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UNIT TRUSTS: THE FUNCTIONS AND DUTIES OF THE MANAGER AND TRUSTEE

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1 INTRODUCTION

The managed funds industry at 31 March 1992 had some $2.88 billion under management.[1] Within the group of services offered and collectively called managed funds[2], unit trusts have witnessed an exponential growth since 1985[3] and at 31 March 1992 comprised nearly $1.4 billion of investors' money. The majority of investors are individual (as opposed to corporate) investors.

A unit trust is a collection of many investors' funds, pooled together to form an enterprise, and managed by professional managers with the aim of providing the investors with a high rate of return on their money at low risk.

Unit trusts have many attractions to investors. First, by pooling the resources of numerous investors, unit trusts can provide to those investors with relatively small amounts to invest, the benefits of wide ranging and diversified investment portfolios.[4] Secondly, unit trusts have the benefit of constant professional expertise at a cost to the collective of investors comparatively lower than would be available to investors individually.[5] Thirdly, the units issued to investors are generally transferable and redeemable, enabling investors to have ready access to their funds.

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1 Statistics were provided by the Financial Planning Group to Mr R S Carr, Chief Manager BNZ Retail Financial Services and presented at the nationwide BNZ Trust Group Seminars by R S Carr "The Managed Funds Industry in New Zealand Past, Present and Future Prospects Present and Future Developments" (Unpublished, seminar paper, Wellington, June 1992). See also Financial Alert Bulletin (29.6.92) Vol 7 Issue 7, 1.

2 Other services included in the figures are Insurance Bonds, Group Investment Funds, Personal Superannuation Plans, above n1, 2.

3 Refer to Appendix I which sets out a graph of the growth of unit trust funds in New Zealand since 1985; see above n1 Slide 9.

4 There are a variety of portfolio options that investors can choose, ranging from foreign equities to New Zealand property unit trusts, or a mixture of several investment options.

5 Unit trusts are treated as companies for tax purposes, by virtue of the dividend imputation scheme the double taxation of income earned and distributed by unit trusts is avoided (s211 Income Tax Act 1976).

Although unit trusts have witnessed a growth in popularity, the legal framework under which they operate is unsatisfactory. That framework[6] is an amalgamation of a number of statutes, and of equitable and common law principles, all of which fail to clearly define the duties of the trustees and the managers of unit trusts creating uncertainty. These uncertainties mean that managers and trustees are potentially liable for breaches of statutory and fiduciary duty. Furthermore, the lack of a clearly defined code has led to a duplication of work by trustees and managers resulting in excessive cost structures.

The author's concerns may be summarised:

(i) There is significant potential for liability on the trustee of a unit trust by virtue of the use of the term "trustee" and a misconception about the real functions and duties of the trustee .

(ii) There is insufficient awareness among managers of the extent of their functions and duties. Many managers are overly concerned with obtaining a share of the booming market without assessing their potential liability.

(iii) The unit trust legislation is imprecise in its conceptual framework and fails to provide trustees and managers with sufficient certainty and as a result, does not provide investors with the protection it was designed to achieve.

(iv) In considering the unit trust transaction courts should be more ready to recognise the distinction between traditional trusts and unit trusts and also need to understand how unit trusts work in commercial and practical terms.

This paper discusses these concerns with specific analysis of the trustee's duties of supervision, and the manager's functions and duties in selling units to investors and investing the unit trust funds, and attempts to clearly define these respective duties. The paper also examines the regulation of units trusts in Australia and presents suggestions for reform.

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6 Below 3.0 for a discussion of the statutory framework and below 4.0 for a discussion of the functions and powers of the manager and the trustee.

2 THE UNIT TRUST

2.1 Structure and Workings

A unit trust is defined in Section 2 of the Unit Trusts Act 1960 as

> any scheme or arrangement, whether made before or after the commencement of this Act, that is made for the purpose or has the effect of providing facilities for the participation, as beneficiaries under a trust, by subscribers or purchasers as members of the public ..., in income and gains (whether in the nature of capital or income) arising from the money, investments and other property that are for the time being subject to the trust.[7]

A unit trust results from the creation of an express trust[8] constituted under a deed of trust ("the unit trust deed").[9] The manager is the initiator of the transaction and is generally the settlor of the trust (or is closely associated with the settlor). Property[10] is made subject to the trust and, by the terms of the Unit Trusts Act , that property is required to be vested in an independent trustee[11] for the benefit of, and on behalf of, the beneficiaries.[12]

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7 The only reported case in New Zealand which discusses the definition of a unit trust is *Re Mortgage Management Ltd* [1964] NZLR 576.Section 2(a)-(g) Unit Trusts Act 1960 excludes: (a) trust for the benefit of debenture holders; (b) common funds of the Public Trustee; (c) common funds of the Maori Trustee; (d) group investment funds under the Trustee Companies Act 1967; (e) friendly societies; (f) superannuation schemes registered under the Superannuation Schemes Act 1989,(g) employee share purchase schemes.

8 Like any other trust, a unit trust must be established with certainty of intention, object and subject matter. For a general discussion of the three certainties see J K Maxton *Nevill's Laws of Trusts, Wills and Administration in New Zealand* (8 ed, Butterworths, Wellington, 1985), 22-29 ; H A J Ford and W A Lee below n 66, 504.

9 Section 9 Unit Trusts Act 1960 requires an authenticated copy of the trust deed to be lodged with the District Registrar.

10 The use of the words "investments" and "property" throughout this paper includes all "investments and other property" as defined in s2 Unit Trusts Act 1960.

11 Sections 3(4), 4 and 5 Unit Trusts Act 1960.

12 Section 8(1)(a) Unit Trusts Act 1960 provides that no units may be offered to the public until a trustee has been appointed.

The beneficial interest is divided into units which initially are held by the manager. The manager in turn promotes[13] the sale of the units[14] to investors. As investors subscribe for units the size of the trust property increases and the beneficial interest in the trust will be divided into more units.

The subscribers in purchasing the units become "unitholders". Unitholders do not have any proprietary interest in any particular asset of the unit trust fund.[15] Instead the units bought represent a direct beneficial ownership of the collective property of the unit trust fund and a right against the trustee to receive repayment of monies invested in proportion to the units held.[16]

For its efforts the manager obtains remuneration and pays few expenses for the setting up or continuing administration of the unit trust. These costs are generally paid by the unit trust fund.[17]

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13 Below 5.1 where the relationship of the manager to unitholders when selling units is discussed.

14 The offering, issuing and selling of the units to the public is governed by the Unit Trusts Act 1960 and not the Securities Act 1978. See below 3.4 where the Securities Act 1978 is discussed.

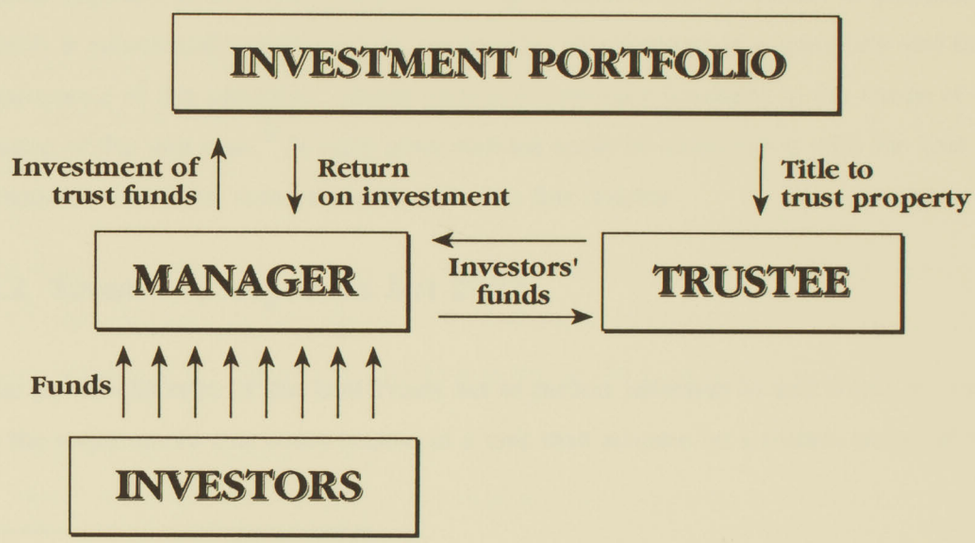
15 A Unit trust may be compared with a Company, however a company is a distinct and legal person (a trust is not) and holds property in its own right. Shares held by shareholders do not represent any legal or equitable interest in the company's property. For a discussion on the difference between a share in a company and a unit held in a unit trust see *Charles* v *Federal Commissioner of Taxation* (1954) 90 CLR 598, 609; H A J Ford "Unit Trusts" (1960) 3 MLR 129,130-133. It is uncertain whether unit holders would be liable for undischarged liabilities of the trustee or manager if those liabilities exceeded the trustee and managers assets; compare *Rita Joan Diaries Ltd v Thomson* (1974) 1 NZLR 285; *J M Broomhead (Vic) Pty Ltd (In Liquidation) v J W Broomhead Pty Ltd and Ors* 3 ACLC 335 and *McLean v Burns Philp Trustee Co Pty Ltd* (1985) 9 ACLR 926.

16 *Costa & Duppe Properties Pty Ltd* v *Duppe* [1986] VR 90.

17 Management fees range from 1-2% of the gross asset value of the fund. There are additional costs including purchasing, switching, selling, cash management fees plus the payment by the trust of legal, audit, printing, certificate, register fees and any other fees reasonably incurred.

The manager of the unit trust is charged with the management and day to day administration of the trust property on the terms set out or implied into the unit trust deed.[18] The trustee on the other hand has little to do with the administration of the unit trust fund. The trustee holds the title to the trust property and assumes a "watchdog" role over the manager.[19] The trustee's presence enables the manager to market the unit trust as a "safe" investment, with many prospectus documents representing the trustee to be the investors' guardian angel. The trustee is remunerated for carrying out these functions.[20]

The transaction may be simply illustrated:



[18] Below 6.0 where the managers duties are discussed.

[19] Below 7.0 where the trustees duties are discussed.

[20] Trustee fees are generally about 0.1% of the gross asset value of the fund. In addition fees are payable on the termination of the trust.

This paper discusses "flexible" (as opposed to "fixed") unit trusts. In a "flexible" unit trust the manager and trustee have the power under the unit trust deed to vary the nature and proportions of the property comprising the trust fund. However, such variation is limited to those investments authorised in the unit trust deed. Under a "fixed" unit trust, the portfolio and proportions of investment are fixed. The first portfolio of investments is described as a unit and the beneficial interest is divided into sub-units.[21]

[21] H A J Ford "Unit Trusts" (1960) 3 MLR 129.

3 THE STATUTORY FRAMEWORK

3.1 The Unit Trusts Act 1960

The Unit Trusts Act 1960 ("the Unit Trusts Act") regulates the selling of units in a unit trust by prospectus[22], and provides for the management by the manager[23], and the supervision by the trustee[24], of the unit trust.

The Unit Trusts Act is not a code in itself rather, it provides the structure for a unit trust and places on the manager and trustee certain functions, powers and duties. The policy objective of the Unit Trusts Act is to give unitholders a measure of protection which is substantially similar to that enjoyed by shareholders in a company and in furtherance of this objective[25] places certain supervisory functions in the hands of the trustee of the unit trust.[26] Several other statutes apply in conjunction with the Unit Trusts Act and these statutes are discussed in this chapter .

3.2 Trustee Companies Act 1967

The policy objective of the Unit Trusts Act to protect investors in unit trusts, is evident in the requirement that every trustee of a unit trust scheme be a trustee corporation[27]

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[22] Section 7 Unit Trusts Act and the Schedule to the Unit Trusts Act set out the statutory requirements which must be included in any prospectus offering units to the public.

[23] Below 4.1 and 6.0 where the manager's functions and duties are discussed.

[24] Below 4.2 and 7.0 where the trustee's functions and duties are discussed.

[25] See Parliamentary Debates 324 (30 August 1960), 1923; and 325 (19 October 1960) 3086.

[26] Explanatory Note Unit Trusts Bill 1960.

[27] Section 2 Trustee Companies Act 1967 sets out which companies are trustee companies for the purpose of the Trustee Companies Act 1967. Every trustee company is deemed to be a trustee corporation for the purpose of the Trustee Act 1956, however, it should be noted that not all trustee corporations are trustee companies. See s2 Trustee Act 1956 and s2 Trustee Companies Act 1967 for the definitions of trustee corporation and trustee company, respectively.

[28] Section 5(1)(b) Unit Trusts Act 1960.

or a company or bank approved for that purpose by the supervising Minister.[28]
A trustee company which accepts appointment as a trustee of a unit trust scheme[29] is subject to the statutory obligations imposed on it by the Trustee Companies Act[30] and the Trustee Act.[31]

In discharging any of the duties imposed on it, the trustee is entitled to claim remuneration for its services[32]. However, the trustee company's capital and assets are charged with any liability the trustee company incurs as a result of failing to fulfil the duties imposed upon it by the trust deed, equity, common law, or any Act.[33]

3.3 Trustee Act 1956

The provisions of the Trustee Act 1956 ("the Trustee Act") are implied into the operation of all trusts including unit trusts[34], unless expressly excluded by a trust instrument.

The powers conferred by the Trustee Act on a trustee, whether it is a corporation or not,[35] are additional to the powers given to the trustee by a trust instrument or any other Act unless the contrary is expressly stated in the trust instrument or that Act.[36]

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29 Section 7(2)(p) Trustee Companies Act 1967 authorises trustee companies to be trustees of unit trusts.

30 1967.

31 Section 3(1)(b) Trustee Companies Act 1967.

32 Section 18 Trustee Companies Act 1967.

33 Section 6(1) Trustee Companies Act 1967. The trustee and manager cannot seek indemnity from the unitholders for failing to perform their functions and duties; s24 Unit Trusts Act 1960.

34 Section 2(3) Trustee Act 1956.

35 Sections 2(4) and (5) make a distinction between trustees which are corporations and trustees which are not corporations. Trustees which are corporations should be distinguished from "trustee corporations" which are defined in s2. The manager is a trustee which is a corporation for the purposes of the Trustee Act 1956 because s4 Unit Trusts Act 1960 requires the manager to be a public company. Similarly the trustee will be a trustee that is a corporation and may also be a "trustee corporation".

36 Section 2(5)(a) and (b) Trustee Act 1956.

In the unit trust transaction, the Trustee Act applies to both the trustee (as a trustee company) and to the manager because the manager when exercising its powers and functions[37] must exercise those powers and functions as a trustee.[38]

The Trustee Act authorises trustees to undertake a number of activities, whether provided for in the trust instrument or not, but implies certain duties of care, skill and diligence into the carrying out of those activities.[39]

3.4 Securities Act 1978

The Unit Trusts Act is the only major piece of fundraising legislation that was not replaced by the Securities Act 1978 ("the Securities Act").[40]

The Securities Act regulates the issuing, allotting and selling of securities to the public by requiring disclosure of certain information in a prospectus and by restricting the content of advertisements for securities. The purpose of the Securities Act is to provide investors with a high standard of information to ensure investors are informed of the nature of their investments. The Securities Act deals with issues of debt, equity and participatory securities.[41]

Unit trusts are excluded from the statutory requirement for a prospectus under the Securities Act.[42] However, the Securities Act and Securities Regulations43 which relate

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37 Below 4.1. where the powers and functions of the manager are discussed.

38 Below 6.0 where the manager's duties are discussed.

39 Above n 19. See also above n33 regarding the managers' right to indemnity.

40 For a good discussion of the Securities Act 1978 see Darvell and Clarke *Securities Law in New Zealand* (Butterworths Wellington 1983); see also *New Zealand Company Law and Practice*, (Commerce Clearing House Reporter) Volume 1, Ch 7.

41 For a definition of Debt, Equity and Participatory Securities see s2 Securities Act 1978.

42 Section 5(2A) exempts unit trusts from ss 33(3), 37, 37A, 39 to 44, and 44B to 54 of the Securities Act 1978.

43 1983.

to the content of advertisements,44 the Registrars powers of inspection,45 and the liability and offence provisions[46] still apply to unit trusts.

The Securities Act was enacted after the Unit Trusts Act and therefore, it can only be assumed that it was the belief of the legislature that the provisions of the Unit Trusts Act, relating to the content of unit trust prospectuses, provided sufficient information and protection to investors.

Although a unit trust transaction does not fall clearly within the definition of debt or equity securities in the Securities Act, unit trusts could be classified as participatory securities. As the policy of the Unit Trusts Act is to protect investors it is the author's view that this goal would be more appropriately achieved by adopting requirements of more stringent disclosure and more full and accurate information, especially in respect of fees payable by unitholders.[47] This could be achieved by amending the Schedule to the Unit Trusts Act and analysing what requirements of the Securities Act may also be appropriate to include in the schedule.[48]

Many managers have commented that with respect to disclosure of information the industry standard is much higher than that required by the Unit Trusts Act and on par with the Securities Act requirements. The author disagrees. Many of the New Zealand prospectus documents (as opposed to Australian and UK prospectuses on the whole) are little more than company profiles with the management fees tucked away in fine print in the middle of the document. The list of authorised investments, coupled with the manager's statement of its objectives, are often inconsistent with the investment guidelines issued by the trustee. On the whole, the standard is unsatisfactory.

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44 Sections 38, 38A, 44A Securities Act 1978 and Part II Securities Regulations 1983.

45 Sections 66 - 70A Securities Act 1978.

46 Sections 55 - 65 Securities Act 1978.

47 Compare s39 Securities Act 1978 and Third Schedule Securities Regulations 1983 with s7 Unit Trusts Act and the Schedule to the Unit Trusts Act.

48 Refer to ss 41, 42, 43, 44 Securities Act 1978. See below n160.

4 THE FUNCTIONS AND POWERS OF THE MANAGER AND TRUSTEE

The extent of the duties owed by the manager and the trustee in carrying out their respective functions and powers are discussed later. The powers and functions required to be exercised by each party under the terms of the Unit Trusts Act may be summarised as follows.

4.1 The Manager's Functions and Powers

4.1.1 The manager performs the function (whether as a principal or by an agent) of issuing or offering units in a unit trust to the public for subscription or purchase or inviting the public to subscribe for or purchase units, or both of these functions.[49]

4.1.2 Upon the purchase of units by an investor, the manager must issue a certificate as evidence of the investor's interest.[50]

4.1.3 The manager must pay all money received from investors into a separate bank account and pay that money to the trustee.[51]

4.1.4 The manager must file annual audited accounts with the District Registrar, a list of unit holders for the relevant period, and a list of the distributions made to those unitholders.[52]

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[49] Section 3(2)(b) Unit Trusts Act 1960; see above n 22 for the statutory requirements which need to be included in any unit trust prospectus.

[50] Section 13 Unit Trusts Act 1960; The certificate must be authorised in writing by the manager but given by the Trustee or someone other than the manager.

[51] Section 14 Unit Trusts Act; All money received by the manager and required to be paid to the trustee becomes subject to the trust upon receipt of that money by the manager (or its agent).

[52] Section 20 Unit Trusts Act 1960.

4.1.5 The manager must also lodge an authenticated copy of the trust deed with the District Registrar.[53]

4.1.6 The manager has the powers of management of the investments and other property that are subject to the unit trust.[54]

4.2 The Trustee's Functions and Powers

4.2.1 The trustee (or its associated company) must have vested in it the investments and other property that are from time to time subject to the unit trust.[55]

4.2.2 The trustee must hold the register of unitholders.[56]

4.2.3 The trustee must cause proper accounts to be kept, either by the trustee or the manager, and send annual accounts to unitholders.[57]

4.2.4 The trustee must also supervise the manager in carrying out its powers in respect of management.

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53 Section 9 Unit Trusts Act 1960.

54 Section 3(2)(a) Unit Trusts Act 1960.

55 Section 3(3) Unit Trusts Act 1960.

56 Above n 55.

57 Section 11 Unit Trusts Act 1960.

5 THE MANAGER AND TRUSTEE RELATIONSHIP VIS-A-VIS UNITHOLDERS

The manager's functions and duties as set out in 4.1 may be divided into two broad categories:

(i) the functions and powers of offering and selling units; and

(ii) the functions and powers associated with the management of the unit trust fund.

The powers and functions of the manager raise the question of what is the relationship between the manager and the trustee in carrying out these powers and functions?

The answer to this question will identify which party unitholders have recourse to in the event of a unit trust collapsing. From the trustee's and manager's point of view, a definition of the trustee/manager relationship is essential so that each understands and is fully aware of its potential liability and takes the appropriate precautions to guard against being implicated for any breach of trust, negligence,[58] default or dishonesty of the other party.
The relationship of the manager and trustee is discussed below by reference to the two broad categories stated above.

5.1 Selling of Units

The function of issuing or offering units to the public for subscription or purchase is placed upon the manager (either as a principal or by an agent) by the Unit Trusts Act.[59] Although the Unit Trusts Act uses the word "principal", it is unclear what the managers' capacity is in offering and selling units, vis-a-vis unitholders. Is the manager in fact a principal, or is it an agent, and if so, of whom?

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[58] Below 8.0 where the liability of the manager and trustee is discussed.

[59] Above 4.1.1 where the manager's functions are discussed.

5.1.1 *Agency*

The relationship of agent and principal may be defined as a fiduciary relationship which existing between two persons, one of whom (the principal) expressly or impliedly consents to the other (the agent) acting on its behalf, and the agent consents to so act.[60]

The manager in offering and selling units to the public cannot be an agent of the trust itself because the trust is not a legal person at law. However, it may be argued that the manager is an agent of the trustee, whose duty it is to get in and hold the trust property. This argument may be further supported by the following factors:

(i) In the normal case, the manager does not initially own any of the units which it offers to sell (although it may hold them in a 'float') rather, unit certificates are issued as the demand for them arises.

(ii) Any money that is received from investors by the manager is received on behalf of the trustee.

Thus, the manager may be said to be the agent of the trustee by procuring investors to enter into a relationship with the trustee as beneficiary.[61]

5.1.2 *Principal*

Although the relationship between the manager and the trustee vis-a-vis unitholders could be classified as an agency relationship, that classification is undesirable for a number of reasons.

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[60] F.M.B. Reynolds *Bowstead on Agency* (5ed, Sweet & Maxwell, London, 1985), 1.

[61] R Stewart "Unit Trusts - Legal Relationships of Trustee, Manager and Unitholders" (1988) C&SLJ 269, 271.

First, in commercial reality,[62] the manager is the primary instigator or entrepreneur of the investment scheme, without which there would be no unit trust[63]. As a result, the manager has a direct contractual relationship with investors.

Secondly, the prospectus, which is issued to attract investors, generally contains application forms, addressed to the manager, for the investors to fill out covenanting with the manager that the investor will be bound by the unit trust deed. Such an application also requires a cheque to be sent with the application, payable to the order of the manager. The manager then has a discretion to either accept or decline the investor's application, without reference to the trustee.

Thirdly, the Unit Trusts Act recognises that the manager is a principal[64] and contemplates that the manager will be contracting directly with investors in selling units. This is evidenced by the fact that the manager is responsible to unitholders for its acts and omissions in selling and issuing units as if it were a trustee.[65]

The use of the word 'principal' by definition cannot mean the manager is the trust itself, as a trust is not a legal person. Rather the term means that the manager is in a direct contractual relationship with the investors.

It is the author's view that not only does the Unit Trusts Act provide that the manager, in offering and selling units to the public, is a principal, but also that it makes commercial sense for this to be the case. If the manager were the agent of the trustee, any acts, defaults, or misrepresentations made by the manager (or its agents) would make the trustee liable as a principal. Such a proposition would lead to higher trustee's fees and even a reluctance by the trustee companies to act as trustees.

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62 *Graham Australia Pty Ltd* v *Corporate West Management Pty Ltd & Anor* 1 ACSR 682, 687 where Brooking J proceeded on the basis, which his honour believed was sound, that the manager was in a direct contractual relationship with unitholders.

63 *Parkes Management Ltd* v *Perpetual Trustee Co Ltd and P.T. Ltd* (1977) ACLC 29,545, 29,551.

64 Section 3(2)(b) Unit Trusts Act 1960.

65 Section 3(2)(c) Unit Trusts Act 1960; see below 6.0 where the manager's duties are discussed.

5.2 Management of Unit Trust

The manager of a unit trust in carrying out its functions and exercising its powers of management could be seen as either an agent of the trustee or as a co-trustee under traditional trust law principles ("traditional trust law").

5.2.1 Agency

Under traditional trust law trust property is vested in a trustee who is required to administer the trust property in accordance with the terms of the trust, in an impartial manner and for the benefit of the cestuis que trust. In that relationship, many fiduciary duties are implied [66] one of which is the duty to act personally and not to delegate duties or decisions that may be performed by the trustee.[67]

The trustee may employ agents to assist in arriving at a decision or to carry that decision into effect[68] once it has been made by the trustee.69 However the trustee may not employ an agent to make a decision required to be made by it. The trustee must, therefore, employ a proper person to act and continue to supervise the agent's work.[70]

Under traditional trust law, the manager would be seen as an agent of the trustee but it is apparent that the powers and functions of the manager do not fit within the traditional trust principles.

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66 For a good discussion on trustee's duties see H A J Ford and W A Lee *Principles of the Law of Trusts* (2ed, The Law Book Company Ltd 1990), Ch 9; P D Finn, *Fiduciary Obligation*, (The Law Book Company Ltd, 1977); W F Fratcher *Scott on Trusts* (4ed, Little Brown and Company, Boston), Vol II, para 187.

67 *Turner v Corney* (1841) 5 Bear 525; There are exceptions to this rule: (a) where delegation is permitted by statute, see ss 28, 29, 31 Trustee Act 1956; (b) where delegation is permitted by the trust deed; (c) necessity, see *Speight* v *Gaunt* (1883) 9 App Cas 1.

68 Section 29(1) Trustee Act 1956.

69 For a discussion on the liability of trustees for the acts of agents see J Maxton Nevill's *Law of Trusts, Wills and Administration in New Zealand* (8ed, Butterworths, 1985), 185; H A J Ford and W A Lee above n 66, 444.

70 *Fry* v *Tapson* (1884) 28 Ch D 268; *Carruthers v Caruthers* [1896] AC 659; *Wyman v Paterson* [1900] AC 271.

The reasons for this are that the manager, in carrying out its management functions, is the active party in the unit trust transaction, making daily decisions and exercising powers of management. It would be unduly expensive and commercially impractical for the trustee of the unit trust to consider the advice of the manager and to approve that advice before the manager could act in each case.

Thus, the manager in carrying out its managerial functions should not be viewed as an agent of the trustee.

5.2.2 Co-Trustee

A manager when exercising its powers and functions in managing the unit trust fund must exercise those powers and functions as a trustee.71 Traditional trust law would dictate that the existence of more than one trustee makes the trustees co-trustees, and all decisions that are required to be made must be done so unanimously.72 Co-trustees occupy a joint office[73] and one trustee cannot make a decision without the authorisation of the other trustees.[74] Consequently a co-trustee's liability is joint and several so that a passive trustee is prima facie liable for any breach of trust committed by an active trustee.[75]

It would be unduly burdensome on a trustee of a unit trust to make it potentially liable for every decision and act of the manager in the daily management of a unit trust, unless such an act was manifestly not in the best interests of unitholders.[76] It would be equally burdensome to require that every decision made should be made unanimously.

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71 Above n 65.

72 *Lake* v *South Kensington Hotel Co* (1879) 11 ChD 121, 125.

73 *In the Estate of William Just* [1973] 7 SASR 508, 513.

74 *Lee v Sankey*(1873) LR 15 Eq 204.

75 *Bahin v Hughes* (1886) 31 ChD 390, 396.

76 Below 7.1 where trustees duty of supervision is discussed.

5.3 Dichotomy of Functions Powers and Duties

The relationship of the manager and the trustee of a unit trust is different to the traditional trust law relationship between trustee and agent or between co-trustees. There is no concept in equity that trustees may divide duties among themselves, unless expressly provided for by the trust instrument, so that one trustee performs some functions and the other trustee other functions.

In the unit trust transaction there is a dichotomy of powers, functions and duties between the manager and trustee akin to the statutory exception (that there cannot be a division of duties) in section 50 of the Trustee Act. That section enables a corporation to be appointed as a custodian trustee for the sole purpose and with the sole function of getting in and holding the trust property. Any investments made by the custodian trustee are at the managing trustee's direction.[77] The custodian trustee is in a fiduciary relationship with the managing trustee[78] but its liability is limited to its own actions and does not extend to the acts or defaults of the managing trustee.[79]

The Unit Trusts Act recognises the division of roles between the manager and the trustee by providing that the manager shall be liable for its own acts and omissions in the exercise of its powers and functions as it would if it exercised those powers and functions as a trustee.[80]

It is submitted that the terms "managing trustee" and "custodian trustee" are in fact better descriptions for the relationship between the manager and the trustee, and that the use of these (or similar terms) would provide investors with a better understanding of the parties' functions and duties. Most managers would object to being renamed managing trustees. Generally, the image managers portray in

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77 Section 50(2)(c) Trustee Act 1956.

78 *Re Brooke Bond & Co Ltd's Trust Deed* [1963] Ch 357.

79 Section 50(2)(f) Trustee Act 1956.

80 Above n 65.

prospectus documents is the professional service that they offer, down-playing and often not mentioning that they have any duties to investors, because of the connotations that the word "trust" gives to the public.

In Australia, the statute regulating unit trusts[81] does not impose the duties of a trustee on a manager. However, the Australian courts have recognised on a number of occasions[82] the division of managerial and custodial functions. The statement of Young J in *Re Application of Permanent Trustee Nominees (Canberra) Ltd* correctly summarises the trustee/manager relationship in Australia and New Zealand

> It must thus be realised that trusts such as the present constitute a special species of trust where the power to manage and what I might call the "watchdog powers" are deliberately compartmentalised.[83]

The trustee and manager are not in any hierarchy, rather they occupy co-ordinate offices, each being responsible for complimentary duties, the supervision of the other for the protection of unitholders, and providing mutual "checks and balances".

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[81] Coporations Law Part 7.12 Div. 5

[82] *Parkes Management Ltd* v *Perpetual Trustee Co & PT Ltd* (1977) ACLC 29,545, 29,551; *Elders Trustee and Executor Co Ltd* v *Reeves (EG) Pty Ltd and Ors* (1987) 78 ALR 193; *Re Application of Permanent Trustee Nominees (Canberra) Ltd*, (NSW, Supreme Court) Unreported, 24 June 1985 cited by D Brewster "Fiduciary Obligations of Trust Manager and the Takeover of Unit Trusts" (1990) C&SLJ 303, 315; *Telford Property Fund and Anor* v *Permanent Trustee Co Ltd*, Unreported, 28 February 1985 cited in R Stewart "Unit Trusts - Legal Relationships of Trustee, Manager and Unitholders" (1988) C&SLJ 269, 274.

[83] Above n 82.

6 THE MANAGER'S DUTIES TO THE INVESTORS, UNITHOLDERS AND THE TRUSTEE

To outline the functions and powers of the manager[84], and the relationship between the manager and trustee[85] does not however define the manager's duties at law to the public (as potential investors), unitholders, and the trustee, in offering and selling units and managing the trust fund.

6.1 The Manager's Duties to Investors in Offering and Selling Units

It has been noted that when accepting an offer from an investor for units the manager is in a direct contractual relationship with that investor. However, before the manager accepts that offer from investors, it is unclear what duties, if any, the manager owes to the public.

Section 3(2)(c) Unit Trusts Act provides that a manager, in carrying out its functions and powers as a manager (one of which is to offer and sell units), must exercise those powers and functions as a trustee.

6.1.1 Trustee To Whom

The first question that arises is, to whom does the manager owe a duty as a trustee towards? Under traditional trust law the trustee is a trustee to the beneficiaries (in this case unitholders). It is arguable that the manager owes the duties of a trustee to the public, who are potential unitholders in a unit trust because arguably the Act deems them to be beneficiaries.

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[84] Above 4.0 where manager's functions are discussed.

[85] Above 5.0 where trustee's functions are discussed.

Traditional trust law recognises that a trust can be created for beneficiaries not yet in existence[86] and a trust will not fail for lack of certainty provided that the beneficiaries able to enforce the trust, are ascertainable.

As long as the trust instrument shows how the beneficiaries are to be ascertained within the perpetuity period then the trust will be valid.[87]

Unit trust deeds generally provide that the beneficiaries will come into existence and be ascertainable upon investors purchasing units in the trust and becoming a registered unitholder. Accordingly, the manager will be a trustee to registered unitholders as beneficiaries.

It is submitted that it is not the intention of the Unit Trusts Act to deem potential unitholders to be beneficiaries, because potential unitholders in a unit trust cannot be seen as an ascertainable class of people able to enforce the trust. In this case, the trust would fail for lack of certainty.[88]

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86 *Elliot* v *Joicy* [1935] AC 209.

87 *Re Flavel WT* [1969] 1 WLR 444.

88 *Inland Revenue Commissioner v Broadway Cottages* [1955] Ch 20; *McPhail v Doulton* [1971] AC 424.

6.1.2 *Duties to Investors and Unitholders*

As we have seen, the manager should be seen as owing the duties of a trustee to unitholders and cannot correctly be classified as a trustee to potential investors when offering and selling units.

It is submitted that the extent of the manager's obligations to potential investors are set out in section 7 of the Unit Trusts Act which provides that before any interest in a unit trust is offered or issued to the public, the manager must set out certain information in a prospectus89 and must not mislead the public in fulfilling these requirements or in advertising any unit trust.[90] The manager's activities come within the definition of 'promoter' and 'issuer' under the Securities Act,[91] therefore, the manager will be liable for any misleading, deceptive, or false statements in any advertisements.[92]

The manager does not therefore have a duty to disclose any more information than, that required by the Unit Trusts Act and Securities Act. However, many managers, at present, in offering and selling units to the public, could be seen at the pre-contractual stage, as owing a duty of care to potential investors either in equity or tort. The reason for this view is that many managers hold themselves out not only as

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89 Above n 22.

90 Sections 44A, 55 Securities Act 1978.

91 Section 2 provides that a "Promoter in relation to securities offered to the public for subscription (a) a person who is instrumental in the formulation of a plan or programme pursuant to which the securities are offered to the public".

92 Sections 55 - 59 Securities Act 1978; also ss 9, 13 Fair Trading Act 1981. The trustee is specificaly exempt from liability for ommisions or misstatements by the manager in respect of the prospectus documents by s7(5) Unit Trusts Act 1960.

professional managers but also as independent financial advisors to investors, discussing with investors their financial needs on the one hand and advocating their products to meet those needs on the other.[93]

While the doctrine of *caveat emptor* may be argued to counter this view, it is submitted that the Unit Trusts Act and the Securities Act attempt to provide investors with as much protection as possible in purchasing units and securities, and that this protection (given the correct set of circumstances) would be extended in the form of equitable or tortuous duties where an investor, without warning to seek a second opinion, relies on a manager for advice and believes, that the manager is acting on behalf of the investor and in its best interests.

An analogy may be drawn with the banker/customer relationship. The courts have generally held, that except in exceptional circumstances, a bank has no duty to advise or make inquiry of or explanation to a potential customer. However, where a relationship of reliance and confidence is established a bank may be liable in equity by virtue of a fiduciary relationship with the customer.[94]

Similarly, a manager may be liable by virtue of a tortious duty of care where the manager voluntarily assumes responsibility for giving financial advice. As a consequence, the law imposes a duty on the manager to take proper professional care in formulating and delivering that advice.[95]

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93 "A fiduciary" is simply someone who undertakes to act for or on behalf of another in some particular matter. That undertaking may be of a general character. It may be specific and limited. It is immaterial whether the undertaking is or is not in the form of a contract. It is immaterial that the undertaking is gratuitous. And the undertaking may be officiously assumed without request; P D Finn *Fiduciary Obligations* above n 66, 201.

94 *Woods v Martins Bank Ltd* [1959], 201; *National Westminster Bank Plc v Morgan* [1985] 2 WLR 588, 829 Lord Scarman considered that explaining a document did not of itself create a fiduciary duty.

95 *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465; *Mutual Life & Citizens Assurance Co Ltd v Evatt* [1971] AC 793; descenting judgment of Sir Robin Cooke in *The Royal Bank Trust Co (Trinidad Ltd) v Pampellonne* [1987] 1 Lloyd's LR 218; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447. The Consumer Guarantees Bill 1991 if enacted will enable investors to bring an action against financial advisors who are not "fit for the purpose" thereby eleviating the difficulty of proving a cause of action in tort or equity.

6.2 Investment of Unit Trust Fund

The manager owes the duties of a trustee to act in the best interests' of unitholders and in good faith, ensuring that its duties do not conflict with its own interests.[96]

Thus, after accepting an investor's application to purchase units, the manager must act with due diligence, skill and care in the day to day administration of the trust fund and must exercise its best endeavours to ensure that the unit trust is managed in a proper and efficient manner. Furthermore, when the manager is required to exercise its judgment, it must do so reasonably.[97]

When investing the trust funds the manager, must exercise the care that a prudent person, of similar skill and expertise, would when investing for others[98] and, when redeeming units for unitholders, must act in the best interests of unitholders and not make an undisclosed profit.

6.2.1 Duty to invest prudently

Under the Unit Trusts Act the manager is responsible for the investment of the trust funds and must act as a trustee in carrying out that function.[99] The Trustee Act provides that a trustee (or in this case the manager) has the power to invest any trust funds in any property[100] and that any investment may be varied from time to time.[101]

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96 *Bray v Ford* [1896] AC 44,51.

97 Section 12(1)(a) implies into every unit trust deed the requirement for a manager to use its best endeavours.

98 *Luciv v Fillinov* [1982] 2 CL 38 (CA) (unreported) cited in W F Fratcher *Scott on Trusts* above n 66.

99 Section 3(2)(c).

100 Section 13A Trustee Act inserted by s3 Trustee Amendment Act 1988.

101 Section 13A(2) Trustee Act 1956.

This unlimited power of investment may, and is generally limited by the unit trust deeds so that trust funds can only be invested in "authorised investments"[102]. Often unit trust deeds will also provide for guidelines to be agreed upon between the trustee and the manager. These guidelines restrict the percentage of trust funds that can be invested by the manager in certain categories of the authorised investments at any one time. The purpose of these guidelines is discussed below.[103]

Unless a unit trust deed expresses a contrary intention,[104] the manager in carrying out its powers of investment must exercise the care, diligence and skill that a prudent person of business would exercise in managing the affairs of others.[105] The manager is required to exercise a higher degree of care, diligence and skill in exercising its powers, because it possesses special skill in the investment area.[106] In any particular

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[102] The authorised investments generally may be amended after agreement between the manager and the trustee.

[103] Below 7.1 for a discussion on the duty of the trustee to supervise the manager.

[104] Section 13D Trustee Act 1956.

[105] Section 13B Trustee Act 1956. The prudent person rule found its origins in the Supreme Court of Massachusettes in *Harvard College v Amory* (26 Mass (9 Pick) 446 (1830)) and is used in some forty States of the United States of America (for an excellent comparison of the prudent man rule and the legal list approach see D Grosh "Trustee Investment" (1974) 23 ICLQ 748.). The rule expounded in that case was that the trustee must observe how men of prudence, discretion and intelligence manage *their own affairs*. The prudent person rule was modified and adopted by the New Zealand Legislature in 1988 (inserted by s3 Trustee Amendment Act 1988) so that a trustee when investing must carry out its duties of investment as a prudent trustee would in investing for *others*.

Due to the similarity between the New Zealand and American rules, the American cases may be of some assistance in New Zealand in ascertaining what is prudent. But such cases should be read with caution for two reasons. First, there is a distinction between the New Zealand rule and the rule set out and adopted by many States in the *Harvard* case (see highlighted words above). Lindley LJ in *Re Whiteley; Whiteley v Learoyd* (1886) 33 ChD 347 stated correctly the distinction, at page 355, where His Honour said "The duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider, the duty is rather to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide". Secondly, many of the cases are concerned with applications by trustees to courts, asking whether a particular investment in particular circumstances, is prudent. There are few decisions where beneficiaries have asserted that a trustee has breached its duty to invest prudently.

[106] Section 13C Trustee Act 1956.

case, it will be a matter of fact, ascertainable from the evidence before the court, whether a manager has exercised the care, diligence and skill required of it.[107]

The prudent person rule is a test of conduct rather than performance or result. The manager cannot be viewed as a guarantor of the trust fund[108] and the mere fact of loss does not necessarily imply that an imprudent investment has been made.

The general thrust of the rule is that it is the manner in which the manager acts in choosing investments which is of chief importance. If a manager exercises the reasonable care and skill that a prudent person engaged in the business of investing would exercise in managing the affairs of others, it will not be liable if the investment turns out badly.

6.2.1 *Duty to Diversify*

An important question that requires clarification is whether the manager is under a duty to distribute the risk of loss of the unit trust funds' capital, by reasonable diversification of the investment portfolio.[109] The Trustee Act does not state that the manager is under a duty to diversify. However, section 13E[110] sets out matters which the manager may have regard to in exercising its powers of investment. The first of these matters is the "desirability of diversifying trust investments."[111]

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[107] The "legal list" was replaced by the "prudent person rule" after the Joint Working Party recommended that the difficulties with the legal list were sufficiently serious to justify abandoning that approach in favour of a principle which, though less precise, was more suited to modern investment conditions see Joint Working Party "Trustee Investment - The Prudent Man Approach?" Report of the Joint Working Party Department of Justice 1986 para 13.

[108] Re *Chapman; Cocks v Chapman* [1896] 2 Ch 763, 775.

[109] For a discussion on the meaning of "diversification" see McSwain "Prudent Diversification : Suggested Solutions for Trust Investors" (1967) 106 Trust & Es 845, 846; H E Bines "Modern Portfolio Theory" below n 112.

[110] Trustee Act 1956.

[111] Section 13E(1)(a), above n 109.

The Modern Portfolio Theory[112], which is widely accepted by professional fund managers throughout the world, dictates that maximised diversification is essential to eliminate the consequences of risk and to achieve an "efficient" portfolio. It is submitted that as a matter of course managers should have regard to the desirability of diversification[113] and that it will be necessary for a manager to be able to justify why in their view it was not prudent to diversify in any particular case or why the manager did not diversify more or less.

Other matters that may justify why the manager did not diversify (or diversify more or less) are set out in Section 13E. These are:

(i) The nature of the existing trust investments.
(ii) The need to maintain the real value of the capital or income of the trust.
(iii) The risk of capital loss or depreciation.
(iv) The likely income return.
(v) The term of the investment.
(vi) The duration of the trust.
(vii) The marketability of the investment.
(viii) The aggregate value of the trust fund.
(ix) Tax liability.
(x) The likelihood of inflation affecting the investment or trust fund.

[112] It is neither within the scope of this paper, nor is the author competent, to discuss the technicalities of the Modern Portfolio Theory. See W A Lee "Modern Portfolio Theory and the Investment of Pension Funds" in *Equity and Commercial Relationships* P D Finn (ed) Law Book Co Ltd (1987) 284, 298; F J Finn and P A Ziegler "Prudence and Fiduciary Delegations in the Investment of Trust Funds" (1987) 61 A L J 329, 334; H E Bines "Modern Portfolio Theory (1976) 76 Columbia L Rev 721, 743".

[113] A duty to diversify may be imposed by the trust deed or by a court.

6.2.2 *The Courts Approach : One or All?*

When managers invest trust funds they generally attempt to reduce the possible risk to which the capital is exposed. This may be done by selecting some investments that are by themselves speculative but in combination with other investments form a secure portfolio. This attempt to mask the consequences of risk is called co-variance.[114] However, will the New Zealand courts recognise such portfolio investment strategies? The situation that may arise is best illustrated by an example. An action may be brought by an aggrieved unitholder in the following way.

A unitholder alleges that the manager has breached its duty to invest prudently because one particular investment (A) was very risky and therefore imprudent. The manager on the other hand claims in its defence that its portfolio investment strategy was such that the risk of A failing was accounted for by other investments (B,C,D).

The courts have shown a tendency to test whether a trustee had breached its duty to invest prudently by reference to each investment taken individually[115] as opposed to considering an entire investment strategy and ascertaining whether the investment, in the context of that strategy was prudent.

However in a recent English High Court decision[116] Hoffman J recognised the merits of investment strategies where His Honour stated:

> Modern trustees acting within their investment power are entitled to be judged by the standards of current portfolio theory, which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation ... an investment which in isolation is too risky and therefore in breach of trust may be justified when held in conjunction with other investments.

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[114] Above n 112.

[115] For example see *Astbury v Beasley* (1869) 17 WR 638.

[116] *Nestle v National Westminster Bank plc* Unreported 29 June 1988 noted by N Clayton "The Duty of a Trustee to be Prudent and Fair" [1988] 6 JBL 284.

The Trustee Act encourages courts (where appropriate) to take into account investment strategies in any action against a trustee for a breach of its duty to act prudently.[117] However, it is submitted that in any action against a unit trust manager for a breach of duty to invest prudently the court should always consider the manager's investment strategy. A failure to do so would be to disregard the working parties intentions'[118] and the commercial reality of how managers operate.

6.2.3 *Is a High Risk Unit Trust Imprudent?*

A manager may propose putting together a portfolio of extremely risky investments and offering units to the public. Suppose the investments were oil futures, an investment generally seen as not being an investment a prudent person would make when investing on behalf of others. Because the portfolio is made up of such high risk investments (and assuming the manager fulfils the disclosure requirements set out in the Unit Trusts Act) can the portfolio be said to be imprudent and in breach of the provisions of the Trustee Act? Or can it be said that because all of the investors have been fully informed they will realise the risk that they will be taking and therefore section 13C only requires the manager to manage the otherwise imprudent investments as a prudent person of its same skill would, in investing in those investments for others.

In the author's view the manager, in selling units, does not owe duties to potential unitholders to either enquire about the investor's financial status, or to enquire whether in fact the unit trust scheme which is being marketed (low, medium or high risk) is suitable for that particular investors circumstances. The manager is required by statute[119] to disclose certain information to the public, and, having fulfilled those

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[117] Section 13M Trustee Act 1956.

[118] Above n 107, 12 para 20.

[119] Above n 22.

requirements need not make further inquiry or disclosure (in the absence of a duty of care in equity or tort).

It may be arguable, however, in the oil futures portfolio scenario that the manager owes a duty of care to investors to ensure that they are fully aware of the risk of loss, a duty over and above that imposed by the Unit Trusts Act. Disclosure of the risk of loss would no doubt be prudent.

The prudent person rule is a test of the manager's conduct, (ie how the manager carries out its investment functions). Therefore, as long as the investors in the oil futures portfolio are fully informed of the high risk, and the manager makes those investments as any other prudent manager would make in the circumstances, then the manager could not be seen to be in breach of trust.

This anomaly arises because the Trustee Act applies to all trusts and not only investment trust schemes. The courts have shown a very conservative approach to investment, generally looking at the elimination of risk as the most important factor. For the traditional trust this view is understandable because without the capital there can be no income. In the traditional trust, a trust is set up by the settlor for beneficiaries who give no consideration for the benefit. The appointed trustees are required to invest and manage the trust fund vested in them on behalf of those beneficiaries. The trust's objectives are typically that the capital of the trust fund should not be placed at risk and that there should be a moderate income earned.

In the unit trust transaction, the trusts objectives are different. The settlor sets up a high, medium or low risk scheme to meet the demand of investors. The beneficiaries give consideration and unlike the traditional trust have a choice of a number of trusts to invest in to meet their apparent needs.
In a recent case regarding superannuation[120] the Court of Appeal recognised the difference in nature between traditional trusts and trusts for a commercial purpose. Richardson J stated (by way of obiter dicta) that the contractual and commercial origins of pension schemes makes a practical and purposive approach to interpreting such documents appropriate.

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[120] *Re UEB; UEB Industries Ltd v Brabant* (1991) 1 NZSC 40,243.

This "purposive approach" is to be commended. It is submitted that the courts should apply this approach, to recognise the commercial structure of unit trusts and that a particular unit trust's objectives may differ from those of a traditional trust, when considering whether a manager has acted prudently under the prudent person rule. This is not an introduction of special rules for commercial trusts but a recognition of their specific purposes so that reasonable and practical effect can be given to the obligations created by the trust deeds[121] or implied by statute.

7 THE TRUSTEE'S DUTIES

In the unit trust transaction the trustee's role is generally to ensure the safe custody of trust funds and once investments are made, to hold the title to those assets.

The trustee will generally have a duty to collect the income from investments and ensure that it is distributed to unitholders in accordance with the unit trust deed. It also has a duty to hold the register of unitholders[122] and keep and distribute annual audited accounts.[123]

The trustee has a general duty first to act continuously as trustee and not to do or omit to do anything which might cause it to be disqualified from acting as trustee and secondly to ensure that persons that have been delegated functions by it, duly perform the covenants and obligations required of them.

Thus, the trustee takes only a passive role in the day to day running and management of the unit trust fund and in this regard its duties are different from a traditional trust. Jessel MR illustrated the need for the courts to look at the circumstances of each trust when His Honour stated in *Earl of Egmount v Smith*,[124] "it is a fallacy to suppose that every trustee has the same duties and liabilities". It is submitted that the "purposive approach" discussed in 6.2.3. is equally relevant when deciding whether trustees have fulfilled their duties.

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[121] See J K Maxton "Who is Entitled to a Superannuation Surplus?" [1992] NZ Recent Law Review 210.

[122] Section 3(3) Unit Trusts Act 1960.

[123] Section 11 Unit Trusts Act 1960.

[124] (1877) 6 ChD 469, 475.

7.1 Duty to Supervise the Manager

Of greatest significance is the duty, implied into every unit trust deed by the Unit Trusts Act, that the trustee shall not act on any direction of the manager to acquire or dispose of any property in the unit trust, if, in the trustee's opinion (conveyed in writing to the manager) the proposed acquisition or disposal of an investment is manifestly not in the best interests' of unitholders.[125]

At this point it should be noted that in practice few managers instruct trustees to dispose or acquire property. Generally, the manager has the ability to authorise the sale and purchase of the unit trust's investments without reference to the trustee. In logistical terms this is the most practical approach - saving the double handling of work which the manager is better qualified to perform.

This is not to say that the manager has a carte blanche reign. Trustees generally prepare, and issue, guidelines to the managers which set out the percentages of the authorised investments that may be bought at any one time. These guidelines ensure the integrity of the portfolio strategy.

Most trustees are of the view that if the guidelines are regularly updated, and the manager follows the guidelines carefully,[126] then the trustee will be fulfilling its duty to ensure that investments are not manifestly not in the best interests of unitholders. This chapter is concerned with whether this view is well founded and what exactly the duty entails.

Although the trustee has a duty to act in the best interests[127] of unitholders, it is not the duty of the trustee to invest the unit trust fund prudently. This is the job of the manager.[128] However, as set out earlier, the Unit Trusts Act imposes upon the Trustee

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[125] Section 12(1)(c) Unit Trusts Act 1960.

[126] The manager, with agreement from trustee can generally work outside the guidelines.

[127] *Cowan v Scargill* [1985] 3 ChD 270 for a definition of "best interests".

[128] Above 6.1 where the manager's duties when selling units are discussed.

a duty to supervise the manger in carrying out its investment function. The duty is a subjective one requiring the trustee to veto proposed sales or purchases of investment if, in its opinion such an action is manifestly not in the best interests of unitholders ("the duty to supervise").

7.1.1 Does the Trustee Need to be Involved in Every Transaction?

The purpose of the duty to supervise is in futherance of the purpose of the Unit Trusts Act to protect the interests of unitholders. However, with unit trusts becoming increasingly sophisticated trustees are required to have a detailed understanding of the nature of the investments and the investment strategy. The issue of guidelines by trustees' attempts to circumvent, the duty to supervise which, on a strict reading of the Unit Trust Act, would require constant daily monitoring by the trustee of the manager, and for the trustee to have equivalent management expertise. Common sense suggests, that such a requirement would be impractical, costly and inefficient.

In the author's view, provided that a trustee issues regularly revised guidelines reflecting the investment strategy devised by the manager, and in the trustee's opinion that strategy is prudent, then the trustee does not need to be constantly involved in the running of the unit trust. It is submitted that coupled with strict audit requirements of the manager's activities the trustee can satisfactorily monitor the performance of the manager.

Essential to the duty to supervise is the need for the trustee to have access to information. The Unit Trusts Act provides that any information relating to the unit trust must be produced to the trustee[129] by the manager, on demand.

With the ability of investment portfolios values to rise and fall so quickly, managers and trustees cannot be required to be guarantors or clairvoyants. As long as the trustee remains fully informed of the financial position of the unit trust and queries

[129] Section 12(1)(b)(i),(ii).

any untoward transaction in breach of the guidelines then it will fulfil its duty to supervise. The case of *Bartlett & Ors v Barclays Bank Trust Company Limited*[130] may illustrate the position that a New Zealand Court would take.

In that case, the settlor placed upon trust properly consisting of debenture stock and company shares. The trustee was the defendant bank. The company shares were in a property owning company and after a change in the board of that company, the directors decided to engage in a speculative property development through another company as a project vehicle.

After substantial losses on the development project were incurred the beneficiaries of the trust claimed that the defendant trustee was liable to make good to the trust all losses because it had permitted the two companies to engage in property development.

Brightman J held that a prudent trustee must see that he has sufficient information to enable him to make a responsible decision from time to time whether to let matters proceed or to intervene if it is dissatisfied.[131] This does not mean the monitoring of every move of the directors, but of making it reasonably probable, so far as the circumstances permit, so that the trustee receives an adequate flow of information,[132] a means by which to safeguard the interests' of the beneficiaries.

Furthermore, where the trustee holds itself out as having, a special skill it will be liable for a breach of trust if it does not exercise the care and skill it professes to possess.[133] On the facts of the *Bartlett* case His Honour held that had the defendant

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[130] [1980] 2 WLR 430.

[131] Above n 130, 432.

[132] Above n 130, 433.

[133] Above n 130, 434.

been in receipt of more information it would have been able to step in and stop, and ought to have stopped, the speculative and imprudent project and therefore, it failed in its duty to the beneficiaries.[134]

With respect to a trustee intervening to stop a manager's actions, it is always a matter of degree at what point a transaction will be manifestly not in the best interests' of unitholders. Although the facts of the *Bartleet* case are distinguishable from the unit trust scenario, in that the manager has the duty to invest prudently, it is submitted that the decision is important in terms of the trustee's duty of supervision of the manager.

The duty to supervise is greater than that imposed by the Trustee Act upon a trustee for the acts of agents. In that situation the trustee will not be liable for any loss or acts of an agent if the agent is employed in good faith.[135] The trustee can seek indemnification for the agent's acts provided that any loss caused is not through the trustee's wilful default.[136]

7.1.2 Does a breach of trust require intervention by the trustee?

In a fluctuating market, a manager may wish to purchase investments that are outside the guidelines or, in exceptional cases, the authorised investment list. In both cases, without reference to the trustee, this will generally be a prima facie breach of the unit trust deed. It is not necessarily, manifestly not in the best interests of unitholders, therefore, requiring intervention. The manager may believe that the investment is a prudent one. For example, in a property unit trust, where property values are plummeting, if the manager realises a property at market value, and purchases

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134 Above n 130, 435.

135 Section 29(1) Trustee Act 1956.

136 Section 38, Trustee Act 1956. For a discussion of the meaning of "wilful default" see J E Stannard "Wilful Default" [1979] Conv 345; see also H A J Ford and W A Lee above n 66, para 965.

government stock (an unauthorised investment) because in the manager's view government stock will give a higher return than reinvestment in property, this will not be manifestly not in the best interests of unitholders.

Conversely, if a manager does abide strictly by the guidelines, and acts within the investment strategy, a trustee may still have a duty to intervene in the event of an unexpected negative change in the market. The likelihood of the need for such an intervention can be and generally is, minimised further by a portfolio investment strategy and a requirement that the manager issue a certificate to the trustee, on a regular basis, stating that it has complied with the guidelines.

It is submitted that the trustee will only need to intervene in exceptional circumstances and in those cases, the prudence of the manager would be also in doubt. This view is not only practical but in keeping with the policy of the Unit Trusts Act.

8 LIABILITY OF MANAGER AND TRUSTEE FOR BREACH OF STATUTORY DUTY, AND NEGLIGENCE

In the event of a collapse of a unit trust, unitholders will generally seek to ascertain who is responsible for the collapse. Inevitably, unitholders bringing an action will attempt to claim against both the manager and the trustee for their loss, under as many causes of action as are available to them.

This chapter deals with the question of whether a unitholder may bring an action against a manager and/or trustee for a breach of statutory duty and negligence in addition to an action for breach of trust. And whether a manager or trustee may claim contribution from the other party.

This point was discussed in the recent New Zealand case of *Fletcher v National Mutual Life Nominees Ltd*[137] in the context of the Securities Act. The facts of that cases may be stated briefly.

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[137] [1990] 1 NZLR 97.

AIC Securities Ltd ("AIC") had carried on business as a money market operator in the course of which it invited subscriptions from the public. To enable AIC to undertake such business the Securities Act 1978 required that a trustee be appointed for the depositors in AIC. AIC appointed National Mutual Life Nominees Ltd ("National Mutual"). Deloitte Haskins & Sells ("Deloitte") were AIC's auditors.The AIC Group collapsed and AIC was unable to repay its depositors. The plaintiff brought an action against National Mutual for breaches of its obligations. National Mutual accepted it was negligent and settled out of court with the depositors. National Mutual joined Deloitte and claimed a contribution from Deloitte as joint tortfeasors on the grounds that:

(i) Deloittes breached a common law duty of care and a statutory duty under section 50(2) of the Securities Act;

(ii) National Mutual and Deloitte owed common duties of care to the depositors; and

(iii) Deloitte owed a duty of care to National Mutual in respect of the accuracy of accounts in the AIC prospectus.

Only the first two grounds are relevant to this discussion. In a reserve judgment Henry J held that the relationship between National Mutual and the AIC depositors was one of trustee/beneficiary and that National Mutual's liability to depositors arose from breaches of trust, not tort. Thus, National Mutual's claim for contribution could not succeed because the law does not provide for contribution for concurrent wrongs (except in tort), nor mixed concurrent wrongs.

On the breach of statutory duty issue, His Honour held that a breach of the Securities Regulations (Regulation 24), which deem certain clauses to be contained in every trust deed, (like section 12 of the Unit Trusts Act) was a breach of the trust deed and that a failure to exercise reasonable diligence in the ways specified in the deemed clause becomes a breach of trust not a tortous breach of statutory duty.[138]

[138] Above n 137, 103.

His Honour went on to hold that apart from the trust deed National Mutual had no relationship with the depositors that would give rise to a duty of care. A depositor must bring an action for a breach of trust against a trustee, in equity, and it was not open to a depositor to claim negligence under the jurisdiction of the common law.

The effect of this judgment, when it is applied to the unit trust transaction, is that unitholders must bring their action, for a breach of trust by the manager or the trustee in equity. It is not open for the unitholders to argue that the manager or trustee were negligent in carrying out their functions[139] i.e. the manager and / or trustee cannot be concurrently liable in tort and equity.

In turn, a manager or trustee cannot argue that the other party, as the case may be, should contribute to any claim against it because such a claim is only available to joint tortfeasors.[140]

In light of some of the New Zealand Court of Appeal's dicta in recent times regarding concurrent liability in tort and contract[141] and the fact equity and common law have been pleaded in several recent cases[142] without objection, Henry J's view has levied some criticism.[143]

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[139] The question whether the manager or trustee may be liable in tort for inducing or procuring a breach of trust has been left open in New Zealand. See *Kupe Group Ltd v Ariadne Australia Ltd,* (High Court Auckland, C 151/88, 10 July 1989, Barker J); and *Metall & Rohstoff AG v Donaldson Lufkin & Jenrette Inc* [1988] 3 All ER 116.

[140] Above n 137, 104; see also Section 17(1)(c) Law Reform Act 1936; compare with S.1(1) Civil Liability (Contribution) Act 1978 where a person who is liable whatever the legal basis of his or her liability may claim contribution; see articles on contribution set out in CEF Rickett "Trust or Tort? Tort and Trust? Some Questions About Civil Liability" [1990] NZ Recent Law Review 259.

[141] *Day v Mead* [1987] 2 NZLR 443; *Elders Pastoral Ltd v Bank of New Zealand* [1989] 2 NZLR 180; *Attorney-General for the United Kingdom v Wellington Newspapers Ltd* [1988] 1 NZLR 129; *Aquaculture Corp v New Zealand Green Mussell Co Ltd* (CA 69/87, 11 June 1990); *Rowlands v Collow* [1992] 1 NZLR 178, all of which indicate a fusion of the common law and equity.

[142] *Shivas v Bank of New Zealand* (1990) 3 NZBLC 101,540; for example *Kupe Group Ltd v Ariadne Australia Ltd* above n 139.

[143] C E F Rickett, above n 140.

In *Mouat v Clarke Boyce*[144] Cooke P stated that the common law and equity are mingled and that a duty of care is identical whether derived from theoretical sources of tort, contract, or equity or from all of them in a situation where they overlap. It is submitted that Henry J's findings in the *Fletcher* case will not be sustainable against the Court of Appeal's willingness to impose a duty of care on a party where the justice of the case requires an appropriate remedy.

The *Fletcher* case severely limits the causes of action available to unitholders. However, if the *Fletcher* case is correct it is submitted the courts, being faced with such a restriction, would be more ready to find a breach of trust by placing a lower standard of proof on unitholders in proving a breach of trust and a higher standard upon managers and trustees in fulfilling their duties. It is also less likely that the courts, pursuant to the Trustee Act,[145] would excuse a manager or a trustee for a breach of trust.[146]

Although the Unit Trusts Act, in keeping with the policy of the legislature to protect unitholders as if they were shareholders in a company, allows a Court to assess damages against delinquent directors of the manager, in the event of a winding-up[147] causes of action in equity and at common law should be available to unitholders. Furthermore, there is a need for the Law Reform Act 1936 to be amended to enable managers and trustees to claim contribution regardless of the legal basis of their liability.[148]

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[144] [1992] 2 NZLR 559,564

[145] Section 73 Trustee Act 1956.

[146] *National Trustees Company of Australasia Ltd v General Finance Company of Australasia Ltd* [1905] AC 373 where the Privy Council held that the appellants who were professional trustees although they acted honestly and reasonably ought not be excused.

[147] Section 27 Unit Trusts Act 1960.

[148] Above n 140.

9 REGULATION OF UNIT TRUSTS IN AUSTRALIA

It is not within the scope of this paper to study extensively the Australian legislation relating to unit trusts. However, an understanding of the regulations pertaining to unit trusts in Australia is important for three reasons. First, the Unit Trusts Act 1966 does not apply to Australian unit trusts marketed in New Zealand, those unit trusts being governed by the provisions relating to "participatory securities" under the Securities Act.[149] Secondly, with the Australian and New Zealand Governments having undertaken to build closer economic and commercial relationships,[150] the harmonisation of the two countries' laws in respect of securities regulation is possible in the near future. Thirdly, the Unit Trusts Act 1960 was based[151] on the New South Wales and State of Victoria[152] provisions relating to unit trusts, and the legislation that now governs the operation of unit trusts is substantially similar to the Unit Trusts Act. The Australian decisions,[153] many of which have been discussed earlier in this paper, are therefore of more assistance to the New Zealand unit trust industry and the New Zealand courts than any other jurisdiction.

A unit in a unit trust is regarded as a "prescribed interest" under the Australian Corporations Law. The Australian Corporations Law[154] governs the offering of "prescribed interests" to the public and provides that the funds be held by an

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[149] Some Australian unit trusts are exempt from the provisions relating to prospectuses under the Securities Act 1978. See Securities Act (Australian Unit Trusts) Exemption Notice 1991 (SR 1991/19).

[150] Article 1 of the Closer Economic Relations Treaty, executed on 28.3.1984 to be effective as from 1.1.1983.

[151] Parliamentary Debates 324 (30 August 1960), 1923 and 325 (19 October 1960) 3086.

[152] Companies Act 1958 (Vict) ss 284-293; see also the Anderson Committee Report (Report of the Departmental Committee appointed by the Board of Trade, 1936 Cmnd 5529).

[153] *Perpetual Trustees v Corporate West Management Ltd* [1989] WAR 117 (power of beneficiaries to alter trust deed); In *Parkes Management Limited v Perpetual Trustee Co & P T Ltd* (1977) ACLC 29,545 (division of duties of manager and trustee); *Elders Trustee and Executor Co Ltd v Reeves (EG) Pty Ltd and Ors* (1987) 78 ALR 193 (managers role); *Re Application of Permanent Trustee Nominees (Canberra) Ltd* above n 82, (division of duties of manager and trustee).

[154] Part 7.12 Div 5.

approved trustee[155] and managed by a management company pursuant to an approved deed.[156] That trust deed must contain specific covenants imposing functions and duties upon the management company and the trustee,[157] these are substantially similar to those imposed by the Unit Trusts Act with the exception that the manager does not have the duties of the trustee imposed on it in carrying out its functions by the statute. As a result, there has been a great deal of debate as to whether the manager has such duties.[158] In this regard, the New Zealand Act is more certain than the Australian legislation.

Collective investment schemes are at present under review in Australia[159] in an attempt to ascertain the appropriate legal framework under which they should operate. Unit trusts form part of collective investment schemes. At the time of writing , no recommendations on the legal framework that those schemes should take had been given.

10 REFORM

In 1990 and 1991 the Securities Commission in conjunction with the Trustee Companies Association, Unit Trusts Association of New Zealand, and a number of other organisations frequently met to discuss issues relating to unit trusts with a view to recommending to the Minister of Justice, the most effective legal framework under which unit trusts should operate. A number of suggestions were made by each member of the group but no formal proposals were made. However in view of the

[155] Corporations Law (Clth) s1067(4).

[156] Corporations Law (Clth) s1062(2).

[157] Corporations Law (Clth) s1069(11).

[158] Above n 82.

[159] "Collective Investment Schemes" Australian law Reform Commission, Companies and Securities Advisory Committee Issues Paper 10, September 1991.

present attempts to harmonise the laws of Australia and New Zealand further discussions may take place after the Australian Law Reform Commission makes its formal recommendations on collective investment schemes.

It is worthy to note that agreement was not reached by the New Zealand group as to whether the offering of unit trusts should be retained under the Unit Trusts Act, included within the Securities Act 1978 or whether a totally new act regulating all collective investment schemes should be enacted.

Assuming that the government's policy will continue to be the protection of unitholders the most appropriate way of regulating unit trusts maybe to have an act governing all collective investment schemes. Such an act should provide investors in such schemes with standard, high quality information allowing them to make informed and comparative decisions. It should also standardise the duties of trustees and (where appropriate) managers and clearly set out the remedies available to investors. The same result could also be achieved by placing all collective investment schemes in the Securities Act.

There would be advantages in placing the regulation of unit trusts in the Securities Act. First, it would bring the offering of almost all publicly offered securities under one Act. Secondly, at present the unit trust is still subject to some provisions of the Securities Act, and for ease of reference it would be appropriate to have reference only to one Act. Thirdly, the use of trustees is not foreign to the Securities Act and therefore the case law in this area could be of benefit to practitioners, claimants, and the judiciary. Fourthly, it would be beneficial for the protection of unitholders to have the Securities Commission as a supervisor of the industry. Fifthly, in terms of the disclosure requirements under the Unit Trusts Act, these could be aligned to the Securities Act requirements, giving investors a better quality of relevant information by which to make a choice.[160]

[160] The information relevant to unitholders may be different to that which is relevant to investors in other classes of securities. For example, accounts setting out transactions are not important to unitholders. The managemant fees authorised investments, management performance, and objectives are of primary importance to unitholders.

Regardless of the legal framework under which unit trusts should operate a number of issues require clarification by the legislature to ensure that all of the parties involved with unit trusts are aware of their rights, functions, and duties. In summary these are:

(i) The need for better disclosure in prospectus documents to enable investors to make an informed and comparative decision about unit trust investments;

(ii) The need to separate out, and clarify the extent of the manager's and trustee's duties including the need for the statute to state that the provisions set out in section 13 of the Trustee Act 1956 specifically apply to managers;

(iii) The possibility of renaming the manager and trustee, to correctly reflect their responsibilities,

(iv) The need to clarify whether the manager and trustee will be liable in equity, contract and tort, to unitholders and whether the parties have a right to claim contribution for any liability contributed to by that party.

This paper has suggested possible ways by which these issues maybe clarified to reduce the risk of loss to investors and to enable managers and trustees to perform their functions efficiently, and cost effectively while safeguarding the interests of investors.

11 CONCLUSION

Unit trusts are an effective investment option for individual investors. However the legal framework under which they operate is broad and imprecise. The courts when adjudicating on the functions and duties of managers and trustees, of unit trusts, must do so against the background of how they operate in practice. To interpret the manager's and trustee's duties too strictly could lead to a decline in the use of unit trusts because managers and trustees maybe reluctant to take on overly onerous duties. For those managers and trustees who are prepared to take on the responsibility the cost of fulfilling such duties could be excessive and uncompetitive with other forms of investment scheme.

A balance is therefore required between commercial and practical reality and the need to protect the interests' of investors. This is no easy task, but one which could be assisted by reform.

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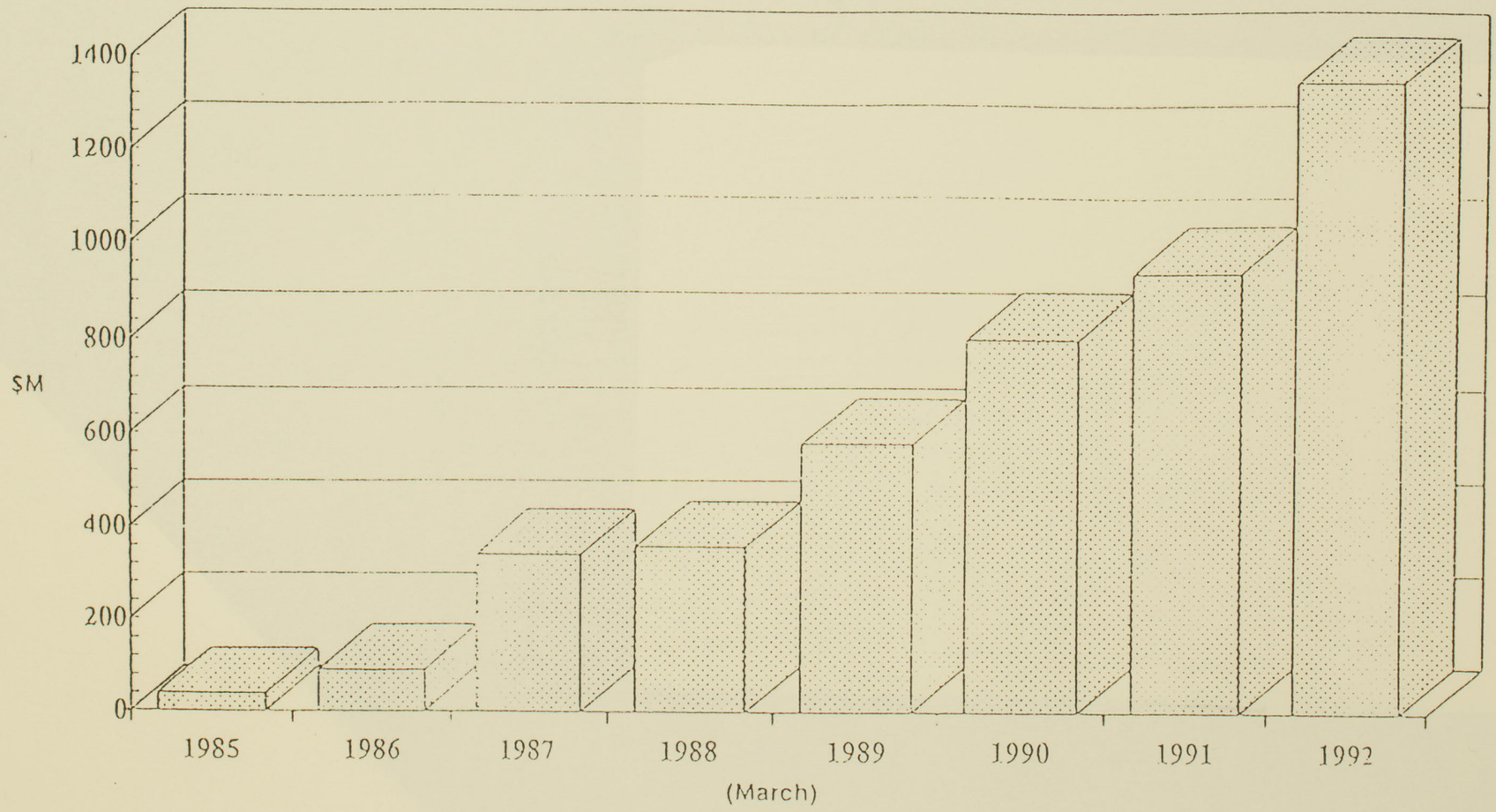
APPENDIX I

Slide 9: The Growth Products: Unit Trusts



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