Can an interest in a discretionary trust ever be a proprietary interest?

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In recent years there have been increasing challenges in foreign courts to the use of corporate and trust structures to hold private wealth. As far as public opinion and news agencies are concerned trusts are utilised for tax avoidance — if not tax evasion — and the avoidance of legitimate claims from the likes of creditors and estranged spouses. Further scrutiny has followed through several global measures such as the United States Foreign Account Tax Compliance Act (FATCA) and the Common Reporting Standard (CRS) and a seemingly inevitable move to registers of beneficial ownership.

The courts do not operate in a social vacuum or in isolation from this movement. There is now a growing body of cases across the common law world in which the courts have prised open trusts, although for the most part such cases remain narrow in application. Whilst political discourse is focused on tax issues, many of the landmark cases have involved relationship property proceedings or are recovery actions by creditors, especially in situations involving fraud. In some instances, the New Zealand courts have played a significant role in developing said case law, such as the Supreme Court decision in *Clayton v Clayton* [2016] NZSC 30.

The latest landmark decision is a case decided by a foreign court but with a New Zealand connection. In *Kea Investments Limited v Watson* [2021] JRC 009, the Royal Court of Jersey was required to consider the novel question of whether a beneficiary's interest under a discretionary trust constitutes property and, if so, whether that interest may be transmitted to a creditor in execution of a judgment. Those central issues have been considered by trust lawyers for many years and, given the sheer volume of trusts in New Zealand could conceivably arise in New Zealand.

Background

The Jersey proceedings formed part of the well-publicised legal battle in the High Court of England and Wales between two New Zealand businessmen, Sir Owen Glenn KNZM and Eric Watson. The High Court of England and Wales had previously held that Mr Watson made fraudulent misrepresentations to secure funding from Sir Owen's company, Kea Investments Limited (Kea), and that Mr Watson acted in breach of his fiduciary duties. Mr Watson was ordered to pay Kea GBP 43.5 million, being money that could not be recovered from the failed joint venture, plus compensation for Kea's lost profits. Mr Watson has yet to pay the judgment debt and in October 2020 he was sentenced to prison for contempt of court in relation to shortcomings in the disclosure of his worldwide assets (which he had been ordered to provide).

In his bid to recover the judgment debt, Sir Owen turned his attention to three Jersey trusts of which Mr Watson is a discretionary beneficiary.

A novel argument

When a creditor is seeking to enforce a judgment (or obtain some other relief) in relation to assets of a discretionary

trust, the courts are often put in the position of having to decide between a more formalistic application of trust law, which provides greater certainty to those seeking to legitimately structure their personal affairs, and the courts' desire for a just outcome in certain circumstances.

On the face of it, assets held by the trustees of a discretionary trust are not vulnerable to execution if judgment is entered against a defendant who is only one of a class of discretionary beneficiaries. A discretionary beneficiary's interest does not amount to a proprietary interest and the judgment will not be enforceable against the trust assets.

There are, however, circumstances in which the courts have moved past this analysis and effectively brought the trust assets within the reach of creditors, including where the trust is a sham (a high threshold), the basis for a constructive trust exists, proprietary or tracing claims, knowing receipt claims, where the defendant has power of disposition over the trust's assets (see *TMSF v Merrill Lynch Bank & Trust Co (Cayman) Ltd (2009)* [2011] UKPC 17, [2012] 1 WLR 1721), the "illusory trust" ground in *JSC Mezhdunarodniy Promyshlenniy Bank, et al v Sergei Viktorovich Pugachev et al* [2017] EWHC 2426 (Ch) and Clayton v Clayton [2016] NZSC 29, and under statutory insolvency and relationship property regimes.

In the present case, Kea first tried something different. Having registered the English judgment in Jersey (a neighbouring but distinct jurisdiction to England and Wales), it argued that it was entitled to attach and seize Mr Watson's interests as a beneficiary, as that interest was Mr Watson's moveable property and was therefore subject to enforcement measures.

By arresting Mr Watson's beneficial interest, Kea would effectively subrogate his rights as a discretionary beneficiary. Kea accepted that it would have no right to the trust property, but it would be entitled to information about the trust, request a distribution from the trust, and expect the trustee to consider that request. Standing in Mr Watson's shoes, Kea would (it was argued) be able to give the trustee a good discharge for any appointment of assets to it. Kea would also be entitled to obtain copies of trust accounts to evaluate the trust property available to be appointed.

The exact mechanism by which Kea sought to arrest and seize Mr Watson's beneficial interest was a Jersey remedy called *arrêt entre mains*, which allows for the satisfaction of a debt by appropriating the debtor's movable property. Putting aside the finer characteristics of that remedy (which has its basis in Norman French law), the central issues for determination were the extent to which a beneficiary's interest under a discretionary trust constitutes property and, if so, whether that interest could be subrogated by a judgment creditor by way of execution. As noted above, those central issues could conceivably arise in a New Zealand context.

Decision

The Royal Court of Jersey refused to allow execution over Mr Watson's beneficial interests in the trusts. While it accepted that the beneficial interests constituted movable property, it held that such property was not assignable or in any way transmissible under the terms of the trust deeds or by its inherent nature: "*[t]hese are not rights which can exist and be exercisable independently of the discretionary beneficiary. They are not transmissible*" (at [30]). The Royal Court concentrated on the doctrine against fraud on a power, noting that as Kea is not a beneficiary, no power could ever be exercised by the trustee in its favour without falling foul of the settlor's intention.

On the other hand, the Royal Court had no difficulty in allowing execution in respect of certain loans made by Mr Watson to the trusts, because of which the debts became due to Kea instead.

Comment

The courts are wary of unscrupulous defendants seeking to 'judgment-proof' themselves and in this judgment, Mr

Watson was bluntly described as “an adjudicated fraudster in and contemnor of the Courts of England and Wales” (at [2]).

But even in this context, it is hard to see any court, in New Zealand or otherwise, granting such an ambitious application. The implications of Kea’s novel argument were simply too far reaching — it would seemingly allow a stranger to a trust to involve itself in the internal affairs of a trust. The application also challenged a fundamental principle of trust law, by compelling a trustee to consider the interests of a third party.

Kea will now, we understand, plead further causes of action available to it against the trusts, namely a proprietary claim and fact-intensive claims that at least some of the corporate assets within the trusts are in fact held on resulting trusts for Mr Watson (at [4]). Accordingly, the case may yet provide some further instruction.

Whilst this type of claim is unlikely to succeed in New Zealand it is reasonably likely that a creditor or official assignee will continue to take a keen interest in New Zealand discretionary trusts due to the lack of independent and proper governance of such trusts and a propensity for powers to be reserved to settlors.

The *Anderson case (FTC v Affordable Media* 179 F 2 13130 (9th Cir 1999)) in California in 1999 is a stark reminder that no trust is impregnable and courts will not always take principled positions. Mr and Mrs Anderson were the settlors of a trust established in the Cook Islands, of which they were co-trustees together with a Cook Islands licensed trust company. They became defendants in litigation in the United States and were ordered by the court to produce financial information pertaining to the trust and procure the repatriation of the trust fund to the United States so that it could be made available to creditors. As a consequence, and in order to protect the trust fund, the Cook Islands trustee removed Mr and Mrs Anderson as co-trustees and refused to comply with the United States court orders. In response and to obviate complex conflict of laws issues, the judge simply imprisoned Mr and Mrs Anderson and held them in contempt of court!

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