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Settlor reserved powers trusts

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1. Introduction

One of the most important considerations, or rather hesitations, of a prospective settlor when setting up a trust is that they are propelled to relinquish legal ownership and control over hard-earned assets to trustees that they may never have met in a jurisdiction that they may never have visited. Having accumulated wealth over what are often generations of labour and sacrifice, it is unsurprising that settlors are loath to part with it and will often seek ways to retain some control over the settled assets. On the one hand, settlors want to set up a trust and segregate themselves from their estate for tax, asset protection, seamless succession and other reasons; while on the other hand, they are reluctant to hand over control of what they consider to be their property to trustees who have little, if any, business know-how of the industry in which the settlors have built their empire. They want to have their cake and eat it too.

Modern trust jurisdictions make this easy for them:

- they will permit the settlor to write a letter of wishes to the trustees outlining how they would like to see their assets utilised (which, although non-binding, is a soft point of reference for trustees);
- it will be proposed to them to appoint a protector who may have far-wielding powers over how the trustees use (or do not use) their powers;
- they will be appeased with legislative security via firewall provisions that, despite their property and business and heirs being located in a multitude of jurisdictions, only their chosen law and forum will apply;
- they may be offered a place on the board of a trust underlying the company; and
- most recently, they will be permitted by legislation to specifically reserve powers under the trust deed, so that they can continue to 'run the show' unfettered by interfering trustees.

It is, however, important from the outset to take into account that reasonable parameters should be set for the utilisation by settlors of such facilitative mechanisms, including settlor reserved powers, to ensure that the

fundamental concept of a trust, under which the trustees owe fiduciary duties and are accountable to the beneficiaries, is not compromised by these mechanisms.

2. Cyprus International Trusts Law

Section 4A of the Cyprus International Trusts Law permits a settlor to reserve powers, to retain a beneficial interest in the trust property and to act as protector or enforcer of the trust. The list of powers that may be reserved is extensive and includes the powers to:

- revoke, vary or amend the terms of a trust;
- advance income or capital of the trust property or to give directions for the making of such advancement;
- give binding directions as to the appointment or removal of a director of any company wholly or partly owned by the trust;
- appoint or remove any trustee, enforcer, protector or beneficiary; and
- restrict the exercise of any powers or discretions of a trustee by requiring that they will be exercisable only with the consent of the settlor.

There is also an explicit provision that where a power listed above has been reserved by or granted to the settlor, a trustee who acts in accordance with the exercise of the power is not acting in breach of trust. Further, the reservation of any powers will not be construed as an 'intent to defraud' the settlor's creditors, and that intent must therefore be independently proven.

3. Settlor reserved powers in other legislation

Cyprus, of course, is not alone in enacting legislation in the form of settlor reserved powers. The British Virgin Islands enshrine these powers in Section 86 of the British Virgin Islands Trustee Act. Section 15 of the Trusts (Guernsey) Law 2007 and Section 47 of the Nevis International Exempt Trust Ordinance make similar provisions. Jersey relies on Section 9A of the Trusts (Jersey) Law 1984, as amended in 2006. The Cayman Islands have Part III of the Trusts Law (2001 Revision), which was introduced as early as 1998 by the Trusts (Amendment) (Immediate Effect and Reserved Powers) Law 1998. Sections 3 and 81(2) of the Bahamas Trustee Act 1998 also provide for the reservation of such powers, as does Section 90(5) of the Singapore Trustees Act (Cap 337), as amended and Part IVD, and Section 41X of the Hong Kong Trustee Ordinance (Cap 29), as amended.

This jurisdictional parade of settlor reserved powers has been introduced specifically to lure hesitant settlors, particularly from civil law jurisdictions, who are accustomed to exerting full control over their assets and for whom the creation of a trust involves a considerable leap of faith, to take that leap. Each jurisdiction wants to remain competitive by making their legislation attractive

to prospective high-net-worth settlors who wish to remain involved (often at the helm) in managing the settled trust assets.

Article 2 of the Hague Trusts Convention[1] buttresses this position by declaring that "the reservation by the settlor of certain rights and powers is not necessarily inconsistent with the existence of a trust". However, despite the widespread legislation and the nod to the practice by the Hague Trusts Convention, there is little guidance on which 'certain rights and powers' it is acceptable for a settlor to reserve and at what point the reservation becomes tantamount to a settlor not relinquishing a proprietary interest to the trustees at all. Because despite each jurisdiction wanting to appear more settlor-friendly, shinier and brighter than the rest, the basic test for the valid creation of a trust remains a test of Millet LJ in the English Court of Appeal case of *Armitage v Nurse*,[2] where it was held that there is an irreducible core of obligations owed by the trustee to the beneficiaries and enforceable by them, which is fundamental to the concept of a trust. If the beneficiaries have no rights enforceable against the trustees, there is no trust.

This core content of obligations represents the minimum set of duties that must be present and exercised by the trustees if the very validity of the trust is to be preserved. If the reserved powers that the settlor purports to reserve, albeit permissible by legislation, overreach the irreducible core needed for a valid trust to be present, there is no trust.

4. The risk of sham

A trust will be held to be invalid if it is found that the arrangement between the trust parties is actually a 'sham', which is a trust resulting out of actions between a settlor and trustees, whereby they execute acts or documents in a manner that is "intended by them to give to third parties or to court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intended to create".[3] In order to determine whether a trust is a sham, a court must consider the subjective intentions of the parties involved. A court, for example, may hold that a trust is a sham when a settlor purports to create a trust for the benefit of stipulated beneficiaries, but at the same time reserves an inordinate amount of powers to themselves, which permit them to secure that the trust is administered by the trustees in accordance with their wishes and interests rather than in the interests of the stipulated beneficiaries and the trustee implicitly or explicitly shares the common intention with the settlor to relinquish core fiduciary duties. As far as settlor reserved powers are concerned, at a minimum, the nature and extent of such powers, if used, must be such so

1 The Convention of 1 July 1985 on the Law Applicable to Trusts and on their Recognition (HCCH 1985 Trusts Convention).
2 *Armitage v Nurse* ((1998) Ch 241 (CA)).
3 *Snook v London and West Riding Investments Ltd* ((1967) 2 QB 786).

as not to exclude the trustee's exercise of their duties in good faith in the best interests of all the beneficiaries. Where the settlor reserved powers are such that they preclude the exercise of this 'irreducible core' of trustee duties and the trustee concedes and shares this common intention with the settlor to create an illusory trust relationship, the trust will be held to be a sham trust.

In *Rahman v Chase Bank*[4] the Royal Court of Jersey considered a trust settlement under which a trust corporation was appointed as trustee to hold the trust fund and income on such trusts as the settlor should appoint during his lifetime, with the trustee's consent. The settlor, under the terms of the trust deed, could in any 12-month period distribute one-third of the capital of the trust fund to himself without the consent of the trustee. Moreover, the trust deed granted the trustees absolute discretion to pay, transfer or apply part or the whole of the trust capital fund to the settlor, having "regard exclusively to the interests of the settlor". The court held that the settlor retained such concentration of powers that he could, whether directly or indirectly, "revoke or otherwise terminate the settlement for his own absolute benefit". The court further examined the practice of the trust administration from evidence showing that the settlor effected gifts and loans to himself or made investments without the trustee's consent concluding that the trust was a sham because the settlor had exercised "dominion and control" over the trustee in the management and administration of the settlement.

In a similar vein, in *Minwalla v Minwalla*[5] the actions of the settlor, who withdrew and transferred trust funds as if they were his own, led the court to infer that the settlor's purpose was "only to set up a screen to shield his resources from other claims or unwelcome scrutiny and investigation".

A prerequisite for the creation of a trust is transfer of legal ownership to the trustee. If it can be shown from either the nature or the amount of powers reserved to the settlor that the transfer cannot be said to have occurred because the intention of the parties was for the settlor to remain as the effective legal owner, to do as they please with the assets and the trustee implicitly or explicitly agrees with this arrangement relinquishing core fiduciary duties, the trust will be held void *ab initio*. The problem lies in identifying the point at which the settlor has retained so much control that it can hardly be said that they have relinquished any proprietary interest to the trustees. It is not only the number but also the nature of the powers, cumulatively, that may imply a sham trust. So, a settlor power to remove and replace trustees may alone cause a court to hold that the trust is a sham, whereas a settlor reserving the power to add to the class of beneficiaries and change the governing law may, together, be held to be reasonable and permissible reservations.

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4 *Rahman v Chase Bank (CI) Trust Co Ltd* ((1991) JLR 103).
5 *Minwalla v Minwalla* ((2004) EWHC 2823 (Fam)).

The Bermudan case of *Re the AQ Revocable Trust*[6] demonstrates clearly that while a settlor can validly reserve certain powers, there comes a point where the extent of the powers can subsume the irreducible core needed for the existence of a valid trust. In this case, the settlor, who was also sole trustee, was given a power to remove and appoint trustees and to provide written approval for any transaction that would be "a complete release of the trustee (including the settlor) of any liability or responsibility of the trustee to any person in respect of this transaction". The court held that the concatenation of powers in the settlor, in conjunction with the fact that he was the sole trustee, rendered the trusts he purported to create illusory during his lifetime.

In 2017 the English High Court decision of *Mezhprom Bank v Pugachev*[7] considered the validity of five New Zealand trusts that the settlor retained extensive powers over (he was also a beneficiary and protector of the trusts with powers as wide as appointing and removing trustees and directing a sale of trust property). It was held that although the trustees were properly appointed the facts of the case pointed towards an undue concentration of power in the person of the settlor, who remained, in his various capacities, in effective control of the assets. The extensive powers that Mr Pugachev kept for himself meant he could act for his own interest rather than that of the beneficiaries, and the trusts were thus held to be shams.

Similarly, in a more recent case, *Webb v Webb*,[8] where the settlor had retained a number of powers, including the power to remove and appoint beneficiaries, the Privy Council held that the reservation of powers by the settlor of two discretionary trusts was so extensive that the trusts were invalid. The facts in this case were that shortly after his second marriage, a New Zealand individual, Mr Webb, set up a trust in the Cook Islands for the benefit of himself and his son from his first marriage and appointed himself as the sole trustee. Mr Webb had a daughter with his second wife and subsequently the marriage broke down. Mr Webb set up a new trust in New Zealand for the benefit of himself and his children, appointing himself and his then girlfriend as trustees. He then transferred the assets from the Cook Islands Trust to the New Zealand Trust for nominal consideration. Mr Webb's second wife commenced proceedings in the Cook Islands seeking a matrimonial property order on the basis that the trust assets should be taken into account in the divorce apportionment. Mr Webb's position was that the assets were held in trust and should not be included in the matrimonial division. The first-instance court agreed with Mr Webb. However, this decision was reversed by the Court of Appeal, which struck down the trusts because, among other things, Mr Webb retained powers under the trust deeds

6 *Re the AQ Revocable Trust* ((2010) 13 ITELR 260).
7 *JSC Mezhdunarodniy Promyshlenniy Bank v Pugache*v ((2017) EWHC 2426).
8 *Webb v Web*b ((2020) UKPC 22).

that allowed him to recover the property purportedly settled on trust at any time he wished. Mr Webb appealed to the Privy Council, which dismissed his appeal, holding that he "had the power at any time to secure the benefit of all of the trust property to himself and to do so regardless of the interests of the other beneficiaries". Interestingly, the Privy Council also held that the trusts were invalid *ab initio* because "the bundle of rights which he retained is indistinguishable from ownership".

5. Court-compelled actions of a power-enabled settlor

A court, particularly a court in a country that has personal jurisdiction over a settlor (eg, because the settlor may be resident or domiciled there or the situs of the trust property may be located there), may rely on settlor reserved powers entrenched in a trust deed to compel the settlor's use of them in favour of a claimant, defeating any purpose, particularly with respect to asset protection, for which the trust is created. This consideration is becoming particularly relevant, not only for creditors and disgruntled beneficiaries, but also for divorcing spouses, too.

A case where the use of reserved powers resulted in a loss of the asset protection that the trusts sought to achieve is that of *Clayton v Clayton*.[9] Mrs Clayton claimed that Mr Clayton's rights and powers under the trust deed amounted to relationship property under the New Zealand Property (Relationships) Act 1976. Under the trust deed Mr Clayton had broad powers including the power to exercise any power without considering the interests of the beneficiaries, to exercise discretion in his favour, to resettle the trust fund, and to exercise a power of appointment to remove beneficiaries. The Supreme Court held that a general power of appointment is usually viewed as equivalent to ownership and can be treated as property for a variety of purposes. Thus, the Supreme Court held that, while the relevant power under consideration was not a general power of appointment in and of itself that would allow Mr Clayton to effectively revoke the trust, the combination of Mr Clayton's powers and entitlements as principal family member, trustee, and discretionary beneficiary of the trust amounted to a general power of appointment in relation to the trusts' assets. These powers were considered property, and because the trust was established during the relationship and the powers were acquired at that time, the property became relationship property, to be shared by Mr and Mrs Clayton.

In the US case of *Re Stephen J Lawrence*,[10] the settlor, who had reserved powers, claimed it was impossible to comply with a court order to return assets from an offshore trust, and failed to comply. The settlor was held in contempt of court and was therefore jailed. On appeal, it was held that the bankruptcy

9 *Clayton v Clayton* ((2016) NZSC 29) and *Clayton v Clayton* ((2016) NZSC 30).
10 *Re Stephen J Lawrence* (279 F3d 1294) (11th Cir 2002).

court did not err in holding that the settlor failed to establish his defence of impossibility because, as a settlor and a prospective beneficiary, he retained *de facto* control over the offshore trust through his ability to appoint trustees who could reinstate the settlor as a beneficiary under the trust and assign the entire proceeds to him. The defence was invalid because the impossibility that the settlor claimed was created by the settlor himself.

6. Tax migration

Settlors who set up trusts in tax-friendly trust jurisdictions with an aim to accumulate assets tax free, but who retain extensive powers over such assets, risk being taxed in their jurisdiction of residence. With an increasing number of courts around the world finding *de facto* directors and taxing accordingly, similarly for trusts, it is feasible that a settlor who has reserved wide-ranging powers to themself may find their actions taxable in their jurisdiction of residence.

In *Ingle v McGowan*[11] the court found that the settlor's power of disposition, which allowed him to amend the trust instrument, gave him a control very close to that of complete owner. The court found that a settlor who can control the spending of the trust fund in every respect except spending it for themself is sufficiently the 'owner' of the trust fund to make its income attributable and taxable to them.

7. Trustee liability

Regardless of powers being reserved to settlors, it is imperative to keep in mind that the overriding common law fiduciary duty lies with the trustees to act in the best interests of the beneficiaries. So, while the legislation, as in Cyprus, may permit settlors to give binding directions to the trustees in connection with the trust property, trustees must ensure that they apply their mind independently to the usefulness of such directions and to the wider benefit of the beneficiaries. They must not just sit back and watch a calamity befall the trust assets by acting as mere nominees. That said, Clause 4A(3) of the Cyprus International Trusts Law explicitly exonerates trustees from breach in such circumstances by providing that, notwithstanding where powers have been preserved or granted to the settlor under either their capacity as such or their capacity as protector or enforcer, the trustee who acts in accordance with the exercise of such power is not considered to be acting in breach of the trust.

8. Conclusion

While settlor reserved powers have become popular and, if used cautiously, are a useful tool to provide some security to settlors who reluctantly part with their

11 *Ingle v McGowan, Collector of Internal Revenue* (189 F2d 785 (1951)).

property, it is important to adopt a conservative approach to avoid defeating the very purpose for which a trust is set up in the first place: to relinquish control and separate the trust assets from the settlor's assets. Great care must be taken to ensure that the use of settlor reserved powers does not jeopardise the asset-protection features of a Cyprus international trust. When viewed cumulatively, the reserved powers should not, in nature or number, overwhelmingly support a finding that there is in fact no trust. Settlors should be made aware of the risk of reserving too many powers from the outset or relying too heavily on jurisdictional firewall provisions to protect their use of powers. It is vital to look beyond the jurisdiction in which the trust is established (which may itself permit settlor reserved powers to the jurisdiction of domicile of the settlor, the settlor's spouse, the beneficiaries as well as the situs of the trust assets), which may have less accommodating legislation. Settlors must remember that there are minimum requirements to ensure that the use of control mechanisms, particularly in the form of settlor reserved powers, will not jeopardise the very existence of the trust they seek to establish and control. So, to answer the perennial question of 'to reserve or not reserve', the most apt reply would be: reserve conservatively and defer to the proverbial impossibility of both having your cake and eating it.

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