

## Asset Protection and Discretionary Trusts

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Asset protection, along with income splitting, is one of the best-recognised advantages of the discretionary trust, the type of trust most often used and referred to as a “family” trust. The protection stems from the legal principle that discretionary beneficiaries have no interest in the assets of the trust. All they have is a right to see that the trust is properly administered by the trustee. If a discretionary beneficiary is an “at-risk” individual with the potential to be sued, creditors or trustees in bankruptcy are generally not entitled to have recourse to the assets of the trust in order to satisfy the individual’s debts. For that reason, discretionary trusts are often associated with professionals who are self-employed or in partnership, as well as with individuals involved in risk-carrying ventures. In practice, control over the trust is often maintained by the at-risk individual, who may also be the trustee, a director of a corporate trustee, or may otherwise hold a “power of appointment” to remove the trustee and appoint a new one.

A line of cases in recent years has however raised the possibility that a trustee in bankruptcy might be able to access assets in a discretionary trust over which a bankrupt has de facto control and apply the assets to pay creditors, even though the bankrupt is neither the trustee nor a direct beneficiary. Most important of these is the *Richstar*<sup>1</sup> case, a 2006 decision of Justice French in the Federal Court. The case involved ASIC bringing proceedings under the Corporations Act seeking the appointment of receivers to the property of certain officers of the failed Westpoint property group. ASIC was successful in bringing into the scope of the receivers’ orders property held by third party trustees of discretionary trusts, in which the individuals, or companies associated with them, were beneficiaries. The common feature of all the trusts in the case was that the individual respondent was both a discretionary beneficiary, and also had effective control of the trustee. This was either by virtue of being sole officer and/or shareholder of the trustee company, or by holding a power of appointment under the trust deed.

It is important to note that the *Richstar* decision was made in the context of an application under the Corporations Act, and turned on the specific definition of “property” in the Act. To date no bankruptcy trustee has successfully relied on the *Richstar* reasoning to access assets in a discretionary trust. Nevertheless the law appears to be heading in that direction and there are some powerful statements in the *Richstar* judgment from the now-current chief justice of the High Court. For example: “the beneficiary who effectively controls the trustee’s power of selection because he is the trustee or one of them and/or has the power to appoint a new trustee has something approaching a general power and the ownership of the trust property”. There is an established line of family law cases, relied on in *Richstar*, in which the Family Court has “seen through” similar trust arrangements and allocated assets held by third party trustees of discretionary trusts into the “pool” of marital assets for purposes of division amongst spouses. In December 2008, a Federal Court judge in *Rafferty v Time 2000*<sup>2</sup> justified a freezing order over assets held by third party trustees of discretionary trusts, on the basis that a trustee in bankruptcy might be able to rely on the *Richstar* precedent in order to gain access to those assets. Other cases have been more reluctant to give the *Richstar* case more general application<sup>3</sup>.

In light of *Richstar*, there has been considerable discussion about how best to protect the assets in a discretionary trust from the risk of attack by creditors of an at-risk discretionary beneficiary. Short of removing all of the beneficiary’s control, eliminating this risk altogether is not possible. As removal of all effective control would involve appointing a truly independent third party trustee, a scenario which is unlikely to be acceptable or appropriate in most family trust situations, it thus becomes a question of risk minimisation.

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<sup>1</sup> *Australian Securities and Investments Commission, re Richstar Enterprises Pty Limited v Carey* (No.6) (2006) 153 CLR 509.

<sup>2</sup> *Rafferty v Time 2000 West Pty Limited* (No 2) [2008] FCA 1931.

<sup>3</sup> eg. *Public Trustee v Smith* [2008] NSWSC 397.

Risk minimisation strategies that have been suggested include:

1. The at-risk beneficiary should not be a trustee. In the case of a corporate trustee, the person should not be a director of the trustee company, or should be only one of two or more directors.
2. The person should not own shares in the trustee company, or should hold only such minority interest as to give them no control over the company at member level.
3. The person should not be the appointor, or should be one of two or more appointors who all need to agree before they can exercise their power to remove or appoint a new trustee.
4. The person should not be a “default” income or capital beneficiary. Default beneficiaries comprise the persons to whom distributions are deemed to have been made if the trustee, for whatever reason, fails to distribute all the income or capital of the trust. Removing the at-risk individual as a discretionary beneficiary has been suggested based on a possible argument that a default beneficiary’s interest in the trust may amount to a proprietary interest capable of being assumed by a trustee in bankruptcy. There are no decided cases on this however.

There is no formula or combination of the above strategies which will guarantee protection from creditors. Particularly where control is transferred to a wife or other family member, there is a chance that a court will, depending on the facts, still consider a trust to be under the effective control of the at-risk beneficiary. Ultimately the reasoning in cases such as *Richstar* has been founded on the conclusion that it was “as good as certain”<sup>4</sup> that the assets in the trust would be distributed to the discretionary beneficiary concerned. The above strategies are ways of reducing the likelihood of a court coming to that conclusion.

The timing of any transfer of control will be important. If it is done at a time when the beneficiary is already under pressure from creditors, courts are likely to be less sympathetic than if a transfer occurs well before the beneficiary is aware of claims or specific risks, or well before the beneficiary embarks on any particular risky venture. The time therefore to effect changes to an existing trust structure is before any such events occur.

Any decision to implement risk-minimisation strategies such as those outlined above must be weighed against other potential effects of the changes, including any applicable tax considerations. There is also the risk of an obvious loss of control over the trust in practical terms. This is potentially significant if control is being transferred in whole or in part to a spouse. Were the marriage to break down the spouse may have far greater scope, on a practical level, to deal with or dispose of trust assets without the consent of the at-risk person, although it is unlikely to alter the legal position as to ownership of the assets for the purposes of any family law property settlement. As discussed there is ample authority that property in a discretionary trust controlled by one spouse will form part of the marital asset pool on a family law settlement.

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Peter Karcher is a partner in the Corporate & Commercial Practice Group at Gray & Perkins Lawyers. Investment managers, business leaders, IT and tourism companies are amongst the clients who regularly rely on Peter’s legal knowledge and transactional skills. Peter regularly gives presentations on his chosen areas of law, and has published numerous articles in industry journals and other publications.

**Peter Karcher**  
**Partner** | Gray & Perkins Lawyers  
t +61 2 8235 1218 m +61 402 312 699 f +61 2 9290 3628  
Level 7, 55 Clarence St | Sydney NSW 2000  
GPO Box 1342 | Sydney NSW 2001  
[www.grayperkins.com.au](http://www.grayperkins.com.au)

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<sup>4</sup> See *Richstar* at paragraph [36].