The Trusts Bill and creditor's rights

The Trusts Bill 290-1 sprung from recommendations in the Law Commission Report entitled "Review of the Law of Trusts: A Trusts Act for New Zealand", August 2013, Report 130. In regard to creditor's claims, the Commission stated "*The current recommendation stops short of permitting creditors to claim directly against the trust property*" and adds that "… *the claim would be against the trustee*", paragraph 16.47.

The Commission's statement is confusing having regard to the nature of a trust and the principles upon which a trustee's 'right of indemnity' and a creditor's right to subrogate into that right arises.

What then is the nature of a trust?

As lawyers know, a trust is not a legal entity like a person or a company. A trust is simply a descriptive term for the relationship between settlor, trustee, beneficiary and the trust property. Laypeople sometimes refer to 'their trust' or 'the trust' incorrectly believing that a trust is like a principal whose agents are the trustees. The correct position is that it is the trustees who are the 'principals' and, in general, they are barred from delegating their trustee powers to an agent or each other.

Property ownership comprises two parts; legal and beneficial ownership. In the context of a trust, the trustee owns only the legal interest in the trust property with the beneficial ownership or 'interest' belonging to the beneficiaries (though their interest may not have vested). The trustee's use of the trust property is constrained by fiduciary duties, so they may only apply the property for trust purposes i.e. in the day-to-day administration of the trust or, say, by way of distribution to the beneficiaries.

Trusts are not usually benign, administering them incurs expenses and liabilities. Because the trust is not an entity, such expenses and liabilities are incurred by the trustees personally. If unpaid, the creditor of the trustee can sue and even bankrupt the trustee notwithstanding that the trustee incurred that debt in the trust's administration. Unless the trustee contracts otherwise, his or her liability is unlimited. The additional rights that a creditor may acquire directly against the trust property is central to this article.

What is a trustee's 'right of indemnity'?

To discharge an expense or liability incurred through conducting trust business, the trustee either:

- Applies trust property direct to pay the expense or a liability (aka recoupment or exoneration). In practical terms, this usually means paying the debt from the trust's bank account, but it could mean selling a trust asset to produce the funds to enable payment; or

- Pays the expense or liability from their own personal funds (i.e. not trust property), then later repays herself or himself from trust property i.e. from the trust's bank account etc. (aka reimbursement).

The trustee's right to apply trust property to meet trust related, but personally incurred, expenses and liabilities is called the 'right of indemnity'. It is expressed as an indemnity because the trustee has personal liability for the expense/liability, so what the trust property is doing is acting as an indemnifier.

The Common Law has always ensured that the 'right of indemnity' is a powerful one, no doubt to reflect the fact that the trustee has personally incurred an expense/liability in relation to property that she or he has no beneficial interest. Illustrations of its power include that:

- It is void against public policy for a trust deed to deny a trustee the right of indemnity.

- It takes precedence over the rights of the beneficiaries.

- A trustee's indemnity is proprietary in nature (*Octavio investments* [1979] HCA 61 and endorsed in *Chief Commissioner of Stamp Duties (NSW) v Buckle* [1998] HCA 4, 192 CLR 226) i.e. it vests in the trustee a beneficial ownership interest in the trust property, and constitutes an equitable charge (*Re Exhall Coal Co Ltd* 901986 35 Beav 449) and equitable lien (*Vacuum Oil Co Pty Ltd v Wiltshire* [1945] HCA 37; 72 CLR 319 and Lewin on Trusts 18th edn Para 21-33) against the trust property.

- It affects all trust property (not just the particular property in respect to which the expense or liability may relate).

- It survives the trustee's replacement as a trustee.

If the trustee incurs the expense/liability in purported administration of the trust, but did so in breach of trust or in some other way that impairs the right of indemnity, then the trustee will likely lose their right of indemnity, and so, will have to discharge that expense/liability from their own personal resources.

When will a creditor subrogate into (acquire) the trustee's 'right of indemnity'?

As a general rule, a trustee creditor has no direct claim against trust property. Instead, the creditor enforces their claim against the trustee personally who, in turn, indemnifies themselves from the trust assets to discharge the creditor's claim.

An exception to this general rule is that a creditor may subrogate into a trustee's right of indemnity (or step into the shoes of the trustee) where it is not possible to enforce

the liability against the trustee personally, for instance where the trustee has absconded, died or become insolvent. Lewin on Trusts (18th edn para 21-10 paragraph 21.38) put it this way:

> *Although unsecured creditors and other claimants do not have a direct claim against the trust property in respect to unsecured liabilities incurred by trustees in the administration of the trust, and cannot levy execution upon the trust property, they may by subrogation have a right to stand in the place of the trustee and enforce their liabilities against the trust property to the extent that the trustee would be so entitled. The trustee's right of indemnity is an asset of the trust, and the trustee's creditors are entitled by subrogation to reach this asset and so enforce their claims against the trust property.*

What are the benefits of subrogation?

Once a creditor has subrogated into the trustee's right of indemnity, the creditor is no longer limited to suing the debtor trustee, he or she may proceed to exercise all the rights the trustee previously enjoyed. Those 'rights' include precedence over the rights of the beneficiaries to payment from the trust property. And, given the trustee's indemnity is proprietary in nature i.e. constitutes an equitable charge and/or an equitable lien against the trust property, it is arguable that any real property may be caveated. The leading authority on the subject is the High Court Judgment in *Official Assignee v Menzies* Unreported HC Auck, CIV-2010-404-5457, 14 February 2011. It is apposite to note that there is healthy debate about that Judgment and the legal ramifications of the right of subrogation and the possibilities this opens up for 'trust creditors' against the trust property. See Bill Patterson's June 2011 NZLS Trust Conference paper entitled "Trustees indemnities, equitable liens, subrogation and caveats – has the law taken a wrong turn? Page 245 Trusts Conference book. And for an alternative and competing view, see: my own paper entitled "Trustees Indemnities, Equitable liens, Subrogation and Caveats" BCB Vol 15 Issue 12 pp 155-168 (Aug 2013).

A further ramification of the proprietary nature of the 'subrogation right' is that trustees may be in breach of trust if they deal with trust assets in a manner that undermines a subsisting right to indemnify.

At a practical level, the subrogated creditor and the trustee are in starkly different practical positions in terms of what they can do with their right of indemnity. As 'legal owner' of the trust property the trustee is the named account holder of the trust bank account, so he or she simply applies the trust property (i.e. writes out a trust account cheque) to discharge the expense or liability. The creditor on the other hand, has no legal title by which they can take such direct action, so they are obliged to enforce their right through the courts i.e. by seeking a declaration confirming their right, then seeking orders compelling application of the trust property (which may include orders to sell that property). Justice Heath in *Levin v Ikiua* [2010] 1 NZLR 400 provides an illustration. In short the 'right' is the same, but the method by which the right is utilised or enforced is different.

The Law Commission

With the above general principles in mind, we may return to consider the Law Commission's statements that "*The current recommendation stops short of permitting creditors to claim directly against the trust property*" and "… *the claim would be against the trustee*", at paragraph 16.47. One could argue that creditors may already claim directly against the trust property in certain circumstances. And creditors have always had a claim against the trustee for debts arising from trust administration, so there is nothing new at all on that score.

In any event - what is the position under the Trusts Bill?

The first thing to note in the Bill is section 5(5)(a) which states that the proposed Act is not an exhaustive code on the law relating to express trusts. Section 5(5)(b) provides that the Act '*is intended to be complemented by the rules of the common law and equity relating to trusts (except where otherwise indicated or where those rules are inconsistent with the provisions of this Act)*'.

It follows that one must know the Common Law in order to apply the proposed legislation. As if matters were not challenging enough.

Creditors' rights are addressed in section 80 which is entitled "*Creditor's limited claim to trust property through trustee's indemnity*". The section is set out below:

(1) This section applies if a trustee incurs an expense or a liability to a creditor and the trustee—

(a) has a right to be indemnified from the trust property; or
(b) for any reason is not entitled to be fully indemnified from the trust property (for example, because the trustee incurred the liability in breach of trust) but—

(i) the creditor has given value; and
(ii) the trust has received a benefit from the transaction between the trustee and the creditor; and
(iii) the creditor has acted in good faith.

(2) The creditor has a claim against the trustee that may be satisfied by the creditor being indemnified from the trust property as if the creditor were a trustee.

(3) The creditor has not acted in good faith for the purposes of subsection (1)(b)(iii) if the creditor had knowledge of any circumstances that excluded or limited the trustee's indemnity (whether or not the creditor knew it would have that effect).

(4) A claim under this section—

(a) is limited to the value given by the creditor; and
(b) must be paid in priority over any payment to a beneficiary, unless the court orders otherwise; and

(c) *does not alter the priority of creditors who are entitled to claim from the trust property.*

(5) *This section applies in respect of a former trustee who incurs an expense or a liability as a trustee acting on behalf of the trust.*

The section is wider in application than first appears. It captures *all* trustees who incur an expense or liability in the administration of a trust. This is because *all* debtor trustees fall into 1 of only 2 possible categories; those that have a right of indemnity (captured in section 80(1)(a)) and those that don't (captured in section 80(1)(b)).

The original draft legislative provision in the Law Commission Report approached things differently. The Report stated: "*The application of the provision is confined to the Official Assignee and bona fide creditors who have given value, and where the trust property retains the value from the particular transaction between the trustee and the creditor*", chapter 16 para 16.44 of the Report. This is a limited subset of all possible trust creditors.

The Law Commission's draft provision is set out below:

48 Creditor's limited claim to trust property through trustee's indemnity

(1) *This section applies where:*

(a) *a trustee has incurred an expense or a liability to a creditor; and*
(b) *the creditor has given value; and*
(c) *the trust property has received a benefit from the transaction between the trustee and the creditor; and*
(d) *the creditor has acted in good faith.*

(2) *In a case to which this section applies, the creditor may claim to be indemnified out of the trust property as if the creditor were a trustee, notwithstanding that the trustee for any reason is not entitled to be fully indemnified.*

(3) *The creditor has not acted in good faith if the creditor had knowledge of any circumstances that excluded or limited the trustee's indemnity.*

(4) *A claim under this section—*

(a) *is limited to the value given by the creditor; and*
(b) *must be paid in priority over any payment to a beneficiary, unless the court orders otherwise.*

This suggested provision is fundamentally different from section 80 of the Trusts Bill. In particular, it does not include an equivalent to subsection 80(1)(a) of the Trusts Bill. That difference expands the application of section 80 to all trustee debtors rather than only those who '*for any reason is not entitled to be fully indemnified from the trust property*'.

While neither the Trusts Bill nor the Common Law require that a trustee creditor 'give value' as a precondition to acquiring rights against a trustee or the trustee's right of indemnity, section 80(4)(a) of the Bill states that "*A claim under this section is limited to the value given by the creditor*". It follows that section 80, which applies to all trustee creditors, provides relief to only those creditors who 'given value' to the trust property. One could argue that the giving of value is a 'precondition' to subrogation by effect.

If 'giving value' is a condition of relief, then the Bill offers no rights to the creditor whose liability arises from, say, a tort or some breaches of contract committed by the trustee. This is because the trust property has to receive value before a claim lies and then such claim is limited to the quantum of the value received.

Another prickly question arises: If section 80 applies to all trustee creditors, but the section grants limited relief to only some of them and in a way which is inconsistent with the "*rules of the common law and equity relating to trusts*", does that mean the Common Law rules are displaced for all creditors by reason of section 5(5)(b)?

Remembering that section 5(5) of the Bill states that the Act is "… *intended to be complemented by the rules of the common law and equity relating to trusts (except where otherwise indicated or where those rules are inconsistent with the provisions of this Act)*".

How does the Bill affect the Common Law right of subrogation?

Section 80(2) of the Bill states "*The creditor has a claim against the trustee that may be satisfied by the creditor being indemnified from the trust property* <u>*as if the creditor were a trustee*</u>". The Bill does not use the word 'subrogate'. Is this it to enhance the legislation's 'plain language' goal or is something different from subrogation intended? The underlined words I underline are identical in both the Trusts Bill and the Law Commission's proposed section.

Is there a difference between a creditor who subrogates into a trustee's right of indemnity as compared to a creditor who is "*indemnified from the trust property as if the creditor were a trustee*"? I suggest that the Trusts Bill does not alter the nature of a trustee's right of indemnity, all that section 80(1) and (2) does is alter when a trustee creditor may lay claim to that right.

If this is correct, then the Commission's statement that "*The current recommendation stops short of permitting creditors to claim directly against the trust property*" is confusing, if not wrong.

The Law Commission Report states that its suggested provisions do not give a creditor a "… *security interest in the* [trust] *property*", at paragraph 16.46. The significance of this statements depends on what is understood by 'security interest'. Aside from that, a creditor who acquires a trustee's right of indemnity does not need a security interest, they acquire something better; an equitable lien/charge and a proprietary interest in the trust property i.e. an ownership right not a mere a security right.

A final observation. The Common Law says that a subrogating creditor gets no better quality of indemnity than the trustee had. In short, if the indemnity is lost because of a breach of trust, then it is lost to the creditor too. This position is mitigated in the Trusts Bill in that provided there is no 'bad faith' by the creditor (section 80(1)(b)(iii)), then the right persists.

There is no doubt that is an enhancement to existing rights under the Common Law. It addresses the unsatisfactory situation where, say, a trustee incurs an expense or liability without his or her co-trustee's consent i.e. unlawfully in breach of the rule as to unanimity of trustee decision making, so impairing their indemnity, while enabling the trust property to be improved in value i.e. unjustly enriching it.

Summary of differences

The following key differences between the Trusts Bill and the Common Law position are offered:

1. The Common Law precondition to creditor's subrogation that the trustee who incurred the expense or liability has absconded, died or become insolvent is been done away with under the Trusts Bill.

2. The Common Law principle that the subrogating creditor gets no better quality of indemnity than the trustee had is also done away with in part, that is, where the creditor acts in good faith and gives value to the trust property.

3. The Common Law requires no mutual giving and receiving of value/benefit between creditor and trust property before the right to subrogation arises and the Common Law rights is not restricted in quantum to value given. So, in the situation where the trustee has impaired indemnity – the position is improved under the Trusts Bill, but where the trustee has an unimpaired indemnity – things are worse.

A postscript

The Common Law position in regard to creditor subrogation is unquestionably altered under the Trusts Bill. Attention must therefore return to section 5(5) and the statement in the Act that it is "… *intended to be complemented by the rules of the common law and equity relating to trusts (except where otherwise indicated or where those rules are inconsistent with the provisions of this Act)*".

Do the changes in the Bill represent an inconsistency with the Common Law requiring that the former be applied instead, or will there be two avenues for relief merely complementing each other, so the Trusts Bill may be taken as adding to rather than replacing existing rights?

If the Trust Bill's rights are additional to existing rights, then creditors of trustees may soon gain important and useful new rights against trust property. If section 80 is a code however, then it is debateable whether the Common Law position has been enhanced or undermined.

Princes Chambers, 3 Princes Street, Auckland 1010
021 673 252
09 974 5483