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Review of Trust Law in New Zealand: Introductory Issues Paper

The New Zealand Law Society (Society) welcomes the opportunity to respond to the questions posed in the *Review of Trust Law in New Zealand: Introductory Issues Paper 19, November 2010* (Issues Paper). This submission has been prepared with assistance from the Trust Law Review Working Group, formed by the Society's Property and Family Law Sections.

Q1: Some academics are of the view that discretionary trusts and powers have been more or less assimilated, and trust deeds with significant powers of appointment seem to be common. Despite these factors, where the deed provides for final beneficiaries, with a vested interest in the capital residue at termination, is a trust always created?

Where a trust deed provides for final beneficiaries to have a vested interest in capital at the termination of the trust, a trust would always be created where the rules in *Saunders v Vautier*¹ do not apply.

The Society agrees that trust deeds containing extensive powers of appointment are commonplace. In practice there is little understanding of the distinction between discretionary trusts and mere powers, and what is meant by, say, "hybrid" or "intermediate" powers.

However, as a legal and trust matter, important conceptual distinctions and consequences are still recognised by the law in this context, as is illustrated by the Supreme Court decision in *Kain v Hutton*².

¹ 49 ER 282, (1841) 4 Beav 115

² [2008] NZCA 122

Q2: Does the law of trusts apply to powers of appointment within a trust merely because the person who has the power is also a trustee?

There is longstanding legal authority to support the proposition that trust law principles apply to powers of appointment where those powers are vested in a person on terms that establish that person as a fiduciary (trustee).

The answer to the question is therefore “yes”. In modern trust practice, mere powers of appointment are packaged in a “trust-like” framework in modern discretionary trusts so, as John Glover observes (note 174, Issues Paper), “trusts and powers are blended together” in the legal concept known as the *discretionary trust*.

Q3: Is it possible to define the interest of beneficiaries in a trust generally; or does this depend on the trust deed in question and the factual and statutory context?

The vast majority of family trusts in New Zealand are discretionary trusts that generally do not identify any specific “interest” in the trust property as belonging to a particular beneficiary. The law is clear in New Zealand (confirmed by a line of appellate authority) that such a beneficiary has a mere *expectancy*, which is not a conventional proprietary interest. Such an interest is held in abeyance under the terms of the trust until such time the trustees determine at their discretion that a beneficiary should benefit.

Many trusts in New Zealand have:

- (a) discretionary beneficiaries (who might better be described as objects of powers of appointment in relation to income and capital); and
- (b) default beneficiaries.

The objects of the powers of appointment have:

- (i) the right to compel proper administration of the trust,
- (ii) an expectancy, and
- (iii) an “interest” in the wide sense of the term (*Gartside v IRC*).

The default beneficiaries have a property right that is contingent (they normally need to be alive on the wind up date) and determinable (they lose their property right if the powers of appointment are exercised for someone else). This is a very common form of trust.

In short, the rights the beneficiaries have depend on the trust deed.

It should also be noted that “property” is an elastic term. Whether any of the beneficiaries’ rights amount to “property” depends on the meaning of “property” under the statute (or other law) in question.

There are also private trusts that contain fixed interests in an identifiable sense, where it is possible to “identify” the beneficiary’s interest in the trust at any point in time. For example, pension and unit trusts.

The Society considers that whether the interest of a beneficiary in a trust can be defined as a matter of law, will depend on the type of trust and the factual and statutory context.

Q4: Is the title split (into legal and equitable estates or interests) a helpful concept that should be part of a definition of a trust in New Zealand?

The Society considers that the “title split” is a helpful concept. The separation of legal and equitable estates is the core legal construct of a trust that distinguishes this legal relationship from other types of legal vehicle, such as a partnership or company.

It is difficult to understand the rationale for moving away from the “title split” concept and adopting a legislative concept of trust that is not consistent with the common law meaning of that term. Doing so would also be inconsistent with international trust practice and precedent relevant to New Zealand law and established commercial and private dealings.

Q5: Are you in favour of a legislative definition of a trust in a new New Zealand Trusts or Trustee Act?

The Society has considered carefully whether a legislative definition of a “trust” should be included in any new trust legislation.

The **advantages** of providing a specific definition include:

- (a) It could assist with clarifying the type of legal (trust) relationship intended to be covered by the legislation.
- (b) It could provide the general public with a better understanding of what a trust is, as a legal matter.

- (c) It could codify or declare the common law notion of trust for the purposes of New Zealand law.
- (d) It could identify (by express exclusion) what types of legal relationship do not constitute a trust for the purposes of the legislation.
- (e) It could be helpful when addressing the meaning of the trust concept in other legislation (such as the Income Tax Act 2007, where there is a link to the Trustee Act 1956 definition for certain taxation purposes).
- (f) It should assist with the interpretation and administration of thousands of New Zealand trust relationships by providing some clear guidance as to what those relationships comprise.
- (g) It could be helpful even if drafted in a general and descriptive way (i.e. outlining the fundamental elements in a trust relationship, and listing exceptions), as opposed to being drafted in a specific and exhaustive way (assuming this is possible).

The **disadvantages** of providing a specific definition of trust include:

- (a) It could create a tension between the purpose and role of the legislation and what have always been private (unregulated) legal relationships. (That is, if the legal relationship does not meet the statutory test it is not a trust, which is consistent with the legislative approach to “unit trusts”, “superannuation trust arrangements” and the like).
- (b) It might unduly restrict ongoing developments in the common law as to what constitutes a trust for legal purposes.
- (c) It might create difficulties for more specific statutory notions of trust that already appear in other legislation, such as unit trusts and charitable trusts (which are a subset and specific type of trust with their own legislative definitions).
- (d) It might constrain judges in particular cases from finding the existence or otherwise of a trust.

- (e) Lawyers, commentators and international trust legislation have usually eschewed attempts to come up with anything other than a general and descriptive definition, which suggests that providing a workable statutory definition is likely to be too difficult to achieve.

The key question is what real purpose will be served by providing a definition.

There can be no doubt that the concept of a *trust* is already well understood by lawyers and the business community, and a definition will be of no assistance to them. To the extent that the wider public have difficulties with the notion of a trust, it is difficult to see how a statutory definition will advance their knowledge in any material way.

It might however be helpful for the Law Commission's final reports to include some practical illustrations or examples (say, of what is/is not a trust), to inform the public. Illustrations of this type would be difficult to capture in a specific definition or legislation (even if a general descriptive definition of the core components of a trust is adopted).

The Society is not persuaded that a statutory definition of trust in any proposed new legislation is necessary. The development of trust law in New Zealand has not been impeded by the absence of an adequate definition. Many other jurisdictions have also not considered a definition desirable, outside certain specific legislative contexts where a definition is important (for example, legislation governing unit trusts or pension trusts). In practice, questions of interpretation can arise at the margin around concepts like the existence of a "bare trust" or "constructive trust". The resolution of such questions is always fact-specific and has not presented material problems for the Courts. In most respects it is better to leave the questions open for interpretation on a case-by-case basis.

Q6: If so, which of the options do you prefer – or do you have an alternative suggestion?

The Society is not in favour of a legislative definition, so it states no preference for the options in the Issues Paper, nor does it have an alternative suggestion.

Q7: If not, what would be a useful working definition for this review?

A number of the definitions in the Issues Paper – i.e., those contained in the American Law Institute *Restatement of the Law of Trusts*, in *Underhill & Hayton Law of Trusts & Trustees* or in Article 2 of the Hague Convention on the Law Applicable to Trusts and Their

Recognition – provide some guidance on what might comprise a useful working definition for the review. However, they all have limitations.

For example, the notion of a “fiduciary relationship” is central to the American *Restatement* definition, which is probably a wider trust concept than has been used in practice in New Zealand. Although Professor Hayton’s definition is closer to New Zealand trust practice, it too is incomplete because it does not deal with trusts for purposes. Finally, as Professor Watters notes, the Hague Convention definition “embraces a wider understanding of the trust idea” than has traditionally been used in Commonwealth jurisdictions.

The Society does not believe that a statutory definition is necessary. It also considers that it is unnecessary at this stage to develop a working definition, given the broad framework for the Commission’s review of trust law. However, if a working definition is considered necessary, the Society suggests the following:

“When a trust arises

A trust is a legal relationship that arises where:

- (1) *A person (called a trustee) holds or is entitled to hold title to property (called trust property) to either:*
- (a) *deal with the trust property on behalf of another person or persons (called beneficiaries); or*
 - (b) *deal with the trust property for a purpose for which purpose trusts may be lawfully carried out (called a trust purpose);*

and

- (2) *The trustee is under a fiduciary duty to deal with the trust property for either:*
- (a) *the benefit of the beneficiaries; or*
 - (b) *the trust purpose (as the case may be).*

Attributes of a trust

A trust has the following attributes:

- (i) *The trust property is a separate fund and is not part of the trustee's personal estate;*

and

(ii) *The trustee's fiduciary duty is a duty of loyalty which requires the trustee to:*

(1) *Always act honestly and in good faith; and*

(2) *Not make a profit from the trust except to the extent the trustee is expressly or impliedly authorised to do so or general trust law allows; and*

(3) *Not put itself in a position of conflict in relation to the trust except to the extent the trustee is expressly or impliedly authorised to do so or general trust law allows;*

and

(iii) *The trustee is also under a duty to comply with the other express or implied terms of the trust and otherwise comply with general trust law except to the extent the trustee is expressly or impliedly authorised not to; and*

(iv) *The trust is attached to the trust property and is enforceable against third parties dealing with the trust property (subject to special exceptions); and*

(iv) *Where the trustee holds the trust property to deal with it on behalf of beneficiaries:*

(1) *Any one or more of the beneficiaries may enforce the trustee's duties against the trustee; and*

(2) *The beneficiaries (whether individually or as a group as the case may be) have equitable property rights in the trust property; and*

(3) *The trustee may be a beneficiary so long as the trustee is not the sole trustee and sole existing or potential beneficiary at the same time."*

Q8: Which provisions of the Act are out of touch with modern drafting practices? Are there any particular limitations or omissions in the existing provisions that you would like to see remedied?

Not surprisingly given the age of the Act, its provisions do not reflect modern drafting practices. Modern drafting tends to use plain English, and has shorter and tighter rules, global definitions to deal with technical concepts, and less duplicative and unnecessary language.

Some sections in the Act are impenetrable (for example, ss31, 40, 43, and 76). Some of these provisions have been earmarked for amendment.

In addition, the existing legislation is not well ordered and streamlined according to subject areas. For example, with careful drafting the Court's powers in Part 5 should be able to be recast into a few provisions and "Trustee Powers" should be listed and drafted in a simpler and more user-friendly manner.

It may be possible to give trustees all the powers of natural persons, as is done in the Companies Act 1993, and thereby limit the number of specific power rules. However, many of the rules contain limitations and conditions that have to be met so they will have to be clearly articulated.

As noted, some deficiencies in the existing legislation have been identified in the Issues Paper, but others include the need for:

- (a) clear rules dealing with beneficiaries' rights in respect of access to the Court for things like directions and accessing information from trustees;
- (b) clear trustee "investment" rules contained in their own discrete part (using sound principles from the 1988 Amendment Act and some of the rules in the English Trustee Act 2000) and covering trustee delegation and title to investment documents; and
- (c) clearer rules dealing with variation and modifications to trusts.

Q9: Do you think that the Act should continue to contain a combination of default and mandatory rules? If so, which should be mandatory?

The Society supports the recommendation at paragraph 4.49 of the Issues Paper to allow a combination of default and mandatory rules to be reflected in the new legislation.

This will confirm traditional and international trust norms and practices and, most importantly, will emphasise that trust relationships are *private* rather than *public* relationships, unless the particular trust has a public profile.

However, clear mandatory rules to protect the interests of beneficiaries (many of whom are minors), to ensure proper administration of trusts, and to establish the obligations and rights of trustees, need to be included in any mandatory rules. These would cover things such as:

- (a) a beneficiary's access to trust information;
- (b) a beneficiary's access to the courts;
- (c) rules governing the investment of trust assets and investment standards;
- (d) rules covering the indemnification of trustees; and
- (e) (possibly) rules covering minimum trustee administration requirements in respect of resolutions, minutes, documentation, insurance, accounts and so forth.

Q10: Do you think that the Act should codify well-understood and well established common law rules, for the purpose of clarifying the law and making it more accessible?

The Society would support codification if the Commission receives submissions or other information suggesting that codification of well-understood and well-established common law rules would assist the public to better understand trusts.

In practice, codifying such rules in a helpful and useful way for the public might prove difficult. It might also be difficult to identify which particular rules should be given such declaratory treatment in the legislation.

For example, take the three certainties that apply to trusts. Codifying the most fundamental rule would require a statement that every valid trust must have subject-matter property of a certain type. The codification would then logically need to describe what was meant by *property*, and the same descriptive extensions would be required in respect of explaining the notion of the "certainty of objects". Similar codifications might record that someone who holds property in the capacity of a *fiduciary* holds that property in a trust relationship and that the donee of a *power* may or may not be a trustee with fiduciary obligations.

These are fundamental trust concepts, but in practice they still give rise, as Lord Wilberforce said in *McPhail & Doulton*, to “delicate shadings” and distinctions that would be difficult for both a logician and a layman to understand.

The Society notes that codification may prove more difficult than it appears and may also be of limited benefit to the general public.

Q11: Which of the above options in paragraph 4.65 do you prefer?

Option 1 is preferred, to the extent that it follows the style of new trust legislation in jurisdictions such as the United Kingdom, Canada and Australia.

However, this is not to say that the legislation should not contain important guidance and modernise the approach to investment and other important practical areas of trust practice. The rules dealing with investment were helpfully reformed in the 1988 Trustee Amendment Act, providing general guidance on the matters that trustees should take into account and containing a mix of both mandatory and default rules that practitioners are able to rely on to modernise trust documents.

Legislation drafted in the modern style, covering substantive trust areas in a logical and clear way, and addressing important matters like disclosure obligations to beneficiaries, the status of protectors and the other matters identified by the Commission, will be a significant improvement on the current position.

Q12: What would be your wish list for a new Act?

The Society’s “wish list” for any new trust legislation would be a relatively short, concise and clearly drafted Act that:

- (a) strengthens the rights of beneficiaries to information and court access;
- (b) clearly identifies the principles applicable to time-bar;
- (c) provides clear mandatory rules that govern key trust administration matters (including voting, appointment, retirement, accounts etc); and

- (d) provides clear and supportive legislative rules to trustees on matters such as indemnification and mistake, and sets out a series of procedural rules to assist trustees on difficult matters like seeking the court's guidance on variation, directions and audit.

Q13: Do you agree with the provisions of the Act we identify as being in need of reform?

The Society agrees with the Commission regarding the provisions of the Act that it has identified as being in need of reform.

Q14: Are there any other provisions of the Act that you would like to see amended or reformed? In what way would you want to see these changed?

The Society has identified other areas where reform is warranted.

Trusts as investment vehicles

There are issues associated with trusts being used as an investment vehicle. In particular, questions arise in connection with trustee delegation and the custody of title to investments with modern investment practice, such as the use of wrap accounts and managed investment funds. Part 4 of the English Trustee Act 2000 (Agents, Nominees and Custodians) would be a useful starting point in considering this issue.

Creditors' rights

An unsecured creditor's access to the trust fund is dependent on the trustee's right of indemnity (often worthless). The question of whether beneficiaries should have this "priority" should be examined.

A related question is the extent to which a creditor needs to investigate whether the exercise of a trustee power is valid so that the creditor can claim against the trust assets.

There is little authority on the effect of s22 of the Trustee Act 1956 (which provides some protection for certain purchasers). The interface of the current law with the indefeasibility provisions of the Land Transfer Act 1952 (and its replacement) will need to be considered.

Provision of trust information

The law has developed significantly in this context and it would be useful to have some mandatory rules about the circumstances in which trust information must be provided to beneficiaries (as noted above).

Clarity is needed on issues such as:

- (a) whether all types of beneficiary (discretionary or otherwise) have an entitlement to have information provided to them;
- (b) whether a trustee's obligation to provide information is an affirmative one (or merely to provide information on request) and at what age (adult or minor) can a beneficiary request information;
- (c) whether trust deeds can build in confidentiality clauses that would trump this obligation;
- (d) the circumstances in which a beneficiary (or other third party) can apply to court to obtain trustee information (s68 of the Trustee Act 1956 is not clear); and
- (e) the types of trust "information" that would be covered by a statutory obligation, and whether it extends to documents such as memoranda of wishes and trustee reasons.

Section 68 – Trustee Act

Section 68 of the Trustee Act allows any person:

- who is beneficially interested in any trust property, and
- who is aggrieved by any act or omission or decision of a trustee exercising any power under the Act,
- or who has reasonable grounds to anticipate any such action,
- to apply for an order under the section.

The Court may require the trustee to appear before it, and to substantiate the grounds for the act, omission or decision being reviewed. When the trustee does appear, the Court can then "... make such order in the premises as the circumstances of the case may require".

There are few cases under the section. It is worth considering *Rossiter v Wrigley* (Doogue J, 3 July 1989, Hamilton A105/80), which indicated that the New Zealand provision permits

review only in respect of the exercise, or anticipated exercise, of a power under the Trustee Act – rather than a power under a deed or other instrument. This is contrary to overseas provisions, particularly in Queensland.

In this regard, there are five factors identified by Professor Rickett³ which need to be considered in the Commission’s review of trust law:

- whether the exercise of the power of investment under the prudent person provisions of the Trustee Act should be capable of being considered under section 68;
- whether the section permits discretionary beneficiaries to apply under the section – arguably it does not;
- are the conclusions in the above case, as to onus, appropriate –in the Queensland cases it is clear that there is a heavy onus on an applicant to show a trustee has breached a duty of standard, which is not the position in New Zealand;
- has the High Court correctly decided that the appropriate standard for review is one of “reasonableness” and not a higher test, such as considering whether the decision was one that was reasonably open to the trustees in the circumstances;
- should guidance as to the correct approach under the section be obtained from the Queensland model and from s2269 of the California Civil Code.

Interface with other legislation

The interface of trust law rules with the provisions of the Property (Relationships) Act 1976 is a contentious area in current New Zealand trust law practice.

This will probably require changes to the Property (Relationships) Act. Any definitional changes as to the extent to which discretionary beneficiaries of trusts or objects of mere powers have “proprietary” interests in trust assets should be central to that reform. Clarifying this will help to resolve a key issue and avoid expensive and unnecessary litigation arising from future trust disputes.

³ “Reviewing a trustee’s act, omission or decision under section 68 of the Trustee Act 1956” [1990] *NZ Recent Law Review* 69, C E F Rickett.

In relation to the Property (Relationships) Act, the proposed abolition of gift duty will see dispositions to trusts occur without a corresponding debt back to the transferor. Traditionally those debts back have been a significant source of capital for compensation orders under sections 44C and 44F of the Property (Relationships) Act. If there is no compensating legislative amendment to the Property (Relationships) Act (and the Family Protection Act), the Society is concerned that the abolition of gift duty will see a spouse/de facto partner being able to defeat the interests of the other by the disposal of relationship property to a trust. The Society's submission on clause 110 of the Taxation (Tax Administration and Remedial Matters) Bill, which covers this issue in more detail, is **attached**.

SUPPLEMENTARY COMMENTS

In addition to the above responses there are a number of other matters that the Society would like to draw to the Commission's attention.

Reforms consistent with rules in other common jurisdictions

Any proposed reforms or new legislation that the Commission recommends should, as far as possible, be consistent with trust laws in other comparable jurisdictions. The development of trust law in New Zealand has to date mostly followed, and been informed by, the precedents and legislative rules in other common law jurisdictions.

Trust law has largely evolved as judge-made law and one of the strengths in the existing body of law and trust practice is the ability to draw on authoritative precedent of direct relevance from other jurisdictions.

The Society believes that any trust law reforms must be consistent with this existing body of law. New Zealand should not "go it alone" in this area unless there are convincing policy reasons to justify doing so.

The Society notes that there has been some academic criticism by international commentators of certain trust law developments at a judicial level in New Zealand. The perceived integrity of New Zealand's trust law has a much wider impact than domestic family trusts; it extends to decisions by foreign businesses and individuals about investing in New Zealand, as many of those investments are facilitated through trust arrangements.

Existing trust rules and practice generally working well

The Society believes that the existing trust rules in New Zealand are working well in practice and it is only at the margin that problems have emerged. The Issues Paper notes that the huge increase in

the use of trusts in New Zealand is largely a recent phenomenon, and it follows that this growth has naturally generated some difficult questions.

It was also inevitable that the rights of beneficiaries under discretionary trusts in respect of information and entitlement would be tested, as has been the case in jurisdictions such as the United Kingdom.

The *Kain v Hutton* judgment tested and resolved the law in respect of fundamental trust notions like the nature of a *power of appointment*, a *power of advancement*, and *fraud on the power*.

Previously, New Zealand's trust jurisprudence and practice was largely associated with the narrower questions of taxation (in particular, estate and gift duty rules and arrangements) and to some extent has developed rapidly in recent times.

The key distinguishing feature between trusts and (mere) powers is whether the power holder is obliged to distribute (a trust or trust power), or is under no obligation to distribute (a mere power). It is important to maintain this distinction, which governs what the beneficiaries' rights are, and what the trustees' duties are.

The "assimilation" that has occurred so far has only occurred because it was necessary. Fine distinctions that can result from drafting are sometimes inappropriate and the Courts recognise this. This issue has been exacerbated by the mixing of trusts and powers in trust deeds in more recent times.

The Courts have taken a logical and in many ways pragmatic approach to this in respect of:

- (a) the validity of trusts (i.e. certainty of objects); and
- (b) the remedies available to beneficiaries (rights to information and what remedies are appropriate).

This may be viewed as "assimilation", but it might also be viewed as the Courts simply saying that they will take a logical and practical approach to trust law from the beneficiaries' perspective.

Kain v Hutton showed the importance of the distinction between trusts and powers. The "property" rights owned by different classes of beneficiaries had to be determined to see what powers they were objects of. This was the key factor in determining whether the trustees had exercised their powers in favour of the right people.

It is therefore very important not to take the "assimilation" argument too far so as to mix up the entitlements of beneficiaries.

Trust issues around *sham trusts* (and validity issues) are again something that has been present in trust practice in other jurisdictions for years (as it has been in New Zealand) but, with the huge growth in trusts and new property relationship laws, these issues are presenting themselves to the Courts more often.

With the possible exception of the interface of the property relationship rules with the law of trusts, recent trust practice and relevant decisions in New Zealand suggest that the Courts are capable of dealing with these issues and providing definitive guidance on key points (as the Supreme Court has done recently in a number of contentious contexts).

In short, much of trust practice in New Zealand is working in an optimal way. Many of the problems that existed say five years ago have largely been resolved by judicial decision.

There may of course still be issues at the margin – for example, the use of trusts to defeat creditors, and whether beneficiaries of discretionary trusts have proprietary interests in trusts that are enforceable or constitute property – where specific legislative clarification is required. However, those cases would be the exception rather than the rule and most logically dealt with in other legislative contexts such as insolvency or taxation rules.

Creditors and trusts

The Society believes that the tension between creditors and trusts needs to be considered carefully.

The public is concerned (and indeed there is an identifiable public interest component) about debtors avoiding creditors through the mechanism of a trust. It seems unfair that someone who has created wealth and has practical access to that wealth can claim to be insolvent when it suits them, particularly in the face of a claim by creditors. Likewise, it seems unfair that someone who has created a trust structure in practical terms for themselves is treated quite differently in an insolvency from someone who has not. Individual creditors may arguably need more protection of their interests vis-à-vis assets held in a trust, although this contentious issue would need to be considered carefully.

Trustees and trust advisors would be well served by having clear principles enunciated either in legislation or through Court decisions.

The issues surrounding creditors and trusts are related to (but not the same) as the difficulty that trusts can cause in relationship property circumstances. The tension is also relevant to the State in such areas as the collection of tax, the assessment of child support and the recovery of student loans (areas not covered by s74 of the Social Security Act 1964).

The tension between creditors and trusts is highly relevant to the Official Assignee in bankruptcy.

It is useful to separate the different classes of creditors.

There is first what might be called “voluntary creditors” who lend money to a person subsequently unable to pay (but connected with a wealthy trust). There seems no particular reason why these creditors need to be better catered for. They have the ability to make their own enquiries, to obtain guarantees and security if necessary, and deliberately misleading information is likely to carry the sanction of criminal law.

Secondly, there are what might be called “involuntary creditors”. This class would include creditors whose debt has arisen through tortious liability, for example, through damage caused by an uninsured or intoxicated driver. Arguably, one could also include a partner with a relationship property claim that is thwarted by the existence of a trust (although not set up with that intention), and creditors who are technically voluntary but where they could not be said to have truly “lent” money (for example, employees owed wages or holiday pay).

Thirdly, there are the State’s various interests in debt. The amounts can be quite significant, particularly in regard to the income tax of insolvents involved in business. Income tax does not enjoy preferential status in insolvency. But the State is also interested in a wide range of other taxes and levies. The State is also indirectly involved through the Official Assignee in having that public official attempt to recover value for creditors. If the Official Assignee does not at least make a minimal recovery in the bankruptcy, then the costs are born by the State as opposed to the State receiving a commission on proceeds recovered. Another indirect interest of the State in debt is through recovery of amounts overpaid by WINZ and ACC.

Given the widespread use of discretionary trusts in New Zealand, the issue of debt and the “real” person behind the trust is very significant. The issue only goes as far as that relationship, and the Issues Paper sees no problem with a third party (e.g. a parent) creating a trust and settling wealth on it for the benefit of others, with such a traditional use of the trust structure being beyond reasonable challenge.

In analysing the tension between creditors and trusts, it is useful to analyse the way in which trusts gather wealth. The common analysis is that a settlor settles assets on a trust, and in current practice this is simply gifting assets or forgiving debt by way of gift. An immediate distinction has to be made between the nominal settlor and the actual settlor. The nominal settlor is simply the person named in the trust deed who generally makes a small gift to the trustees to start the trust. In many law practices this will be \$10.00 out of petty cash, and sometimes the settlor will simply be a partner or employee of a law firm. One view of the “real” settlor will be the person who asks for this process to be carried out and pays for it to be done. That person may or may not be the person who bestows the wealth on the trust. If a separate person bestows a body of wealth on the trust, then that person can also be viewed as the “real” settlor.

Interesting situations can arise where the trust makes its own wealth. That occurs when a trust is used as a vehicle for an individual with entrepreneurial skills. The trust may be worth nothing more than its initial \$10.00 settlement (as above), but may get into business via a debt guarantee by one of the real settlors standing behind the trust. The trust then does profitable business deals that the real settlor would otherwise have done. This is what happened in *Official Assignee v Wilson*, which is referred to in the second Issues Paper at 4.15ff.⁴ In those facts, there was never any transfer of wealth, and indeed even the initial \$100 settlement mentioned in the trust deed had never been paid.

According to the ratio in *Official Assignee v Wilson*, the Official Assignee could not challenge a trust structure if the bankrupt himself could not have challenged it. With respect, this conclusion by the Court does not bear scrutiny. It is understood that the issue was not properly argued: it was not raised as a defence on behalf of the trustees and was therefore not argued in the High Court, and was only briefly raised in oral questions from the Bench in the Court of Appeal. The conclusion appears to confuse the well-known principle that the Official Assignee takes property subject to equities, with a notion that the Official Assignee generally stands in the shoes of the bankrupt. Section 412 of the Insolvency Act may have been overlooked:

In considering a transaction, the Court may look at its real nature, and it does not matter that the transaction appears to be, or is described by the parties to it as being, something different.

In respect of *Official Assignee v Wilson*, it is submitted that:

⁴ *Some Issues with the Use of Trusts in New Zealand: Review of the Law of Trusts, Second Issues Paper*, Law Commission IP20, December 2010.

- The ratio should be overruled by statute, making it clear that the Official Assignee can challenge the existence of a trust (regardless of whether the bankrupt could have done so).
- The *obiter* indicating that a high standard is required to show that the purported trust was a sham should be brought into line with usual civil standard of proof (for instance, through any provisions defining a trust).

The Society believes that these issues need to be debated thoroughly in the Commission's review of trust law.

Some tentative views are advanced on the issues:-

In respect of people who divest themselves of assets because they are insolvent, or can foresee the possibility of insolvency, the Supreme Court decision in *Regal Castings Limited v Lightbody*⁵ is sufficient protection (i.e. ss344 – 350 Property Law Act). That case has application beyond divesting assets to a trust, although it did in fact involve a trust. There are also the antecedent transaction provisions of the Insolvency Act.

With the proposed abolition of gift duty, the relatively common extraction of wealth from trusts by creditors via recovery of the “debt back” for uncompleted estate planning processes will no longer be available. There will no longer be a tail of “debt back” over a period of time. The importance of the *Regal Castings* decision will therefore increase.

Relationship property issues, where the couple set up and operated a trust as part of their family affairs, might be seen in a different light, belonging in the Family Court and dealt with as an adjustment of rights held jointly. A discretion such as that provided in s182 of the Family Proceedings Act 1980 might be appropriate, provided that it was restricted to trusts set up as part of the couple's affairs, and not where some other party such as a parent creates a trust and bestows property on that trust for a child. A careful definition would have to be crafted.

Consideration could be given to altering the circumstances in which the Official Assignee can set aside a gift to a family trust. Sections 204 and 205 of the Insolvency Act apply. The former is of little note, other than allowing a gift to be set aside within two years of bankruptcy. Section 205 allows the setting aside of a gift made between two and five years of a bankruptcy if the donor was insolvent. This section already favours the Official Assignee because it contains a presumption of insolvency, but it could possibly be made more favourable in the case of gifts to a trust connected

to the donor. Presently, the donee trustees (presumably with the active and willing assistance of the bankrupt donor) only have to show solvency any time from the gift to the bankruptcy. In *Regal Castings* the Supreme Court said:

“The most simple case is one in which an insolvent debtor has gifted a substantial asset to a relative or friend or to trustees of a family trust, thereby subtracting from an already insufficient quantum of assets.”

The Court was referring to the proscribed behaviour. It might be appropriate that all transfers of wealth, whether by gifting or by manipulating profit-generating transactions within a trust, are recoverable by the Official Assignee. This would have brought about a different result in *Official Assignee v Wilson*⁶.

There may be grounds to have some sort of statutory remedy in situations where the wealth of a trust can be clearly identified with the actions of a person owing debt which cannot be paid other than by resort to the trust.

Overall, the concept of allowing parties to use trust law to shelter assets against adverse financial circumstances later occurring is valid and should not be undermined. However, the use of the trust structure to shelter assets should be open to challenge in the following circumstances:

- where there has been a transfer of wealth to a trust to evade actual or contingent creditors (being the existing law since *Regal Castings*);
- where a “real settlor” (as above) can be identified, and that person has access to both the benefit of the trust’s assets and effective control of the trust;
- where the trust structure is only a façade for the activities of a “real settlor” (the *Official Assignee v Wilson* situation).

⁵ [2007] NZSC 108

⁶ [2008] NZCA 122

This submission has been prepared with assistance from the Society's Property and Family Law Sections. If you have any queries regarding this submission please contact the Manager of the Property Law Section, Kim Oelofse, by telephone (04) 463 2991 or email (kim.oelofse@lawsociety.org.nz).

Yours sincerely

A handwritten signature in black ink, appearing to read 'Jonathan Temm', written in a cursive style.

Jonathan Temm
President