

Getting it right: examples to learn from



INTRODUCTION

The courts are littered with examples where advisors and their clients have failed to properly establish, operate, restructure or co-ordinate trust structures. Whilst most examples involve discretionary trusts, the last few years have seen the emergence of cases concerning unit trusts and self-managed superannuation funds (SMSFs).

Many of these cases involve inadvertent error arising from not understanding the business and investment structures or ignoring administration procedures. However, some involve deliberate actions to manipulate or reinterpret transactions and structures for ulterior purposes such as to protect assets from creditors.

The courts will often use a purposive approach to interpretation to assist in alleviating the consequences of an inadvertent error. However, some inadvertent errors are beyond court correction. Further, the court will not assist and will likely make every effort to thwart activities that involve deliberate actions to achieve ulterior or improper purposes.

This article discusses five recent court decisions which are a timely reminder of the consequences of not getting it right.

YOU CAN'T GIVE WHAT YOU DON'T OWN

Public Trustee v Smith

Facts

In *Public Trustee v Smith* (5 May 2008)¹ Dr Ward established a discretionary trust to purchase a property in Randwick, New South Wales. Dr Ward was the sole director and shareholder of the corporate trustee, Helen Ward Nominees P/L.

Due to an apparent drafting error in the trust deed, Dr Ward was not named or included as a beneficiary of the trust. Instead the beneficiaries were limited to Dr Ward's children, parents, brothers and sisters, nieces and nephews and charities.

Various trust distributions were made over many years to Dr Ward and her mother (Dr Ward not having any children and only half brothers and a half sister²). Dr Ward treated the property as her own, paying all rates, taxes and the mortgage on the property, and in correspondence demonstrated only a cursory understanding of the trust relationship.

In 2002 Dr Ward made a will purporting to provide a right to reside in the property to a friend Ms Smith for 15 years on condition that she look after her cats. Dr Ward died later in 2002, the Public Trustee became executor of her estate pursuant to the provisions of her will and removed Helen Ward Nominees P/L as trustee and appointed itself as trustee.

Ms Smith accepted the feline maintenance condition qualifying her for the right to reside in the property under Dr Ward's will and sought to enforce that right against the Public Trustee as executor and trustee of the discretionary trust. To enforce that right, Ms Smith sought to establish that Dr Ward was the sole beneficiary of the trust and that as sole controller and sole beneficiary of the trust Dr Ward was entitled to deal with the property in accordance with her will.

The drafting error resulted in difficult technical arguments concerning implied variations, rectification, estoppel and constructive and resulting trust.

Decision

Despite various arguments to try and bring Dr Ward in as a beneficiary of the trust, including attempts to rely on Dr Ward's treatment of the property as her own asset as constituting some implied variation or resettlement of the trust, the court held that such treatment did not resettle or vary the trust to make Dr Ward a beneficiary.³ However, the drafting of the trust deed and evidence of the solicitor was sufficient to permit the court to make an order rectifying the trust deed to include Dr Ward as one of the beneficiaries from establishment of the trust based on the authority of *CSR (NSW) v Carlenka P/L*.⁴

The court rejected the estoppel and constructive and resulting trust arguments. However, the final argument raised by Ms Smith based on a number of decisions in the family law area and also the decision in *Richstar*⁵ was that, because Dr Ward was the sole director and shareholder of the corporate trustee and (after rectification) was also a beneficiary of the trust, she could be viewed as the beneficial owner of the trust property.

The court gave extensive consideration to this argument over 12 pages of the judgment analysing the relevant cases but rejected the argument. Relevantly, the court stated at para 135:

Where, as is the usual case, the trustee of a discretionary trust has a special power to appoint trust property to objects of a designated class (or a hybrid power), I respectfully doubt that it is correct to say that a beneficiary who controls the trustee has what approaches a general power of appointment. In the usual case, as in this case, the power vests in the trustee and is a special power. It does not become a general power of

appointment merely because the beneficiary can compel its exercise in favour of himself. As Gummow J said in the passage cited, a general power is usually understood as one exercisable in favour of any persons the donee of the power thinks fit including himself and his executors and administrators (Geraint Thomas, *Thomas on Powers* (1998) Sweet & Maxwell at [1-18]). *That is not to say that the beneficiary's ability to control the trustee would not justify characterising what might otherwise be a bare expectancy as a contingent interest for the reasons given in ASIC v Carey (No.6) at [36] (quoted in para [132] above), thus conferring a proprietary interest in the trust funds. [emphasis added]*

Comments

While the case is illustrative of the problems simple drafting errors may produce, the case importantly supports a reading down of *Richstar* and the traditional view of beneficial interests and ownership in discretionary trusts as set out in other recent cases.⁶

The comment that a beneficiary's ability to control a trust might convert an expectancy to a contingent interest and, therefore, a proprietary interest in the trust, is however of some concern. Whether there is any real value to such a proprietary interest (if it exists) such that it would cause concern for ongoing asset protection strategies involving discretionary trusts is doubtful.

Reference was made briefly at the end of the judgment as to whether the Public Trustee could or should exercise its powers under the trust deed to give effect to Dr Ward's testamentary wishes in relation to the property. That matter was not argued before the judge and so no opinion was expressed. Since Ms Smith was not a beneficiary of the trust any action to benefit her from the trust could be construed as a breach of trust. To provide the benefit to her the trust would require some amendment or resettlement which again could be construed as a breach of trust. However, it does raise the issue of whether testamentary wishes to distribute to a beneficiary of a testamentary trust could justify a concurrent trustee and executor to exercise a discretion to resettle the trust and provide a benefit to the beneficiary.

Moss Super P/L v Photography Management Services P/L

Facts

In *Moss Super P/L v Photography Management Services P/L* (16 May 2008)⁷ Photographic Management Services P/L (PMS P/L) conducted a Photography Studies College and acted as trustee of a discretionary trust and of a SMSF. Mr Hayne and his domestic partner Ms Moss were the only directors and employees of PMS P/L and each had children but no children born of the relationship.

have relevance if the superannuation fund entitlement remained in the fund).

Decision

As Mr Hayne had not requested payment of his superannuation benefit, a strict technical interpretation of the superannuation fund deed meant that he did not satisfy the definition of a "Pensioner" nor was he a "Member" as during the period between becoming entitled to a pension and actually receiving that pension Mr Hayne was neither an accumulation member nor a pensioner for the purposes of the deed. To overcome

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... independent third parties must exercise care to ensure they are not caught up with breaches of trust.

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Mr Hayne turned 65 but continued working and no steps were taken to pay out his superannuation benefits. He died three months later with a member benefit account of just over \$700,000. His will divided his estate equally between Ms Moss and each of their children and a memorandum of wishes requested his superannuation entitlements be paid to his estate.

Mr Sundberg as executor and director of PMS P/L decided (for reasons he later conceded were incorrect) to have documents prepared and executed to change the trustee of the superannuation fund from PMS P/L to Moss Super P/L. Ms Moss was the sole director of Moss Super P/L. Whilst the resignation of PMS P/L was effective, the appointment of new trustee was invalid as the correct procedures were not followed.

A dispute arose concerning whether the superannuation benefit was retained by the superannuation fund and was therefore payable to Ms Moss and Mr Hayne's children (thus excluding Ms Moss's children) or formed part of the estate and was payable equally to Ms Moss and her children and Mr Hayne's children. A secondary issue related to the validity of the change of trustee of the fund (which would only

this problem, the Court took a purposive approach to interpreting the definition of "Pensioner" to include Mr Hayne within that definition although no payment of a pension had yet been made to him. The alternative view that upon Mr Hayne's turning 65 he became entitled to call for his benefit and therefore, his benefit formed part of his estate was rejected because there was no actual call for any benefit. The only sensible conclusion was therefore, that the superannuation entitlement remained in the fund in a pension account for Mr Hayne to be dealt with in accordance with the fund deed provisions.

PMS P/L as "founder" was entitled to appoint a new trustee. However, the documents prepared were ineffective because they purported that Ms Moss as sole surviving member appointed the new trustee. The court rejected the suggestion that as both directors of PMS P/L had signed the documents that this constituted the necessary action by PMS P/L as founder because there was no evidence of this being the case. Accordingly, whilst PMS P/L had validly resigned there was no trustee appointed in its place therefore, PMS P/L as the founder retained the power to appoint a new trustee.

Comments

Passing control in a SMSF is critical, particularly with blended families. Where control is confused by people having multiple roles, errors in administration often occur if the role in which a person acts is not abundantly clear.

Regardless of whether a new trustee was appointed, that new trustee would be bound by the provisions of the deed as interpreted by the Court. The result appears to be that, subject to any appeal, Mr Hayne's clearly stated will and statement of wishes that his superannuation become part of his estate and become partly distributed to Ms Moss' children will be thwarted without an act of benevolence by Ms Moss and Mr Hayne's children to gift some of the benefit to Ms Moss's children.

POOR DOCUMENTATION PRACTICE DOES NOT ACHIEVE ITS EFFECT

Kawasaki (Australia) P/L v ARC Strang P/L

Facts

In *Kawasaki (Australia) P/L v ARC Strang P/L* (9 April 2008)⁸ *Kawasaki (Australia) P/L*, ARC Strang P/L and a company which later become Toll Holdings P/L as shareholders in a joint venture company granted pre-emptive rights under a shareholders' agreement. The shareholders' agreement did not include provisions dealing with a change in control of a shareholder.

ARC Strang P/L initially negotiated with *Kawasaki (Australia) P/L* (to the exclusion of Toll Holdings P/L) to acquire its interest. When negotiations broke down, ARC Strang P/L negotiated with Toll Holdings P/L (to the exclusion of *Kawasaki (Australia) P/L*) to acquire its interest. To indirectly effect the transfer to Toll Holdings P/L, ARC Strang P/L as trustee of the Strang Trust assigned its beneficial interest in the shares in the joint venture company to itself in its own right, changed the trustee of the Strang Trust and then sold the shares in ARC Strang P/L to Toll Holdings P/L.

Kawasaki (Australia) P/L took action against ARC Strang P/L and Toll Holdings P/L for breach of the pre-emptive rights clause in the shareholders' agreement.

Decision

The court analysed the meaning of the word "transfer" in the pre-emptive rights provisions and concluded that a reference to a transfer of shares in the ordinary sense means the transfer of the legal interest in the shares and could not refer to a transfer of the underlying beneficial interest in the shares.⁹

The effect of the assignment was not a disposition of anything, it was not a transfer, passing or transmission of the beneficial interest in the shares from one person or entity to, a third party, another person or another entity. Since the Strang Trust was a discretionary trust, no beneficiary under it had a vested interest. Accordingly, there was no disposition of the beneficial interest in the shares by the trustee to a third party. Such interest of the beneficiaries of the Strang Trust was a right to have the trust administered in accordance with the terms of the trust deed. The court quoted with approval an excerpt from *Lygon Nominees P/L v CSR (Vic)*¹⁰ and limited *Richstar* to its Corporations Act 2001 context.

Comments

Again, this is another case which supports a reading down of *Richstar* and the traditional view of beneficial interests and ownership in discretionary trusts as set out in other recent cases.

This case shows the importance of carefully drafting agreements to ensure that the provisions cover all intended circumstances. The drafting inadequacies of the shareholders' agreement resulted in *Kawasaki (Australia) P/L* having to make difficult submissions regarding concepts of legal and beneficial ownership in an unsuccessful attempt to salvage the shareholders' agreement.

Sutcliffe v Heathcote

Facts

In *Sutcliffe v Heathcote* (20 June 2008)¹¹ Mr Sheppard purportedly told his daughter, Ms Sheppard, that he was giving her his residential unit in South Yarra, Victoria. Ms Sheppard and her son occupied the unit for approximately 3 years rent-free then moved to another property in South Yarra and continued to receive the rental income from the unit and also paid for \$30,000 renovations to the unit. The unit

remained in Mr Sheppard's name until death and there was no documentation evidencing the gift. Ms Sheppard sought orders that the unit be transferred to her as beneficial owner pursuant to the gift.

Decision

The court rejected Ms Sheppard's ownership of the unit pursuant to the gift because s 126 of the Instruments Act 1958 (Vic) required the transfer of an interest in real property to be effected or evidenced in writing and there was no such writing in this case. Further, there was no other documentation to support the alleged existence of the father's intention to give or to hold on trust for his daughter at any stage.

Comment

Whilst this was a relatively easy case for the court to decide (and was probably never really in doubt) it does serve to highlight the three most important rules of getting it right, namely: *documentation, documentation, documentation!*

BAD BEHAVIOUR WILL NOT BE REWARDED

McNally v Harris

Facts

In *McNally v Harris* (30 June 2008)¹² Mr McNally who was a tax consultant received an unexpected tax bill of over \$500,000 which he proposed to dispute. Within 11 days of being advised of the tax bill and in accordance with a pre-existing asset protection strategy for the benefit of his wife and children, Mr McNally established the Harraw Trust and transferred shares in Oxiana Ltd to Harraw Nominees P/L as the trustee of that Harraw Trust at a significantly under market value.

Whilst Mr McNally and his family were beneficiaries of the Harraw Trust, the directors of Harraw Nominees P/L were two close friends of Mr McNally namely Mr Harris and Mr Warton and the sole appointor of the Harraw Trust was Mr Harris. There was conflicting evidence regarding the date the Harraw Trust was established and whether this transfer of shares was to Harraw Nominees P/L as trustee of the Harraw Trust or as a bare trustee for Mr McNally. The settled sum was apparently not paid by the settlor.

Some months later Mr McNally purported to transfer “his” shares in Oxiana Ltd to his related company Harris Johnsson Nominees P/L in exchange for the transfer of shares owned by Harris Johnsson Nominees P/L in the public company Sentinel Properties Ltd. All documentation for this including the relevant transfer of shares was signed by Mr Harris claiming to be sole director and secretary of Harraw Nominees P/L. Mr Harris also lodged an ASIC form for change of directors noting the resignation of Mr Warton. In fact Mr Warton did not resign as director.

Harris Johnsson Nominees P/L proceeded to deal with the Oxiana Ltd shares by selling some of these at a profit and transferring the remainder to another company Harris Johnsson Partners P/L, the directors of which were Mr Harris and his wife, Mrs Harris. Those shares were then sold and the proceeds paid to a bank account in the name of Mr and Mrs Harris.

After the Oxiana Ltd shares had been transferred Mr Harris arranged for Harraw Nominees P/L to be deregistered. Some time later the Court appointed Mrs McNally and Mr Warton as trustees of the trust.

Mr McNally’s wife, Mrs McNally, and other beneficiaries brought various actions against Mr Harris, Harraw Nominees P/L and Harris Johnsson Nominees P/L arising from the dissipation of the value of the Oxiana Ltd shares.

Decision

The court held that the non-payment of the settled sum did not prevent the trust being later established if property (such as the entitlement to the Oxiana Ltd shares) were transferred to it and held by the trustee of the trust on the terms of the trust as contained in the trust deed.

Although there was evidence and conduct that Mr McNally and Mr Harris intended Harraw Nominees P/L to hold the shares on bare trust for Mr McNally personally those instructions to Mr Harris did not occur until after the shares had been transferred into the trust. Therefore, upon the execution of the transfer of shares, the entitlement to the shares became trust property and when the share transfer was registered some days later the shares themselves became trust property.

Having concluded the facts set out above, the court had little trouble in finding that all of Mr Harris, Harris Johnsson Nominees P/L and Harraw Nominees P/L were in breach of trust as regards to the beneficiaries of the trust. The Court applied the two limbed test in *Barnes v Addy*.¹³

On the evidence Mr Harris clearly had knowledge of the true position when entering into the share transactions and this knowledge was attributed to both companies on the basis that Mr Harris was the controlling mind of those companies. A claim of breach of trust against Mrs Harris (who was a co-director of Harris Johnsson Nominees P/L and had signed documents as part of the transaction) was unsuccessful on the basis that Mrs Harris had no knowledge of the circumstances of the transaction and simply signed documents at the instruction of her husband.

Mr Harris’s action in signing and submitting the ASIC form incorrectly claiming that Mr Warton had resigned as director of Harraw Nominees P/L and signing and submitting the share transfer form to the share registry of Oxiana Ltd claiming he was sole director of Harraw Nominees P/L had the potential for constituting the tort of injurious falsehood as detailed in *Palmer Bruyn and Parkey P/L v Parsons*.¹⁴ The court held that the submission of the ASIC form incorrectly claiming that Mr Warton had resigned as a director was not an injurious falsehood because no damage or loss arose from that action. However, the submission of the Oxiana Ltd share transfer resulted in damage because the shares ceased to be the property of the trust, that action, therefore, constituted the tort of injurious falsehood.

Mr McNally was not sued by the plaintiffs in the matter and so Mr Harris, Harraw Nominees P/L and Harris Johnsson Nominees P/L claimed equitable indemnity and contribution from Mr McNally in relation to the claims against them. The court refused the indemnity because the parties did not have “clean hands” for equitable relief, having been knowing parties in the breaches of trust.

Comment

Although the inclusion of independent third parties in positions of control within discretionary trusts is often recommended for asset protection structuring, those

independent third parties must exercise care to ensure they are not caught up with breaches of trust.

Aggressive structuring to protect assets once a claim arises may result in many and varied liabilities for those that participate in the structuring.

CONCLUSION

The above are just some examples of things going awry in the operation of discretionary trusts and superannuation funds and there will no doubt be many more to come.

Better administration practices and understanding of documents, structures and the relationship of entities is necessary to prevent ineffective actions or costly court proceeding to correct inadvertent errors.

Adopting better administration will not of course guarantee an avoidance of disputes or court proceedings in some circumstances, however, the chances of such disputes arising will certainly be minimised and the prospect of successful outcomes in any proceedings will be greatly increased.

Where parties are acting properly and without ulterior motives the courts are more likely to assist with the correction of errors to the greatest extent possible. However, the courts will likely thwart any improper actions.

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Reference notes:

- 1 *Public Trustee v Smith* [2008] NSWSC 397.
- 2 Interestingly, as a side issue, the court also decided that the terms ‘brother’ and ‘sister’, used (but not defined) in the trust deed, were sufficiently broad in their ordinary meaning to include the half sister and half brothers of Dr Ward.
- 3 *Public Trustee v Smith*, *ibid*, para 62.
- 4 *CSR (NSW) v Carlenka Pty Ltd* (1995) 41 NSWLR 329.
- 5 *Australian Securities and Investments Commission v Carey and Ors* (No.6) [2006] FCA 814.
- 6 *Refer Lygon Nominees Pty Ltd v CSR (Vic)* [2007] VSCA 140 and the *Kawasaki (Australia) Pty Ltd v ARC Strang Pty Ltd* [2008] FCA 461 (9 April 2008).
- 7 *Moss Super Pty Ltd v Photography Management Services Pty Ltd* [2008] VSC 158 (16 May 2008).
- 8 *Kawasaki (Australia) Pty Ltd v ARC Strang Pty Ltd* [2008] FCA 461 (9 April 2008).
- 9 *Refer Safeguard Industrial Investments Limited v National Westminster Bank* [1981] 1 WLR 286 which was quoted with approval in the case.
- 10 *Lygon Nominees Pty Ltd v CSR (Vic)* (2005) 60 ATR 135.
- 11 *Sutcliffe v Heathcote* [2008] VSC 224 (20 June 2008).
- 12 *McNally v Harris* [2008] NSWSC 659 (30 June 2008).
- 13 *Barnes v Addy* (1874) LR 9 Ch App 244.
- 14 *Palmer Bruyn and Parkey P/L v Parsons* [2001] HCA 69.