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Getting trusts and related arrangements match-fit

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Introduction

Under the legal system in which all practitioners dealing with the creation, administration and enforcement of trusts operate what judges say about trusts and trust principles really matters, particularly given the limited role that detailed statutory rules have historically played in the trust law context and the statutory rules that do exist are often permissive in nature.

In focussing on the role that judges play in shaping our thinking about important trust matters, it is also axiomatic that in a legal system whose foundations include a hierarchy of courts and a doctrine of precedent, what certain judges determine and reason about trust law and trust situations will be significantly more relevant to one's thinking than others.

While the case for a specialist court (in some form) to deal with trust matters makes good sense (as does judicial specialisation in other substantive legal areas), the judicial decisions about trusts that obviously matter the most are the holdings (and statements) contained in any judgments of New Zealand's highest courts (and their counterparts in other recognised jurisdictions).

This will remain so even where the relevant Court, as is often the case, expressly indicates that it is confining its judicial findings and reasoning to the particular facts before it because, in commenting on those specific facts it may still provide certain general signals or guidance as to how another "trust" case with similar (or broadly similar) facts and issues would likely be treated were it to come before it. In addition, certain statements (concerns) about trust practices or trust developments might be voiced judicially.

Identifying and being aware of any relevant judicial signals or concerns about trusts and trust practices, whether express or implicit, is an important task for any practitioner because it is almost certain that if any client's trust is subjected to serious challenge the challenger and their counsel will seize on any judicial comments or positions that can fairly (or even questionably) be advanced in support of the claims being made.

Given that judicial thinking from a court like the Supreme Court or Court of Appeal on any matter (trust or otherwise) will often form part of New Zealand law for many years, unless amended by Parliament, then for any trust to be truly match-fit and safe from future challenge it must be able to withstand the types of arguments that at the point of challenge will be sourced from prevailing judicial attitudes about trusts and trust behaviour.

Some possible judicial attitudes that have implications for trusts and trust practice are now discussed below.

What trust meant to do legally

While the purpose(s) for which different people may want to settle property into a trust in 2012 may vary (including conventional purposes like succession planning, tax minimisation, creditor protection, long-term investment etc), the **legal goals** of any settlement onto a trust (invariably a discretionary trust today) are essentially the same as those that existed at the origin of (and since) the first trust settlements in the 16th century.

Those legal goals normally comprise *inter alia*:

- Changing the ownership of property (and any benefits flowing from that property) by subjecting the property to a new legal relationship in terms of which its former exclusive ownership in **"A"** is now held for the benefit of another person **"C"** or persons (that might include A) or for some purpose authorised by law;

- Ensuring that the person(s) **"B"** who holds the powers to give effect to and administer the new legal relationship (settlement) and the relevant property subject to that relationship for the benefit of others is at all times acting as a selfless fiduciary and complying with those legal principles that regulate the conduct of fiduciaries. As Professor Donovan Waters notes:

> "**The hallmark of a trust is the fiduciary relationship which the trust creates between the trustee and the beneficiary. The whole purpose of a trustee's existence is to administer property on behalf of another**, to hold it exclusively for the other's enjoyment. The express trustee is expected to put the interests of the trust and the beneficiaries first in his thinking whenever he is exercising the powers, or performing the duties of, his office. **His duty is one of selfless service**." (see *Water's Law of Trusts in Canada*, 2005, at p38)."

- Ensuring that any property intended by A to form part of this new legal relationship is vested in that new legal relationship (settlement) effectively;

- Giving effect to the terms of the settlement (through the life of the settlement) as envisaged by A when he or she gave up the beneficial ownership of their property and vested it on the terms of the new legal relationship. This will include ensuring that the property (and any other benefits arising from the property) are, subject to the terms of the settlement, dealt with by **B** in the interests of the new "owners" of that property **C** which will require **B** at some point during the life of the new trust to make that property available to **C** to perfect their beneficial interest in that property.

Legal goals of trusts in contemporary setting

These legal goals for discretionary trusts are made against a backdrop where the settlement that is established and its ongoing administration form part of the law of obligations or property rights (or a combination of both). More importantly, the reality of day-to-day trust practice includes the possibility that these legal goals (individually or collectively) may now come under serious challenge at any point during the life of the trust on a range of legal bases (some found in the general law and some in statute).

Challenges to the legitimacy of trusts are not new even in terms of targeted statutory rules (many of the targeted “reserved benefit” and tax avoidance rules that existed in the past in say United Kingdom finance legislation (of various types) being of significant breadth. Nor are judicial criticisms of trust use in particular contexts just a modern phenomenon (see e.g. *In re Weston’s Settlements* [1969)] 1 Ch 223, although the concern expressed was not about the blatant tax avoidance).

However, legal and economic changes have occurred (both domestically and globally) in recent times in the trusts’ setting that must inevitably impact on how trusts and trust arrangements will be assessed judicially going forward including *inter alia*:

- Specific statutory rules that apply directly or indirectly to trusts (e.g. s 44C of the Property (Relationships) Act 1976 and Subpart 6 of the Property Law Act 2007) and any additional rules that may emerge from the current work of the Law Commission (or otherwise);

- The desperate demand for increased tax revenues on behalf of the Government to fund the rebuild of Christchurch, to provide normal Government services, and to repay the country’s burgeoning indebtedness;

- The significant demand for persons to be held *personally* accountable for finance company and other similar defaults and for them to consequently be required to disgorge any moneys (often held in trusts) that were obtained from unlawful or improper activities;

- The lack of affirmative and consistent judicial endorsements for the use of trusts in particular contexts. For example, it seems considerably less likely that a statement of the following type by the Court of Appeal in *Coles v Coles* (1985) 3 FRNZ 101 (CA) would now be made judicially, in terms:

  > “In the present case the Court must be satisfied that Mr Coles adopted the company/trust structure as a means to achieve the end of putting the property involved beyond the reach of his wife. In the light of the finding that Mr Coles was motivated by no more than the desire of many farmers in his situation to save duty on his estate and to benefit his children (for which there is abundant evidence), the first ground of appeal must fail.”

  Similarly, a judicial statement of the following type made by Cooke J in *Loader v C of IR* (1974) 1 NZTC 61,132, at 61,137 seems at odds with modern judicial sentiment:

  > “The answer suggested by counsel for the Commissioner was the artificiality of a situation in which one man controls or very largely controls the administration of both trust and company and yet carries on the business much on the same lines in fact (apart from the increase in the size of the business) as before incorporation. Having regard to the familiar concepts of the separate identities of companies and trusts already mentioned, the situation does not appear abnormally artificial.”

- A general change in the extent to which the **form** of legal arrangements (including those involving trusts) in the commercial context is to be respected as opposed to having the ability to look at the **substance** of those arrangements. While equity will not be blinded by the form of things in the trust context (see *Official Assignee v Wilson* [2007] NZCA 122 at [44]), and while there has been no judicial rejection of the requirement to adhere to the form of the arrangements (including trusts) that commercial and private parties have freely negotiated or arranged, in the taxation context (a context in which many trusts have been assessed) there has been a clear movement away from what Harrison J in *Westpac Banking Corporation v C of IR* (2009) 24 NZTC 23,834 at [176] described as the "formalistic or juristic approach" to looking at commercial and taxation transactions and their outcomes.

- The last point mentioned is a significant one because legal recognition of any "legal relationship" or "legal fiction" (other than those whose existence is confirmed by statute like companies) depends to a significant degree on an ongoing acceptance in the majority of situations of formalistic or juristic things as Winkelmann J recently observed in *The Financial Markets Authority v Hotchin*, CIV 2010-404-8082, 21 February 2012 at [49-50] in order that commercial certainty in trust and other dealings is maintained. Similar comments about "commercial certainty" for trust arrangements were made in *Official Assignee v Wilson* at [50].

While the history and fact of trusts as part of the commercial and private fabric of New Zealand life is something that no judge can obviously ignore, if a judicial perception is held that many modern trusts are simply devices designed to enable people to avoid their obligations and this is now unacceptable in the context of New Zealand society in 2012 and beyond, then the way in which many trust arrangements will be analysed judicially is inevitably going to be different from the type of analysis adopted in the past and significantly higher standards required (both legally and evidentially) to confirm the legitimacy of the trust and the particular trust behaviours or outcomes being challenged.

While trust practitioners can obviously not control any change in the mood of the judiciary towards trusts, they can respond in their trust advice and trust practices in ways that meet those higher standards thereby making it considerably more difficult in any case for the veil of trust to be lifted and the relevant arrangements to be disregarded because in substance they disclose a "dodgy" legal pretence under the control of the trust's creator.

Demonstrating a change in the ownership of property

FMA v Hotchin

In the ongoing litigation involving the Financial Markets Authority (**FMA**) and Mr Mark Hotchin (**Hotchin**) (the most recent of which reported cases is the one cited above), the FMA sought and obtained certain interim asset preservation orders under ss 60H and 60I of the Securities Act 1978 against certain trusts connected to Mr Hotchin.

The litigation is interesting as the pleadings advanced by the FMA against the corporate trustees of the trusts in support of its request for interim preservation orders against the trusts' property included that *inter alia*:

- The trustees hold funds **on behalf of** associated persons (namely, Hotchin's children), as that term is defined in s 60H of the Securities Act 1978;

- The trusts were not intended to be legally binding, and so are void for lack of intention to create valid trusts;

- The trusts were a sham from settlement or subsequently;

- The power of control retained by Hotchin in the relevant trust settlements was evidence that Hotchin never intended to create a binding trust and not a legal structure to hold property for persons other than Hotchin;

The essence of a number of the pleaded grounds is that, whatever the <u>form</u> of the legal arrangements holding Hotchin's former property might purport to have been, <u>in substance</u> **the ownership of that property was not held in a trust relationship**. In short, the first of the fundamental legal goals identified above is alleged to never have been achieved: A's (Hotchin's) property never got into a new legal relationship where its ownership was held for C (persons other than (but possibly including Hotchin)).

While the **actual evidence** surrounding the establishment and operation of the trusts will obviously be critical to any final judicial decisions in this context a number of preliminary comments can be made about the pleaded grounds in terms of recent Supreme Court and Court of Appeal authority.

Sham

While the **actual evidence may prove otherwise**, the "sham" argument pleaded by the FMA seems (at least superficially) an act of regulatory overreach because *inter alia*:

- The KA3 and KA4 Trusts were both discretionary trusts established by Hotchin under Deeds of Trust in 1999 and 2003 respectively. Hotchin is not a discretionary beneficiary of the KA4 Trust and one of a class of discretionary beneficiaries of the KA3 Trust (but not a final beneficiary). Hotchin was for a time the sole trustee of the KA4 Trust and then a co-trustee prior to the appointment of the existing corporate trustee (in which he is neither shareholder or director). Since 2003, the KA3 Trustee has been a corporate trustee with a separate director/shareholder. Under the KA4 Trust Hotchin holds a power to nominate discretionary beneficiaries;

- In *Ben Nevis Forestry Ventures Ltd v C of IR* (2009) 24 NZTC 23,188 the Supreme Court stated that:

    ⇨ In order for documentation to constitute a "sham" it must <u>not</u> reflect the true legal and commercial nature of what the contracting parties have agreed [34].

    ⇨ There can be no sham at law where the document or arrangement "evidences the true common intention of the parties" [33].

- In *Official Assignee v Wilson* the Court of Appeal reasoned that:

- ⇨ To draw an inference of sham in any case <u>in the absence of direct evidence</u> requires "compelling material" [93].

- ⇨ Where a document or transaction entered into between arm's length parties is clear on its face as to its legal nature then a sham finding "cannot be made [because] another inference [i.e. that recorded in the documentation] is ... equally open on the evidence [93];

- ⇨ "Once a trust is validly created, the beneficiaries have an interest in the trust property that cannot easily be undone. Unless the latter appearance of a sham can be traced back to the creation of the trust, the trust remains valid [57];

- ⇨ "In the absence of statutory authority, there needs to be an equitable basis for avoiding a trust" [68].

- In *Equuscorp Pty Ltd v Glengallow Investment* (2004) 218 CL 471, the High Court of Australia confirmed that:

  - ⇨ Legal arrangements [like trusts] freely entered into will normally be given effect to and cannot just be brushed aside [46] (the case involving a loan arrangement).

- In *FMA v Hotchin* formal trust arrangements recorded in deeds of trust were established by Hotchin a number of years before this litigation arose. The trusts had trustees (some independent from Hotchin but at one point including in the case of the KA3 Trust, Hotchin) and beneficiaries that included members of Hotchin's family (and also Hotchin as discretionary beneficiary in the KA3 Trust). In light of the clear "sham" directives in the above cases, and the overall very high threshold for a finding of sham declared in those cases, it is difficult to see how the sham pleading could be maintained in the absence of very **compelling evidence** demonstrating a false and misleading representation of the trust relationships declared in the relevant Deeds of Trust for the KA3 and KA4 Trusts and the reality disclosed elsewhere in the evidence. It seems illogical and implausible that Hotchin did not intend to create trusts and valid ones from their inception(usually the critical timing point for validity);

- More particularly, the facts that Hotchin was the sole trustee of one of the Trusts, held powers of appointment to alter the class of beneficiaries in one of the Trusts, or was able to "influence" the trustees in respect of the Trusts would not be sufficient factors (in the absence of other evidence, see below) to support a sham finding because:

  - ⇨ The fact that Hotchin may have been the sole trustee of one of the trusts would not be a basis (standing alone) for a finding of sham unless there was <u>actual evidence</u> that Hotchin had not discharged his role as an independent fiduciary and, even if that evidence existed, that would more likely found a limited claim for a breach of trust in terms of the specific trustee default, as opposed to attacking the general invalidity of the trust (*Official Assignee v Wilson* [71]);

  - ⇨ Evidence of "influence" by Hotchin over third party trustees of the trusts would again, without more, not support a sham finding. There would need to be clear evidence that the trustees had acquiesced and relinquished their stewardship of the trusts to Hotchin **as a matter of fact** and allowed him to assume "effective control" of the trusts post their settlement (*Official Assignee v Wilson* [71]);

- Furthermore "evidence of poor administration of the trust is insufficient, of itself, to establish a sham"(see *Official Assignee v Wilson* [91]);

- The fact that Hotchin held a power to appoint beneficiaries (or even if he had other specific powers) would not necessarily support a sham finding. As Winkelmann J correctly noted in *Financial Markets Authority v Hotchin* [2011] 3 NZLR 469 at [131] "Powers of appointment of trustees, and even of discretionary beneficiaries, are not sufficient to give Mr Hotchin control over the assets of the Trusts, because that control rests, at law, with the trustee once appointed";

- The comments of Winkelmann J about the significance of the role of "powers" held by someone like Hotchin have been examined by the courts in other contexts. For example, in *Vestey's Executors v IRC* [1949] 1 All ER 1108 (HL) an issue arose in terms of a discretionary trust as to whether Lord Vestey (who was not a beneficiary under the trust but held appointment powers over new trustees and trust investment) was, because of the existence of those appointment powers, someone who came within s 18 of the Finance Act 1936 (UK) because the income or property of the relevant settlement was "payable to or applicable for the benefit of the settlor". The House of Lords rejected the Crown's arguments about this effect of the "powers" and stated that the relevant powers (emphasis added):

  > "... **had to be exercised with a single eye to the benefit of beneficiaries**. Only express words in the deed could justify a construction which would enable those who exercise the power of direction to disregard the interests of the beneficiaries. [1115]"
  >
  > ....
  >
  > **The contrast is between substance and form**, so, if it can be shown in the present case that the effect of ... operations is to vest a benefit in (e.g.) a company over which the settlor has complete control, the court may say then that, though in form the company benefits, in substance the company and the settlor are one, and the settlor, therefore benefits, **but the court cannot take this last step unless it is shown that the settlor himself has legal control, and no reliance must be placed on his influence over others who are not in law bound to follow his directions**. [1119]"

Obviously, some types of reserved powers that are retained by a settlor of a settlement, even if not exercised, may be so fundamental in nature that it is possible to contend that the "effective ownership" of the assets subject to the settlement is with the settlor because the assets can revert back to the settlor and they are therefore in substance the settlor's assets and available to a judgment creditor: see e.g. *Fonu v Merrill Lynch*

Bank & Trust Company [2011] UKPC 17 (where the settlor of two settlements retained a very broad power to revoke and amend those settlements, although the position may have been otherwise if the revocation power had been held by the trust company and the settlor could not assume control of that revocation power).

- Having said this, the ongoing potential problem in trust situations where a "sham" is pleaded is that despite the very high evidential thresholds that must be proved to found a sham the relevant judicial commentaries all recognise and reserve the right for a sham to be pleaded if in terms of the relevant evidence "effective control" over the settlement can be shown to exist in a person (invariably the settlor) post settlement, rather than in independent trustees (see discussion on second goal for trusts below) (see *Official Assignee v Wilson* [71]. Put differently, while the settlor being the sole trustee and having powers of appointment under the deed may not establish a sham **in strict legal theory** they are factors (along with other evidential factors like bad administration and compliant trustees etc) that make a challenger's life easy. **The question therefore always becomes an evidential enquiry as to "effective control" in fact**;

- It is not surprising therefore that Winkelmann J struck out the unparticularised pleading for the sham (and emerging sham) finding for the KA3 Trust [56]. The fact that the pleading was so difficult to particularise and was struck out was likely due it is submitted to its highly questionable and untenable basis in terms of existing authority;

- It is perhaps more of a concern (although illustrative of the points made in the context of the second legal goal below and the importance of what indicative evidence there may have been of Hotchin's "control") that Winkelmann J was prepared to find an arguable case for sham in respect of the KA4 Trust due to its "single trustee, Mr Hotchin" and **subsequent dealings** with the principal asset of the Trust (the Paratai Drive property) as if they were Hotchin's assets [53].

No intention to create a trust

Again **while the actual evidence may prove otherwise**, it seems illogical and implausible that Hotchin never intended to create the trust relationships as asserted by the FMA.

While the authorities have set a very high threshold for the existence of a sham finding, they have equally set a very low threshold for the requisite evidence that will support the existence of an express trust. For example:

- In *Byrnes v Kendle* [2011] HCA 26 the High Court of Australia stated (in a case involving whether an undivided half interest in property had been conferred on a woman by her former partner under a written acknowledgement of trust):

  > "... The opening language twice described it as a trust. Clause 1, a key operative provisions, used the language of trust. These indications, not countered by any other aspect of the document, are more than sufficient to support the conclusion that it was a trust. [117]"

- Similarly in *Official Assignee v Wilson* it was noted:

> "In this case, there was a trust instrument, which, on its ordinary meaning, clearly created a trust. There was a small amount of property transferred to and further property acquired by non-complicit trustees (on the findings of the Judge). In such circumstances, a settlor (or the Official Assignee in the shoes of the settlor) cannot argue successfully that, objectively determined, there was no intention to create a trust. Unambiguous words were used to create the trust. Further, property has been transferred to and acquired by trustees who have, as far as they were concerned, assumed the obligations under the trust deed. [105]"

- And finally, these authorities both confirm that an express private trust can be established at law even if the settlor does not fully understand what he or she is doing (citing the decision of the House of Lords in *Twinsectra v Yardley* [2002] 2 All ER 377, in terms):

> "... A settlor must, of course, possess the necessary intention to create a trust, but his subjective intentions are irrelevant. If he enters into arrangements which have the effect of creating a trust, it is not necessary that he should appreciate that they do so; it is sufficient that he intends to enter into them. [71]"

Again it is no surprise in light of these judicial statements that the no-Hotchin-intention-to-create-a-trust pleading made by the FMA against the KA4 and KA3 Trusts was held by Winkelmann J to have "no prospect of success". It did not of course prevent the FMA from advancing the claim in the first place which seems very questionable in light of existing legal authority.

Property held on behalf of a person

More important than judicial statements for lifting the veil of trust (or aggregating assets) are specific statutory rules that assist a challenger with that outcome, particularly rules whose scheme and purpose requires them to be broadly construed.

Historically, many of these types of specific statutory rules operating in the case of discretionary settlements have been (depending on their precise language) interpreted restrictively (see *Vestey's Executors v IRC*, *Gartside v IRC* [1968] AC 553 (HL) and *Hunt v Muollo* [2003] 2 NZLR 322 (CA)), but arguably interpreted more liberally in recent times (see *Fonu* and *Kennon v Spry* [2008] HCA 56).

However, the **precise terms of the specific statutory rule** that purports to unveil a trust or attribute the assets of a settlement to a settlor are critical to particular outcomes. For example, is property held "on behalf of" a person who is not a beneficiary of a trust (but has a power to become one)? Is property held "on behalf of" the associates of a person (e.g. their family members) if those family members are simply discretionary beneficiaries of the relevant settlement and to the extent it is held in what proportions or is that not relevant?

Sometimes in this statutory-rule-context how the courts view the nature of the interests held by beneficiaries under a settlement can be critical and in the writer's view there has been an arguable shift by the courts in this context also which may be relevant to actual outcomes (see discussion below regarding legal goal three).

Establishing a proper and independent fiduciary relationship

Ensuring the completion of the second legal goal in any settlement (the existence of an independent fiduciary or fiduciaries administering property on behalf of others) is a corollary of the first legal goal because, if this element cannot be demonstrated then that in turn may call into question whether or not the relevant trust under challenge has been properly created.

In the writer's view it is this second trust feature that in many trust situations **will be the pivotal one in determining whether the trust can be successfully challenged** because the more evidence that there is that confirms that the settlement has been administered by persons other than the settlor for persons other than the settlor, then the case for invalidating the trust becomes extremely difficult and this is so even if the "independent trustees" have administered the trust poorly because, in this latter situation, the proper action will be one for breach of trust and that type of action is invariably a confined one in terms of the relevant trust's activities and also one where good defences are often available (time limitations, beneficiary acquiescence, trustees acted honestly and reasonably etc). An action of this latter type is a far cry from a challenge that seeks to overturn the validity of the trust completely.

Understandably, judges do not expressly comment on how a settlor should go about ensuring that any trustee(s) selected for administering the relevant settlement is one who can act selflessly and on behalf of others. Again, **legal theory** says that the settlor can be that trustee and also be a beneficiary of that trust (at least if the settlor is one of a number of beneficiaries).

The question is not what "legal theory" says should work but what <u>day-to-day trust reality says is likely to work</u> and certain indications from the courts are that they are not always convinced by the strict legal theory of trusteeship. For example, would the FMA have contemplated a sham and no-trust pleading if say the Public Trust had been the trustee of the KA3 and KA4 Trusts? In the writer's view that answer is probably no, which is a critical point one would have thought if one of the main original reasons for the settlements by Hotchin was to withstand a regulatory or third party challenge of the type these Trusts are now presently facing (although whatever the trustee make-up may not have mattered to the "on behalf of" statutory challenge under ss 60H and 60I of the Securities Act 1978 (depending how that language is finally interpreted)).

For those involved with settlements involving *material trusts* (and Hotchin's ones would have been in that category) it simply makes no sense in the writer's view to leave the legal destiny of those trusts at potential risk because of a failure to adequately secure this second legal goal. Furthermore, while the courts sensibly do not stipulate who should be the stewards of private trust arrangements they have made comments in recent judgments of relevance in this context.

In *Hotchin* Winkelmann J was obviously more suspicious of the fact that Hotchin had been <u>the sole trustee of the KA4 Trust</u>, which while as noted above may be strictly irrelevant in legal theory, because potentially very relevant at the point of challenge to the assessment of how that Trust had behaved in terms of its assets and obligations through its life.

Similarly, in *Penny & Hooper v C of IR* [2011] NZSC 95 the Supreme Court noted in respect of family trusts <u>that were administered by independent professional advisers</u> on behalf of the relevant orthopaedic surgeon settlors that (emphasis added):

> "Although neither taxpayer was a trustee, **each could naturally expect that the trustees whom they had chosen would act as in fact they did**, and that the benefits of the use of the funds would thereby be secured without the impost of the highest personal tax rate. [35]"

These comments by the Court may have been made in the context of the fact that this was a tax avoidance (s BG 1 Income Tax Act 2007) case where it is permissible for the challenger to look at the "substance" of things. However, if this is so, why does it follow legally that an independent trustee charged with fiduciary obligations would automatically do the "taxation bidding" of the doctor establishing each commercial and tax structure? This statement would suggest that the relevant trustees in the *Penny & Hooper* case were viewed by the Court as little more than the compliant "agents" of the respective doctors and, even if this was not what the Court was intending by this statement, it is not **the type of evidential finding or view that one would want to be present if the overall integrity of a trust arrangement (for tax or other purposes) was being defended from challenge**.

Again the question has to be put as to whether the Court's comment would have been made if a professional trust company or trustee firm (like Public Trust) had been the trustee of the relevant trading trust/company arrangements and for a whole range of reasons one imagines that would likely not have been the case.

Importantly, in *Penny & Hooper* the Crown's pleading as to why s BG 1 of the Income Tax Act was engaged in terms of the arrangements included the allegations that each business structure allowed for the channelling of company profits to the underlying trusts and the benefit of those funds then made available to the individual doctors (and their families). Clearly, the trustees as administrators of the trusts were complicit (according to the Court) in allowing this outcome to occur and again the query arises as to whether these tax and commercial outcomes would have been allowed to occur if the trustee had been a truly arm's length one insisting on contestable arrangements for salary, loans and the like.

Requirements to secure first two legal goals of trusts

In light of the above judicial statements and comments it can be said that if one is trying to secure for clients the first of the two legal goals in the current trust, commercial and regulatory environment then (amongst other things):

- Considerable thought will need to be given to the specific configuration of any discretionary trust. The deed should generally not contain wide powers of variation and/or extensive reserved powers if these are vested in the settlor (or even an appointor "related" to the settlor), if the effect of those powers (which is usually the case) is the ability of the settlor to alter key "control" and "entitlement" mechanisms in the settlement. The position would be improved substantially if these variation and appointment powers are held by the trustee(s) of the relevant settlement (but see below);

- In some situations it may be preferable for the settlor not to be a discretionary beneficiary of the trust and to have no legal ability (directly or indirectly) to become one;

- Who is selected as the trustee(s) of the trust will often be the critical requirement if the trust is to survive challenge. Mates of the settlor as trustees should be avoided at all costs and also tame professional advisers who are not going to be able to act as proper fiduciaries. If the settlor(s) wants to be a trustee(s) then their decision-making should be **tied to the decision-making of other independent trustees** and the overall evidence of decision-making involving key matters for the trust (i.e. resolutions and the like) able to demonstrate the respective inputs of those persons from time to time;

- Trustee conduct and activities generally cannot be cured retrospectively and the overall integrity of the trust will invariably be driven and established (in documentary and other terms) by the quality of the trust's trustee(s). All the trustees of a trust need to show that they have been aware of and had a hand in all key trust affairs;

- Despite all the arguments to the contrary, the case for having a professional trust company (or equivalent trustee organisation) administering *material* private trust settlements in 2012 and beyond is a compelling one. The existence of such a trustee will in many situations remove any basis for challenge proceedings going to the trust's validity. While the role and standards of a professional trust company should in theory be able to be duplicated by other trustee arrangements it is vital that they are **in fact**;

- Formal procedural and documentary things (like regular and meaningful trustee meetings, fulsome and meaningful resolutions, trust bank accounts and other normal "trust" features) simply go without saying.

Effective disposition of property into trust settlement

In practice many trusts receive ongoing settlements of property throughout their lives. With the abolition of gift duty and the possible reform (or extension) of the perpetuities rule there is now considerably greater freedom (and incentive) for a person to transfer property that they beneficially own into trust solution. For this reason alone trusts should have a bright future!

In respect of dispositions of property onto discretionary trusts the legal goal in terms of the trust arrangement is to ensure that the disposition of relevant property from A to the trust is legally effective as a matter of law, so that there can be no subsequent claw-back of that property out of the settlement. Here the focus is not with the validity of the settlement *per se* but the validity of any particular disposition onto that settlement.

The implications of the decision of the Supreme Court in *Regal Castings Limited v Lightbody* [2008] NZSC 87 are well-known. For the purposes of this paper what is also of relevance are some of the more general judicial "trust" statements contained in the judgment which provide indications of things that practitioners need to be cognisant of in their advice to clients.

Debtor remaining in possession of asset under trust

While the comments in *Regal* regarding the "gifting" programme that was undertaken are with the abolition of gift duty less likely to be relevant going forward (i.e. these will be no or fewer debts-back), the Court's general comments about a debtor (i.e. the person whose disposition is being challenged like Mr Lightbody) remaining in "possession" of the transferred asset under challenge are perhaps more significant. The Court noted:

> "Furthermore, it is another badge of fraudulent intent if the debtor remains in possession of the asset, as the Lightbodys did. They were also discretionary beneficiaries of the trust in respect of both capital and income." [61]

This statement arguably confirms the more substance-oriented (less "juristic") way in which trusts that receive dispositions of property from insolvent (or questionably insolvent) debtors will now be viewed in terms of any challenge under Subpart 6 of the Property Law Act 2007.

While it is clear what was intended by these comments as a matter of practical fact (Mr and Mrs Lightbody did continue to live in (remain in possession of) the house that they transferred into trust, does it always follow that a discretionary beneficiary of a trust that has received an asset by way of a gift (or even where value has been provided) has some type of "possessory" interest in that (now) trust property by virtue of their status as an income and capital beneficiary?

If their entitlement as a trust object is contingent and discretionary, then traditional trust law doctrine has often said that an interest of that quality does not give rise to "possession" (see e.g. *Gartside v IRC* [1968] AC 553 (HL), albeit in terms of a specific statutory rule), at least if that concept of "possession" is akin to beneficial ownership which is what in the writer's view the Court may have been suggesting by the comment.

Furthermore, would the Lightbodys' "possession" of the trust's house have been the same in the Court's thinking were they to have say entered into a licence to occupy and paid a return to the trustees under that licence?

Whatever was intended by the Court to be the exact meaning of their comments they have subsequently been interpreted as an important indication that will assist with an invocation of the rules in Subpart 6 of the Property Law Act 2007.

For example, in *Redmond Trustees No. 5 Limited v Official Assignee* (2010) 3 NZTR 20-034, Hugh Williams J applied this type of *Regal* reasoning to find that an advance made by a person to a trust to enable that person to buy a house was voidable under s 60 of the Property Law Act 1952 (emphasis added):

> "True, she transferred the bank money she borrowed and her own funds to the Trust at full value **but, given that she was both a trustee and a beneficiary of the Trust, she stood to benefit from her making those monies available by acquiring a house for herself and her family**. She adopted a means of acquiring a home for herself and her family which deprived her and thus her creditors of access to any future capital gain. Though for full value at the time, **this was a transfer of assets to a close family entity whose affairs she could direct and deprived her creditors, both present and future, of access to an asset of possibly greater value**." [109]

These last judicial statements simply reinforce a number of the themes already advanced in this paper.

Transferor/settlor of asset also trustee

Another significant finding of the Court (of a more general nature) was its holding that if the debtor disposing of the relevant asset is a also trustee of the receiving trust then their "knowledge" about the potential claims of any creditor in respect of that transferred asset **taints all other trustees** (emphasis added):

> "It is contended for the trustees that the trust acted in good faith in receiving the transfer of the property as the trustees collectively did not have, at that time, notice of Mr Lightbody's intention to defraud any creditor. That is no doubt true in respect of Mr Horrocks who was not aware of the Regal debt until some years later. **But his unawareness of the intent of Mr Lightbody cannot immunise the trust when Mr Lightbody himself was also a trustee and, of course, was the very person who was alienating the property with that intent. Mr Lightbody's knowledge taints the receipt by the trustees of the property. They received it as a unity**. They did not have separate interest in it. Taking as joint tenants, they must be treated as one purchaser who has knowledge of the fraudulent intent." [70]

If there was ever a judicial statement signalling the importance of having a trustee(s) in a trust that <u>did not include the settlor</u> it is this one. The reasoning applies equally to sub-trusts that might be receiving distributions from a head-trust.

While it is true that dispositions onto trusts may be made at a time when the transferor is not insolvent, the effect of Subpart 6 of the Property Law Act 2007 with its focus on debtors (who "reasonably should have believed" they might incur a debt) has an inevitable retrospective flavour and for this reason all current gifting arrangements involving material assets into trusts should be subjected to some type of carefully documented "due diligence" so that if a subsequent challenge to any gift or disposition is mounted the (now) debtor can honestly advance the position as to why there was no debt in existence at the time of the disposition (the critical timing point) but no also debt that could have reasonably have been anticipated.

The role that key "evidence" and key participants play in voidable disposition cases is illustrated by *Taylor v Official Assignee* [2011] NZCA 630 which is helpful as an authority as it shows the extent to which a court will look at the precise reasons why a disposition or gift of property was made onto a trust **at a particular point in time** by a person who subsequently becomes a bankrupt debtor.

Taylor also illustrates the importance of having an independent trustee being involved with the activities that subsequently are challenged because the role of the relevant solicitor's trustee company and its director, and the considered and careful way in which trust, gifting and related things were done by them was a significant factor in some of the conclusions drawn by the Court of Appeal.

Distributing benefits under a trust

The fourth and final legal goal of all discretionary trusts is to be able to effectively through their life distribute trust benefits (income and capital) to relevant trust objects.

Distribution decisions (and other dealings between trustees and beneficiaries) are often highly contestable ones for taxation and other reasons as cases like *Penny & Hooper* and *Kain & Hutton* [2008] NZSC 61 illustrate.

Any particular distribution of trust income or capital (by way of appointment, advancement or otherwise) or trustee/beneficiary dealing might be challenged as a sham, as legally invalid, or as tax avoidance. Invariably, the goal of the challenger will be to reverse the fact of the distribution and the transfer of ownership that passes with it to the appointed trust beneficiary.

Because distributions of beneficiary income take place in a perfunctory manner for thousands of trusts (in terms the authorising powers in a trust deed, the requirements of s HC 6 of the Income Tax Act 2007 and authorities like *Ward v C of IR* [1969] NZLR 12), the focus and importance of making legally effective distributions in trust law terms is often overlooked.

Getting "distribution" things wrong can have a significant legal consequence (often a prejudicial one) as was illustrated in *Kain v Hutton*, where a legal mistake made in the nature of the power utilised to appoint property from one trust to another (the transaction purporting to be a "resettlement" of property but which could only be achieved by an appointment) led to the consequence that the purported transaction was invalid and the relevant property never left the original trust.

In *Kain v Hutton* the Supreme Court was at pains to distinguish between "powers of appointment" and "powers of advancement" and to emphasise that each of these powers has its own specific legal (and sometimes procedural) requirements that must be followed (for example, "trustees may exercise their discretionary power to make an advancement only if they have formed the considered view <u>that there is good reason to so do and it truly will be of benefit to the advanced beneficiary</u> to exercise the power in the manner contemplated" [58].

More generally, the Court noted that (emphasis added):

> "Powers of appointment and advancement are **processes** by means of which interests in property are transferred from one person (usually a trustee) to another. Those affected by their exercise are entitled to expect **that those who exercise them should act with clarity and accuracy**. It is one thing to correct an obvious descriptive slip or other error; it is quite another for the Court to deem a substantively different power to have been exercised." [61]

Similar general judicial guidance on how discretionary powers should be exercised properly was also given by the English Court of Appeal in *Pitt & Futter v Commrs* [2011] EWCA Civ 197, in terms:

> "The purported exercise of a discretionary power on the part of trustees will be void if what is done is not within the scope of the power. There may be a procedural defect, such as the use of the wrong kind of document, or the failure to obtain a necessary prior consent. There may be a substantive defect, such as an unauthorised delegation or an appointment to someone who is not with the class of objects. Cases of a fraud on the power are similar to the latter, since the true intended beneficiary, who is not an object of the power, is someone other than the nominal appointee. There may also be a defect under the general law, such as the rule against perpetuities, whose impact and significance will depend on the extent of the invalidity." [96]

Judicial comments of this kind are important to day-to-day trust practice because they provide us with a reminder of the important legal requirements in terms of decision-making and processes that regulate all distributions under discretionary settlements (sometimes even simple ones that just involve payments of income). They also confirm that for more material distributions of trust property much more thought by trustees about the nature of the authorising power and the position of the beneficiary receiving the relevant distribution needs to be made (with the trustees' conclusions about matters of "benefit" and the like fully recorded in the relevant authorising resolution along with specific reference to the trust deed clause that authorises the distribution in question).

Conclusions

In the last few years trusts in New Zealand have been the subject of a certain amount of "bad press" and some less than enthusiastic political and judicial commentary.

None of this is new. The trust concept will weather this storm as it has other criticisms in the past. It will also weather any statutory reforms designed to lift the veil of trust.

One reason for this is that the vast number of New Zealand-based trusts are not "dodgy" devices at all (they have nothing to hide) but fully tax-and law-compliant legal relationships that are a lynchpin in both the business and family landscape of New Zealand.

Another reason is that helpful judicial guidance about unacceptable trusts and trust practices has emerged in recent times which, if understood and translated by practitioners into the adoption of new legal and evidential standards for trusts and trust administration, will likely mean that in the future *material trusts* meeting these new standards will be more secure from successful challenge.

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