Breach of the separation requirement in family trusts: Why trustees (and trustee-spouses) need to be wary of taking the current approach to “veil piercing” at divorce at face value

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1) INTRODUCTION: The "CORE IDEA" of SA trust:

At all times there must be a SEPARATION of ownership (or CONTROL) of trust assets, from ENJOYMENT of trust benefits:

(***Landbank v Parker*** 2005 (2) SA 77 (SCA)).

This principle is "reinforced" by § 12 of the TPCA:

"Trust property shall not form part of the personal estate of the trustee except in so far as he as the trust beneficiary is entitled to the trust property."

- But, in recent times trust form increasingly **ABUSED**:

  → especially in family trusts / business trusts; and where trustees are also beneficiaries:

  ➔ "**DEBASEMENT of core idea**"

  ➔ "*alter ego*" of trustee / trust founder

  ➔ possibly justifies "going behind" the trust form or "piercing the veil" of the trust.

MJ de Waal (2012) *Rabels Zeitschrift:*

- Distinguishes between "SHAM" and "ABUSE" scenarios;
- Abuse occurs as a result of lack of adherence to the "CORE DUTIES" of a trustee:

1) Trustee must exercise an **independent discretion**;
2) Trustee must **give effect to the trust deed**;
3) Trustee must **act with care, diligence and skill** in performing duties/exercising powers.

Also: Violation of the **joint-action rule** (F du Toit *Journal of Civil Law Studies* 2015: 666).

Trust assets and Divorce

Badenhorst v Badenhorst 2006 (2) SA 255 (SCA):

- LEGAL QUESTION:
  - Can trust assets be taken into account for the purposes of a redistribution order (§ 7(3) – (6) Divorce Act)?

SCA in *Badenhorst*:

- This "is a classic instance of [the respondent] having full control of the assets of the trust and using the trust as a vehicle for his business activities":
- *Why?*

  Trust deed:

  - Nominal amount provided by respondent's father as trust founder;
  - Respondent and brother were co-trustees, but latter could be discharged at any time;
  - Trustees granted *carte blanche* to deal with assets as they saw fit.

Administration of trust:

- Respondent rarely consulted his co-trustee;
- Income that should have been paid to the trust (as a shareholder) was paid to respondent personally;
- Property owned by respondent was financed by the trust;
- Trust property described as personal property for purposes of credit applications.

SCA: "Control Test"

"To succeed in a claim that trust assets be included in the estate of one of the parties to a marriage ***there needs to be evidence that such party controlled the trust and but for the trust would have acquired and owned the assets in his own name*****. Control must be *de facto* and not necessarily *de iure*."**

To determine whether a party has such control:

(i) Terms of the trust deed, and

(ii) Evidence of how the affairs of the trust were conducted during the marriage.

- *Because this test complied with*:

  → **VALUE** of trust assets added to Mr Badenhorst's personal estate

- ***BUT:*** *Badenhorst* created confusion:

  → Was the court "piercing" the trust veil or exercising wide discretion in § 7?

- Conflicting case law:

(1) Binns-Ward J in ***Van Zyl v Kaye*** 2014 (4) SA 452 (WCC) at par [23]:

"I am not aware of any matter in which a South African court has yet 'pierced the veneer' of a trust … *Badenhorst* did not entail any disregard of the trust involved in that case …"

In essence: *Badenhorst* "went to the application of section 7(3) – (5) of the Divorce Act, rather than to any remedy for abuse of the trust form."

(2) Opposite view: ***RP v DP*** 2014 (6) SA 243 (ECP):

- "[T]he power of piercing *either the corporate or the trust veil* ***is derived from common law and not from any general discretion a court may have***. It is a function quite separate from … making a redistribution order under s 7 of the Divorce Act 70 of 1979 … and must not be confused or conflated with such power."

- *Badenhorst* **therefore involved a piercing** because "[t]he only way the personal assets of a trustee can include what is *notionally* regarded as trust assets is by lifting or piercing the trust veil and finding that the trust is indeed the *alter ego* of the trustee …"

Most authoritative view:

- ***WT v KT*** 2015 (3) SA 574 (SCA):
  * Although confirmed that “the legal principles [pertaining to 'looking behind' the veneer of an *alter ego* trust] **have in essence been transplanted from the arena of 'piercing the corporate veil’”,**
  * Court of the view that ***Badenhorst*** actually involved exercise of **“wide discretion” conferred by § 7 of the Divorce Act, that was *not available in other marriages*.**

Net effect seems to be:

- *Even if* a trust is proved to be the trustee-spouse's *alter ego*, the value of trust assets can only be taken into account if marriage falls within redistribution competency in § 7(3)!! (See e.g. Du Toit 2016: 696, 697; Van der Linde 2016 *THRHR*: 172, 173).

- *BUT*: This permits "**divorce planning**":

→ Allows trustee-spouse to "insulate" trust assets while simultaneously abusing the trust!

-> Does not square with trust law;

-> Allows a spouse to evade obligations imposed by matrimonial property law at divorce.

BUT: 3 reasons why we should be wary of accepting the (ostensible) position after *WT* as correct:

(i) *WT* **failed to appreciate the full extent** of the power which the court had itself acknowledged to "have been transplanted from the arena of 'piercing the corporate veil'";

(ii) *WT* **fell for the illusion** that piercing in the divorce context is rooted in section 7(3) – (5) of the Divorce Act, while this is not truly the case; and

(iii) The **factual matrix in *WT* was highly atypical**, which makes drawing definite conclusions from the case problematic.

Reason 1: The true nature of piercing in company law

Cape Pacific v Lubner Controlling Investments (Pty) Ltd 1995 (4) SA 790 (A):

- Idea is that personal liability is attributed to someone who ABUSES corporate personality;
- Circumstances in which this will occur in SA "are far from settled";
- Generally: "An element of **fraud or other improper conduct** in the establishment or use of the company or the conduct of its affairs";

- NB!! No rigid test: **FLEXIBLE APPROACH**

  → Based on FACTS OF EACH CASE

- "Improper conduct" may reveal the company to be the mere *alter ego* of its controllers:

  → Eg to evade legal obligations (as in *Cape Pacific*)

- Piercing may take place only in respect of a **specific transaction** (company otherwise intact).

Section 20(9) Companies Act of 2008:

- Statutory “test” for piercing:

Where:

- the incorporation / use of / any act by or on behalf a company:
- Constitutes an “**UNCONSCIONABLE ABUSE** of the juristic personality of the company”.

Ex parte Gore 2013 (3) SA 382 (WCC):

- § 20(9):
  - **Supplements** the common law;
  - Flexible test ("unconscionable abuse") implies that piercing **no longer a "drastic" remedy**:
  - Available "*whenever* the illegitimate use of the concept of juristic personality *adversely affects a third party* in a way that *reasonably* should not be countenanced".

Conclusion:

- "Piercing" **as derived from the common law**, is a **flexible and self-contained** remedy that allows the outcome of its application to be determined **in accordance with the particular circumstances of each case**.
- This **(INCREASINGLY) flexible** remedy has now been transplanted into the realm of trust law (*WT v KT*).

- Veil piercing does not require judgment to "go against" the company:
  - liability could be imposed *only* against the controller(s) in their personal capacity (see eg *Airport Cold Storage* 2008 (2) SA 303 (C)), OR
  - against the company *and* its controllers (as in *Cape Pacific*).

∴ Applied to *Badenhorst v Badenhorst*:

(i) This is no different to the "personal liability" imposed on Mr Badenhorst; and

(ii) The fact that judgment did not "go against the trust" (see Binns-Ward J in *Kaye*) is irrelevant.

- The "control test" as set out in *Badenhorst* is clearly based on the same considerations that are used to establish whether a company is merely the *alter ego* of its controllers:

∴ In divorce cases, the control test, derived from **common law**, exists independently of Divorce Act or other legislation (such as the MPA).

Reason 2: The illusion that *Badenhorst* merely involved the application of section 7(3)

- *WT v KT* overlooked the fact that *Badenhorst* involved **two distinct processes**:

1) The first, was to ascertain whether (the value of) the trust assets in *Badenhorst* **IN PRINCIPLE** could be added to Mr Badehorst's estate:

   ➔ **Control test**, derived from common law, and not dependent on any legislation

BUT, compliance with this test alone is not sufficient:

2) **To EXERCISE** this power, there has to be a **CAUSAL *NEXUS*** provided by Divorce law:

➔ *In casu*: Section 7(3) – (6) of the Divorce Act:

(i) Mrs Badenhorst had to prove her compliance with the preconditions of this provision to show that she was actually entitled to share in her husband's estate (irrespective of its value).

(ii) Once this was done, the court could determine *the extent* of the redistribution, taking into account the "TRUE" VALUE of the respondent's property.

(iii) This "true" value **could include the value of the trust property *because the "control test" permitted doing so***.

KEY ISSUE:

(i) Section 7(3) – (6) **not only** provides a mechanism for redistributing property in marriages with complete separation of property; **BUT ALSO**

(ii) Imposes a legal obligation on spouses at divorce.

In sum:

- The "control test" established that the trust was the respondent's *alter ego*, and
- the trust "veil" could be pierced because he had used the trust for the "improper purpose" of evading an obligation owed to his spouse at divorce (ie a redistribution of property based on the TRUE value of his estate).

What about accrual claims?

- Conflicting case law: eg *RP v DP* versus *MM v JM*
- BUT: Same rationale:

Step 1: Piercing is a **common law power**
Thus: Ascertain compliance with "**control test**";

Step 2: **Causal *nexus***: section 3(2) of the MPA:

- spouse has "a right" to share in accrual;
- although only a contingent right (*Reeder v Softline*) it is linked to the obligation (section 7) for a spouse "to furnish full particulars of the value" of their estates;

- The use of *alter ego* trust to attempt to "reduce" true value of estate:

  => use of trust for improper purpose of evasion of a legal obligation owed to other spouse at divorce.

- Court has power to conduct an in-depth factual enquiry to determine "true" value of accrual of trustee-spouse's estate:

  (See eg *YB v SB* 2016 1 SA 47 (WCC): par 35)

Final issue: factual matrix in *WT*

- Facts in *WT* were "unfortunate" and atypical:
  - Trust created long before marriage;
  - No evidence that KT had been deceived regarding exclusion of trust property from joint estate or her status as a beneficiary

  ∴ Judgment correct ON THE FACTS.

- BUT: Statement that a spouse who is neither a trust beneficiary nor third party who contracted with trust "has no standing to challenge the management of the trust" (par 33) is **disputed**:

Why?

- Because in divorce context such a "challenge" is not based on any "fiduciary responsibility" owed to the spouse:

- ***Instead***: Based on fact that trustee-spouse used trust as his/her *alter ego* to further his/her own patrimonial interests and thus used trust for the "improper purpose" of concealing "true" value of estate to evade legal obligations owed to other spouse at divorce.

- This aspect of judgment should be viewed with circumspection by future litigants.

My prediction:

- *WT* is not the last word on this issue;

THUS:

- Vitally important for trustee-spouses to ensure compliance with core idea of trust so as to minimise risk at divorce!

THANK YOU !!!