



Discretionary trusts should protect beneficiaries

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One of the supposed benefits of a discretionary trust is that it protects the assets of the key beneficiary(s) of the trust from attack by creditors. This is because although those beneficiary(s) might control the assets, they do not actually own them—the assets are owned by the trustee.

At one stage it looked like the courts were going to overturn this principle. This paper discusses what happened in several court cases.

Richstar case

The 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*), was quite concerning in relation to discretionary trust property.

The issue before the court was whether a receiver could be appointed to property held in trust. Section 1323 of the *Corporations Act 2001* (Corporations Act) allows the court to appoint a receiver over the property of a relevant person. The court found that trusts of which the “relevant defendant is the effective controller, enjoying at least a contingent interest” constituted effective ownership of the trust property.

This case created major concern over protecting property under discretionary trusts from creditors where a bankrupt beneficiary was

in de facto or legal control of the trust. Specifically, the combination of controlling the trust and being a beneficiary of the trust led the court to appoint a receiver and freeze the assets of the trust.

The concern was somewhat alleviated by an analysis of the differences between the *Bankruptcy Act 1966* (Bankruptcy Act) and the Corporations Act. In particular, the Bankruptcy Act states that property of a bankrupt at the time the person became bankrupt passes to the trustee in bankruptcy. However, property held on trust for another is specifically excluded. Division 4A of the Bankruptcy Act sets out provision for circumstances where a bankrupt controls a trust.

It can be argued that the Bankruptcy Act recognises that the contingent interest of the bankrupt in a discretionary trust—that is, contingent on the trustee making a distribution from the trust in their favour—is not transferable to a trustee in bankruptcy.

Smith case

Since the concern raised by *Richstar*, courts seem to be reluctant to follow the case. In the case of the *Public Trustee v Smith* [2008] NSWSC 397 (*Smith*), the issue was whether property that was owned by a discretionary trust could be considered as being owned by a person, who was also the sole shareholder and director of the corporate trustee, to permit the assets to be gifted via that person’s Will.

The court discussed the analysis between actual ownership and effective ownership and concluded that the Will maker was not the actual (beneficial) owner of the trust assets.

In relation to *Richstar*, it was noted that the court in that case "did not say that it followed from the defendants' position as beneficiaries of discretionary trusts and their control of the trustees that this amounted to actual ownership as distinct from effective control".

In *Smith*, the Judge said, "I do not understand *ASIC v Carey* (No. 6) [that is, the *Richstar* case] to establish that because a beneficiary of a discretionary trust controls the appointment or removal of the trustee or controls the exercise of the trustee's power and can appoint trust property to himself or herself, that the holder of such a power is the beneficial owner of the trust property irrespective of the terms of the trust deed." The above reasoning was applied by the same judge in a subsequent 2008 case.

Fordyce case

In the case of *Fordyce v Quinn & Anor* [2016] QSC 307 (*Fordyce*), the court was again reluctant to follow *Richstar*. In the *Fordyce* case, there were three trust structures and the trustee in bankruptcy applied to appoint a receiver to wind up the trusts.

The trustee in bankruptcy relied on the *Richstar* case stating that "the bankrupt's right as a general beneficiary under a discretionary trust should be property under the Bankruptcy Act vested in the trustee in bankruptcy."

It was held in *Fordyce* that the "beneficiaries' or trustees' de facto or legal control of the discretionary trust in the bankruptcy context, does not alter the character of the interest of the beneficiary so as to constitute property of the bankrupt if the beneficiary becomes bankrupt." The court relied on general law principles that the interest of a beneficiary in a trust is a 'mere' discretionary interest. This means that the beneficiary has a right to be considered and a right to enforce due administration of the trust as a personal right that does not pass to the trustee in bankruptcy.

In other words:

- a bankrupt's right as a general beneficiary does not vest in the trustee in bankruptcy as property of the bankrupt, and a beneficiary's right to be considered and to enforce due administration of the trust is a personal right that does not pass to the trustee in bankruptcy
- a trust validly created does not alter the interests of a bankrupt beneficiary because of his or her actions or influence in causing the trustee to make distributions of income to himself or herself
- distributions out of a trust to a bankrupt will fall into the bankrupt's estate as 'after-acquired property' [that is, creditors can access any distributions that the bankrupt beneficiary subsequently receives from the trust].

Conclusion from these cases

Discretionary trusts enable flexibility for the distribution of income for familial beneficiaries. However, legal support should be considered when establishing discretionary trusts to ensure that the desired outcomes are achieved.

Discretionary trusts from a family court perspective

Discretionary trusts are important as they not only offer protection from creditors but also from family members. The Family Court is a court of statute [that is, laws are made by parliament]. The Family Court does not have powers in respect of the law on partnership, but it can exercise powers to alter the interests of the parties to the marriage or de facto marriage.

Specifically, section 79 of the *Family Law Act 1975*, (Family Law Act) allows the Family Court to alter property interests of the parties including assets of a business, property, individual investments and pre-marital owned property.

Typically, the Family Court will take a four-step approach when dealing with property, as follows.

1. Determine the pool of assets and liabilities
2. Evaluate each of the parties' financial and non-financial contributions during the marriage and post-separation
3. Determine if that contribution figure requires adjustment in light of the relevant section 75 factors
4. Consider whether the proposed result is 'just and equitable' in all of the circumstances having regard to the actual result in dollar terms.

Kenon v Spry

It is ironic that discretionary trusts are designed to protect assets, yet in the case of *Kenon v Spry* [2008] HCA 56 (*Kenon v Spry*), even though Dr Spry had removed his spouse as a beneficiary of the trust, she was still held by the High Court—applying family law principles—to be entitled to assets from the trust.

Dr Spry created a discretionary trust and was the settlor and trustee. The trust deed went through several variations to accommodate their marital issues including separating the trust into four separate trusts for the children. In this case, the court even reversed the separation of the trusts.

The issue was whether the trust assets would be property of the marriage. The court held that the assets were in fact part of the marriage due to the control that Dr Spry exercised over the trust.

Family Law Act

Generally, in protecting family wealth the goal is to keep it from being accessed by former spouses. With the appropriate planning, it may be possible to ensure that trust assets are not assets of the marriage or relationship. However, a court can find that the assets are a financial resource of one party and make an alteration of the property interest if 'just and equitable.' If the assets were acquired by one spouse during the marriage, the court will likely find that these are marital assets.

The Family Court will also look at 'control' when



The quote

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making this determination along with legal and equitable interests in trust property and interests of third parties.

Morton v Morton

The case of *Morton v Morton* [2012] FamCA 30 (*Morton v Morton*) demonstrated the importance of thorough planning when establishing a family trust for asset protection. This case addressed whether or not the assets of a discretionary trust of which the husband was a beneficiary, should be included in the pool of financial resources subject to the division of property in the divorce.

Mr Morton was a beneficiary of a discretionary trust. The other beneficiaries of the trust included his relatives. Mr Morton was also the director of a company owned by the trust in which he and his brother each held a fifty per cent share. Mrs Morton said that as her former husband ‘controlled’ the trust, the assets should form part of the asset pool to be divided in the family law division of property.

Mr Morton argued that he did not control the trustee company. The court found that although Mr Morton and his brother were joint appointers and had the power to remove and appoint a trustee, there was no evidence of Mr Morton having sufficient ‘control’ to treat the assets as his own—which meant the assets were not subject to the divorce.

The court pointed out the steps it considered in establishing an absence of ‘control’:

- appointing multiple directors of any trustee company
- appointing more than one appointer
- requiring appointors to act jointly.

Typically when there are a number of trustees or directors of the corporate trustee, the party to the marriage who is a beneficiary of the trust would need to obtain agreement from the other trustees and/or directors before that party could receive assets from the trust.

Bernard v Bernard

In *Bernard & Bernard* [2019] FamCA 421 2019 (*Bernard v Bernard*) the Family Court delivered judgement denying a spouse an order against a discretionary trust created in her father-in-law’s Will, in which her husband was a beneficiary.

Cases are decided on a case-by-case basis, but the court considers the following relevant factors:

Origin of asset test

Whether assets—inherited, joint, or individual—are acquired before or during the marriage.

Control test

Control by a party, whether directly or indirectly is relevant—as seen in *Bernard v Bernard* where the husband did not have control as trustee or appointer to remove the trustee.

Practice test

In respect of a trust created by a Will, clear sufficient evidence of carrying out the deceased person’s wishes, minutes of meetings, major decisions for purchase or restructure of trust assets and the history of distributions of income and/or capital may all play a role.

Trust and equity law

A beneficiary in a discretionary trust has a right to have their property protected by a court. However until the trustee actually resolves to distribute something to them from the trust, they simply have a right to be considered by the trustee when making its decisions. That right to consideration can be regarded as property.

Final thoughts

The High Court decision in *Kenyon v Spry* illustrates the court’s power in family law to take apart trust structures for family law purposes. When setting up a discretionary trust, it is wise to separate the trust from any ‘controlling’ person.

It should be recognised that assets held in a discretionary trust are not necessarily protected from property settlement in divorce proceedings, though with some careful legal planning they can be. **FS**