

the Prudent Person Rule

— you really need to *know* it!

Over the past four years most States in Australia have made radical changes to the laws which apply to investing within trusts. The remaining jurisdiction, the Australian Capital Territory, is likely to make similar changes soon.

The changes have imposed, on just about every trust, a new set of investment principles known as The Prudent Person Rule.

Every trustee and every Financial Adviser to a trustee needs to be up to date with The Prudent Person Rule and follow it to the letter. To ignore these new laws could well lead to non-complying trustees and/or their Financial Advisers being personally liable for any investment losses incurred by the trust.

The range of trusts affected is very broad and can include DIY Super Funds, Family Trusts, Will Trusts, Charitable Trusts and Compensation Trusts, to name but a few.

What is the Prudent Person Rule?

The Prudent Person Rule is a statutory "code of conduct" which trustees and their Financial Advisers must follow in relation to the management of the assets held within trusts.

Every trust affected by these new laws must have a thorough and well-

documented portfolio review completed at least once a year. Each time a portfolio review is conducted a minimum of 15 factors must be taken into account when formulating the investment strategy and investment selection.

Those 15 factors are:

- i. the purposes of the trust and the needs and circumstances of the beneficiaries;
- ii. the desirability of diversifying trust investments;
- iii. the nature of risk associated with existing trust investments and other trust property;
- iv. the need to maintain the real value of the capital or income of the trust;
- v. the risk of capital or income loss or depreciation;
- vi. the potential for capital appreciation;
- vii. the likely income return and the timing of income return;
- viii. the length of the term of the proposed investment;
- ix. the probable duration of the trust;
- x. the liquidity and marketability of the proposed investment during, and on the determination of the term of the proposed investment;
- xi. the aggregate value of the trust estate;
- xii. the effect of the proposed investment in relation to the tax liability of the trust;
- xiii. the likelihood of inflation affecting the value of the proposed investment or other trust property;
- xiv. the costs (including commissions, fees, charges and duties payable) of

making the proposed investment; and

- xv. the results of a review of existing trust investments

Determining how much weight should be given to each factor and then balancing the interests of the various beneficiaries is often a very difficult juggling act for trustees.

If that set of criteria wasn't difficult enough... wait, there's more...

In addition to those rules The Prudent Person Rule also states that trustees must:

1. exercise trustee powers in the best interests of all present and future beneficiaries,
2. invest the trust funds in investments that are not speculative or hazardous,
3. act impartially toward beneficiaries and between different classes of beneficiaries, &
4. take advice

Case Study:

Bill is a successful financial planner. His nephew, Simon, was involved in a school playground accident leaving him incapacitated. A damages suit was brought against the school, resulting in a \$1,000,000 compensation payment. This was to be held in trust for the benefit, welfare and maintenance of Simon for his lifetime. Simon's mother (sole parent) asked to have her brother Bill and sister Sarah (a nurse) appointed trustees.

Bill assumed the responsibility of investing the trust funds, as he had a few

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ideas about 'how to get the most out of the trust'. Sarah was happy to leave this to him, and signed-off on his suggestions. During the next year, Bill became increasingly busy at work, and could not keep a close watch on the trust investments. A major investment in the trust then went into liquidation, resulting in a \$250,000 loss. The trust income was no longer sufficient to meet the specialist medical care Simon required, so the trustees had to tap the remaining capital of the trust.

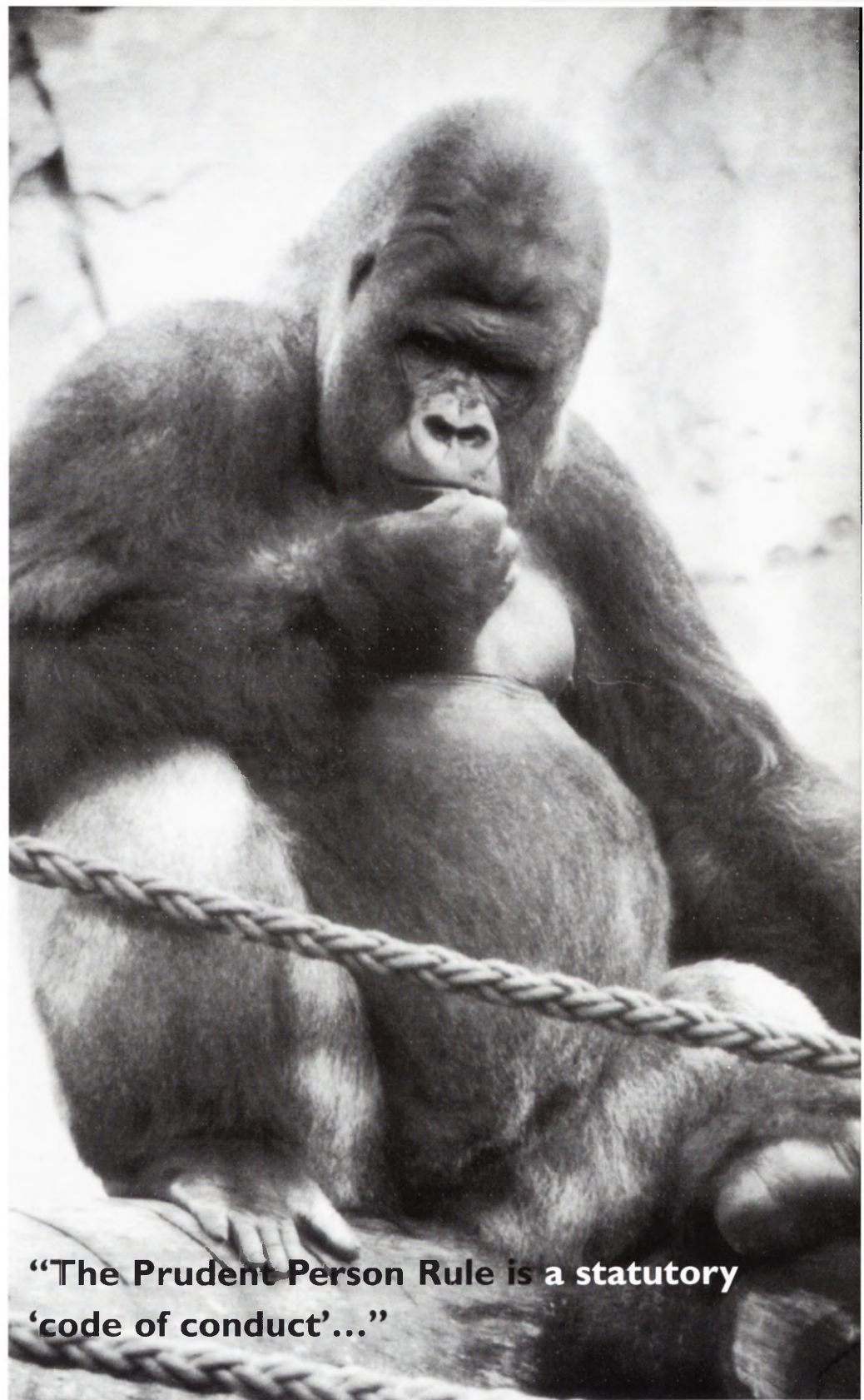
Simon's mother sued her brother and sister for their negligence, as it was apparent that the trust funds were not going to last Simon's lifetime. Sarah was found not liable as she had relied on a professional adviser. Bill was held to be a professional trustee and also solely liable. As a result of the suits, Bill was forced to liquidate his business.

There have been several cases where a professional trustee has been successfully sued on the grounds of their higher level of accountability. As a financial planner, it is clearly important to be aware of this situation from a personal viewpoint, as well as ensuring that clients are made aware of this potential pitfall.

Whilst this example may be based on a worst-case scenario, it is obviously important to find out during meetings with your clients whether they are also performing a trustee role. This information may be critical in your assessment of their risk protection needs. It must be covered in order to ensure that you are not held liable for failing to advise your clients of their duties as trustee. It is also an opportunity to assess whether a discretionary family trust may be appropriate to safeguard their assets against potential claims.

Higher Onus on Professional Trustees

The new laws place much higher standards of conduct on 'professional' trustees compared to 'lay trustees'. A professional trustee is where the trustee's business, profession or employment is or includes acting as a trustee or investing money on behalf of another person. Lay trustees may have a more limited exposure to the relevant investment background, through their experience



“The Prudent Person Rule is a statutory ‘code of conduct’...”

or employment. Therefore, it may be easier for a beneficiary to prove a case against professionals such as accountants, financial planners, solicitors, statutory trustee companies and public trustees who frequently deal with clients' money.

This impacts financial planners in two ways. Firstly, if you personally act as a trustee, you are likely to be deemed a professional trustee. As such, the law may be more stringent when

applied to your actions as trustee. Secondly, if you have a client (an accountant or solicitor for example) who gives incidental investment advice and invests funds on behalf of a client, they too may be deemed to be a professional trustee, even though they may have no formal investment training. As their financial planner you should, therefore, make them aware of their obligations and the potential risks when acting in this capacity. ►



Extra Rules for DIY Super Funds

Trustees of Super Funds must follow the State Prudent Person rule laws as well as the rules set out in the Trust Deed and

in Commonwealth legislation, *Superannuation Industry (Supervision) Act 1993* ("SIS"). Many trust law principles have been incorporated in SIS.

The major additional rules for DIY Super Funds are:

- the sole purpose test (ie: retirement),
- the in-house asset rule, and
- prohibition on gearing

In the event that the trustees of a DIY super fund breached any of these duties, members of the fund can:

- attempt to resolve the matter with the trustee(s) of the fund;
- make a submission to the Australian

Prudential Regulation Authority (APRA); or

- seek a resolution in the Supreme Court.

Damages for non-compliance to Prudent Person

If a beneficiary believes that a trustee has not administered a trust in accordance with the Prudent Person rule, they may pursue several causes of action, the main one being breach of trust. The amount of damages that may be awarded against a trustee for a breach of the Prudent Person rule will depend on the loss suffered (such as actual loss or opportunity cost).

The trustee may also be able to bring actions against an adviser under contract law, negligence, the Corporations Law and/or the *Trade Practices Act* (false or misleading representations etc) for advice given, or for

advice not given where it ought have been given (ie: silence).

Conclusion

Acting as a Trustee or as a Financial Adviser to a trust has now become a more difficult and potentially dangerous occupation. Trustees and their Financial Advisers can only ignore the Prudent Person rule at their peril.

The National's trustee arm, National Australia Trustees Limited ("NAT") offers two levels of service which can minimise or even eliminate the risks. At the first level, professional advice on the specific requirements for any given trust can be given. At the higher level, sharing or outsourcing the risk, by engaging NAT to act as a co-trustee or sole trustee, is available. Even where NAT takes on a trustee role, the Trust's Financial Adviser may be retained as the Investment Adviser to the Trust. **PL**

NSW President Tom Goudkamp proposed in late 1999 that APLA should offer a service to country members and simultaneously promote our organisation through a regional tour.

A program was arranged covering Lismore, Coffs Harbour, Tamworth, Dubbo, Orange, Albury, Wagga Wagga and Goulburn. However, as a result of the Avgas emergency, a charter plane had to be replaced by commercial flights and hire car and as a result the last two days of the tour had to be cancelled.

The tour finally included Lismore, Coffs Harbour, Tamworth and Dubbo.

At each two-hour seminar, the speakers and topics were Tom Goudkamp on *Changes to the Third Party scheme: The Motor Accidents Compensation Act 1999*, Allison Robertson giving an *Update on the Workers Compensation legislation*, and Mark Edmunds on *Personal Injury Claims and the GST*.

The speakers were accompanied by Dr Hannah Middleton, APLA's NSW Campaign Manager, who looked after registrations and publicity.

Attendance ranged from 19 in

**APLA
NSW
Regional
Tour**

**BY DR HANNAH
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Tamworth to 30 in Lismore. The majority of participants were not APLA members.

In each of the four centres visited, appreciation was expressed that APLA had taken the trouble to come to town and present the talks. Participants pointed out that financial and time constraints meant they often could not get to Sydney for the many seminars and lectures on offer. APLA's initiative in taking speakers to the country was therefore most welcome.

In addition to the tour itself, APLA was promoted through the distribution to seminar participants of about 50 membership application forms and about 120 NSW State Conference brochures.

LBC was kind enough to sponsor the regional tour.

The tour received coverage on local radio with repeated news items on 2TM Tamworth, 2PK Parkes and 2DU Dubbo, and longer interviews on ABC Western Plains and ABC Wagga Riverina.

The tour was a success and clearly met a real need. APLA intends over the course of 2000 to repeat the project, reaching out to as many areas of New South Wales as possible. **PL**