision to provide a guarantee a good decision which was for the benefit of all the beneficiaries of the trust? Did the trustees have the power to do this under the trust deed? One of the core trustee duties is to know the trust deed and adhere to its terms. If there was no power in the trust deed to provide guarantees to others, the trustees will be personally liable for the loss.

Have the trustees invested the trust fund as provided in the trust deed and/or trust law? The Trustee Act 1956 provides that ordinary non-professional trustees, when exercising the power of investment, shall exercise the care, diligence and skill that a prudent person of business would exercise in managing the affairs of others.

Could the trustees be personally liable to make good the loss to the trust fund? Yes, if it can be established that the trustees have breached their duties and as a result the trust fund has suffered a loss. A breach of trust will give rise to an action against a trustee by a beneficiary. Potentially trustees' liability for their actions can remain for many years. The beneficiaries' potential cause of action may lie dormant for many years before they discover it and then initiate proceedings.

The over-riding lesson of the above example is that trustees must always be vigilant when dealing with assets when they have, or should have, their trustee hat on. To be influenced by the needs of a company in which the trustees were the major shareholders, to the exclusion of the need to protect trust assets and the interest of all beneficiaries, calls into question the quality of the trustees' decision making and whether they have properly discharged their duties as trustees.

If you wish to discuss any matter raised in this article with us please call either Howard Johnston or Alison Gilbert. In further issues of TrustLaw we will continue to examine some of the difficult situations in which trustees may find themselves in the present economic climate.

Talk to our team for advice on any of these matters.

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