Copyright of the *New Zealand Law Journal* is the property of LexisNexis NZ Ltd and its content may not be copied, saved or emailed to multiple sites or posted to a listserv without the copyright holder's written permission. However, users may print, download or email articles for individual use.

[2011] NZLJ 423

Trust principles overlooked

Jessica Palmer and Nicola Peart, the University of Otago

clarify the relationship between trusts and the PRA

Trusts emerge regularly in relationship property disputes and they are generally well understood to take priority whenever there is a competition between the trust and a claim that the trust property otherwise falls within the pool of relationship assets available for division. Nevertheless, there appears to be some confusion over the boundaries of the Property (Relationships) Act 1976 (PRA) as it applies to trust property and this can cost a spouse, partner or beneficiary property that is rightfully theirs. This article explains three important points that ought to be borne in mind by practitioners working in this area, illustrated by an analysis of three recent decisions.

BENEFICIAL OWNERSHIP

Trust property cannot be classified as relationship property unless it is beneficially owned by either of the parties to the relationship.

The only type of property to which the PRA applies is property beneficially owned by one or both of the parties. Section 2 of the PRA defines an "owner" as "the person who, apart from this Act, is the beneficial owner of the property under any enactment or rule of common law or equity". In other words, where it is alleged that property held on trust should be considered relationship property, that assertion must be determined first by reference to the ordinary principles of trust law. Only if it is established that at least one of the parties has a beneficial interest in the trust property is it necessary then to determine whether that interest qualifies as relationship property or separate property according to the classification provisions in ss 8 to 10 of the Act.

So, in relation to the first enquiry, a party who has a vested interest in a trust will be a beneficial owner of the trust assets. A contingent interest is also treated as property of the beneficiary, though its value will depend on the nature of the contingency (*Hunt v Muollo* [2003] 2 NZLR 322 (CA); *Johns v Johns* [2004] 3 NZLR 202 (CA); *Kain v Hutton* [2008] 3 NZLR 589 (SC)). A discretionary interest, on the other hand, is not property of the beneficiary unless and until the trustees exercise their discretion by making an appointment in favour of a particular beneficiary. Prior to making the appointment the potential beneficiaries have at most a hope or expectation, which is not property (*Gartside v Inland Revenue Commissioner* [1968] AC 553; *Nation v Nation* [2005] 3 NZLR 46 (CA)). Nor is it capable of valuation on ordinary valuation principles (S Griffiths, "Valuation of interests in discretionary trusts; Valuing the invaluable and unvaluable?" New Zealand Law Society *Relationship Property Intensive — your big day out!* (2010) 55 at 63). For that reason, a party's discretionary interest in a trust (prior to any appointment to that party) cannot be property over which the PRA can reach.

This point was, with respect, missed in *SMB v GAC* (FC North Shore FAM-2007-044-946, 19 November 2010; HC Auckland, CIV-2010-404-8320, 25 July 2011). Mr C and Ms B had been in a de facto relationship for some 7 years. Ms B claimed a greater than equal share of the relationship property on the basis of extraordinary circumstances, The litigation involved three trusts. Two of these trusts had made distributions to the parties and these distributions were clearly relationship property.

The Courts' reasoning in relation to the third trust, the C Trust, on the other hand, is problematic. The C Trust held an interest in a superannuation scheme which increased in value during the relationship by some $25,000. There was confusion over the terms of its settlement, which was material to Mr C's interest in the Trust and to Ms B's relationship property entitlement. Mr C had acquired an interest in a superannuation policy called Fidelity Super Cache Plan in 1984. The policy was derived from CFML which sold Fidelity products on commission. Fidelity deducted a portion of the commissions due to CFML as contributions to the superannuation scheme. CFML then paid the remainder of the commissions to Mr C as earnings. On 20 June 1998, six months before Mr C began his de facto relationship with Ms B, Mr C declared in writing that he held his interest in the superannuation scheme on trust for a family trust still to be formed for the benefit of himself and his daughter absolutely. However the terms of the C Trust, which he eventually settled just after the relationship began, differed from the original declaration. The trust deed gave the trustees absolute discretion as to income and capital and had a wider class of beneficiaries.

Both the Family Court and the High Court held that the increase in value was relationship property, but for different and, in our view, incorrect reasons. The increase in value was attributable to the application of relationship property because the contributions to the scheme were sourced from commissions that would otherwise have been paid as earnings to Mr C. However, both decisions failed to ask and answer the prior question discussed above: what property interest, if any, did Mr C have in the C Trust that could possibly be the subject of a PRA claim?

The Family Court relied on the Court of Appeal's obiter dictum in *Walker v Walker* [2007] NZCA 30 that a discretionary beneficiary who controlled a trust had a valuable "package of rights" that was property. As Mr C had the power to appoint and remove trustees, and the power to vary and resettle the trust both as to income and capital, he had total control of the trust, which in combination with his rights as a discretionary beneficiary amounted to a package of rights that was property as defined by the Act (at [40]). Moving on to the second question of classification, the Court held that because that property right was attributable to the

Copyright of the *New Zealand Law Journal* is the property of LexisNexis NZ Ltd and its content may not be copied, saved or emailed to multiple sites or posted to a listserv without the copyright holder's written permission. However, users may print, download or email articles for individual use.

relationship, it was relationship property. Ms B was accordingly entitled to share equally in the increase in value of the Trust's interest in the superannuation scheme.

This sort of reasoning in other cases has been widely criticized. Not only does it misconceive the obiter dictum in *Walker v Walker*, it also disregards the interests of the other beneficiaries in the trust, in particular Mr C's daughter (see further Peart et al "Trusts and relationship property in New Zealand" (2011) 17 *Trusts and Trustees* 866 and J Palmer "Controlling the Trust" forthcoming [2011] Otago LR). Even if this package or bundle of rights idea is accepted, it relates to the party's interests outside the trust. As the Court in *LR v JR (Bankrupt)* FC Auckland FAM-2008-004-000715, 20 April 2011 appreciated, it does not convert a discretionary interest into beneficial ownership of the trust assets (at para [59]). All it accomplishes is to say that Mr C owned powers of control but not, crucially, that he owned the superannuation policy to which relationship property had contributed.

Fortunately, the High Court disagreed with the Family Court's application of *Walker v Walker* but, unfortunately, held instead that the increase in value was relationship property because it was funded from the application of relationship property (at [29]). This presumes that Mr C beneficially owned the policy without actually asking whether that was the case. This reasoning would have been correct (at least as to half of the increase in value) if the original declaration of trust, rather than the trust deed, had governed the trust terms. Pursuant to the declaration of trust, Mr C had a vested interest that therefore rendered him an owner of half of the policy under the PRA with his daughter owning the other half. As to the second question of classification, while the initial capital value would have been his separate property, the increase in value would have been relationship property under s 9A(1), because the increase was attributable to the application of relationship property. However, it seems that the High Court accepted the Family Court's decision that the trust was governed by the trust deed. On that basis, Mr C merely had a discretionary interest in the C Trust, which is not property. Any increase in the value of the trust property was therefore also not property beneficially owned by Mr C and accordingly not within the PRA's jurisdiction.

A similar analysis applies to a forestry investment held by the G Trust discussed at [47]–[49] where the Court awarded half the value of the investment to Ms B on the basis that the investment was funded by the application of relationship property. Once again, this misses the vital point that it was property held on trust. There is no prior discussion of who the beneficiaries of the G Trust were and what interests Mr C had in the trust property.

The errors in analysis resulted in Ms B taking from the trusts property that could not be relationship property and thereby depriving beneficiaries of the trusts of their rights to benefit. It is easy to be distracted by one party's control of a trust, but control does not amount to a proprietary interest. Had the case been analysed properly, Ms B's claims would not have been permitted to undermine the trusts. This does not mean that she was without remedy for the loss of relationship property. The possibility of a compensation claim under s 44C PRA is considered below.

TRUST LAW PREVAILS

The extent of beneficial ownership of property subject to a trust must be determined first and foremost by principles of trust law.

It is necessary to determine the extent of a party's beneficial ownership according to trust law before applying the relevant PRA provisions to classify and divide the parties' assets. This is particularly important where other beneficiaries have an interest in property that would otherwise be subject to the Act.

This point is well illustrated by *L v P* (HC Auckland CIV-201-404-6103, 17 August 2011); on appeal from *DP v UL* (FC North Shore, FAM-2007-044-000882, 17 August 2010)). Mr L and Ms P lived together for about 4 years between 2001 and 2006 (excluding two periods of separation). Mr L bought a home in January 2002 for $285,000, funded by a mortgage of $200,000 and the balance from his separate property. In November 2002 Ms P gave birth to their daughter, K. Mr L's sister died in June 2003, leaving the residue of her estate equally to L and K. In June 2004 Mr L received $287,744 from his sister's estate, on behalf of himself and K. Instead of investing K's half share until her 18th birthday, as his sister had intended, he used $248,000 of the inherited funds to pay off the mortgage and make improvements to the home. It was impossible to ascertain what happened to the rest of the inheritance, because Mr L's evidence was extremely vague. Importantly, the Family Court found that no part of the inheritance received survived in any account or investment apart from the family home (at [27]). The remainder of the inheritance was therefore untraceable. When Mr L and Ms P separated in 2006, Ms P claimed an equal share of the family home which had increased in value to $460,000. The question was to what extent L beneficially owned the family home, given his apparent misappropriation of K's inheritance. The Family Court and the High Court gave different answers to this question, neither of them correct in our view.

The Family Court held that all of K's share of the inheritance was used on the home and should be deducted from the value of the home before dividing the net value equally between Mr L and Ms P. This meant that not all of Mr L's inheritance went into the home and he bore the loss of the untraceable portion of the inheritance. Ms P appealed arguing that the Family Court had no jurisdiction to determine a beneficiary's entitlement pursuant to a trust and was wrong then to deduct that interest so as to diminish her relationship property entitlement.

The High Court rejected the jurisdictional point, as indeed it had to. While issues as between Mr L and K arising from the use of K's inheritance would have to be determined by the High Court under its equitable jurisdiction, the Family Court's primary function in the relationship property proceeding was to ascertain what property Mr L and Ms P beneficially owned and thus the extent of their daughter's beneficial interest in the house. However, the High Court did not agree with the way the Family Court carried out that function. The Court accepted that some of the $248,000 was used by Mr L in apparent breach of trust, but held that for purposes of assessing the rights as between Mr L and Ms P, any adverse consequences of Mr L's breach should be visited fully on him before any were visited on Ms P. Mr L was therefore treated as having first used his own share of the inheritance on the home before he resorted to his daughter's share. This meant that all of Mr L's inheritance and only part of K's legacy was attributed to the $248,000 spent on the home. Thus, after deducting K's interest in the home, the net value to be divided between Mr L and Ms P was greater than that declared in the Family Court.

Copyright of the *New Zealand Law Journal* is the property of LexisNexis NZ Ltd and its content may not be copied, saved or emailed to multiple sites or posted to a listserv without the copyright holder's written permission. However, users may print, download or email articles for individual use.

With respect, the reasoning in both judgments is wrong, because neither gives full recognition to K's rights as a beneficiary of a fixed trust and the remedies available to her to enforce those rights. The flaw in the Family Court's reasoning is that by deducting the amount of K's legacy from the value of the home the Court essentially treated K as a creditor with nothing more than a personal claim for repayment of a debt. The Court disregarded her right as a beneficiary to trace her funds into the home and elect either to claim a proportionate share of the home or take a charge over the home as security for the personal claim she had against her father for restoration of the trust money. Those are the remedies available to a beneficiary when trust money has been misappropriated: *Foskett v McKeown* [2001] 1 AC 102 at 130–131. By limiting K's interest to a monetary amount equivalent to her share of the inheritance, the Court allowed Mr L to profit from the increase in value. That is a fundamental breach of trust law.

The High Court ruling also failed to apply the tracing rules properly. Not only did it limit K to a charge over the property, thus denying her a proportionate share of the property, it also appeared to apply the priority rule formulated in *In re Hallett's Estate* (1880) 13 Ch D 696 (CA) without taking account of the variation made to that rule in *In re Oatway* [1903] 2 Ch 356. Reflecting the no profit rule, *Oatway* established (at 361) that where a trustee mixes his own funds with trust funds, the order of withdrawals is wholly immaterial. The funds that are no longer recoverable must be debited to the trustee, while the trust money must be debited to any investments that remain. The Family Court was therefore correct to apply all of K's share to the expenditure on the home, as that was the only investment that remained, whereas the High Court allowed the abberant trustee to profit from his breach of trust at the expense of the beneficiary.

The Family Court declined to make any order in respect of K's interest given that it was only empowered to settle the relationship property dispute ([32], [43]–[46]). The High Court did not feel so constrained, finding it had jurisdiction both as an appellate Court exercising the equitable jurisdiction of the Family Court, conferred by the District Courts Act 1947, and under its inherent parens patriae jurisdiction to protect K's interests. It gave her an interest in the family home or its proceeds to be held by an independent trustee ([81]–[85]). While this order protected K's funds in the home, she would have to pursue a personal claim against her father for breach of trust to recover the remainder of her inheritance. The relationship property proceedings having been determined, K would have no opportunity in subsequent trust proceedings to revisit the orders made in the PRA proceedings. The effect of the High Court order in the PRA proceedings was to limit K's beneficial interest in the home, contrary to trust law.

TRUST PROPERTY NOT COMPLETELY OUT OF BOUNDS

The third point to bear in mind is that while, in general, the PRA is subservient to trusts, there are nevertheless avenues available to a spouse or partner who faces the problem of assets locked away in trust.

First, it may be that despite the removal of relationship property by one partner to an express trust, the circumstances nevertheless give rise to a constructive or resulting trust against the trustees of the express trust in favour of one or the other partner. A constructive trust may arise on the basis of an intention held by the trustee and the partner in common that the latter would benefit from the former's property. It may also arise on the basis of contributions made to the property by the partner coupled with his or her reasonable expectations of benefitting from the property. A resulting trust will arise where a partner has transferred property to trustees of the express trust, but there is no express or implied indication of what the partner intended.

The possibility of constructive and resulting trusts arising in a PRA matter is illustrated by *G v R* (HC Wellington, Fam 2007-091-892, 23 July 2010; on appeal *Rabson v Gallagher* [2011] NZCA 459). During Ms G and Mr R's de facto relationship, Mr R purchased a Lotto ticket with relationship property which won a prize of $1.3m. The prize money was used to purchase three houses which were held on trust (the MRFT). The MRFT trust deed named, as primary beneficiaries, Mr R and anyone selected by the trustees from the class of "discretionary beneficiaries" which included "any de facto spouse" of Mr R and any children of Mr R. The couple had a daughter A. In respect of each house, the parties received from the trustees acknowledgements of debt as to 50 per cent of the purchase price each. At that time, Ms G was appointed a trustee and primary beneficiary. Later, a second trust (the GRFT) was established for the benefit of both parties, to enable the parties to separate property that the parties considered to be their joint property from the MRFT which also held business assets. The houses were sold to the GRFT at their current value at the time of the transfer, meaning the MRFT benefited from the capital gain. The parties then separated. Mr R exercised his power to remove Ms G as trustee of the MRFT and removed himself as beneficiary, appointing the daughter A as primary beneficiary. The parties' consequential property dispute covered a range of items of property but it is the issue of the houses bought with the Lotto winnings which was most significant and with which these comments are concerned. On appeal to the High Court, this issue was analysed under the rubric of constructive and resulting trusts.

The Court ruled that Ms G's share of the houses could not be held on a resulting trust because it was clear that she had intended to transfer it absolutely in return for a debt back ([85]–[87]). However, a constructive trust was found to arise on the basis of an arrangement or common intention between the parties that Ms G would benefit from the MRFT ([91]–[92]). An earlier article in this *Journal* analysed the High Court decision in detail and expressed doubt over the validity of the constructive trust ruling (Rickett and Palmer, "Trusts jurisprudence in the High Court" [2010] NZLJ 353). Put briefly here, the factual basis for a common intention was contrary to the earlier finding that Ms G had intended a loan transaction with the trustees. It was also weak given that emphasis was placed only on Ms G's expectation, and not on the trustees' understanding. Further, the remedy indicated by the Court as appropriate was not consistent with a declaration of constructive trust. The Court concluded that an order should be agreed by the parties that would enable Ms G to participate as a beneficiary in the MRFT trust. Constructive trusts give rise to a proprietary interest. They do not enable participation in a discrete express trust. Reliance on established principles of constructive and resulting trusts in order to give priority to a spouse or partner where property is subject to an express trust and beyond the reach of the PRA must be done with care so that the relevant principles of trust law are not misconstrued.

Copyright of the *New Zealand Law Journal* is the property of LexisNexis NZ Ltd and its content may not be copied, saved or emailed to multiple sites or posted to a listserv without the copyright holder's written permission. However, users may print, download or email articles for individual use.

Secondly, it may be that statute authorises a partner to access or take account of trust assets in some way. Such authority exists where property has been settled on trust by one partner with the intention to defeat the interests of the other which would otherwise arise under the PRA (s 44 PRA); or where there was no such intention but a disposition nevertheless defeated the claims of one of the parties (s 44C); or where dissolution of a marriage or civil partnership results in a change to the parties' expectations of the trust when they settled it (s 182 Family Proceedings Act 1980). Much has already been written on the content and application of these well-known provisions (see, for example, Peart et al). Nevertheless, there is still misunderstanding as to when and how they should apply.

In *Rabson v Gallagher* [2011] NZCA 459, on appeal from *G v R*, counsel for Ms G changed tack somewhat and, instead of relying on constructive or resulting trusts, sought application of s 44C which provides for compensation where either party has transferred relationship property into trust with the effect of defeating the claim or rights of one of the parties under the Act. The Court of Appeal allowed the s 44C claim (and subsequently declined to give any indication on the appropriateness of a constructive trust claim in the event the PRA claim had not been successful ([83])). However and with respect, we question whether s 44C was properly applied by the Court.

The Court analysed the claim as involving six requirements. All but one of the requirements was readily met on the facts. The transfer of the winnings to the MRFT was a disposition of relationship property to a trust by both of the parties after the relationship had begun. Further, the transfer was not subject to s 44 PRA. The acknowledgement of debts back from MRFT and the subsequent resettlement on the GRFT suggest that Mr R had no intent to defeat Ms G's rights under the PRA.

Fulfilment of the sixth requirement, considered at [59]–[61], was more problematic. The disposition must have the effect of defeating the rights of *one* of the parties under the PRA. The Court appeared to analyse the requirement only from Ms G's perspective — the houses had increased in value but Ms G had only received a static debt in return whereas, but for the trust, she would have been able to share in the increased value. The Court made no mention of the effect of the disposition on Mr R. This omission overlooks the purpose of s 44C. It is a compensation provision designed to restore equality between the parties in line with the underlying right of the parties under the PRA to share equally in all relationship property, Unless the disposition produces an unequal benefit as between the parties, there can be no reason to order one party to compensate the other. There would be jurisdiction to order compensation only if one party stood to benefit more from the disposition than the other party.

It was therefore necessary to compare Mr R's ability to benefit from the disposition of the relationship property with that of Ms G. Mr R's share in the lotto winnings, and thus the houses, was also transferred to the MRFT and he too had received in return a debt from the trust. Likewise, when the houses were transferred from the MRFT to the GRFT, there was no unequal benefit because both Mr R and Ms G have equal opportunity to benefit from that Trust. The GRFT owed a significant debt to the MRFT as a result of the transfer of the houses and while it was very unlikely that Ms G would benefit from the MRFT following separation, given that Mr R held the power to add and remove beneficiaries and make appointments (as noted by the Court at [72]), there is nothing in the judgment to indicate that the Court considered whether Mr R would continue to benefit from that trust. He had removed himself as a beneficiary and appointed his daughter as the primary beneficiary in his place. Of course, it is possible that he could reappoint himself as beneficiary or benefit indirectly through appointments to his daughter. But neither of these points was mentioned at all. Any consideration of Mr R's standing to benefit was conspicuously absent. While the Court of Appeal was right that the disposition defeated Ms G's rights, it did not address whether it would defeat her rights more than Mr R's rights and that question is crucial to the availability of relief under s 44C.

While there is much to be said for s 44C being too narrow to meet the demands of many cases, it is worthwhile noting that sometimes its availability appears to be overlooked. *SMB v GAC* is such an example. As we argued earlier, Ms B's claim under s 9A to an equal share of the increase in value of the C Trust's interest in the Fidelity superannuation scheme was misconceived because Mr C had no property right in the Trust assets. But a claim under s 44C might well have been open on the facts. As required by that section, the contributions to the superannuation scheme sourced from Mr C's commissions were dispositions of relationship property to a trust. As Fidelity withheld the contributions from what would otherwise have been C's earnings, they would qualify as dispositions made by C. Each disposition had the effect of defeating Ms B's rights more than Mr C's rights. But for those dispositions, there would have been no increase in value in the trust capital and she would have shared in the full value of the commissions. Furthermore, it was extremely unlikely that Ms B would derive any benefit from that increase in value in the future, whereas Mr C was very likely to benefit from the superannuation scheme in due course through his status as a beneficiary of the C Trust. Nor did Ms B derive any benefit from the C Trust during the relationship. There was therefore jurisdiction to make an order under s 44C. Moreover, there was sufficient property outside the trust from which an appropriate award of compensation could have been made.

CONCLUSION

The relationship between trusts and the PRA is not an easy one. There is a popular conception that trusts are being used inappropriately to avoid the consequences of the PRA and that the PRA ought to be extended to include trust busting provisions with greater scope than those currently provided for. This is a question of policy that may be the subject of comment by the Law Commission when it completes its review of trusts.

Until then, the priority afforded to trusts by the PRA needs to be given effect because that is what the Act currently requires and because to do otherwise is to create confusion and uncertainty, and to illegitimately undermine beneficiaries' interests. The basics of establishing a PRA claim should not be lost sight of whenever one or both of the parties is connected to a trust. The basics are that the PRA's jurisdiction extends to property beneficially owned, but goes no further; determining beneficial ownership is a matter of trust law; and there are some legitimate ways both within trust law and pursuant to statutory authority to access trust assets but these must be properly applied. ❐