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"Trustee limitation of liability clauses in commercial transactions: issues and observations from a New Zealand perspective." [1]

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1. Introduction

The demise of the local finance company sector is the unfortunate context in which New Zealand is currently contributing to the jurisprudence on trustee liability. During the period 2006-2009, spurred by the onset of the Global Financial Crisis, 65 local finance companies failed, causing a loss of approximately NZ$6 billion to retail investors and sparking a major programme of law reform to restore investor confidence. The statutory trustee companies were key players in the debt-funded finance company model and questions about the scope of their duties, and to whom they are owed, has been the focus of two recent strike-out applications in the High Court.

Before investigating the relevant litigation, it is helpful to revisit the applicable legal framework, and to explain the evolution of New Zealand's indigenous corporate trustees and their core "reasonable diligence" duties.

2. The New Zealand legal framework for trustee limitation and indemnity

In New Zealand, the Trustee Act 1956 is the primary statute affecting trusts and overlays the rules created by the courts of equity in England, and developed across the common law jurisdictions. To recap the key principles: a trust is not a legal entity and "trust" property is owned legally by the trustee, and equitably by the beneficiary.[2] Since the trustee is the legal owner of the trust property, and must enter into contracts with third parties, the trustee is personally liable without limit to all third parties for liabilities incurred in performing its trust duties *unless* and *to the extent* there is a clause in its contract with a third party which limits the trustee's personal liability to that third party.[3]

The trustee has a primary right of indemnity against the trust assets[4] which is reinforced by section 38(2) of the Trustee Act:

> A trustee may reimburse himself or pay or discharge out of the trust property all expenses reasonably incurred in or about the execution of the trusts or powers.

The indemnity right creates an equitable proprietary interest in all trust assets for satisfaction of the trustee's indemnity claim which has priority over the claims of beneficiaries[5] and third parties,

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[1] The legal issues arising in relation to trustee liability and limitation are many and complex, and Diccon Loxton and Nuncio D'Angelo's article (*Trustees' limitation of liability: Myths, mysteries and a model clause* (2013) 41 ABLR 142) provides a comprehensive analysis of the legal framework within which trustee limitation of liability clauses operate. Accordingly, this paper has a limited focus on issues of current practical significance in New Zealand's financial markets. I also wish to acknowledge *Trustee Indemnity v Trustee Liability,* a paper by Helen Dervan, a senior lecturer at AUT Law School, AUT University (***Dervan***), which provides a broader perspective on this issue.

[2] While technically there are no "trust" assets nor "trust" creditors, but rather only assets and creditors of the trustee (given the trust has no individual legal personality), I use these terms for the sake of brevity and in accordance with common market parlance.

[3] *Re Johnson* (1880) 15 Ch D548 (***Re Johnson***); *Worral v Harford* (1802)8 Ves 4; *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 (HCA) at 367.

[4] *Re Johnson* (n 3). This proprietary indemnity comprises a right of reimbursement from trust assets where it discharges a properly-incurred trust liability out of its own money (*recoupment*), and a direct right to apply trust assets to meet a properly-incurred trust liability (*exoneration*) as detailed in Loxton & D'Angelo paper (n 1). It also has a secondary *personal* indemnity right against the trust beneficiaries in respect of liabilities properly incurred in administering the trust unless excluded in the trust instrument (*Hardoon v Belilios* [1901] AC 118 (PC) cited in Andrew S Butler (ed) *Equity and Trusts in New Zealand* (2nd ed, Thompson Reuters, Wellington, 2009) (***Butler***) at page 131.

[5] *Dodds v Tuke* (1884) 25 ChD617; *Jennings v Mather* [1902] 1 KB 1, 6 and 9 (***Jennings v Mather***).

other than secured creditors with a perfected security interest.[6] It arises by operation of law so is not registrable on the Personal Property Securities Register,[7] and is non-possessory so remains attached to trust assets when they leave the trustee's possession (e.g. when it is replaced as trustee).[8]

Importantly, the trustee's proprietary interest in trust assets passes by way of subrogation to the trust's unsecured creditors.[9] Subrogation arises by operation of law and puts the creditor in the place of the trustee to ensure that the right of indemnity from trust assets is exercised to secure repayment of the debt. The right of subrogation is intended to avoid injustice caused by a beneficiary receiving assets that have been acquired without paying for them. In that situation, equity regards a creditor's claim as having priority over that of the beneficiary because it stands in the shoes of the trustee, whose claim has that priority.[10] Accordingly, the trust creditor depends on the trustee's right of indemnity to access the trust property and, as it is a derivative claim, the creditor can be in no better position than the trustee. The subrogation right is most valuable to unsecured trust creditors which have no direct access to trust assets, but is also relevant to secured trust creditors to the extent there is a shortfall between the value of any proceeds of security realisation and the amount of their claim.

In order for a trustee to fully access its rights of indemnity against the trust property, the indemnified liabilities must have been properly incurred[11] and the trustee must not have otherwise breached another duty to the beneficiaries.[12] Failure to satisfy both those conditions may impair or negate the indemnity. As Justice Paul Heath, writing extra-judicially, succinctly puts it: "Perversely, the rights of creditors will be affected adversely if the trustee has been guilty of disentitling conduct."[13]

Another critical factor in determining a trust creditor's recourse to trust assets is the scope of the trustee's documented indemnity right and any limitation of liability clause in the trust deed.[14] Justice Heath describes the extent to which the right of proprietary indemnity may be modified by the trust instrument as "a vexed question".[15] However, New Zealand appears to support the position expressed in *Armitage v Nurse*[16] that there is an "irreducible core" of obligations owed by a trustee to a beneficiary in respect of which the trustee must remain liable because it is so fundamental to the concept of the trust. Exactly what that "irreducible core" is comprised of is uncertain, and may vary from trust to trust.[17]

In the context of retail securities, this "irreducible core" of duties is clarified by statutory restrictions which void any contractual indemnity or limitation provision to the extent it derogates from the

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[6] *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 (HCA) (***Octavo***); *Re Johnson* (n 3).

[7] Section 23(b), Personal Property Securities Act 1999 and, for the Australian analysis, see Nuncio D'Angelo and Helena Busljeta, *The trustee's lien or charge over trust assets: a PPSA security interest or not?* (2011) 22 JBFLP 251.

[8] *Jennings v Mather* (n 5); *Rothmore Farms v Belgravia* (1999) 2 ITELR 159.

[9] Or the Official Assignee on behalf of the trustee's creditors. Accordingly, the trustee's equitable interest in trust assets is a critical asset of the trustee for bankruptcy purposes, particularly where the trustee is an otherwise "assetless" corporate trustee. *Ex parte Garland* (1804) 10 Ves 100; *Octavo* (n 6). Also refer to Justice Paul Heath's paper *Bringing Trading Trusts into the Company line* [2010] New Zealand Law Review, 519 at [526] (***Heath***).

[10] Heath (n 9) citing *Re Johnson* at page 552 per Jessel MR.

[11] *Re O'Donoghue* [1998] 1 NZLR 116 (HC). The trustee must have incurred the liability in the proper administration of the trust – i.e. with full capacity, authority and without breaching any duty it owes to the trust beneficiaries (for example, entering into a contract which breaches the duty to act in the interests of the beneficiaries as a whole).

[12] If it has, the trustee's recovery under the indemnity is reduced by the extent of the cross-claim by the beneficiaries to replenish the trust assets. This is also described as the "clear accounts" rule.

[13] Heath (n 9) at p 526.

[14] Ibid at p 528. In simple terms, a narrow indemnity will not only prejudice the trustee; it will also prejudice the trustee's creditors by reducing its ability to subrogate to the indemnity. In some cases, trust deeds may purport to exclude or severely limit the right of indemnity, which prejudices the ability of both trustees and trust creditors to access trust property.

[15] Ibid at p 527. There are also cases concerning how broad a limitation of liability might be. At the extreme end, a trust deed could purport to exclude liability for any breach of trust by a trustee.

[16] *Armitage v Nurse* [1998] Ch 241; [1997] 2 All ER 705 (***Armitage***).

[17] *Armitage* (n 16) at p 251; p 711 per Millet LJ, cited in *Butler* (n 4) at p 458. In *Armitage*, Lord Justice Millett did not distinguish between exclusion clauses and indemnity clauses.

trustee's reasonable diligence obligations (discussed in section 3 below).[18] Subject to those overriding statutory limitations, the leading New Zealand case on trustee exemption clauses, *Spencer v Spencer,*[19] confirms that a trustee can validly exclude personal trustee liability for all conduct including negligence and recklessness, but not for fraud or dishonesty.[20]

It is clear, then, that the courts have to strike a careful balance when assessing trustee indemnity and limitation clauses: on the one hand, from a policy perspective, the clauses should be broadly construed in favour of the trustee to maximise trust creditors' access to trust assets via their subrogation right (which equity says should trump the rights of beneficiaries); on the other hand, the clauses cannot be so broad or so forgiving of trustee misconduct as to remove personal liability entirely or to cut into the uncertain "irreducible core" of trustee duties which are essential to the existence of the trust.[21] This trade-off reflects the inherent tension between the competing rights of trust creditors and trust beneficiaries to trust assets, in which the trustee is the intermediary.

Parliament recognised the delicacy of the trustee's position by awarding the courts a significant (but seldom-used) power in section 73 of the Trustee Act to partially or wholly relieve a trustee from personal liability in circumstances where a trustee has acted in breach of trust, "but has acted honestly and reasonably, and ought fairly to be excused from the breach of trust."

3. The evolution of the trustee company and its "reasonable diligence duties"

So how do the trustee companies fit within this legal framework for the purposes of the finance company litigation?

New Zealand has been an enthusiastic importer of trusts law since the concept of the trust was introduced by the first British settlers.[22] However, in the late nineteenth century, there was a shortage of individuals in the new colony able and willing to assume the responsibilities of trusteeship to serve the new landed gentry. New Zealand's solution was to incorporate "trustee companies", statutory vehicles which could discharge the function of trustees in accordance with established trust law principles, while benefitting from standard corporate limited liability.[23] (Reference in this paper to "trustee companies" is limited to the specifically authorised or licensed trustees, as distinct from the "assetless" limited liability companies that commonly serve as trustees of trading trusts).

Today trustee companies are an established feature of New Zealand's capital markets, supervising financial arrangements with assets approaching NZ$200 billion in the context of bond issues, managed investment schemes, securitisations and other security and custodial arrangements.[24] Since 2011, they have been subject to a compulsory licensing regime and have assumed a more formal supervisory role in retail transactions as quasi-regulators for the Financial Markets Authority.[25]

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[18] For example, section 62(1) of the Securities Act 1978; section 11 of the Superannuation Schemes Act 1989; section 116J of the KiwiSaver Act 2006; section 24 of the Unit Trusts Act 1960. The same principle is reflected in sections 105, 107, 136 and 146 of the FMCA which provide that a right of indemnity is only available to a trustee/supervisor "in relation to the proper performance" of its reasonable diligence and prudent supervisor duties.

[19] *Spencer v Spencer* [2012] 3 NZLR 229 (HC) (***Spencer***); *Wong v Burt* [2005] 1 NZLR 91 (CA) and *Gillespie v Guest* (No2) [2013] NZHC 669 (strike-out application).

[20] "Dishonesty" is an objective standard and means not acting as an honest person would in the circumstances *Spencer v Spencer* [2012] 3 NZLR 229 (HC).

[21] *Watling v Lewis* [1911] 1 Ch 414 cited in Butler (n 4) at p 453.

[22] There is currently thought to be one trust for every 17 New Zealanders. *Review of the Law of Trusts: Preferred Approach* (NZLC) *Issues Paper* (2013) at p 15.

[23] Each statutory trustee company was originally enacted by its own Act of Parliament, and is further enabled by the Trustee Companies Act 1967. Traditionally, the Securities Commission would specifically authorise bond trustees. However, the Securities Trustees and Statutory Supervisors Act 2011 introduced a new licensing regime for the statutory trustee companies which play a role in the financial markets, and the Securities Act 1978 has been updated accordingly.

[24] Website of the Trustee Corporations Association of New Zealand Inc (www.tca.org.nz).

[25] As set out in the Securities Trustees and Statutory Supervisors Act 2011.

In the context of retail debt securities – in which the finance company litigation occurs - the Securities Act 1976 requires an issuer to appoint an authorised trustee company on behalf of debt security holders and to enter into a trust deed with the issuer.[26] The trust deed itself is a hybrid trust/funding document which establishes the trust; provides for the creation and issuance of the debt securities; specifies financial and other commercial covenants applicable to the borrowing; and includes standard trust terms, such as trustee powers and indemnities, and procedures for appointing and replacing the trustee. The trustee company also holds the benefit of any security supporting the borrowings, or the negative pledge (as applicable), for the benefit of the investor beneficiaries.

The Securities Regulations imply certain duties into trust deeds for debt securities, including the trustee's duty to find out whether breaches of the trust deed have occurred, to take steps to remedy breaches and to ascertain whether the assets of the borrowing group are sufficient to discharge the amounts of the debt securities as they fall due. These are commonly known as the trustee's "**reasonable diligence duties**".[27] (These reasonable diligence duties are substantially preserved, and supplemented, in the Financial Markets Conduct Act 2013, which replaces New Zealand's securities laws and takes full effect from 1 December 2014).[28]

The nature of the trustee company's reasonable diligence duties are contractual, irrespective of whether or not they are express terms of the trust deed.[29] However, the courts also consider that those duties are enforceable in equity and possibly also in tort.[30] The New Zealand High Court has held that it is "elementary" that the trustee company is in a fiduciary relationship with the holders of validly issued debt securities and that the trustee company's "essential function" is to look after investors' interests.[31] In another case, the High Court observed that while the fiduciary relationship provides the setting in which any breach of duty occurs, with it exists "such tortious proximity…as may be necessary".[32] This view was affirmed in two recent strike-out applications of the High Court, discussed later in this paper: *National Finance 2000 Limited (in rec. & in liq.) v William Buck New Zealand Limited*[33] and *Mark Stephen Hotchin v The New Zealand Guardian Trust Co. Limited*.[34]

4. Who has standing to sue the trustee company for breach of its duties?

4.1 *The role of the trustee company in the generic finance company model*

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[26] Section 33(2) (*Debt securities*) of the Securities Act 1978, and section 104 of the Financial Markets Conduct Act 2013 (**FMCA**).

[27] Securities Regulations 2009, clause 1 of Schedule 15 (formerly Securities Regulations 1983, clause 1 of Schedule 5). The Securities Act and Regulations which create the reasonable diligence duties do not say to whom they are owed. The leading decision in New Zealand on the nature of the trustee company's duty to exercise reasonable diligence to ascertain whether a trust deed had been breached is the judgment of the Court of Appeal in *Pakuranga Park Village v Fenton* (1998) 3 NZConvC 192,681. It focuses on the integrity of the decision-making process undertaken by the trustee, rather than the merits of the ultimate decision reached. (This case related to participatory securities, not debt securities, but the reasonable diligence duties are equivalent).

[28] Refer to sections 112-113, FMCA, in relation to debt securities. In addition to a requirement to exercise "reasonable diligence in carrying out its functions as a supervisor" (s 112, FMCA), the trustee company must, in exercising its powers and performing its supervisory duties, "exercise the care, diligence and skill that a prudent person engaged in that profession would exercise in the same circumstances." While the trustee companies are re-branded as "supervisors" in relation to debt issues, they still enter into a "trust deed" and the trustee company continues to hold the investors' benefits in relation to the debt securities "in trust" for them (section 104, FMCA).

[29] The court in *National Finance* recognised a separate statutory duty (*National Finance* (n 33) at [42] owed to investors. The Privy Council expressed the opinion that, irrespective of whether the duties are express terms of the trust deed, by implying them into the trust deed "the legislature was contemplating a contractual duty owed…rather than a statutory duty owed independently" of the trust deed (*Christchurch Pavilion (no 1) v Deloitte & Touche Tohmatsu Trustee Co Ltd* [2002] 3 NZLR 289). This judgment related to the nature of the statutory supervisor's duties in relation to a deed of participation governing participatory securities but applies equally to the duties of trustee companies in relation to debt securities.

[30] For example, in *Bank of New Zealand v New Zealand Guardian Trust Co Ltd* [1999] 1 NZLR 664 (CA) (***BNZ v NZGT***) in which Gault J said in *obiter* the trustee's reasonable diligence duties were "enforceable in equity [and t]here is doubtless the same duty in tort." The existence of the tortious duty was further considered in *National Finance* (n 33) and *Hotchin* (n 34).

[31] Judgment of Tipping J in *Porter v New Zealand Guardian Trust Co Ltd* (1996) (CP136/91), 7 TCLR 323 at 330.

[32] *BNZ v NZGT* (n 30) per Tipping J at [688].

[33] *National Finance 2000 Limited (in receivership and in liquidation) v William Buck New Zealand Limited,* HC Auckland CIV-2010-404-7157, 7 December 2011 (***National Finance***) at [24].

[34] *Mark Stephen Hotchin v The New Zealand Guardian Trust Company Limited and Perpetual Trust Limited* in the CA 494/2013 (***Hotchin***) at [37] citing Gault J and Tipping J's judgments in *BNZ v NZGT* (n 30).

Before considering to whom the trustee owes its duties, it is useful to consider the commercial framework in which the finance company litigation originated. In the generic (and now largely defunct) finance company model, a limited liability company issued debt securities to the public under a debenture trust deed. As required by the Securities Act, the trust deed was entered into between the finance company issuer itself and an authorised trustee company, and the finance company investors had the dual status of beneficiaries under the trust deed, and secured creditors of the issuer by virtue of the security held for them by the trustee.[35]

The finance company would on-lend the proceeds of the debt issuance, often referred to as deposits or debenture stock, at a margin. In many cases, there was a mismatch between the maturity and repayment profiles of the finance companies' loan books and their repayment obligations to investors. With the onset of the GFC, a pattern of borrower defaults emerged, triggering liquidity problems for the finance company lenders and a sharp decline in asset values, especially in the property sector. In a number of cases, the situation deteriorated into insolvency, with the receivers and eventually liquidators called in.

It is important to note that very many finance companies traded responsibly, yet they too suffered liquidity crises as investors – who were rapidly losing confidence in the sector – sought to withdraw their deposits, creating a "run on the bank" phenomenon.[36] Anecdotally, a large proportion of the finance company investors were retirees who had "diversified" their portfolios across a large number of ill-fated finance companies and ultimately lost their life savings. The subsequent litigation has brought the finance companies, their directors, auditors and trustee companies under scrutiny as investors have attempted to recover some value.

4.2 *Does the trustee company owe its reasonable diligence duties to the issuer of debt securities?*

It is a well-established principle of trusts law that the trustee owes fiduciary and other trust duties to the trust beneficiaries.[37] Can the trustee of debt securities also owe its reasonable diligence duties to the issuer?

National Finance Limited was a motor vehicle financier that was placed in receivership in May 2006 owing investors NZ$21 million. As required by the Securities Act, National Finance had issued debt securities to the public under a debenture trust deed entered into between it, as issuer, and Covenant Trustee Company Limited (**Covenant Trustee**).[38] When it failed, the receivers took proceedings against the company's auditors in contract and tort for negligent failure to detect and report related party loans which breached provisions of the trust deed. The auditors issued a third party claim against Covenant Trustee seeking contribution under section 17(1)(c) of the Law Reform Act 1936 as concurrent tort-feasors.[39] Covenant Trustee responded by bringing an application to strike out the third party claim.

The key question before the High Court in *National Finance* was whether a trustee of debt securities owes an actionable duty of care to the issuer, in addition to the investor beneficiaries. The auditors framed Covenant Trustee's alleged duties in terms of the statutory "reasonable diligence duties". Covenant Trustee accepted it owed the reasonable diligence duties to investor beneficiaries, but denied that it owed them to the issuer, National Finance.

The auditors' first cause of action, based on breaches of the statutory duty, was struck out because the issuer was not within the limited class which Parliament had intended could enforce the statutory duties (i.e. investors).[40] However, the court found it was arguable that the trustee owed duties to the issuer in contract – although this had not been pleaded - and potentially concurrently in tort. This was because the reasonable diligence duties prescribed by the

[35] The finance company investors are described variously as "depositors", "debenture holders" and "investors" in the litigation.

[36] The New Zealand government responded with the temporary Crown deposit guarantee scheme which ended on 31 December 2011.

[37] For example, *Fletcher v National Mutual Life Nominees Ltd* [1990] 3 NZLR 641 (HC) and *Deloitte Haskins & Sells v National Mutual Life Nominees Ltd* (1991) 3 NZBLC 102,259 (CA); [1993] 3 NZLR 1 (PC), cited in *National Finance* (n 33) at [25].

[38] Section 33(2)(a) Securities Act 1978: No debt security shall be offered to the public unless the issuer of the security has appointed a trustee for the security and both the issuer and the trustee have signed a trust deed for the security.

[39] *National Finance* (n 33).

[40] Ibid at [42].

Securities Regulations 1983 that had been imported into the debenture trust deed were silent as to whom they were owed and there was sufficient proximity to support a potential common law duty to the issuer.[41] The fact that National Finance had been "the author of its own misfortune" could not absolve Covenant Trustee of these contractual and tortious duties.[42]

Importantly, the court considered the trustee indemnity in the debenture trust deed which expressly excluded from Covenant Trustee's indemnity liabilities arising out of its "wilful default" or "wilful breach of trust."[43] Associate Judge Bell noted that the indemnity clause "may impinge on the effectiveness of any duty of care owed by the trustee to the company". Tellingly, the judge went on to observe:

> The difficulties do not arise when investors sue the trustee for breach of the reasonable diligence duties. If the trustee has breached those duties, and as a result there is a shortfall in company assets so that the investors cannot be paid in full, the indemnity will be worthless because there will be no assets from which the trustee can recoup any payments it has made under its liability to investors**. But if the company successfully sues the trustee for breach of the reasonable diligence duties and the trustee meets the judgment, the company will have funds from which it can honour the indemnity** [*emphasis added*].[44]

The Judge considered whether the reference to "breach of trust" in the trust deed indemnity clause should be construed narrowly to incorporate only breach of an equitable duty giving rise to an equitable claim, or more broadly to include breach of a common law duty (i.e. in contract or tort) giving rise to a common law claim. In doing so, the Judge considered section 62(1) of the Securities Act which voids any contractual provision to the extent it would have the effect of:

> exempting…or indemnifying [a trustee] **against liability for breach of trust** where he or she fails to show the degree of care and diligence required of him or her as trustee… [*emphasis added*].

The Judge found that the broader interpretation of "breach of trust" was appropriate to meet the purpose of section 62(1) of the Securities Act. (Section 62(1) refers only to "breach of trust", a lower standard than "wilful" breach of trust which was the exclusion threshold in the contractual indemnity provision). Referring to the investor protection rationale which underpins the Securities Act, Associate Judge Bell commented:

> Giving "breach of trust" a narrow meaning does not meet the purpose of the provision [i.e. s 62(1) of the Securities Act 1978]. **It is intended not to allow trustees to invoke indemnities when they have failed to exercise due care and diligence, so that company assets will be available for investors rather than the trustee**. To meet that purpose breach of trust should be taken as meaning breach of a term in the trust deed, whether the claim is made in equity or not. On that interpretation, [s 62(1)] may prevent Covenant relying on [the indemnity clause] in the trust deed [*emphasis added*].[45]

It is apparent from these remarks that the court was focussed entirely on giving out-of-pocket investors compensation. However, the comment that section 62(1) operates to ensure that "company assets will be available for investors rather than the trustee" is somewhat perplexing as it implies the competition for trust assets is between the trustee personally and the beneficiaries. However, the trustee does not rely on the indemnity for its own enrichment;[46] rather its indemnity right facilitates creditor recovery out of trust assets in priority to beneficiaries' rights in accordance with established trust principles.

In this regard, it is relevant to remember that the *National Finance* investors were creditors of the issuer, not just trust beneficiaries. As secured creditors the investors had a proprietary claim to the issuer's secured assets. However, upon the insolvency of National Finance, the secured

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[41] Ibid at [70].

[42] Ibid at [69]. Also *Anns v Merton-London Borough Council* [1978] AC 729 (HL).

[43] Ibid at [71].

[44] Ibid at [72].

[45] Ibid at [74].

[46] It is deigned to reimburse the trustee, where it has satisfied trust liabilities from its personal funds, in accordance with the reimbursement right of indemnity, in circumstances where the exoneration right has not or cannot be exercised. But this is different from trustee enrichment which is what the court's words imply.

assets were insufficient to cover the secured liabilities, and so the investors were effectively unsecured for the residual liability. As creditors, the investors theoretically have an interest in the trustee having a broad indemnity right, to enhance their own ability to subrogate to it, and from this perspective the purpose of section 62(1) of the Securities Act 1978 might equally support an expanded indemnity and a narrow interpretation of "breach of trust" (contrary to the court's conclusion described above). After-all, subrogation developed to ensure the claim of trust creditors' would rank ahead of beneficiaries claims to trust assets.

However, since practically the creditor path would have resulted in a dead end for investors (i.e., an insolvent issuer and, therefore, no "trust" assets) the prospect of a trustee company's personal deep pockets becomes a tantalising option. Was the court inclined to lower the threshold which triggers personal trustee liability to put the National Finance receivers in funds to compensate investors? This motivation seems to be transparent in the Judge's observations that trustee accountability will be enhanced if trustees are found to owe a duty of care to the issuer of a debt security.[47] While the court acknowledged that Parliament has taken steps to strengthen trustee accountability,[48] Associate Judge Bell concluded this "does not mean other ways of holding trustees to account should be rejected."[49] The question is whether the desire to achieve investor recompense by opening the door to personal trustee liability may come at the expense of the proper application of established trust principles.

Ultimately, in *National Finance*, the court held that there was a possibility that Covenant Trustee owed the issuer a duty of care at common law (contract or tort) giving rise to a negligence claim. The issue was not considered at trial as the parties settled the dispute, but the case raises interesting questions for further consideration when a party (in this case the investors) have co-extensive claims against the issuer, both directly in debt and indirectly via their ability to subrogate to the trustee's right of indemnity.

4.3 *Does the trustee company owe its reasonable diligence duties to prospective and roll-over investors?*

In another recent strike-out application, the New Zealand High Court considered the existence and nature of duties owed by debt security trustees to prospective and existing investors.[50]

The plaintiff, the Financial Markets Authority (**FMA**), issued compensation proceedings against Mark Hotchin, a director of Hanover Finance Limited and United Finance Limited at the time those companies issued prospectuses and advertisements in connection with the offer of debt securities to the public. The New Zealand Guardian Trust Company Limited and Perpetual Trust Limited (together, the **Trustees**) were the appointed trustees in respect of the issue of the debt securities. The FMA alleges the prospectuses and advertisements authorised by Mr Hotchin and other directors contained untrue statements relating mainly to the companies' liquidity and brought an action for compensation under s 55G of the Securities Act 1978 for subscribers who invested in debt securities in reliance on the untrue statements. Section 55G permits the court to order compensation for the loss or damage that subscribers have sustained by reason of the untrue statements.[51]

Mr Hotchin joined the Trustees to the proceedings, claiming that the Trustees:

> …owed a duty of care in tort to the depositors…including prospective depositors, and existing or rollover depositors, to exercise reasonable diligence, care and skill...based on its statutory purpose to protect and represent the interests of the depositors.[52]

[47] *National Finance* (n 33) at [62] and [63].

[48] By way of section 43 and associated provisions of the Securities Trustees and Statutory Supervisors Act 2011.

[49] *National Finance* (n 33) at [66].

[50] *Hotchin* (n 34) at [1].

[51] *Hotchin* (n 34) at [2] and [3].

[52] Hotchin claimed the Trustees were liable to contribute to any compensation he was ordered to pay as joint tort-feasors under the Law Reform Act or, alternatively, in equity because they have contributed to the losses suffered by the investors. The present

The Trustees alleged that their duties arose only contractually under the terms of the trust deed, which imported terms from the Securities Act and Securities Regulations,[53] not in tort. The Trustees further alleged that their duties were owed only to existing depositors, and not to prospective or roll-over depositors.[54]

Justice Winkelmann granted the strike out application but held it was arguable that trustees owe duties to depositors in tort.[55] One of the questions before her was whether the trustees' reasonable diligence duties extended beyond current investors to prospective and roll-over investors (i.e. investors whose deposits had matured but had been reinvested).[56] On that question, Justice Winkelmann found that:

> …in this case at least there is a tenable argument that the trustees owed a duty of care to prospective investors including roll-over investors…[57]…The Securities Act does not state to whom [the reasonable diligence duties] are owed and there is nothing in the [Securities] Act or Regulations which is inconsistent with the extension of that duty to roll-over and prospective depositors.[58]

However, the court struck out the claim on the ground that there was no coordinate liability to support a contribution claim under section 17 of the Law Reform Act nor to support a claim of equitable contribution. Mr Hotchin has appealed to the Court of Appeal and the appeal was heard in June.[59] If Mr Hotchin succeeds on appeal, then the extent of the trustees' duties will be adjudicated at trial, currently scheduled for July 2015.

4.4 *"Tuning down" the trustee-beneficiary relationship in commercial trusts*

Although they were only strike-out applications, *National Finance* and *Hotchin* demonstrate the potential expansion of the classes of persons who have standing to bring a claim against the trustee companies for breach of their reasonable diligence duties, and their possible liability in statute, equity, contract and tort. The nature and scope of a trustee's duties are directly relevant to the trustee's right of indemnity and its ability to limit its liability.

It is interesting to compare those judgments with the decision of the English Court of Appeal, upholding a High Court decision in *Citibank NA v MBIA Assurance SA,*[60] in which the court recognised that a trustee in relation to wholesale debt securities can contract out of its fiduciary duty to act in the best interest of beneficiaries. The litigation concerned notes issued as part of the securitisation of debt which funded the Eurotunnel. Citibank was the trustee for the holders of notes (comprising four priority levels) and entered into a trust deed with the issuer under which it held the covenant package and note security on trust for the holders. MBIA provided a guarantee in favour only of the senior note-holders and had the right to direct Citibank to act on its instructions under the terms of the trust deed, which bound the subordinated classes of note holders. The trust deed contained a broad clause exempting Citibank from all liability to note-holders when acting upon MBIA's instructions pursuant to the trust deed.

The question before the High Court was whether Citibank would be in breach of its core trustee duties, and therefore ineligible to rely on its indemnity right, if it followed MBIA's instruction to the benefit of the senior note-holders and the detriment of the subordinate classes. In particular,

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proceedings were a strike-out application in the High Court by the Trustees in respect of the contributory claim against them. (The proceedings were subsequently appealed to the Court of Appeal).

[53] Clauses 1-11 of Schedule 5 by way of regulation 24 of the Securities Regulations 1983, subsequently replaced by regulation 5 of the Securities Regulations 2009.

[54] *Hotchin* (n 33) at [24].

[55] Ibid at [37], citing Gault J and Tipping J's judgments in *BNZ v NZGT* (n 30).

[56] *Hotchin* (n 34) at [36].

[57] Ibid at [41].

[58] Ibid at [43]. The court found that the duties imposed on the trustees by the trust deeds and the Securities Regulations did not extend to verifying the accuracy of statements in the prospectus (Ibid at [55]).

[59] The primary issue on appeal is whether the alleged wrongful trustee conduct result in Hotchin and the trustees being liable in respect of the "same damage" so as to permit a claim for contribution by Hotchin against the trustees under s 17(1)(c) of the Law Reform Act 1936.

[60] [2007] EWCA Civ 11.

would permitting Citibank to act against the interest of some beneficiaries reduce the trustee's obligations below the irreducible minimum core which Millet LJ had identified in *Armitage*?

The High Court disagreed, and emphasised that the subordinated note-holders had agreed to this commercial arrangement at the outset. The decision was upheld unanimously in the English Court of Appeal, which denied that the contractual provision had the effect of derogating from the trustee's core duties. Lady Ardern read down the "irreducible core" and confirmed that "the trustee continues at all times to have an obligation of good faith."[61] In this regard, the *Citibank* decision is consistent with an observation of Lord Browne-Wilkinson in *Kelly v Cooper* which was similarly made in the context of a wholesale trust:

> The fiduciary relationship, if it is to exist at all, must accommodate itself to the terms of the contracts that it is consistent with, and conform to them.[62]

The *Citibank* decision could be said to modify the view expressed in *Armitage*[63] to acknowledge that beneficiaries may have competing interests. In other words, the "irreducible core" of a trustee's obligations encompasses the duty to act in good faith and honestly for the benefit of beneficiaries - except to the extent that the beneficiaries expressly agree that one class may be given priority over another, and is capable of so agreeing given the commercial context of the trustee relationship. This point is of direct relevance in the finance company cases where the interests of existing investors were at times in direct conflict with the interests of prospective investors, and in which it may be unreasonable to expect the trustee to act in the best interests of beneficiaries as a whole.[64]

The *Citibank* case related to wholesale, not retail debt securities, and so the sophistication of the note-holder investors justified the court's emphasis on the commercial and contractual framework, above the trustee-beneficiary one. However, the case reminds us that not all trusts are created equally, and the courts should be prepared to "tune up" or "tune down" the commercial and fiduciary elements of the parties' relationships appropriately when considering parties' claims against the trustee. While the finance company investors may have lacked the sophistication of the *Citibank* note-holders, the finance company trusts existed in a commercial context and the fiduciary obligations must be weighed against other commercial considerations, including preservation of creditor rights.[65]

4.5 *The New Zealand Law Commission's proposals to narrow trustee indemnities*

[61] *Citibank* at [82].

[62] *Kelly v Cooper* [1993] AC 205.

[63] *Armitage* (n 16).

[64] In this regard, the decision of *Re O'Donoghue* [1998] 1 NZLR 116 (HC) in which the trustee's duty to act in the interests of beneficiaries as a whole. See also the decision of Tipping J in *Porter v New Zealand Guardian Trust Co Ltd* (1996) (CP136/91), 7 TCLR 323 at 330.

[65] Interestingly, the United States courts are trending in the opposite direction with the emergence of a "doctrine of direct access" which supports the exclusion of all personal liability by the trustee and the ability of an unsecured trust creditor to directly access trust assets without needing to rely on the trustee's right of indemnity.[65] This doctrine effectively reallocates the risk of dealing with an insolvent or defaulting trustee from the creditor to the beneficiaries and remains open for consideration in New Zealand. The New Zealand Law Commission has commented that the doctrine is a "radical option". Refer New Zealand Law Commission, *Court Jurisdiction, Trading Trusts and Other Issues: Review of the Law of Trusts, Fifth Issues Paper No. 28* (December 2011) (***Fifth Issues Paper***) at [7.50] and [7.73].

Against the background of the finance company litigation, it is significant that the New Zealand Law Commission has proposed further statutory restrictions on trustee indemnity and limitation clauses in relation to all trusts.[66] It supports expanding the "irreducible core" of trustee duties to incorporate all mandatory content duties (i.e. all duties implied by statute or common law in all contexts), and to void any indemnity or limitation clause to the extent that the trustee incurs liability as a consequence of negligent breach of any of those duties:

> [T]he law should prevent the use of exemption clauses to exclude liability for a breach of a mandatory duty due to negligence...We consider that the mandatory duties are essential obligations in a trust and trustees who breach them negligently should be liable for compensation.[67]

The Law Commission further supports prohibiting trustee limitation or indemnification for breach of any other non-mandatory duty, although it would apply the higher threshold of recklessness, rather than negligence:

> We suggest that a standard of recklessness be used, that is, having knowledge that there is a risk that by acting or failing to act in a certain way there will be a breach of trust and taking this risk even though an honest and reasonable person would not. A trustee would not be able to avoid liability for a breach of trust resulting from this conduct by relying on an exemption clause.[68]

While the above statement is not obviously controversial, the difficulties of its commercial application become apparent if one applies the *Citibank* facts. In that case, might Citibank, acting on MBIA's instructions as required by the express terms of the trust deed, have nevertheless been "reckless" in failing to adequately consider the impact of its actions on the subordinate note-holders, and so have lost the protection of its indemnity? When one considers the pace at which commercial trustees have to act, what level of consultation or consideration might this practically require, and at what cost? How does one determine what subjective standard of negligence or recklessness applies in the context of a specific commercial transaction?

The New Zealand market commonly excludes negligence from the scope of the trustee's limitation of liability and indemnity clauses, and so in that regard the Law Commission's proposal should not have a significant impact on the current risk allocation in commercial transactions. However, if the scope of trustee liability and the classes of persons to whom the duties is owed is expanded beyond existing investor claims, it may be appropriate for the market to revisit the extent of the exclusions to maintain appropriate flexibility. As Helen Dervan notes, similar proposals mooted by the UK Law Commission in 2002 were abandoned after it faced strong opposition from the Financial Markets Law Committee.[69]

4.6 *Conclusion*

There is no doubt that the protection of investor interests is central to New Zealand securities law, and that beneficiary protection is central to trusts law. However, this paper submits that the trustee-beneficiary relationship should not be assessed in a vacuum, and the courts and legislature must carefully consider the context in which a trust operates to ensure the appropriate duty/liability/indemnity balance is achieved.[70] The commercial trust differs in many important respects from the traditional trust, and is in particular a creature of contract.[71] Accordingly, the New Zealand courts should heed the words of Lord Browne-Wilkinson who famously observed:

> [W]ise judges have often warned against the wholesale importation into commercial law of equitable principles inconsistent with the certainty and speed which are essential requirements for the orderly conduct of business affairs.[72]

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[66] New Zealand Law Commission, *Review of the Law of* Trusts*: Preferred Approach* (2012) (Issues Paper 31) (***Review Paper***) at [3.43] – [3.46].

[67] *Review Paper,* (note 70) at [3.49].

[68] Ibid at [3.50].

[69] www.fmlc.org.

[70] Dervan (n 1) at 5.

[71] By contrast, the traditional trust arises through the transfer of property by way of gift.

[72] *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] AV 669.