

## Inaugural Professorial Lecture: October 23rd, 2008

### Can Your Trust be Trusted?

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#### Introduction

Professor FW Maitland, a 19th-century internationally renowned legal historian, famously told his students:

Of all the exploits of Equity the largest and the most important is the invention and development of the Trust. It is an “institute” of great elasticity and generality.<sup>1</sup>

New Zealanders have certainly seen the advantages of this “institute”. Family trusts in particular have become quite the fashion. I am not aware of any other population having as many trusts as we do per head of

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\* Thank you to Mark Henaghan for his generous introduction and for positively reinforcing us at every possible opportunity. I would also like to acknowledge my parents for indulging my whim to study law rather than nursing, and my husband, David, and my children, Simon and Emma, for their amazing support over the years. I am grateful to John Smillie, Dean of the Law Faculty in 1986 when we arrived in Dunedin, for recommending that I enrol in some core law papers. They became the foundation of my subsequent teaching and research. Kathy Grant then introduced me to New Zealand’s particular brand of Land law, which was wholly foreign to me and which I enjoy teaching to this day. Richard Sutton and Struan Scott ignited my interest in Equity and Succession, which has been a major focus of my teaching and research ever since. I am especially indebted to Richard Sutton for involving me in his research at the Law Commission during the 1990s and thereafter. I am lucky to be surrounded by wonderful colleagues. I have benefited enormously from their wisdom and collaboration, especially the current and former members of the Property team, Margaret Briggs with whom I co-teach Advanced Family Property Law and have co-authored several publications, and my medical law colleagues, Peter Skegg and John Dawson. Many legal practitioners around the country have also helped me. The discussions I have had with them about trusts and relationship property disputes have greatly assisted my understanding of the practical implications of trust law. Thank you especially to Stuart Anderson and Charles Rickett for helpful comments on tonight’s lecture, to Theresa Forbes for her assistance and patience in preparing the power point slides, and to Margaret Briggs for her valuable suggestions in preparing this lecture for publication. The one person to whom I owe my career is Professor Tom Bennett of the Law Faculty at the University of Cape Town. He encouraged me to apply for my first academic job, steered me through my LLM degree, and guided me through the early stages of publishing my research. He was a wonderful mentor and has remained a close friend.

<sup>1</sup> FW Maitland *Equity* 2<sup>nd</sup> ed, Cambridge University Press (1936) 23.

population. A recent estimate puts the number of trusts at about 400,000.<sup>2</sup> That is a staggeringly high number in a population of just over 4 million people. Why do we have them? What do we think we are gaining by having a trust? Can our trusts be trusted to meet our expectations, now and in the future?

In this lecture I want to dispel a few myths and misconceptions about trusts and point to some of the pitfalls that tend to become apparent when people's personal or financial circumstances change.

My lecture is in four parts. In Part One I shall very briefly explain some of the basics of trusts and the common reasons for having trusts. In Part Two I shall sketch some typical features of family trusts which tend to create problems when people's circumstances change. In Part Three I will address the current legal responses to these problems. This will show that trusts can protect against a wide range of claims, but that this protection is not always just. In Part Four I want to look to the future and suggest some reforms to trust law to reduce injustice.

## Part 1: The essentials of trusts

### *What is a trust?*

Trusts are often referred to as entities, as if they have separate legal personality, like a company.<sup>3</sup> That misconceives trusts. Although Maitland referred to them as an 'institute', trusts are not independent entities. They are relationships. On the one side of the relationship is the trustee and on the other side the beneficiaries. Trustees are the legal owners of property and have a duty to deal with that property in the interests of the beneficiaries. The core of the trust is the fiduciary relationship between the trustees and the beneficiaries. It is a relationship of trust and loyalty, a relationship in which the trustees are expected to put the interests of the beneficiaries ahead of their own.

### *Trustee duties*

To that end, the law imposes several specific duties on trustees.<sup>4</sup> They must comply with the terms of the trust. They must act personally and, if there is more than one trustee, they must act together and be unanimous in their decision-making. They breach their obligations if they leave it to one of the trustees to run the trust and make all the decisions.<sup>5</sup> Trustees must not put themselves in a position where their personal interest conflicts with their obligations to the beneficiaries, unless the trust deed

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<sup>2</sup> "Please sir, can we have some more?" *Sunday Star Times* 24/8/08, Business section D1.

<sup>3</sup> See the recent observations of Fogarty J in *Harrison v Harrison* 18/9/08, HC Auckland, CIV 2008-404-001270.

<sup>4</sup> Noel Kelly, Chris Kelly and Greg Kelly, *Garrow and Kelly's Law of Trusts and Trustees* 6<sup>th</sup> ed Lexisnexis, Wellington (2005) ch 20.

<sup>5</sup> *Niak & Somerville v MacDonald & Bank of New Zealand* [2001] 3 NZLR 334.

so provides, for example by appointing the trustee as a beneficiary.<sup>6</sup> Related to the no conflict rule is the duty not to make a personal profit from the trust, again unless provided for in the trust deed.<sup>7</sup> That is why professional trustees insert a charging clause in the trust deed. Trustees are also expected to invest the trust assets prudently and in a manner that maintains an even hand between the various beneficiaries.<sup>8</sup> These duties are onerous and if trustees breach any of them they are personally liable for any resulting loss.<sup>9</sup>

Why be a trustee? That is a question prospective trustees should ask themselves. My impression is that few realise the onerous obligations that rest upon them.

### *Separation of legal and beneficial ownership*

Trustees have the legal ownership of the assets, while beneficiaries have beneficial ownership of the assets, either immediately or at some point in the future. It is of the essence of trusts that the legal ownership of the assets is separated from the beneficial ownership.<sup>10</sup> If the legal and beneficial ownership is vested in the same person there is no trust, because you cannot owe yourself a legally enforceable obligation to act in your own best interests. A trustee can be a beneficiary of a trust. Indeed, in family trusts they frequently are. But they cannot be the only trustee and the only beneficiary. There must be at least one other trustee or beneficiary for a trust to exist.

### *Discretionary trusts*

Most family trusts in New Zealand are discretionary in nature. The trustees are often given very wide discretionary powers to decide which beneficiaries nominated in the trust deed should benefit from the trust assets, when and in what way. Until the trustees exercise their discretion in a beneficiary's favour, that beneficiary has no property interest in the assets of the trust.<sup>11</sup> Beneficiaries of a discretionary trust merely have a hope that the trustees will exercise their discretion in their favour. They can hold the trustees to account for failing to perform their duties, but they have no beneficial ownership of the trust assets. That is often the very reason that people put their property into trust. They want to make sure that they do not own any assets if creditors, spouses or the State come knocking on their door.

<sup>6</sup> As in *Re Mulligan* [1998] 1 NZLR 481.

<sup>7</sup> *Robinson v Pett* (1734) 3 P Wms 249.

<sup>8</sup> Section 13B, 13C and 13F Trustee Act 1956; *Re Mulligan* [1998] 1 NZLR 481.

<sup>9</sup> As both the professional trustee and the late Mrs Mulligan were in *Re Mulligan* [1998] 1 NZLR 481.

<sup>10</sup> *Harrison v Harrison* 18/9/08, HC Auckland CIV 2008-404-001270.

<sup>11</sup> *Johns v Johns* [2004] 3 NZLR 202 (CA); *Hunt v Muollo* [2003] 2 NZLR 322 (CA); *Nation v Nation* [2005] 3 NZLR 46 (CA).

### *Why have a family trust?*

People set up trusts for a wide range of reasons, depending on their personal circumstances and the socio-economic environment of the time.

#### *Protection against creditors*

Business and professional people often use family trusts as a means of protecting their family assets from potential claims by creditors. That was the purpose of the trust set up by Mr Reynolds, an entrepreneur in Southland.<sup>12</sup> In 1996 Mr Reynolds signed an agreement to buy a house in Invercargill, but, having been bankrupted some years earlier, he decided to set up a trust to protect the house from future creditors. The trustees were his solicitor, Mr Wilson, and his de facto partner's mother, Mrs Harvey. The trustees completed the purchase and were registered as the legal owners of the house. Mr Reynolds, his de facto partner, Ms Clyma, and their children moved into the house. But neither Mr Reynolds, nor Ms Clyma, were beneficiaries of the trust. Their children were the beneficiaries. A few years later the family moved to a house in Queenstown, which Mr Reynolds also bought in the name of the trustees. When in 2001 Mr Reynolds was declared bankrupt for the second time, the house was protected from his creditors. Whether that was right in the circumstances I shall come back to later.

#### *Protection against claims from spouses and partners*

Another reason for putting assets into trust is to protect those assets from claims by future spouses or partners under the Property (Relationships) Act 1976. For example, parents may wish to provide for their children, but not necessarily their children's partners. Or a separated spouse or partner may want to preserve assets from a former relationship for the children of that relationship and avoid the risk of those assets becoming part of a subsequent relationship. Some people who have gone through a separation feel aggrieved about the settlement they got at the end of their relationship, and transfer their settlement into trust to avoid losing part of it to a subsequent partner.

#### *Preservation of economic assets*

Relationship property entitlements have also motivated owners of farms and family businesses to put those assets into trust to protect their economic viability and preserve them for future generations.

#### *Provision for future generations*

Trusts have always been used to provide for future generations and vulnerable family members. By means of a trust a settlor can create successive interests. Wills often establish trusts that provide first for the surviving spouse or partner and then for the children of the

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<sup>12</sup> This case went to the High Court and the Court of Appeal. The decisions are reported as *Official Assignee v Wilson* [2006] 2 NZLR 841 (HC) and *Official Assignee in Bankruptcy v Wilson* [2008] 3 NZLR 45 (CA).

relationship.

Parents may also want to set up trusts during their life time for their children, for example to finance their education or to provide a source of income for a vulnerable child.

#### *Tax benefits*

If the trust includes income-producing assets, there may also be tax advantages in having a trust, though tax avoidance must not be the sole or primary purpose of establishing a trust.<sup>13</sup> Before estate duty was abolished in 1993, trusts would also have avoided estate duty.<sup>14</sup>

#### *State benefits*

A very common reason in New Zealand for putting assets into trust is the means tested entitlement to State support, such as the residential care subsidy for the elderly.<sup>15</sup> This reason is based on a flawed understanding of the State's powers when assessing an applicant's assets and means for purposes of a state subsidy. It is widely believed that the State will decline a subsidy only if applicants have deprived themselves of assets in the five years immediately preceding their application for state support.<sup>16</sup> While that is the general practice, the law does not impose a time limit on the asset and means test, and sometimes the State goes back much further than five years.<sup>17</sup> The dramatic rise in family trusts may also persuade the State to amend its practice in the future. Eligibility for state support is therefore not a reliable reason for having a trust, but it remains a very common one.

#### *Me Too!*

Some people set up trusts simply because others have one and it seems like a good idea to have one too – a safety net to protect against some unknown future event from as yet unknown quarters. That is hardly a good reason for entering into a transaction that has far-reaching consequences.

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<sup>13</sup> Income Tax Act 2007, BG1.

<sup>14</sup> Section 3 Estate Duty Abolition Act 1993 states that no estate duty is payable in respect of an estate of a person dying on or after 17 December 1992. The Estate Duty Repeal Act 1999 repealed the parts of the Estate and Gift Duty Act 1968 that dealt with estate duty.

<sup>15</sup> Social Security Act 1964, Part 4.

<sup>16</sup> Schedule 27 of Social Security Act 1964 deals with the means assessment for long-term residential care in hospital or rest homes. For purposes of the definition of assets in clause 4 of Part 2 of Schedule 27, gifts in excess of \$5000 per year made within a period of 5 years before the means assessment is carried out are automatically treated as assets of the applicant. But that does not prevent the means assessment from treating gifts of assets made more than 5 years before the date of the assessment as deprivations of the applicant.

<sup>17</sup> Section 147A Social Security Act 1964.

## Part 2: Some typical features of family trusts

### *Subject matter of family trusts*

Any type of property can be the subject matter of a family trust, but in New Zealand it is particularly common to put the family home into trust. Other property, such as a holiday house and investments are also often held in trust, as are family farms and the assets of a family business.

These family assets are often produced or increased in value through the joint efforts of couples during their relationship. While the relationship is on foot, both partners usually enjoy the benefits of their efforts. But if they separate, their entitlement to share in those assets frequently becomes an issue, particularly if the trust is one which will provide an ongoing benefit to one party, while the other is left in the cold. Parliament tried to address this problem when it amended the Matrimonial Property Act 1976 in 2001. But, as we shall see later, the new legislation is inadequate.

### *Control*

A related problem is the extensive control that settlors often exercise over their trusts. In some cases the control is the result of powers reserved to the settlor by the trust instrument.<sup>18</sup> I shall call that legal control. In other cases, control is simply assumed and taken. I shall call that factual control. The effect in both cases is that the trust is largely ignored and settlors treat the trust assets as their own.

The Reynolds Trust, mentioned earlier, is a good example of factual control by the settlor, Gary Reynolds. He was neither a trustee nor a beneficiary of the trust. Legally speaking, he had nothing to do with the trust. Yet, he bought the houses on behalf of the trust. He arranged the financing, paid all the outgoings on the houses, and lived there with his partner and children. There was no lease or licence that entitled him or his partner to live in the home. Nor was there any documentation to support the financial arrangements in respect of the house. His personal finances and the trust's finances were intermingled and the trust's bank statements were sent to Mr Reynolds, not to the trustees. This trust was under the factual control of Mr Reynolds. The trustees did not perform their duties as required by law. They allowed Gary Reynolds to control the trust and treat the trust assets as his own.

The Reynolds trust was unusual in providing no benefit for Gary and his partner. It is more common for settlors of trusts to be discretionary beneficiaries of the trust. The trust deed may even list them as "primary beneficiaries", thus directing the trustees to exercise their discretion principally in favour of the settlor beneficiaries. The settlors may also be trustees of the trust, which entitles them to make all the decisions pertaining to the trust. There may be an independent trustee, either

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<sup>18</sup> For example *Harrison v Harrison* 18/9/08 Fogarty J, HC Auckland, CIV 2008-404-001270; *Isolare Investments v Fetherston* 15/9/06 Williams J, HC Auckland, CIV 2002-404-1791.

instead of or in addition to the settlor trustee, but usually the settlor has the power to appoint and remove trustees. So, even if the settlor is not a trustee, he or she controls the trustees. Trustees often have wide discretion in regard to both income and capital of the trust. They may even have the power to vest all of the capital in the settlors as primary beneficiaries. Armed with those sorts of powers, it is hardly surprising if settlors treat the trust assets as their own. They control the trustees and they are the primary beneficiaries.

These sorts of trusts invite challenge when there is a bankruptcy or relationship breakdown. The terms of the trust, the reasons for its establishment, the subject matter of the trust and its *modus operandi* are then put under the microscope.

### **Part 3: How does the law respond to these trusts?**

There is a variety of ways in which family trusts can be unravelled or challenged. Sometimes their very existence is questioned on the grounds that the trust is a sham or the alter ego of one of the parties.

#### *Shams and alter ego trusts*

That is what happened with the Reynolds Trust.<sup>19</sup> The Official Assignee in Mr Reynolds' bankruptcy brought proceedings in the High Court, and on appeal in the Court of Appeal, alleging that the Reynolds Trust was a sham. It was not a genuine trust. It was a trust in appearance only. As an alternative ground the Official Assignee argued that the trust was the alter ego of Mr Reynolds and should be ignored. The trustees were mere puppets of Mr Reynolds. He controlled the trust and treated the home as his. The Official Assignee sought a declaration that the trustees held the house in Queenstown on trust for Mr Reynolds rather than his children, who were the beneficiaries named in the trust deed.

The High Court and the Court of Appeal rejected both arguments. They were critical of the way the trust had been administered and the extensive control that Mr Reynolds had exerted over the trustees, but the trust was not a sham. The Court of Appeal held that a sham requires evidence that the settlor and the trustees had a common intention that the trust was not to take effect as a genuine trust. The documentation and transactions purporting to create the trust must have been intended as a façade to mislead people into thinking there was a trust when in fact there was not. If there is such evidence the trust is void from the start for lack of intention to create a trust.

Finding a sham is a serious matter, the Court said, because of the adverse effect on commercial certainty and the beneficiaries. For that reason the Court insisted on compelling evidence:

A Court will only look behind a transaction's ostensible validity if there is good reason to do so, and "good reason" is a high threshold, since a

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<sup>19</sup> *Official Assignee in Bankruptcy v Wilson* [2008] 3 NZLR 45 (CA).

premium is placed on commercial certainty.<sup>20</sup>

That threshold was not met in the Reynolds case, the Courts found. When the trust was set up, Mr Reynolds intended to create a genuine trust to protect the home from his business risks. There was also evidence of the trustees performing their fiduciary duties, at least in the early days. They declined Mr Reynolds' request to renovate the Invercargill house because there was insufficient equity in the house to support an increase in the mortgage. That was one of the few occasions when the trustees displayed the kind of independence expected of trustees. It showed that the trust was genuine when it was first established. Subsequent sloppy conduct by the trustees could not turn a valid trust into a sham.

The intention requirement for a sham trust has been the subject of recent academic debate.<sup>21</sup> The prevailing view is that a sham requires a common intention to create a trust in appearance only.<sup>22</sup> Both the settlor and the trustees must have that intention, though it may be sufficient if the trustees merely go along with the shammer, neither knowing or caring about what they are doing.<sup>23</sup> My colleague, Jessica Palmer, disagrees.<sup>24</sup> She argues that only the settlor's intention is relevant, not the trustee's intention, because only the settlor's intention is relevant to the creation of a trust. If a settlor had the intention to establish a trust in respect of property for the benefit of certain persons, then the trust will not fail for want of a trustee. The Court will appoint a trustee if there is not one, or, if the trustee cannot or does not perform his or her obligations, the Court can appoint another trustee. As the trustee's intention is not material to the establishment of the trust, it should also not be material to proving that a trust is a sham.

What if a settlor has not made his or her sham intentions known to the trustees, and the trustees act in accordance with their fiduciary duties? The Courts have used that scenario in support of the common intention requirement, because in their view it would be ridiculous to say the trust did not exist in those circumstances. The settlor would be estopped from denying the existence of the trust. But upholding a trust on estoppel grounds is entirely different from upholding a trust for lack of common sham intent. The end result may be the same, but the grounds are fundamentally different.<sup>25</sup>

I am in the Palmer camp. In my view her argument is more principled

<sup>20</sup> *Official Assignee in Bankruptcy v Wilson* [2008] 3 NZLR 45 at para [52].

<sup>21</sup> Jessica Palmer "Dealing with the emerging popularity of sham trusts" [2007] NZ Law Rev 81; Mathew Conaglen "Sham Trusts" [2008] CLJ 176; Jessica Palmer "What makes a trust a sham?" [2008] NZLJ 319.

<sup>22</sup> *Official Assignee in Bankruptcy v Wilson* [2008] 3 NZLR 45 (CA); *Raftland Pty Ltd as trustee of the Raftland Trust v Commissioner of Taxation* [2008] HCA 21.

<sup>23</sup> *Midland Bank v Wyatt* [1995] 1 FLR 696.

<sup>24</sup> Jessica Palmer "Dealing with the emerging popularity of sham trusts" [2007] NZ Law Rev 81.

<sup>25</sup> Jessica Palmer "What makes a trust a sham?" [2008] NZLJ 319.

and logical.<sup>26</sup> But we both concede that the weight of authority is against us.<sup>27</sup> In practical terms it will seldom make a difference, because proving that the settlor never intended to create a genuine trust will generally depend on evidence of the way the trust was administered after it was established. There will seldom be direct evidence of the settlor's intentions at the time of the creation of the trust.<sup>28</sup> The relevant intention is more likely to be inferred from subsequent conduct of the settlor and the trustees. Provided that evidence shows that the trust was never intended to take effect as a genuine trust, it will be a sham and void from its inception.

The term "sham" is also problematic, because it suggests a dishonest motive. That is how it is often described: a counterfeit, a false front, a pretence, an intention to mislead.<sup>29</sup> These descriptions all have malevolent overtones. But a sham does not depend on a dishonest motive or malevolent intent. The essence of a sham is that the appearance is not intended to match the reality of the arrangement. That will frequently involve some dishonesty, at least on the part of the settlor, but it may also be sheer ignorance of what a trust entails that results in the trust being a sham.

The Court of Appeal also rejected the Official Assignee's argument that the trust could be ignored because it was the alter ego of Mr Reynolds. The alter ego argument was not an independent cause of action. It could at most be used as evidence in support of an established cause of action, such as the sham doctrine. Once a trust has been validly created, the fact that someone exerts significant control over the trustees and that the trustees fail to act independently may found a breach of trust claim, but it does not render the trust invalid. So, Mr Reynolds' extensive control over the trustees was not sufficient to invalidate the trust.

This decision is a victory for settlors, trustees and beneficiaries of trusts, but it is a significant blow to creditors. Trusts that function as the alter ego of a debtor are valid unless the alter ego evidence is sufficient to meet the high threshold required for a sham. There are of course statutory remedies available to creditors in the Insolvency Act 2006 and other legislation,<sup>30</sup> but the requirements for those remedies limit their usefulness. They would not have assisted Mr Reynolds' creditors.

<sup>26</sup> N Peart, "Equity in Family Law" in A Butler (ed) *Equity and Trusts in New Zealand* 2<sup>nd</sup> ed (Thomson Brookers, Wellington, 2008), chapter 40 (forthcoming).

<sup>27</sup> It was for that reason that the Court of Appeal rejected the Palmer argument in *Official Assignee in Bankruptcy v Wilson* [2008] 3 NZLR 45.

<sup>28</sup> *Begum v Ali* 10/12/04, FC Auckland FAM-2001-004-866.

<sup>29</sup> *Official Assignee in Bankruptcy v Wilson* [2008] 3 NZLR 45 at para [26].

<sup>30</sup> For example, s 348 Property Law Act 2007 and its predecessor s 60 Property Law Act 1952 as well as s 47 Property (Relationships) Act 1976. Recent cases include *Regal Castings Ltd v Lightbody* [2008] NZSC 87 on s 60 Property Law Act 1952 and *Felton v Johnson* [2006] NZFLR 759 (SC) on s 47 Property (Relationships) Act 1976.

The decision is also a major blow to spouses and partners who have separated. In fact, it was in the context of property proceedings following a relationship breakdown that the alter ego trust idea made its first appearance in New Zealand.<sup>31</sup> The Court used it to access trust assets that were otherwise beyond its reach to achieve a just division of assets that the spouses or partners had built up during their relationship.<sup>32</sup> What are their options now?

### *Property (Relationships) Act 1976*

What if Mr Reynolds had not gone bankrupt, but had separated from his de facto partner, Ms Clyma? Instead of the Official Assignee making a claim against the house held in trust, Ms Clyma wanted to claim a share of the house. It was the family home after all, and the law would generally expect her to share that on separation.

The statute that governs the division of property when a couple separates is the Property (Relationships) Act 1976. It used to be called the Matrimonial Property Act 1976, but was renamed in 2001 when de facto partners were brought under the Act.<sup>33</sup> Ms Clyma, as Mr Reynolds' long time de facto partner, would be covered by the Property (Relationships) Act.<sup>34</sup>

The Property (Relationships) Amendment Act 2001 did not change the essence of the regime established by the Matrimonial Property Act 1976. It is still a deferred community property regime. Each spouse or partner is free to deal with his or her assets during the relationship,<sup>35</sup> but on separation there is a presumption that the family home, the family chattels and any assets acquired during the relationship as a result of the parties' joint efforts will be divided equally between them.<sup>36</sup> These assets are known as "relationship property".<sup>37</sup> Assets not acquired as a result of the couple's joint efforts, such as gifts, inheritances, and distributions from trusts settled by a third party, are "separate property" of the owner and not subject to the equal sharing regime.<sup>38</sup> The statutory sharing

<sup>31</sup> *Prime v Hardie* [2003] NZFLR 481; *Glass v Hughey* [2003] NZFLR 865.

<sup>32</sup> For example, *O v S* 12/12/06 Judge O'Dwyer, FC Dunedin, FAM 2004-002-000080; *C v C (No 2)* [2006] NZFLR 908 and, strangely, *Harrison v Harrison* 18/9/08 Fogarty J, HC Auckland, CIV 2008-404-001270, heard after the Court of Appeal had rejected the alter ego argument as an independent cause of action.

<sup>33</sup> Section 1 Property (Relationships) Amendment Act 2001.

<sup>34</sup> Sections 2D and 4C Property (Relationships) Act 1976. The facts of the case indicated that the couple had been living together as a couple for many years.

<sup>35</sup> Section 19 Property (Relationships) Act 1976.

<sup>36</sup> Section 11 Property (Relationships) Act 1976. This presumption is rebuttable if there are extraordinary circumstances that make equal sharing repugnant to justice (s 13) or the marriage or civil union was of less than 3 years duration: ss 14 and 14AA. A de facto relationship of less than 3 years duration is not normally covered by the Act: s 14A.

<sup>37</sup> Section 8 Property (Relationships) Act 1976.

<sup>38</sup> Section 10 Property (Relationships) Act 1976.

regime can be avoided by contracting out of the Act, but Ms Clyma and Mr Reynolds did not make such a contract.<sup>39</sup> On separation, therefore, Ms Clyma would be entitled to a half share of the couple's relationship property.

However, the Act applies only to property that is beneficially owned by one or both of the spouses or partners. It does not apply to assets held in a discretionary trust.<sup>40</sup> Even if the parties are "primary beneficiaries" of such a trust, they do not own the assets held in trust until the trustees exercise their discretion in favour of those beneficiaries.<sup>41</sup> As Mr Reynolds and Ms Clyma are not even beneficiaries of the trust, they have no property interest in the home to which the Act can apply.

Section 44 of the Property (Relationships) Act allows the Court to set aside dispositions to a trust if they were made in order to defeat the rights of a spouse or partner under the Act. Proving that intention has always been notoriously difficult,<sup>42</sup> because often the dispositions are made for perfectly acceptable reasons, as in the Reynolds' case. Mr Reynolds had disposed of money to the trust by paying the mortgage instalments on the property, but his intention was not to deprive his partner of her rights under the Act. He intended to protect the home from creditors. So, that remedy would be of no use to Ms Clyma.

By the middle of the 1980s it was becoming apparent that trusts were undermining the matrimonial property regime. In 1988, the Government set up a Working Group that recommended reform to prevent substantial amounts of matrimonial property being diverted away from one of the spouses.<sup>43</sup> That recommendation eventually led to the adoption of s 44C Property (Relationships) Act in 2001. It was one of many amendments made to strengthen the equal sharing regime.

Section 44C is a compensation provision aimed at redressing inequality between spouses or partners resulting from a disposition of relationship property to a trust. It provides:

- (1) This section applies if the Court is satisfied—
  - (a) that, since the marriage, the civil union, or the de facto relationship began, either or both spouses or partners have disposed of

<sup>39</sup> Section 21 Property (Relationships) Act 1976.

<sup>40</sup> See the definitions of "property" and "owner" in s 2 Property (Relationships) Act. But note, also, the Court of Appeal's decision in *Walker v Walker* [2007] 2 NZLR 261 where a discretionary interest in a trust was held to be part of a bundle of assets for purposes of valuing a debt owed by the trustees to the husband.

<sup>41</sup> *Nation v Nation* [2005] 3 NZLR 46 (CA).

<sup>42</sup> The Court of Appeal decided in *Coles v Coles* (1987) 3 FRNZ 101 that the intent required evidence of a conscious desire to remove property from the reach of the Court. While that did not have to be the sole purpose of the disposition, the Court held in *Lowe v Lowe* (1987) 3 FRNZ 107 that it did have to be the true explanation for the transfer.

<sup>43</sup> Report of the Working Group on Matrimonial Property and Family Protection, Wellington (1988) at p 30.

relationship property to a trust; and

(b) that the disposition has the effect of defeating the claim or rights of 1 of the spouses or partners; and

(c) that the disposition is not one to which section 44 applies.

(2) If this section applies, the Court may make ... orders for the purpose of compensating the spouse or partner whose claim or rights under this Act have been defeated by the disposition....

Could this provision assist Ms Clyma? She would have no trouble meeting the first requirement in subsection (1)(a). Her partner, Mr Reynolds, disposed of relationship property to the trust during their de facto relationship by using his income to pay the mortgage on the house. That income was relationship property.

The third requirement in subsection (c) would not be a problem either. As we established earlier, the dispositions were not made to defeat Ms Clyma's rights under the Act.

What about the second requirement? She does not have to prove an intention to defeat her rights, merely that the disposition has the *effect* of defeating her rights. The wording of subsection (b) is important here. It refers to dispositions that defeat the rights of "1 of the spouses or partners". It is not aimed at dispositions that affect both parties equally, only those where the disposition results in an unequal benefit as between the parties. It is the unequal effect resulting from a disposition of property that would otherwise have been equally shared that justifies ordering the advantaged spouse or partner to compensate the disadvantaged spouse or partner.

For example, a couple sells their family home into a discretionary trust leaving the purchase price owing to them as an interest free debt.<sup>44</sup> On separation a few years later, the outstanding debt is equally divided, because it is relationship property. But the home is not subject to the Act's equal sharing regime, because it is in trust. By putting the house into trust, the spouses exchanged an asset capable of increasing in value for a static debt. If the trustees are loyal to the husband, rather than the wife, they are likely to favour him over the wife. He will then continue to benefit from the asset held in trust, whereas his wife will not. It is that sort of inequality that s 44C is aimed at redressing.

If Ms Clyma separated from Mr Reynolds she would struggle to prove that the dispositions to the trust defeated her rights more than Mr Reynolds' rights. As neither of them were beneficiaries of the trust they were equally affected by the dispositions to the trust. However, if the trustees granted Mr Reynolds a lease or licence to occupy the home in exchange for him paying the mortgage, then Ms Clyma's rights would be defeated.

<sup>44</sup> This example is based on the facts of *Nation v Nation* [2005] 3 NZLR 46, which the Court of Appeal described as a paradigm case.

Ms Clyma would then meet the requirements of s 44C, and the Court would have jurisdiction to order Mr Reynolds to compensate her either from his separate property or from his share of the relationship property. But he has no property. In that case the Court has the power, as a last resort, to order the trustees to pay income from the trust to compensate Ms Clyma.<sup>45</sup> This trust produces no income, because its only asset is the family home. The Court has ancillary powers under the Act that it could use to order the trustees to sell the property and invest the proceeds in income producing assets, but it has not thus far taken that step.<sup>46</sup> Nor is it likely to do so in relation to a home that is used by minor or dependent beneficiaries of the trust. Contrary to the 1988 Working Group's recommendations, Parliament chose not to give the Court the power under s 44C to recover capital from the trust to achieve an equal division of relationship property.<sup>47</sup> So, even if Ms Clyma meets the criteria for a compensation order, there is no source from which compensation can be awarded.

While the Reynolds' trust may be unusual in some respects, the lack of property from which to award compensation is not. Many trusts hold only non-incoming producing assets, such as the family home. And the debt owed by the trustees may have been forgiven over the years, leaving little or no property against which a compensation order could be made. If there is still a debt outstanding to one or both of the spouses or partners, the Court can order its repayment and award compensation from that source. Repaying the debt may force a sale of trust assets, but the equity of the trust capital will be safe from s 44C claims. The Court's inability to make orders in respect of trust capital severely constrains the usefulness of s 44C. It is not the trust busting provision it was hailed to be.

Furthermore, with careful planning, exposure to s 44C can be avoided altogether. If the dispositions are made before the relationship began, s 44C will not apply.<sup>48</sup> Nor is it applicable if the trustees acquired the property directly from a third party, rather than from one or both of the spouses or partners.<sup>49</sup> It also does not apply to separate property.<sup>50</sup>

In short, trusts are still an effective means for protecting assets against claims under the Property (Relationships) Act. However, it does mean that trusts continue to undermine the relationship property regime, depriving spouses or partners of a fair share of the assets they helped to

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<sup>45</sup> The Court may not make an order diverting income from the trust unless the respondent's separate property or share of the relationship property is insufficient to compensate the applicant: s 44C(3) Property (Relationships) Act 1976.

<sup>46</sup> Section 33 Property (Relationships) Act 1976.

<sup>47</sup> Report of the Working Group on Matrimonial Property and Family Protection, Wellington (1988) at p 30.

<sup>48</sup> *Genc v Genc* (2006) 26 FRNZ 67 (HC).

<sup>49</sup> *Genc v Genc* (2006) 26 FRNZ 67 (HC).

<sup>50</sup> *Bourneville v Bourneville* 24/4/08 Wild J, HC Auckland CIV 2007-404-2656.

accumulate. Not surprisingly then, the Courts have started using other avenues in an attempt to give effect to the Act's equal sharing policy.

### *Section 182 Family Proceedings Act 1980*

One of those avenues is s 182 Family Proceedings Act 1980. This provision is a true trust busting provision, but it can only be used on dissolution of a marriage or civil union. It is not available to de facto partners. It is therefore of no use to Ms Clyma. But for spouses or civil union partners it has enormous potential.

Section 182 has a long history dating back to the English Matrimonial Causes Act 1859 and New Zealand's Divorce and Matrimonial Causes Act 1867, when husband and wife were one person in the eyes of the law and divorce was fault based. Marriage settlements were common in those days, and on divorce the Court had discretion to vary those settlements for the benefit of the innocent spouse and children of the marriage.<sup>51</sup>

That power is still available in s 182 Family Proceedings Act 1980, and has been extended to civil union settlements.<sup>52</sup> For a trust to qualify as a marriage or civil union settlement the trust must be settled on one or both of the spouses or civil union partners in their capacity as spouse or partner.<sup>53</sup> This would be another reason why Ms Clyma would not be able to invoke s 182. The Reynolds Trust was not settled on Mr Reynolds or Ms Clyma. They were not beneficiaries of the trust.

For spouses or civil union partners who are beneficiaries of a family trust in their capacity as spouse or civil union partner, s 182 Family Proceedings Act offers the kind of relief that the Property (Relationships) Act does not. It gives the Court broad discretion to make orders in respect of a trust for the benefit of an applicant spouse or civil union partner. The Court may exercise its discretion if the trust no longer meets the reasonable expectations of the parties because of the divorce, thereby creating a significant unfairness for the applicant.<sup>54</sup> In recent years, the Courts have been using s182 to vest trust capital in spouses who would otherwise be denied an equal division of relationship assets. Those orders are overtly linked to the relationship property entitlement that the spouse would have had under the Property (Relationships) Act if the assets had not been in trust.<sup>55</sup> In other words, the Court is using s 182 to achieve an outcome that it could not achieve under the Property (Relationships) Act; an outcome that Parliament rejected when it adopted s 44C!

Section 182 is obviously not intended to redress the shortcomings of the Property (Relationships) Act. The Property (Relationships) Act is a code intended to govern relationship property division on separation and on

<sup>51</sup> *March v March and Palumbo* (1867) LR 1 P&D 440; *Hartopp v Hartopp and Akhurst* [1899] P 65.

<sup>52</sup> **Section 44(1) Civil Union Act 2004.**

<sup>53</sup> *Mosaed v Mosaed* [1999] 3 NZLR 634; *Ward v Ward* [2008] NZFLR 316.

<sup>54</sup> *Chrystal v Chrystal* (1993) 10 FRNZ 441.

<sup>55</sup> **For example,** *Cooper v Cooper* 13/7/07 Wild J, HC Nelson CIV 2007-442-241; *Fielding v Burrell* [2005] NZFLR 558.

death.<sup>56</sup> The compatibility of s 182 Family Proceedings Act with such a code is questionable. It seems, however, that no thought was given to the future role of s 182 alongside the Property (Relationships) Act and, in particular, the limitations on compensation imposed by s 44C.

### *Constructive trust*

Where neither the Property (Relationships) Act nor the Family Proceedings Act provide a remedy, the Courts have sometimes been able to invoke the general law by imposing a constructive trust on the trustees of a spouse or partner's express trust.<sup>57</sup> This was the cause of action commonly used by de facto partners before they were brought under the Property (Relationships) Act.<sup>58</sup> Applicants had to show that they had made financial or non-financial contributions to the acquisition, improvement or retention of the property owned by the respondent, and that both parties reasonably expected to share the beneficial ownership of the property.

When the property is already in trust, the applicant must show that the trustees of the property reasonably expected to yield an interest to the applicant. If the trustees are remote from the applicant, or have made it clear to the applicant that she could not expect to share the beneficial ownership of the property, the applicant will fail.<sup>59</sup> But where the trustees have been the alter ego of the applicant's spouse or partner and have allowed him to treat the assets as his own, the Courts have imposed a constructive trust on the trustees, because both the applicant and the trustees would have had a reasonable expectation that the ownership of the assets would be shared. This is another example of the alter ego evidence being used in support of an established cause of action.<sup>60</sup>

Ms Clyma is unlikely to succeed with this claim, because the whole point of putting the home into trust was that she and Mr Reynolds would not be beneficiaries and thus protect themselves from creditors. She could hardly claim to have a reasonable expectation of sharing the beneficial ownership of the home in those circumstances.

So, none of the remedies would enable a person in Ms Clyma's position to access the family home held in trust, even though in reality it is relationship property. One might have little sympathy for Ms Clyma, because she probably went into this arrangement with her eyes open. If she consciously sought to avoid property ownership, she cannot later complain that she has no assets. But many spouses and partners do not act with conscious forethought of all the consequences of having

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<sup>56</sup> Section 4 Property (Relationships) Act 1976.

<sup>57</sup> *Prime v Hardie* [2003] NZFLR 481; *Glass v Hughey* [2003] NZFLR 865.

<sup>58</sup> *Gillies v Keogh* [1989] 2 NZLR 327 (CA); *Lankow v Rose* [1995] 1 NZLR 277 (CA).

<sup>59</sup> For example *Endres v Glendining* 25/11/03 Durie J, HC Palmerston North, CIV 2003-454-189; *Boys v Calderwood* 14/6/05 Young J, HC Auckland CIV 2004-404290.

<sup>60</sup> *Prime v Hardie* [2003] NZFLR 481; *Glass v Hughey* [2003] NZFLR 865.

a trust, or of contributing to assets held in trust. When they separate they are surprised to learn that they cannot obtain their full relationship property entitlement. Despite the changes made in 2001, the Property (Relationships) Act is not achieving its objective of a just division of assets produced by the joint efforts of the parties. As for creditors, they may not feel well served by the current law either. It may be time then to reform the law.

#### **Part 4: What about the future?**

One area in obvious need of reform is the Property (Relationships) Act. The Act's stated purpose is "to provide for a just division of the relationship property between the spouses or partners when their relationship ends on separation or death".<sup>61</sup> Trusts are clearly undermining that purpose. The Act is a code that applies instead of the rules and presumptions of the common law and equity.<sup>62</sup> As a result, the Court is deprived of its usual powers to develop legal concepts in response to changing circumstances. That puts the onus on Parliament to monitor the Act closely and amend it if it is not meeting its objectives. In regard to trusts, this could be done in several ways.

One way would be to amend the Act's definition of ownership of property to include discretionary interests of spouses or partners who are beneficiaries of a trust under their control and that holds assets produced by the parties' joint efforts. For purposes of relationship property division, the spouses or partners would then be treated as beneficial owners of those assets. There is precedent for this sort of approach in such statutes as the Child Support Act 1991 and the Legal Services Act 2000. There are also comments in the case law which suggest that the Courts may be tempted to move in that direction.<sup>63</sup> That would be undesirable in my view, because a ruling from the Courts would apply to trusts generally, which would have consequences going well beyond the confines of relationship property claims.

Another way would be to amend the compensation powers in s 44C, along the lines recommended by the 1988 Working Group. That would allow the Court to award compensation from trust capital if other sources of compensation were inadequate. That would not necessarily achieve an equal division of relationship assets, because the jurisdictional requirements of s 44C provide a narrow gateway into compensation. The trust property may not have been relationship property at the time of its transfer into trust, or it may have been acquired from a third party, rather than from one of the spouses or partners. Yet, some or even all of the assets may in reality be relationship assets. An amendment to the

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<sup>61</sup> Section 1M Property (Relationships) Act.

<sup>62</sup> Section 4 Property (Relationships) Act.

<sup>63</sup> *Isolare Investments v Fetherston* 15/9/06 Williams J, HC Auckland, CIV 2002-404-1791; *Harrison v Harrison* 18/9/08 Fogarty J, HC Auckland CIV 2008-404-001270; *Cooper v Cooper* 13/7/07, HC Nelson, CIV 2007-442-241.

jurisdictional requirements would be necessary to bring these assets within the scope of an expanded compensation provision.

Another reform that Parliament could make is to require spouses and partners to obtain independent advice prior to setting up trusts that are expected to hold relationship assets. Those sort of trusts are in effect another way of contracting out of the Act's regime. Yet, in contrast to agreements contracting out of the Act, there is currently no requirement that spouses or partners receive independent legal advice about the effect and implications of transferring relationship assets into trust.<sup>64</sup> An amendment to the Act requiring such advice would ensure that spouses and partners could not later claim ignorance about the consequences of putting assets into trust.

What about creditors? Should they also be able to access assets held in trust in certain circumstances? The Courts are clearly very reluctant to do so. That is obvious from the Court of Appeal's decision in the Reynolds case. But why should the law protect a person like Mr Reynolds? While he was living on credit, he was shoring up assets in a trust that he controlled and from which he was benefiting. Trusts lack transparency. They can be created with little or no formality and without creditors knowing of their existence.<sup>65</sup> Unlike companies or security interests, there is no requirement that trusts be registered. They are not in the public eye. They are invisible.

Trusts, such as the Reynolds trust, provide protection for the family at the expense of creditors. Some might argue that this is a legitimate use of trusts. A person's responsibility should be to one's family ahead of one's creditors and society in general. Others may disagree with those priorities, believing that one should not make others pay for one's debts. There is a real tension between these competing interests.

The credit crunch and financial crisis that has hit the world in the last fortnight may force Parliament to address this tension. It may be persuaded to shift the burden back to the debtors by introducing measures designed to make trusts more transparent and remove some of the protection currently provided by trusts. Debtors, like Mr Reynolds, may then be called upon to pay their debts, rather than hide behind a paper trust.

## Conclusion

The title of my lecture posed the question "Can your Trust be Trusted?". My answer to that question is that, at present, trusts cannot be trusted to prevent claims by spouses and civil union partners, but they are effective against claims by de facto partners and creditors. Whether they can be trusted in the future is up to Parliament. I believe the time for reform

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<sup>64</sup> Section 21F Property (Relationships) Act.

<sup>65</sup> For example, *Regal Castings Ltd v Lightbody* [2008] NZSC 87 where Mr Lightbody's major creditor was unaware that he had transferred his house to a family trust.

has come. When it does, trusts may provide considerably less protection than they do now.