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STEP ADVISING FAMILIES ACROSS GENERATIONS

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The International Family Offices Journal

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Globe Law and Business would like to congratulate Barbara Hauser on being listed in *Spears 500* again in 2018 for Family Offices Services.

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Volume 3, Issue 1, September 2018

Trusts and settlors – can a settlor have too much power?

Dawn Goodman

The continuing popularity of the trust

The Anglo Saxon trust, with its origin in medieval knights departing for foreign wars (perhaps never to return) entrusting their assets to a bishop to look after for the benefit of wives and children, remains one of the most commonly used wealth planning tools 800 years or so later.

In spite of unwelcome – and often misguided – publicity associating trusts with tax evasion or concealing assets for nefarious purposes, the trust is alive and popular. Perhaps this is because of the comfort derived from the court having a supervisory function which can be called upon to guide trustees, determine issues of difficulty, give comfort on momentous decisions and call trustees to account. However, it is more likely due to the trust's ability to be framed to meet an almost infinite variety of circumstances (provided they are not unlawful) and to adapt over the years to the needs of the family or purpose for which it was intended to provide. As some of England's oldest trusts attest, they can keep up with the times or be changed by the court to enable them to do so, for example to enable modern forms of investment (eg, *Anker-Petersen v Anker-Petersen* [1991] 16 LS Gaz R 32) and shield young adults from the dangers of accessing too much capital too soon (*Wyndham v Egremont* [2009] EWHC 2076 (Ch)), pass on to a similar charity when the charitable purposes for which the trust was made are no longer practicable or be varied when the family is pulling in different directions and the structure needs to be fundamentally redesigned.

Whatever the advantages of foundations, family investment companies, family limited partnerships, companies, limited liability partnerships and other modern asset-holding structures, the trust retains its attraction, not least with settlors in regions with little or no common law heritage such as Russia and the CIS, Central and Latin America, the Gulf and South East Asia. They value the trust's potential to help them provide business succession and assist in protecting them and their families from personal and political pressure. A key element of the trust's attraction in achieving these aims or minimising risk is the division between the legal and beneficial ownership of the assets.

It is by no means exclusive to settlors from such regions that they like to retain control. But when taking into account the lack of familiarity with the concept, the experience of abuse of power in their own or neighbouring countries, the single-minded ambition that has often driven the creation of the new wealth to be settled and the absence of an established relationship with trust service providers in far-off jurisdictions, it is hardly surprising that some settlors have difficulty parting with legal title, possession and particularly control of their assets to their trustees.

The framework within which flexibility can be achieved

There is almost no limit to the ingenuity which can be applied to the draftsmanship of a trust but it is always worth going back to basics to consider what are the essential components of a valid trust. If these are not borne in mind, the 'trust' may not be valid or may be incapable of withstanding pressure. Any inventive solution must always be tested against a list of the trust's essential components:

- certainty of intention, of subject-matter and of objects;
- accountability of power holders;
- not ousting the jurisdiction of the court; and
- not being for an unlawful purpose or contrary to public policy.

While there are cases dealing with certainty of subject-matter and objects such as the unhappily named *In re Double Happiness Trust* (Royal Court of Jersey, 10 December 2002), where an attempt to introduce a letter of wishes into the provisions of a fully discretionary trust resulted in the Jersey court not being able to work out what the trust meant and so the trust failed, the issue which is at the centre of the control versus invalidity debate is the issue of intention to settle a valid trust.

At its most basic the trust entails the settlor parting with legal title, possession and control of his assets to a trustee or trustees to manage according to the trust's terms and relevant statutory and case-law for the benefit of the beneficiaries to whom the trustee is accountable (as well as to its supervisory court) for the exercise of its powers.

The settlor must intend to part with his assets at the time he puts them into an English law trust or one in a jurisdiction which has taken the English trust as its model and adapted it to their circumstances (the Bahamas, the Cayman Islands, Canada, New Zealand,

The absence of intention is also apparent in cases where the trust – or rather the documentation in which it is set out – is intended to be a cloak, device or mask to deceive others as to the true nature of the relationship.

Australia, Hong Kong, British Virgin Islands, Bermuda, Jersey, Guernsey, Isle of Man, Cyprus, Mauritius, Gibraltar – to name a few).

In such jurisdictions a trust which springs into life only on the death of the settlor is a will by any other name and is not a trust during the lifetime of the settlor (*Cock v Cooke* (1866) LR 1 P&D 241; the Canadian case *Re Pfrimmer* [1936] 2 DLR 460 and more recently, *Re AQ Revocable Trust* [2010] SC (Bda) 40 Civ).

This latter case is interesting because it entailed a trust agreement in New York form being created under Bermudian law by a US settlor who, the court decided, had not intended to part with control of his assets and as a matter of fact did not do so. The court also held that as a matter of construction the deed did not create a valid trust under Bermudian law – a clause common in US trusts absolving the trustees of liability to their beneficiaries if the settlor agreed with their committing a breach of trust was considered contrary to the principle that trustees are accountable to beneficiaries and the supervisory court. The trust could not operate as a will either because it would have been revoked by remarriage. Indeed, in most cases an attempted trust will not have been executed in a way which would enable it to stand as a will if it fails as a lifetime trust.

The case was a salutary lesson against not intending to part with control (made worse by the settlor appointing himself trustee and continuing to behave as though nothing had changed) and also of expecting concepts in one jurisdiction always to work in another. In the United States a will substitute trust does work – indeed, the form of revocable trust envisaged by Article 6 of the US Uniform Trust Code is used primarily as a will substitute to avoid probate. Such a trust is not intended to be effective against creditors – it does not achieve the passing of assets to another to that extent – but it is still regarded as a valid *inter vivos* trust.

Revocable trusts are not, of course, invalid *per se* in trust jurisdictions following the English model. But if it is really intended that the trustee has no powers until after the settlor dies, or that the trustee's obligations can be overridden by the settlor, a valid trust will not have been created.

The absence of intention is also apparent in cases where the trust – or rather the documentation in which it is set out – is intended to be a cloak, device or mask to deceive others as to the true nature of the relationship. The true relationship may be that the assets are actually held by the trustee as nominee for the settlor instead of for the beneficial class, or that while the trustee holds the powers it is always intended that it will be the settlor who decides how they should be exercised. It is generally recognised to render the trust vulnerable if the way in which it is managed is not in conformity with the way it is supposed to operate. Anyone with an interest in upsetting the trust (whether a creditor, fiscal authority, divorcing spouse, disappointed heir or government seeking to take the assets of the trust) will point to such inconsistencies in the management of the assets and allege sham.

If the trust is a sham then there is no intention to create a valid trust. But that does not mean that in every case where there is a lack of intention there is a sham. For example, the lack of intention could be due to lack of mental incapacity (an issue we can expect to come up quite frequently with increasingly elderly and or frail settlors), lack of understanding on the part of a settlor who does not have a knowledge of trusts or has not read a copy in the language with which he is most familiar or does not understand the effect of what he is reading, or simply that the settlor has a sham intent but the trustee knows nothing of it. For a trust to be a sham there should, as matters stand at present, be a common intention – which may be inferred from the way they behave – on the part of the settlor and trustee not to act in accordance with the terms of the express trust but in some other way, usually for the trustee to act as nominee for the settlor. (For a relatively recent restatement of the necessity for a sham transaction to be double-sided, see *Re Reynolds* [2007] NZCA 122.) Mere artificiality of arrangement or a sense of general dodginess is not sufficient (*Stone v Hitch* [2011] EWCA Civ 63 and *A v A* [2007] EWHC 99 (Fam)), it has to be a document conceived to dishonestly distract from the true relationship between the parties.

As such, sham is increasingly difficult to sustain in regulated jurisdictions where a finding of sham against a regulated entity will almost certainly result

in the regulator investigating and the trustee being at risk of losing its trust licence. But it is by no means impossible, as the recent decision in *Mezhprom Bank v Pugachev* [2017] EWHC 2426 (Ch) has shown, the court considering the respected lawyer who was a director of the trust company being too compliant to the demands of a highly controlling settlor.

A question arises as to whether the settlor has given sufficient powers to the trustee so that he has not retained overall control. It is possible to create a 'thin' trust where the trustees have few powers and the remainder are held by the settlor or his appointees but care needs to be taken to ensure that the conclusion is not reached that the settlor has too much power and the trustee not enough duty – there has to be an irreducible core of obligations:

> *I accept … that there is an irreducible core of obligations owed by the trustees to the beneficiaries and enforceable by them which is fundamental to the concept of the trust … But I do not accept the further submission that these core obligations include the duties of skill and care, prudence and diligence. The duty of the trustees to perform the trusts honestly and in good faith for the benefit of the beneficiaries is the minimum necessary to give substance to the trusts, but in my opinion it is sufficient (per Millet LJ in* Armitage v Nurse [1998] Ch 241).

Designer trusts

In response to a desire on the part of settlors to have more control, legislation has been introduced by many of the trust jurisdictions to enable the settlor to retain a high degree of influence if not control without *per se* invalidating the trust. Perhaps the first major innovation in this area was the introduction of the BVI Vista trust (Virgin Islands Special Trust Act 2003) which not only permitted the trustees to adopt a hands-off approach to the running of an underlying company but also enjoined them not to interfere except in specific circumstances.

The Cayman Islands STAR trust (Special Trusts (Alternative Regime) Law 1997) addressed different issues – it enabled purposes to be mixed with benefit to human beneficiaries. It also transferred the accountability to beneficiaries to an enforcer, an attractive option to some settlors.

Although reserved powers are nothing new – as shown by *Lord Vestey's Executors v IRC* [1949] 1 All ER 1108 – numerous trust jurisdictions have specifically introduced reserved powers legislation in response to the market need to clarify the position of those settlors who wish to retain certain powers for themselves or to confer it on others, apart from the trustee.

The general tenor of the legislation is that the retention by the settlor of such powers or the conferring of such powers upon another will not, of itself, render the trust invalid. The legislation differs in its treatment of the trustee's response to a direction from such a power holder – most seek to absolve the trustee from liability for loss if they follow such a direction (see eg, Section 9A(3) of the Trusts (Jersey) Law 1984).

Some legislation seeks to characterise the powers so held or conferred as personal or fiduciary or provide a default position where the trust deed does not specify how the powers are held. For example, in Guernsey the default position is that the powers are personal (Trusts (Guernsey) Law 2007, Section 15(2)(b)). This can create difficulties for trusts created before the 2007 law came into force, given that as a matter of construction powers were generally considered fiduciary unless otherwise specified. Even if the powers were described as personal the court could decide that they were fiduciary, ie, to be exercised solely in the interests of the beneficial class. Given that the appointee could be a protector with hire and fire powers normally regarded as fiduciary (*Re Skeats Settlement* (1889) LR 42 Ch D 522), a default position of the power being a personal power could be regarded as problematic.

The later Bermudian legislation has dealt with this differently – by providing that the default position is that the powers are fiduciary unless the power holder is the settlor or a beneficiary (provided that he is not also the sole trustee (Section 2A(7) of the Trusts (Special Provisions) Act 1989 (as amended)).

The range of powers that can be retained or conferred is generally also set out in the statute (the Isle of Man legislation being an exception) but often include powers to:

- revoke the trust in whole or in part;
- appoint and remove trustees;
- vary the trust deed;
- direct/consent to distributions of trust assets;
- direct addition or removal of beneficiaries;

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- restrict trustee powers;
- change governing law; and
- manage/direct investments.

It is generally inadvisable for a settlor to retain all these powers; they should be encouraged to choose those which are most important to them. Power-sharing between different power holders is possible – for example the settlor may wish to retain the power of revocation, give the protector the power to hire and fire trustees and make/consent to/veto major dispositive decisions and appoint a management committee or investment adviser to direct or manage investments. It is probably better to power share than for a wide range of powers to be retained by the settlor but this will not suffice to protect the settlor from being found to hold all such powers if a court decides that the other power holders are mere cyphers (*Mezhprom Bank v Pugachev* [2017] EWHC 2426 (Ch)).

At face value it is very attractive to a settlor to retain powers and put other powers in the hands of trusted advisers and friends. But this may not always be wise, particularly if the powers so retained or granted are described in the trust deed or by the relevant legislation characterised as personal powers. It may result in a situation where the trustees – undoubtedly owing fiduciary duties – are little more than custodians and the real power holders are lay people who do not (or at least, may not) have to use their considerable powers under the constraint of having an obligation of loyalty to the beneficiaries.

There is also the potential for a disconnect between the place where any loss may be felt should a poor decision be taken and where any right to pursue a loss may lie. Take, for example, the position of a friend of the settlor who is appointed investment adviser with power to direct investments which the trustee is obliged to carry out. He gives a direction which is based on advice he has received but which he does not communicate to the trustees, having no need to do so. The investment is one that should never have been recommended and fails spectacularly.

Usually the investment adviser, the settlor and the beneficiaries will then all urge the trustee to 'do something' about the loss.

But what is the trustee to do?
The real villain of the piece is the (presumably) professional investment adviser who gave the advice. However, the trustee has neither a contractual nor tortious claim against him – the trustee may not even know of his existence. He has definitely not seen his advice, nor relied on it. All the trustee has done is to comply, as required by the trust deed, with a direction of the investment adviser.

Is there a claim by the trust against the investment adviser? There might be if the investment adviser is exercising a fiduciary power but if it is specified as personal or is considered personal by default what is the claim? Besides, the investment adviser may have taken sensible precautions in engaging a reputed investment adviser who none the less gave poor advice.

Can the investment adviser sue the adviser? He has the contractual relationship and if there was negligence, it is a failure of duty to him. But can he establish that he has suffered a loss in consequence? It appears not.

There may be sophisticated solutions to this conundrum but the position is far from straightforward.

Then take the situation where the power holder is also a beneficiary. The way in which he acts will be influenced by his personal interest which may not be in the interests of the trust.

If, on the other hand, the power holder is undoubtedly exercising fiduciary powers, a direction he gives will not be a valid direction if given in breach of fiduciary duty, ie of his duty of loyalty to the beneficiaries. But how does the trustee know whether the direction is valid or not? And if the trustee has a suspicion should it take the risk of making an application to the court to ask for a direction as to whether it should or should not comply, possibly losing and/or facing a claim for losses alleged to have been sustained by not complying with the direction?

These are just some of the complications which can arise with such power-sharing arrangements. They need to be thought through very carefully at the drafting stage and when making the choice as to who should fulfil the various roles. The settlor may be content that close friends or advisers are running the trust but it may not work out well for the beneficiaries. Power without responsibility – or considerable power with limited responsibility – is not a great combination. Indeed, for the first time at a major offshore trust conference last year I noted with

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interest that a number of speakers were saying that they thought reserved powers trusts could be problematic.

Vulnerability of the power holder

Another issue needs to be given serious consideration when choosing power holders – do they risk making the trust vulnerable?

This is a matter of grave importance for settlors from jurisdictions where political or personal pressure can be brought to bear on power holders. So if, for example, a protector with the power to hire and fire the trustee and/or change the governing law of the trust comes under such pressure, the trustee could be changed to a trustee in the affected jurisdiction and moreover one who is sympathetic to the aims of the person or entity exercising the pressure. In any event, moving the trustee into the jurisdiction will render them susceptible to a judgment against the assets which they may be ordered to bring into the jurisdiction. Such orders may be backed up by imprisonment if not complied with. Changing the governing law may result in the loss of firewall or creditor protection legislation in the offshore jurisdiction. The former is particularly important if the structure is coming under pressure as the result of a divorce.

Where the power holder is situated may also result in reporting obligations by reason of his/its location, irrespective of whether the structure would otherwise need to be reported under FATCA or CRS. The location of the power holder may also be of critical importance for tax reasons – if the power holder is considered the real source of power over the trust and its underlying assets and/or decisions are taken in that jurisdiction, the trust may be regarded as resident in or otherwise appropriate to be charged to tax in the jurisdiction where the power holder is located.

A power holder who fears that he will be subjected to such pressure should immediately resign to avoid risk to the trust and its beneficiaries. If he fails to do so another power holder – perhaps the settlor or the appointor – may have and can exercise power to remove him. But it is not always possible to gauge precisely when such power needs to be exercised and it may be too late before steps can be taken.

It is possible to draft decapitation or trigger clauses into the trust deed so that the power holder's powers are removed if certain events occur to prevent the power holder succumbing to pressure. Indeed, such mechanisms can assist in discouraging such pressure from being exerted if known to the pressurising party. Whether they will work if tested depends on their drafting and the attitude of the court in question. In the Anderson case (*FTC v Affordable Media, LLC* 179 F.3d 1228) the trusteeship of the Andersons over their Cook Islands trust was designed to fall away in the event of an 'event of duress' such that they were unable to repatriate the trust assets as ordered to meet a fraud claim. The first instance court and the United States Court of Appeal of the Ninth Circuit simply ordered their committal to prison until they should find a way of repatriating the assets.

It is generally better to avoid such a situation if possible by sharing power with those who are not politically or by reason of location likely to be exposed to such pressure or influence.

Vulnerability of the settlor if he retains powers

While it is unquestionably preferable for the settlor to retain powers he intends in any event to use rather than risk allegations of sham, a settlor wishing to retain considerable power should be aware that this may render him and the trust vulnerable for several reasons.

First, the powers he retains may be so extensive that the court concludes that the trust is illusory, or rather that on its true construction he has retained control of the trust and its underlying assets. In *Mezhprom Bank v Pugachev* the settlor, as original protector, retained a considerable number of dispositive and management powers – he was also a member of the class of discretionary beneficiaries. He could in effect use his powers to bring about the appointment of the whole of the trust fund to himself. The claimant alleged that the trust was illusory but Justice Birss preferred to describe his task as determining the true effect of its terms. Unusually, given the powers included removal and appointment of trustees, Birss decided that these were personal powers, the true effect of the trust deed being that the settlor retained control. He concluded that if he was wrong to characterise the powers as personal rather than fiduciary the trust deed was a sham, because Mr Pugachev had no intention to relinquish control.

It is our experience that when pressure starts to be exerted – such as in the Arab Spring – settlors who have retained a power of revocation are anxious to rid themselves of the power.

Such a finding may in future pose a particular risk for the settlor who is also a beneficiary in whose favour he can, as power holder, direct distributions.

Secondly, that level of control can be turned against the settlor. The Andersons learned this to their cost as long ago as 1999. At the time it may have appeared to be a particularly bad case where the result was richly deserved and/or that this was unlikely to happen outside the United States. But it is clear that, even leaving aside for a moment the obvious risks in some jurisdictions of a settlor with power over assets being forced against his will to sign them over, courts in other jurisdictions are increasingly resorting to steps designed to exert maximum pressure on settlors in appropriate cases.

In this respect the case of *TMSF v Merrill Lynch Bank & Trust Co (Cayman) Ltd* [2011] UKPC 17 is highly significant. A guarantor of a substantial liability to a bank revocably settled most of his assets on a Cayman Islands trust for the benefit of his family at a time when he knew that he would be called upon to meet the guarantee. His transfer of assets into the trust could have been attacked on the basis that it was a disposition intended to defeat the claims of creditors but the creditor chose instead to seek the appointment of a receiver over his power of revocation. It was a novel concept that a power of revocation could be treated as property and so a receiver appointed over it but the Privy Council so held. The receiver was therefore able to exercise the power resulting in the trust assets flowing back into the debtor's free estate where they could be taken to meet the claims of his various creditors.

It is our experience that when pressure starts to be exerted – such as in the Arab Spring – settlors who have retained a power of revocation are anxious to rid themselves of the power. But if they do so voluntarily they are at risk of that step being regarded as a step intended to defeat the claims of creditors, whether that be the state or another. Assuming that they are not in a situation where they could be regarded as assisting the settlor to defeat the claims of legitimate creditors, the trustees could take the lead by restructuring to preserve the assets for the benefit of the beneficiaries and reduce the risk of pressure being exerted on the settlor.

Alternatively, making the settlement irrevocable but capable of being amended within certain parameters or making the power of revocation subject to consent of another, may reduce the risks associated with an untrammelled power of revocation at the outset.

In the context of divorce and the very wide powers of the family court in England and in other jurisdictions with similar divorce legislation (such as Hong Kong and Bermuda), the retention of significant powers – or even an indication in a letter of wishes of an expectation that the settlor expects to exercise powers – can result in a trust being treated as a resource available to a party to the marriage. This occurred in the case of *Charman v Charman* [2005] EWCA Civ 1606, where the husband's letter of wishes asking the trustees to treat him as principal beneficiary and to respect his wishes with regard to investment led to the court finding that the whole of the trust assets were a resource of his so that they should be treated as equivalent to assets in his bank account.

Settlors can also be called upon to disclose information relating to a trust they have created if the court considers that they continue to exercise significant control notwithstanding that they have given the assets to the trustees. Settlors in *North Shore Ventures Ltd v Anstead Holdings Inc* [2012] EWCA Civ 11 were ordered to disclose information about trusts they had settled to their creditors (with the potential of such orders to be backed up by committal proceedings in the event of default), and in *Revenue and Customs Commissioners v Parissis* [2011] UKFTT 218 (TC) settlors were ordered on pain of ongoing fines to produce information relating to Guernsey trusts they had created for their families.

Some final thoughts on settlor control

Settlors, particularly those who may be vulnerable to pressure, should consider carefully whether they should retain significant powers which could be turned against them or their beneficiaries. It really is a case of the level of vulnerability being directly related to the level of power they retain.

In an ideal world they would be able to trust their professional trustees, provide a meaningful letter of

wishes and act by influence rather than control. Rather than seek to assert control over every decision, they can ensure that the nuclear weapon of removal is held by a responsible protector. Should they be concerned that the protector and trustee will both fall short, an appointor at the top of the tree can be given the power to remove the protector in appropriate circumstances.

In the real world, settlors – particularly those from regions where trusts are not part of the national psyche or where distrust of institutions is the natural result of unfortunate experiences – may find it difficult to part with assets on trust even with such levels of protection. In such circumstances the role of the adviser and draftsman is to advise on a trust where the settlor retains only those powers most important to him and ideally shares them with others (eg, a committee or board of a company), and where other power holders operate with sufficient independence that there is a genuine balance of power. In cases of severe concern for personal or political pressure, trigger mechanisms will be needed to try to avoid the risk of the powers being available to be exercised under threat of imprisonment or physical harm.

Working with clients from such regions requires an understanding of the risks and of difficult situations to help the settlor make fine judgement calls between the competing aspirations of retaining significant powers and/or influence and standing back from being key power holders if the trust and the financial security of their beneficiaries is capable of being damaged through them.

Dawn Goodman has a wealth of experience of litigation in most offshore jurisdictions, as well as in Europe, the Middle East and Asia. She advises parties who may be involved in disputes arising out of lifetime estate planning or on death, including trusts, foundations, professional negligence, fraud or succession. Previously a divorce lawyer, Dawn also specialises in advising trustees and beneficiaries caught up in divorce proceedings.

'The 'Trusts and settlors – can a settlor have too much power?' at a time of crisis' by Dawn Goodman is taken from the ninth issue of the new *The International Family Offices Journal*, published by Globe Law and Business, http://ifoj16.globelawandbusiness.com.

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