

Discretionary trusts post the Westpoint litigation

IS IT NOW JUST A MATTER OF EFFECTIVE CONTROL?



TRUE OR FALSE:

A beneficiary who effectively controls the trustee of a discretionary trust may have what approaches a general power and thus a proprietary interest in the income and corpus of the trust?

If the above question had been posed a few months ago then the likely response would initially have been “false” without the need for much consideration although perhaps some curiosity as to the context of the question. Given that the above is a direct quote from Justice French in the recent case of Australian Securities and Investments Commission In The Matter of Richstar Enterprises Pty Ltd (ACN 099 071 968) v Carey (No. 6) [2006] FCA 814 (**Richstar**), the answer may now be different.

Context of the case – “bad” law or new law?

It has often been said of the development of legal precedent through case law that “hard cases make bad law”. In more recent times it seems to be more the case that “bad” cases make “bad” law or in some circumstances new law.

The maxim stems from cases in which one party to litigation has suffered some significant hardship and the court’s sympathy for that party’s situation leads to the court looking for new principles upon which it can base a grant of relief. In some cases the novel approach taken by the court becomes accepted and a new branch of the law may be born. The old “snail in the bottle” case of *Donoghue v Stevenson*¹ is a good example of this. The court in that case would have felt some sympathy for the person discovering the snail in the bottle and, when faced with the dilemma that, because that person was not the one who purchased the bottle they

did not have any contractual rights against the seller, the court found another method of compensating the person; the law of negligence was born.

In other circumstances the court’s sympathy for an aggrieved party may be combined with an underlying desire to ensure that the person who is perceived to have done the wrong thing and caused harm to the aggrieved party, should not be allowed to “get away with it”. This may lead to the court overstepping the boundary and making a decision that becomes viewed as incorrect, but nevertheless a precedent which will remain until overturned by later case law or statute. An example of this is the more recent experience with the case of *Hanel v O’Neill*.² The court in that case may have felt some sympathy for the plaintiff landlord who was out of pocket and also that the tenant’s actions in dissipating its available cash through trust distributions were “smart”. Perhaps, in an effort to ensure that the directors of the tenant company did not “get away with” this the court came up with a novel interpretation of a recently updated section of the Corporations Act 2001 concerning the liability of directors of corporate trustees for debts of the trust. That case has had much criticism but has not been overturned. It did however result in legislation to clarify that the interpretation of the relevant section adopted by the court in *Hanel v O’Neill* was not the one intended by the legislature.

In similar circumstances but where the Court adopts a different approach the consequences may be quite different, for example where there is a “bad guy” who should not really be allowed to get away with his behaviour, but the court considers itself constrained by its interpretation of the law at the time and so effectively “lets the bad guy off”. The hue and cry which arises from such cases in the public and in the media may then result in an actual change in the law to ensure that the situation

cannot recur. A recent example of this is the case of Mr Cummins who failed to lodge his tax returns for some considerable time but whose house and other assets (in his wife’s name) the Full Federal Court felt it could not claw back under the existing bankruptcy laws. Whilst the Full Federal Court’s decision was ultimately overturned by the High Court, in the meantime the government proposed radical changes to bankruptcy laws to deal with the situation and a revised version of these proposals has now come into force.

It is therefore important to look at the context of *Richstar* in order to try and determine what may flow from it. *Richstar* is just one of a number of hearings and decisions concerning the collapse of the Westpoint group of companies (Westpoint group). The collapse of the group has left a large number of investors significantly out of pocket and there is a significant amount of quite understandable public sympathy for those aggrieved persons. On the other hand the various individuals involved in the companies which have collapsed being Messrs Carey, Rundle, Beck and Dixon seem to be receiving a lot of negative press. The Australian Securities and Investments Commission (ASIC) is under a lot of pressure to ensure that any persons whose actions may later be found to justify personal liability for investors’ losses do not escape simply because they do not have any assets which can be accessed.

It is in this context that Justice French has made the bold statement cited at the start of this article. It remains to be seen whether it is a *Donoghue v Stevenson* type revolution or just a *Hanel v O’Neill* type aberration. If it turns out to be an aberration and is overturned on appeal, will the aftermath of the appeal result in a Cummins type legislative reaction?

The facts and legislative background

Prior to Richstar, ASIC had succeeded in having the Federal Court appoint receivers to the property of several directors and companies within the Westpoint group for the purpose of preserving that property pending further proceedings which would decide the extent of the liability of those companies and directors to creditors and other aggrieved parties. In Richstar ASIC was seeking to extend the definition of the property to which the receivers had been appointed to:

“Property held by a Third Party, as trustee for a trust, where the Individual Defendant is a beneficiary of the trust (including as a general beneficiary of a discretionary trust); and

“Property held by a Third Party on behalf of a superannuation fund, where the Individual Defendant is a beneficiary of the superannuation fund”.

The “Individual Defendants” referred to in the proposed orders are three of the four individuals who are parties to the proceedings namely Messrs Carey, Beck and Dixon (the Individuals).

The source of the power to appoint a receiver is found in s 1323(1)(h) of the Corporations Act 2001 (the Act) which provides that:

“The Court may, upon application by ASIC or by the aggrieved person, make one or more of the following orders:

“.....

(h) an order appointing:

(i) if the relevant person [in this case each of the Individuals] is a natural person – a receiver or trustee, having such powers as the Court orders, of the property or of part of the property of that person

Crucial to the Court’s consideration of the proposed orders is the definition of “property” in s 9 of the Act which reads:

Property means any legal, equitable estate or interest (whether present or future and whether vested or contingent) in real or personal property of any description and includes a thing in action.

The question therefore became whether the property of the trusts of which the Individuals were beneficiaries can somehow be classed as property of the Individuals themselves or whether the beneficiaries had an interest in the assets of those trusts sufficient to constitute property so that those interests could be the subject of the appointment of receivers.

Although Richstar also deals with unit trusts and superannuation funds, this article in essence considers its application to discretionary trusts.

What constitutes property?

It is important to remember that property in a legal sense does not mean the same as “property” in that word’s ordinary usage. Whereas most people will think of property as being the tangible objects that one can own such as land, motor vehicles and personal effects, in the legal sense property means the rights which a person (usually the owner) has in relation to those tangible items. As it is the rights rather than the objects which constitute “property” in a legal sense, it is possible for rights in relation to intangible matters to be property in themselves. For example a person who is owed money by another person has a right to sue the other person for payment of the debt and this right (called a “chose in action” or sometimes now called a “thing in action”) is a form of property.

It is in this context that the definition of property in the Act is considered. The breadth of the definition is about as wide as could be imagined. In the context of a discretionary trust, the extension of the definition to contingent equitable interests opens the door to the question in the case as to whether the Individuals as beneficiaries of their respective discretionary trusts have a contingent interest in the property of those trusts which would constitute those interests as property of the Individuals themselves and therefore potentially subject to an order for the appointment of receivers.

What constitutes an “interest” in property?

As with the word “property” the word “interest” has a number of potential meanings but usually a restricted meaning in a legal context. Interests in the strict legal sense can be either vested (the right does not depend on whether or not some event occurs) or contingent (the right depends on whether or not some other event occurs). Contrast these with the wider more popular use of the term “interest” as connoting that a person has an interest in a particular subject matter, ie. it matters to them or is of interest to them.

The specific reference in the definition of property in the Act to an interest “whether vested or contingent” suggests that the use of the word in the section is in its strict legal sense as opposed to any wider or more popular sense.

Who has an interest in the trust fund of a discretionary trust?

A detailed explanation of the powers and duties of the various persons who may be involved in a discretionary trust relationship is beyond the scope of this article. The

position of each of these persons will be discussed in turn:

Trustee

A trustee of a discretionary trust will, as the legal owner and registered proprietor of assets of the trust fund clearly have a legal interest in the assets of the trust.

A trustee of a discretionary trust does not however have a beneficial interest in the trust fund of the trust of which it is the trustee (except to the extent of any right of indemnity out of the trust assets) and so the exposure of trust assets to any receivership order would likely be limited to the nuisance value of having assets frozen for a period of time and incurring legal costs “unfreezing them”.

The only exception to this might be where the trustee has a general power of appointment exercisable in favour of any person, including the trustee themselves. In such a case the trustee is in the position to appoint the whole of the trust property for its own use and benefit absolutely. A trustee in such a position is generally viewed as, for all intents and purposes, the legal and beneficial owner of the trust property. Contrast this with the more usual position in a discretionary trust that the trustee is excluded and the potential beneficiaries are not unlimited but instead restricted to a particular class of beneficiaries, for example the members of a particular family group. In these circumstances the trustee will not have a general power of appointment but a special or hybrid power which does not bring with it “de facto ownership”. It is a reference to a general power (rather than a special or hybrid power) being “tantamount to ownership” in a 1989 Federal Court case³ which is relied upon as the basis for the observation cited at the start of this article.

There is no analysis in Richstar of the extent of the powers of the trustees of the discretionary trusts concerned, and so it is unclear whether or not the trustees had a general power of appointment, nor is it explained how a beneficiary who “effectively controls the trustee” can be viewed as standing in the shoes of the trustee so that it is the beneficiary itself who has the general power, if it is indeed a general power. The corporate veil between a company and its directors and/or shareholders appears to have been lifted. If a corporate trustee can be simply viewed as the “alter ego” of its di-

rectors/shareholders then this will represent a significant shift in the law of trusts as it is applied to standard discretionary trusts in the commercial world.

Default beneficiaries

It has long been the accepted position that the beneficiaries who would be entitled to the trust fund of a discretionary trust upon the vesting of that trust in default of the trustee exercising its discretion to appoint the trust fund elsewhere (default beneficiaries) have an interest in the trust fund of the trust in the true legal sense. Whether such an interest is a vested interest subject to divestment or a contingent interest is of no real concern for the purposes of this discussion. It is considered that such an interest would constitute property in the true legal sense and would likely fall within the definition of property contained in s 9 of the Act. It is therefore perhaps rather curious that there is no consideration in *Richstar* as to whether or not the Individuals were default beneficiaries of any of the relevant trusts. It would appear that if they were then the Individuals' contingent interests in those trusts may be brought within the definition of property for the purposes of the receivership order without the need to consider the issues of effective control of the trustee and the lifting of the corporate veil discussed above. It should be noted however that the interest which a default beneficiary has in a discretionary trust may not necessarily be as extensive as set out above (refer *Pearson v Inland Revenue Commissioners* [1981] AC 753 referred to in *Taxation Determination TD 2003/28*).

Mere objects

It has been the generally accepted position (at least until *Richstar*) that a general beneficiary of a discretionary trust, not being a default beneficiary, (mere object) does not have an interest in the trust fund of the trust. Reference can be made (and indeed was made in *Richstar*) to *Gartside's* case.⁴ The judgment in *Richstar* has effectively turned the legal principle contained in *Gartside* on its head by concluding that the *Gartside* principle only applies in the "ordinary case" and not in the case where a "beneficiary effectively controls the trustee's power of selection. Then there is something which is akin to a proprietary interest in the beneficiary".⁵ By making this leap it appears

the potential for a trustee who has a general power of selection to have a proprietary interest in a trust fund is being attached to the position of a director and shareholder of that corporate trustee who happens also to be a beneficiary of the trust. If indeed the ability to have effective control over a trustee's power of selection is a relevant issue then it must relate to the circumstances or position which give rise to that power or control ie it is the fact of being a trustee or a director or shareholder of the trustee (or perhaps an appointor of the trust) which is relevant not the person's coincidental position as a beneficiary of the trust. If some doctrine of effective control is to be developed then this should not change the answer to the question of whether or not a mere object of a discretionary trust has an interest in the trust fund of the trust.

One wonders how the Court might approach different circumstances such as that of a husband and wife including other family members in the control of a discretionary trust set up for the benefit of their immediate family. For example a husband and wife might include their siblings as shareholders of the corporate trustee or as appointors of the trust. Would the court then conclude that the siblings had a proprietary interest in the trust assets simply because the siblings might be said to have some degree of control of the trustee and also happen to be beneficiaries of the trust? It would be hoped that such a conclusion would not be reached.

Appointor

It has not yet been previously suggested that the person who has the power to appoint or remove trustees of a discretionary trust (appointor) has any interest in the trust fund of the trust. In fact such a suggested conclusion would make no sense in circumstances where the appointor was not themselves a beneficiary of the trust and so would be unable to benefit themselves by exercise of their power to appoint and remove a trustee.

The question of whether an appointor's power of appointment constitutes property for the purposes of the Bankruptcy Act 1966 was considered in the case of *Wily v Burton*⁶ (a case not referred to in *Richstar*) where it was concluded that:

"... as the interests of the beneficiaries must be taken into account, and the power exercised in their interest,

the power which Mr Burton holds as appointor is not "property" which vests in his trustee in bankruptcy nor a power "as might have been exercised by the bankrupt for his own benefit".⁷

The position of the appointor is not mentioned until quite late in the judgment in *Richstar* where it is included as one of the ways in which a beneficiary might have effective control of the trustee's power of selection. Can it really be said that, because, theoretically, a sole appointor of a discretionary trust who is also a beneficiary of the trust could appoint themselves to be trustee and distribute the trust property to themselves, that that sole appointor has an interest in the trust fund of the trust any more or less than any other mere object of the trust?

Directors and shareholders of corporate trustees

Before *Richstar*, it would probably not have been thought necessary to consider whether the director or shareholder of a corporate trustee of a discretionary trust might have an interest in the trust fund of that trust. A director simply has the day to day running of the company and is subject to removal by shareholders. Directors do not own or have an interest in the assets of the companies of which they are directors. Similarly shareholders of a company (unlike unitholders in a unit trust) do not have any interest in the assets of the company in which they hold shares, their property being the bundle of rights which is the shares themselves.

Notwithstanding this, *Richstar* appears to conclude that a person who is a director and shareholder of the corporate trustee of a trust may, by them being in effective control of the trustee, and in combination with the coincidence that they are also a beneficiary of the trust, have a proprietary interest in the trust fund. The assumption made is that in these situations the company is really the "alter ego" of the beneficiary and in particular relies on a number of cases in the family law jurisdiction. It is submitted that the issues needed to be addressed in a family law context (where one is considering what assets should be taken into account in making an order for the adjustment of property in a family law dispute) are very different to the issues which arise in *Richstar* and in the area of the availability of assets in a commercial insolvency context.

Combination of the above

Even if *Richstar* is incorrect and the otherwise understood position that none of the above persons (apart from the trustee and default beneficiaries) by themselves

can have any interest in the trust fund of a discretionary trust, can the positions be somehow aggregated as factors to be considered to determine whether the requisite interest exists? This appears to be the analysis and conclusion in *Richstar* in that where a person happens to be a beneficiary of the trust and, in some other role, has some effective control of the trustee, then they have an interest whereas if only one such factor applied they would not have an interest. It is difficult to see how this can be correct. If it is correct that a mere object of a discretionary trust does not have an interest in the trust fund of that trust and if it is also correct that the power of an appointor to appoint and remove trustees is not property of the appointor then why should these principles change just because a particular example of each category of persons is or can be the same person? It is however possible that this “aggregate” kind of approach may find favour in the court. It is not unlike the analysis that the Australian Taxation Office (ATO) has used in its “statement of principles” where it gives its views on when changes to a discretionary trust may cause a resettlement of that trust. The approach is also enshrined in the process of considering whether or not tax avoidance has occurred under Part IVA of the Income Tax Assessment Act 1936 where a number of factors are looked at and weighed up.

Questions that will be asked of the Court in the future

In light of *Richstar* and the potential future cases which may further test the water in this area there are a number of questions which the Court will ask or will have asked of it in the context of discretionary trusts. The answers to these questions will be relevant in determining the fate of the assets held in those trusts. Some of the more important questions are set out below:

Trustees:

1. What is the identity of the trustee of the trust – is it a company or an individual, and if a company who are the directors and shareholders?
2. Can the trustee benefit themselves either directly or indirectly from the trust?
3. Is the trustee effectively controlled by someone else eg through director/ shareholder of a corporate trustee or through an appointor?
4. Is the trustee merely the “alter ego” of some other person?
5. Is the trustee’s power to distribute income or capital restricted in any way, eg is the consent of some other party required?

Beneficiaries:

6. Who are the potential beneficiaries of the trust?
7. Who are the default beneficiaries?
8. Are the beneficiaries limited to a particular class?
9. Can beneficiaries be added or deleted and if so who has the power to do this?
10. Do all beneficiaries have the same potential to receive income and capital?

Appointors:

11. Who are the appointors of the trust?
12. Can the appointors benefit themselves from the trust?
13. Does the appointor usually act in accordance with the wishes of some other person?
14. Is an “independent” appointor really just the “alter ego” of some other person?
15. Must appointor decisions be unanimous?

Having answered the above and other relevant questions the court may determine whether or not the relevant parties have an interest in the property of relevant trusts by considering the answers in a combined context.

To work out the degree of risk that a trust’s assets may be exposed according to the circumstances, it is instructive to look at some actual examples referred to in *Richstar* which are summarised below:

1.
 - X is the director and secretary of corporate trustee
 - X was the original appointor, the appointor is now X’s wife
 - The trustee has wide discretion including the power to prefer one or other beneficiary to the total exclusion of any other beneficiary
2.
 - X is the trustee
 - X and his family members are beneficiaries
 - No more than 39% of income and capital can be distributed without a unanimous resolution from the appointor
 - The appointor is X’s wife
3.
 - X is the appointor of the trust
 - X is a member of the class of beneficiaries
 - The trustee has every power as if it were the absolute owner of the trust fund

In each of the above examples the court was of the opinion that X had an interest in the relevant discretionary trust and, in all but the second example, X had what approached or amounted to ownership of the whole of the trust fund of the relevant trust. In the second example the court was of the opinion that X had only what amounted to ownership of 39% of the trust fund.

None of the above examples included full details of all relevant factors such as the identify of trustees, directors, shareholders and appointors and more importantly the terms of the relevant trust deeds. It is submitted that all of these factors will need to be carefully considered before a court can properly come to the conclusions reached in *Richstar*.

Where to from here?

It is obvious that the issues raised in *Richstar* are significant and require anybody with a discretionary trust or proposing to use a discretionary trust as part of their group structure to reanalyse who should fulfil the various roles such as trustee, directors, shareholders, appointors and default beneficiaries. The challenge will be to get the right combination to minimise any possible attacks on the assets of the trust without comprising the flexibility and control of the trust from the point of view of asset protection, taxation, succession and estate planning.

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Reference notes

- 1 *Donoghue v Stevenson* [1932] AC 562
- 2 *Hanel v O’Neill* [2003] SASC 409
- 3 *Federal Commissioner of Taxation v Vegners* (1989) 90 ALR 547
- 4 *Gartside v Inland Revenue Commissioners* [1968] AC 553
- 5 *Richstar*, paragraph 29
- 6 *Re Burton: Wily v Burton & Ors* 126 ALR 557
- 7 *Op cit* at 560