

Fettering of a trustee's discretion - when will it be ignored?

- by **Matthew Burgess, Director, View Legal**

Discretionary trusts are regularly used in commercial transactions, and of course tax issues are always present. But, there is a more fundamental issue that deserves attention – fettering of a trustee's discretion. Take for example an insurance funded buy-sell arrangement that uses options under the contractual arrangement to help facilitate any ultimate buyout. This is a widely used, and generally very sensible, approach to take. A significant difficulty can arise however where the parties to the buy-sell agreement include trustees of discretionary trusts.

There are cases (admittedly dating back many years) which provide that unless a trust deed for a discretionary trust specifically allows the granting or an acquiring of an option, then the arrangement will not be enforceable as the trustee has effectively fettered its discretion.

In order for a discretionary trust to remain an ongoing valid structure, it is necessary for the trustee to always retain its discretion and therefore not enter into arrangements which will remove this flexibility in the future.

Traditionally, entering into option arrangements has been seen as clearly limiting future decision making ability and therefore prohibited - unless specifically allowed under the trust instrument.

Despite the longstanding rules in this area, many otherwise "modern" trust deeds do not have the required powers to in fact allow a trustee to grant options.

Leading case

The principle in relation to the prohibition on a trustee fettering its discretion is arguably best captured in the decision of *Fitzwood Pty Ltd v Unique Goal Pty Ltd (in liquidation)* [2001] FCA 1628.

In this case, the key concepts concerning fettering were summarised as follows –

"... a trustee is not entitled to fetter the exercise of a discretionary power (for example a power to sell) in advance: *Thacker v Key* (1869) LR 8 Eq 408; *In re Vestey's Settlement* [1951] Ch D 209.

If the trustee makes a resolution to that effect, it will be unenforceable, and if the trustee enters into an agreement to that effect, the agreement will not be enforced (*Moore v Clench* (1875) 1 Ch D 447), though the trustee may be liable in damages for breach of contract ...".

Arrangement in breach of fettering trustee's discretion enforced

Arguably the leading case explaining when the prohibition on fettering of discretion will essentially be ignored is *Dagenmont Pty Ltd v Lugton* [2007] QSC 272.

The background in this case was as follows:

- a family discretionary trust was established to be the owner of a start-up business;
- a company was nominated as trustee of the trust, with the shares in the company owned by the husband and

- wife and the husband as the sole director;
- the wife's brother was listed as the sole appointor, with the right to remove the trustee in his sole discretion;
- the wife's brother had no involvement in the business at any stage, and the husband and his wife claimed they had never understood why the brother was nominated as appointor, nor indeed the extent of his ultimate power;
- as part of a succession and estate planning exercise, the wife's brother agreed to relinquish his rights as appointor;
- in particular, an agreement was entered into by the wife's brother as the original appointor of the discretionary trust and the husband, wife and one of their sons, whereby the wife's brother would resign as appointor of the trust, in return for guaranteed distributions from the trust for as long as he lived;
- the distributions were set at an amount of \$150,000 each year, indexed for inflation, in priority to any other distributions from the trust, and regardless of the level of profitability of the business owned by the trust;
- the agreement by the trustee to make these future distributions was therefore effectively a fetter on its future discretion;
- each party received independent legal advice at the time of the agreement, however some years later the trustee attempted to cease the distributions due to the, argued, invalid fettering of its discretion and in turn the apparent inequality of the original bargain struck - the wife's brother had never had any involvement in any aspect of the business and indeed had never exercised his power as appointor.

The Supreme Court specifically acknowledged the general prohibition on a trustee fettering its discretion (based on the case law stretching back over hundreds of years), confirming that:

"trustees cannot fetter the future exercise of powers vested in trustees ... any fetter is of no effect. Trustees need to be properly informed of all relevant matters at the time they come to exercise their relevant power."

While therefore agreeing that the agreement was at face value void and should be set aside, the court went on to in fact ignore the fettering and uphold the validity of the agreement.

In rejecting the trustee's attempt to avoid the agreement and in turn the obligation to continue to make the trust distributions of \$150,000 a year for the rest of the wife's brother's life, the court confirmed:

- a provision in a document authorising a trustee to release powers which they would otherwise have a duty to exercise is valid;
- here, the document confirming the agreement between the parties was in essence a release by the trustee of the power conferred on it to exercise an unfettered discretion to distribute amongst all potential beneficiaries;
- alternatively, the agreement effectively amounted to a variation of the terms of the original trust deed;
- this meant that what would otherwise have been an unfettered trustee discretion became reduced in scope, simultaneously with an obligation being imposed on the trustee (created by the agreement with the wife's brother as original appointor) to distribute the annual amount of \$150,000 (indexed);
- arguably, particularly where parties receive independent advice at the time, the court should always uphold bargains where it can, rather than destroy them - even where there is longstanding case law suggesting the

opposite conclusion .

Conclusion

As explored regularly in this *Bulletin*, while reading the trust deed of a discretionary trust (including all valid variations) is necessary, it will **not be sufficient by itself**. This is because there are a myriad of related issues that need to be considered that may impact on any intended distribution, aside from whatever powers are set out in the trust instrument.

While not necessarily an obvious example, the rules in relation to trustee fettering are longstanding and go to the heart of a trustee's duties. A failure to understand the impact of the regime can have significant detrimental impacts both from a trust law perspective and the related tax consequences - regardless of whether any purported fettering is ultimately held to be valid or invalid.