

STEP BAHAMAS

17 JULY 2003

RECENT TRUST CASES
RESERVED POWERS TRUSTS

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1. . **RECENT OFFSHORE CASES**

1.1 **IRC V Rysaffe Trustee Co (CI) Limited (CA, 20.03.2003)**

The Court of Appeal confirmed that five identical discretionary settlements that had been created over the space of several weeks were not to be regarded as a single settlement, either as the product of associated operations or otherwise.

The Court held that inheritance tax should be calculated on the basis that each brother made five separate settlements with Rysaffe Trustees in the Channel Islands. Each of the five trust deeds was to be taken to be a settlement because it satisfied the definition in section 43(2)(b) IHTA 1984 and was a separate trust under the general law of trusts. The property in each settlement was to be treated as the number of shares in that settlement and not the total number of shares in all five. The associated operation rules in section 268 did not permit the Revenue to aggregate a number of settlements which would individually satisfy the definition of a settlement. Thus the basis of calculation of the ten year charge was that each settlement was constituted independently of the others.

It is perhaps too early to judge, but this might have a bearing on the plan to sell property to a trust in exchange for a loan note (the lifetime loan scheme) and then settle the loan note into a separate trust. There is an associated operation concern here, perhaps alleviated by Rysaffe.

1.2 **Re: the Double Happiness Trust (Royal Court of Jersey, 10 December 2002)**

A poorly drafted trust deed was treated as void.

A trust deed drafted by a firm of accountants was extremely difficult and ambiguous to interpret, and although the Court "struggled manfully" to make sense of the trust, it could not do so and on that basis it was treated as void for uncertainty. The subject matter was clear, but both the beneficial interests and the class of beneficiaries was confused. The Court felt that extrinsic evidence could be admitted but it gave no assistance. Despite the fact that the Court was reluctant to allow the trust to fail it was nevertheless treated as void.

Although this is an extreme case, it clearly does demonstrate that drafting must be carried out with great care. There is always a danger of using untailored precedents.

1.3 **Re: MJB/SJB Amethyste Trust (Royal Court of Jersey, 10 October 2002)**

This case involved rectification of a trust deed.

In error, the intended beneficiaries were excluded from benefiting. The Court maintained that it had to be "satisfied to the civil standard that a mistake had been made so that the settlement does not carry out the true intention of the parties (and the settlor in particular)". Here, the Court felt that the settlement deed contained an error so that the settlement did not reflect the intentions of the settlor, there had been full and frank disclosure of this error and there was no other practical remedy available. Despite the fact that three years since the trust was created, as the case came to Court shortly after the mistake was noticed, the Court was prepared to order rectification.

This demonstrates how useful rectification can be as a remedy, provided action is taken on a timely basis. However, it should not be relied upon.

1.4 **Abacus Trust Co (Isle of Man) Ltd and Colyb Ltd v Barr (ChD, 6 February 2003, Taxation)**

In *Abacus Trust Co (Isle of Man) Ltd v NSPCC [2001] STC1344*, the Court held that the rule in *Hastings-Bass* should apply to a tax avoidance scheme which had been improperly executed by Trustees. As the Trustees had acted without due consideration of all relevant matters, the appointment under the Trust was set aside. In a further case involving Abacus, an appointment was made under a misapprehension.

Shortly after the settlement was created, the settlor expressed a wish that 40 per cent. of the trust fund should be appointed on discretionary trusts leaving the remaining 60 per cent. under the existing life interest trust. However these figures were transposed. When the mistake was discovered it was decided to leave matters as they were as the tax consequences of reversing the appointment would have been adverse.

The Court considered that the Trustee's mistake was sufficiently fundamental to bring the *Hastings-Bass* rule into play. The problem was in the transmission of the settlor's wishes from an officer of the trust company to those who were directly involved in this particular trust. It was held that the appointment was voidable rather than void ab initio, on the basis that substantial distributions had already been made on the erroneous appointment. The parties were left to reach agreement on whether or not the appointment should be voided, and, if so, on what terms.

Ideally we should have a proper Court of Appeal decision on the *Hastings-Bass* principle and it is possible that pension trusts and private trusts may be treated differently in the future under this principle.

1.5 **Re: Stephen Jay Lawrence (Debtor) (US Court of Appeals for the 11th circuit, 23.01.2002)**

Although this case involved a so-called asset protection trust, it is a salutary reminder about the dangers of reserving powers to the settlor. I will deal with reserved powers later more specifically.

Mr Lawrence created an offshore trust under which he retained sole power to appoint trustees. The trust could also be amended in certain respects, in that spendthrift and duress clauses were added, followed by an exclusion of Mr Lawrence as a beneficiary, which was declared to be irrevocable much later. The Court found that in his bankruptcy proceedings, the fact that he retained the power to appoint and remove trustees and to add and exclude beneficiaries meant that Mr Lawrence exercised control over the trust. The Court also held that the trust was governed by the Law of Florida and not Mauritius, although the latter was specified as the proper law in the trust deed.

The Court found that the purported exclusion was just a smoke screen which the trustees could revoke, and Mr Lawrence, as settlor and prospective beneficiary, retained control over the trust through his power to appoint trustees who would then be able to reinstate him as a beneficiary and appoint the entire trust fund to him. The duress and spendthrift provisions were declared void. Mr Lawrence ended up in jail.

The result would have been interesting had Mr Lawrence not retained such powers, but the concern about reserving powers extends beyond creditors, to divorce and

tax concerns. The other point that is interesting is that the power to appoint trustees, reserved to the settlor, gave him the “big stick” to control the trustees. This has always been a concern of mine, although I do not think that English law goes that far yet, provided the powers reserved are not too extensive. I will return to this later.

1.6 **Sinel Trust Ltd v Rothfield Investments Ltd (CA, 13 December 2002)**

Shares in a Jersey company, Rothfield Investments Ltd, were held for JCB absolutely; he gave instructions that the Jersey trustee should hold them for himself and a Mrs Ellis as joint tenants. In 2001 he died, so under Jersey Lex Situs (of the shares in the trust), Mrs Ellis became absolutely entitled to the shares. By JCB's will he chose English law (not his Swiss law of domicile) as the Lex Successionis, leaving 50 per cent. of the JCB Group to Mrs Ellis for life and the remainder to two trusts equally for his two sons and their families, residue to Mrs Ellis. The Swiss executor and JCB's wife and sons did not want the shares in Rothfield to be transferred to Mrs Ellis and so the Jersey trustee sought the Court's directions under article 47 to protect itself if the shares should be transferred to Mrs Ellis.

The Royal Court of Jersey held that there was no realistic possibility of the executor or the JCB family establishing any proprietary claim to the Rothfield shares which should therefore be transferred to Mrs Ellis. Under Jersey law there was a valid lifetime transfer when the trust had been set up and so the shares were not part of the estate to be governed by the Lex Successionis. The Court said that forced heirship claims are personal and not proprietary.

The Court of Appeal allowed the appeal because it felt that the executor and the JCB family must be allowed to be heard on the issues raised. It said that the capacity to transfer property inter vivos should be governed by the Lex Situs, while the capacity to create a trust of property which the transferor is able to transfer should be governed by the proper law of the trust.

This is an excellent conflict of laws case which well deserves further study. It is particularly interesting in relation to the issue as to whether foreign succession rules and forced heirship provisions can be circumvented by having jointly owned property.

1.7 **Twinsectra Ltd v Yardley [2002] UK HL 12, [2002] to 1 AC 164 (HL)**

Mr Yardley employed Mr Leach as a solicitor to negotiate a loan of £1 million from Twinsectra Ltd. However Mr Leach dealt with a Mr Sims who represented to Twinsectra that he acted on behalf of Mr Yardley and he received the £1 million in return for an undertaking which was breached. The firm did not apply the money in the acquisition of property as undertaken. The money was paid by Mr Sims to Mr Leach who paid it out on Mr Yardley's instructions, and in breach of the undertaking. The loan was not repaid and Twinsectra sued all parties involved. The basis of the claim was that the payment by Mr Sims to Mr Leach was in breach of the undertaking and in breach of trust, and Mr Leach was liable for dishonestly assisting in a breach of trust.

The House of Lords held that the monies were subject to a trust in favour of Twinsectra. They also found that if Mr Leach honestly believed that the money was at Mr Yardley's disposal, then Mr Leach was not dishonest. They held that dishonesty for instigation or facilitation of a breach of trust or other fiduciary duty requires conduct that an ordinary reasonable person would consider dishonest, and that the defendant knew this. Mr Leach did not know that he was assisting in paying away money to which the recipient was not entitled.

This case is relevant for exemption for clauses where dishonesty is alleged. As a result, in the case of *Walker v Stones* [2001] QB 902, the defendant's solicitor may escape liability in the House of Lords as he was not dishonest in these terms even if no reasonable solicitor in his shoes should have held his belief that the breach of trust was in the best interests of the beneficiaries. This may be very relevant for the solicitor's insurance cover as well.

1.8 **Nearco Trust Company (Jersey) Limited v AM (2003 [WTLR]491)**

The trustees of two Jersey law discretionary trusts were joined to divorce proceedings in Illinois, USA, by the wife of the settlor of the two trusts. The wife contended that the trusts were shams.

If it had been the case that the trusts were shams, the settlor would own the assets, would be in control of the assets, and receive the income from the two trusts. The trustee unsuccessfully challenged the jurisdiction of the Illinois court, and the settlor's wife obtained an order for the trustee to produce written documents. The trustee refused to comply with this and sought directions from the Jersey court as to what part it should play in the Illinois proceedings.

The Jersey court held that the trustee should take no further part in the Illinois proceedings and should not comply with the order for the production of documents. The reason for this was that the Jersey court felt that it would be more appropriate for the validity of the two trusts be adjudicated upon in Jersey rather than Illinois. The interests of all the beneficiaries in relation to the trustee participating in the Illinois proceedings were considered, although the reasons for the court's decision as to their interests remained confidential due to the nature of those proceedings.

The court decided to withhold disclosure of the trust accounting documents since it was satisfied that to do so was in the best interests of the beneficiaries as a whole, although the settlor's wife was a beneficiary of one of the trusts and the daughter a beneficiary of both trusts. The court was concerned that the settlor's wife would use any disclosed documents in her action to invalidate the trusts.

The court said that if the settlor's wife withdrew her allegation that the trusts were invalid the court would view sympathetically any application by her or her daughter for disclosure of such information as would enable the Illinois court to make an informed decision as to an appropriate rate of child maintenance.

1.9 **B and Others v Auckland District Law Society – (Times 21 May 2003 – Privy Council)**

This was a case on legal professional privilege.

Legal professional privilege was of public interest, fundamental to the administration of justice, which could not be overridden by any competing public interest except as provided expressly or by necessary implication in a statute.

A statute which, in the public interest of maintaining the integrity of the legal profession, required a solicitor against whom a complaint was being investigated to produce for inspection any documents in his possession or control relating to the subject matter of the enquiry, could not be construed as overriding, by necessary implication, a claim to legal professional privilege.

Where such documents were made available for a limited purpose in such an investigation, but subject to an agreement that any privilege would not be waived, then they could not be retained or used in breach of that agreement even on the basis of some contrary public interest.

The judge held that the statute did not override the privilege, but declined to order the return of certain documents which had already been supplied to the Law Society on the grounds that the Society was entitled to use them for the limited purpose agreed.

1.10 **Grupo Torras SA v Sheikh Fahad Mohammed Al-Sabbah (Jersey 2003)**

This was an interesting case on sham in relation to the assets of the Esteem Settlement.

Grupo Torras claimed that the settlement was a sham, that the settlor had not given away the assets, and that they should be available to Grupo Torras as a creditor of Sheikh Fahad. They also argued that the settlement should be declared invalid as being a breach of public policy and that the assets of the settlement should be made the subject of a remedial constructive trust in favour of Grupo Torras.

The Jersey court found that as the settlor and the trustee did not have the necessary intention that the real purpose of the arrangement was different from that which appeared on the documentation, the trust was not held to be a sham. This was found to be the case both at the inception of the settlement and later.

The court also found that the settlor had not retained the power freely to dispose the assets given to the trust and therefore there was no reserved right by the settlor. Sheikh Fahad was not at any stage in control of the Esteem Settlement or the assets comprised in it.

The settlement was not invalid as being contrary to public policy, and would not have been so even if Sheikh Fahad had had control over the assets.

The court also found that it was doubtful whether a remedial constructive trust was a remedy available in Jersey law. However even if it was, this would not be the case where the imposition of a remedial constructive trust could be justified, even if Sheikh Fahad had control over and misused the assets of the settlement.

It would therefore not be right for the court to treat the settlement as a sham or void.

2. **AN INTRODUCTION TO "RESERVED POWERS" TRUSTS**

2.1 **What are "reserved powers" trusts?**

The term "reserved powers trust" refers to a trust under which the settlor has reserved to himself, or granted to a third party (such as a protector), certain powers. The reservation of powers is not revolutionary: it is firmly established under English common law principles that, for example, powers of appointment and powers of revocation may be reserved. Certain of the offshore jurisdictions have in addition enacted legislation which specifically confirms that the reservation or grant of certain powers shall not of itself cause a trust to be invalid. This therefore lessens the risk that an extensive reservation of powers might otherwise cause the trust to be a formal sham (therefore invalid).

(1) The Bahamas

See section 3 of the Trustee Act 1998.

(2) The Cayman Islands

The Trusts (Amendment) (Immediate Effect and Reserved Powers) Law 1998 (now section 14 of the Trusts Law (2001 Revision)) provides.

(3) The Cook Islands

See section 13C of the International Trusts Act 1984.

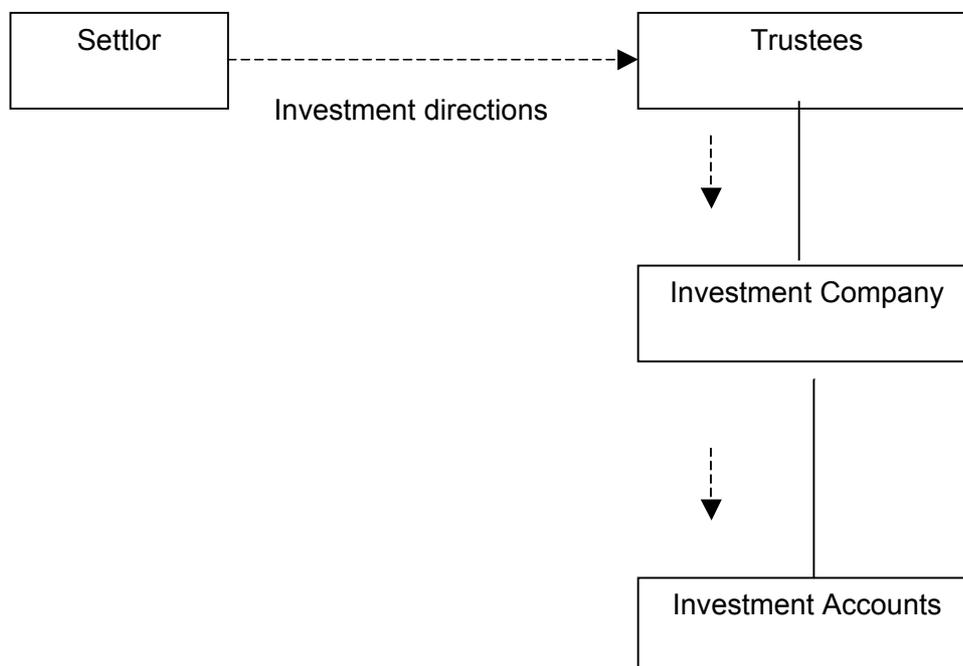
A careful reservation of powers in appropriate cases may assist in reducing the risk of a formal sham. The reserved powers approach may in some cases also lessen the risk of a substantive sham, on the basis that the trust deed more closely reflects the reality of the arrangement.

2.2 When may it be appropriate for powers to be reserved?

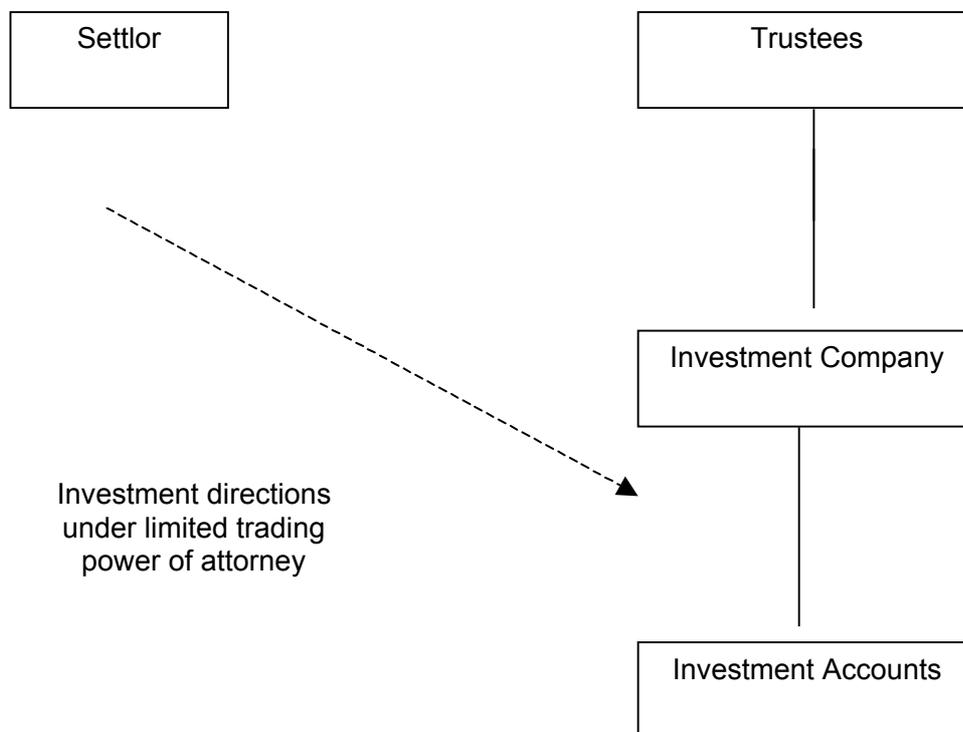
If it is intended that the settlor is to have some active role in the management of the trust or its investments, it may be advisable for that role to be formalised, rather than having the trustees permit the settlor to exercise indirect influence or control under a standard-form discretionary trust (which could give rise to a sham argument).

2.3 The reservation of investment powers

Offshore, there is increasing interest in the reservation of powers for the direction of investments. Broadly, there are two possible approaches for a settlor (or third party) to direct investments:

(1) Power to *direct* investments

Under this approach, there is included in the trust deed an express power for the settlor to give investment directions to the trustees (usually only for as long as he is not under any incapacity). During this period, the trustees' own investment powers are effectively "suspended". This is similar to the position under unit trusts governed by English law, which are commonly established by deed between a trustee (administrative custodian) and an investment manager.

(2) Power to *effect* investments

Under this approach, the trust deed includes a provision enabling the settlor to direct the trustees to issue to him a limited trading power of attorney, enabling him to effect investments. As with the first approach, the trustees' own powers of investment are "suspended".

Some advantages of this approach:

- The settlor may deal directly with the broker in effecting investment transactions, and without being deemed an agent of the trustees.
- The substantive sham risk is likely to be reduced because the trust deed more closely reflects how the trust is to be administered in practice.

Some issues which require consideration, whether the investment direction mechanism is structured as a power to direct investments or a power to effect investments:

- Can the trustees be relieved of their own investment duties? Armitage v Nurse¹, per Millett LJ:

¹ [1998] Ch 241

"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."

- The English case of Galmerrow Securities Ltd v National Westminster Bank plc² provides some further support for the "directed investments" approach. The case concerned a unit trust established to finance speculative property deals. The trust agreement included terms that:
 - (1) "the acquisition, management and realisation of the property shall ... be the sole responsibility of the Managers";
 - (2) "the ... property shall be dealt with by the Trustee on the direction of the Managers"; and
 - (3) the managers "shall have as full powers of dealing with ... the ... property as if they were the beneficial owners" (clause 15 of the agreement).

The property market unfortunately took a downturn, and the investors brought an action against NatWest as trustees, claiming breach of trust. It was held that, given clause 15 of the agreement, NatWest had no duty to the subscribers, once the trust was constituted, to make enquiries or take advice so as to satisfy itself that the property to be acquired for this trust for a purpose described as speculative was likely to produce an adequate return. In other words, "where property is paid to a person to be trustee upon the terms that the property will be held pursuant to an instrument known to the payer to be the intended trust deed, then the fiduciary duties of the intended trustee are limited by the terms of the intended deed"³.

- Note the importance of careful drafting of the relevant provisions, if the trustees are actually to be relieved of their investment duties.
- Can the settlor give any type of investment direction to the trustees, or are there limits? Consideration needs to be given to:
 - (1) The "self-dealing" issue: the settlor should not be in a position where he can exercise the investment powers so as to confer a benefit on himself out of the trust fund (e.g. by directing that assets are sold to himself at an undervalue).
 - (2) Should the power of the settlor to give investment directions be reserved in a *non-fiduciary* capacity? (Lord Vestey's Executors v IRC⁴ provides authority that a power of investment can be reserved free of fiduciary duties.)

² [2002] WTLR 125

³ Harman J at p.148

⁴ [1949] 1 All ER 1108

- (3) Does the drafting, in the particular case, make it clear that the power to direct investments need not be exercised in the best interests of the beneficiaries?
- (4) Are the trustees under any duty to examine each direction, to see whether the settlor is exercising the power in his own interests rather than in the interests of the beneficiaries?
- (5) Do the trustees have a right or duty not to follow some directions? Where the trust is governed by Cayman Islands law, section 15 of the Trusts Law assists the trustees on this point:

“A trustee who has acted in compliance with, or as a result of an otherwise valid exercise of, any of the powers referred to in section 14(1) shall not be acting in breach of trust”

But arguably the trustees must check that the direction is ostensibly valid (i.e. within the scope of the power) and that there is no indication that the settlor is acting irrationally (for example, by reason of drug addiction or mental illness).

2.4 Some general considerations regarding the reservation of powers

- Tax considerations are highly relevant. In some cases, it may be inappropriate for certain powers to be reserved (although consideration could perhaps be given, in appropriate cases, to vesting the powers in a committee, possibly with the settlor as a minority member). In particular, where the settlor has UK connections, the tax considerations may require that various powers are not reserved, and the "directed investments" approach may be inappropriate because there may be a risk that the underlying investment company could be regarded, for UK tax purposes, as having its management and control in the UK, possibly with the settlor being regarded as a shadow director.
- The possible risk of co-trusteeship, and tax treatment, also requires consideration: could the settlor be deemed a co-trustee for the purposes of liability or tax (which could in turn affect the tax residence of the trust)?
- Are the powers reserved so substantial, when viewed together, that there may not be a trust at all? In other words, is no real benefit conferred on the beneficiaries, or does the arrangement show a lack of the requisite intention on the part of the settlor to create a trust?
- The risk of a substantive sham cannot be eliminated solely by careful drafting of the trust deed. It is essential that the assets are properly transferred under the control of the trustees, and that the trust is properly administered. As regards investment powers, the inclusion of a provision to prevent self-dealing by the settlor may assist in this regard, by indicating that the assets have ceased to be within the settlor's personal ownership.
- The Galmerrow case highlights the importance of independent legal advice for settlors proposing to establish reserved powers trusts.

- Where the assets are “non-standard”, thought should be given at the outset to the issue of management succession. How will the management powers be passed on to persons with appropriate experience in managing the particular type of assets? What will happen on the settlor’s death or incapacity?
- A trust document with extensive reserved powers might closely resemble a will, if it intended to be dependent on his death for its “vigour and effect”.⁵ Care must be taken to ensure that the settlor does intend the trust to take effect immediately.

2.5 Conclusion

- Trust companies offshore are increasingly recognising the potential advantages of structuring trusts, in appropriate cases, as reserved powers trusts rather than as fully-discretionary trusts. This approach can be of practical assistance in cases where the settlor wishes to direct investments, or where it is proposed that “non-standard” assets are to be settled.
- Reflecting the reality of the intended arrangement in this way, rather than having a settlor exercise indirect control or influence over the trust administration, is likely to assist in lessening the risk of the trust being regarded as a sham.

These notes are intended only as an introduction to these topics, and do not purport to be comprehensive or to render legal advice.

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⁵ See Baird v Baird [1990] 2 AC 548