The potential vulnerability of reserved powers trusts

Chris Duncan* and Henry Brandts-Giesen†

Abstract

Trusts are commonly used for asset protection, however the popularity of revocable trusts and reserved powers trusts has led to a tendency to draft trust deeds with extensive powers reserved to the settlor or some other person to ensure that an element of control over the trust is retained. That approach is not without risk and the extent and scope of any reserved powers can have unintended consequences and can lead to a trust's asset protection characteristics being eroded. In this article we look at some of the key decisions where the use of reserved powers resulted in a loss of the asset protection their trusts sought to achieve, highlighting the risks to trust structures in utilising reserved powers, and offer some practical guidance on how those risks might be mitigated when forming a new structure or dealing with existing structures where extensive powers have been reserved.

Introduction

Trusts are commonly used for asset protection, however the popularity of revocable trusts and reserved powers trusts has led to a tendency for settlors to draft trust deeds with extensive powers reserved to the settlor or some other person to ensure that an element of control over the trust is retained. That approach is not however without risk and the extent and scope of any reserved powers can have unintended consequences and can lead to a trust's asset protection characteristics being eroded.

In this article, we look at some of the key decisions concerning reserved powers including the Privy Council (PC) decision in the Cayman Islands (Cayman) case known as *TMSF* and the New Zealand decision of *Clayton v Clayton*,[1] where the use of reserved powers resulted in a loss of the asset protection their trusts sought to achieve. We contrast these decisions with attacks as to the validity of trusts on other bases such as 'sham' and what has become known as 'illusory trust' or true effects of the trust as was the case in the English High Court decision in *Pugachev*[2] and the very recent PC decision in *Webb v Webb*[3] which took another direction in ruling trusts invalid. While there are some other interesting points which arise from these judgments, we focus here on the questions of validity, and powers as property.

Finally, we highlight the risks to trust structures in utilising reserved powers consequent to these decisions and provide some practical guidance on how those risks might be mitigated when forming a new structure or dealing with existing structures where extensive powers have been reserved.

* Chris Duncan, Counsel, Cayman Islands Trusts and Private Wealth team at Carey Olsen. E-mail: chris.duncan@careyolsen.com
† Henry Brandts-Giesen, Partner and Head of Private Wealth, Dentons Kensington Swan. E-mail: henry.giesen@dentons.com

1. [2016] NZSC 30.
2. [2017] EWHC 2426.
3. [2020] UKPC 22.

doi:10.1093/tandt/ttaa118
Advance Access Publication 19 February 2021

Key decisions

Tasarruf Mevduati Sigorta Fonu (Apellant) v Merrill Lynch Bank and Trust Company (Cayman) Limited and Others (Respondents)[4] (TMSF)

In the first important decision to look at, the appellant TMSF was established by the Turkish State to restructure and administer failed banks whose banking licences had been revoked, and had authority to bring proceedings in its own name for the recovery of any losses sustained by the banks. As part of its efforts, TMSF acquired the assets of two Turkish banks, Bank Ekspres and Egebank. Mr Demirel was the controller of companies which owned Egebank. TMSF claimed that he had misappropriated some US$490m from Egebank and US$336m from other banks. Arising out of those claims, the Turkish courts gave judgment against Mr Demirel *in personam* in the sum of US$30m in respect of a right of action by Bank Ekspres against Mr Demirel.

TMSF learned that Mr Demirel had established two Cayman discretionary trusts with assets of US$24m, of which he and his wife were beneficiaries. Mr Demirel had a power of revocation over the trusts and TMSF therefore sought the appointment of a receiver by way of equitable execution with a view to reaching the power of revocation and thereby accessing the funds in the trusts.

The PC ultimately held that the Court had the jurisdiction by way of equitable execution to appoint a receiver in respect of a power to revoke a revocable discretionary trust vested in the judgment debtor settlor.

The PC appeal centered on the jurisdiction of the Cayman Grand Court to appoint receivers by way of equitable execution and in particular whether the Cayman Court should apply the English Court of Appeal decision in *Masri v Consolidated Contractors International (UK) Ltd (No.2)*[5].

The question on appeal was whether there is a discretion to appoint receivers over the powers of revocation and to order Mr Demirel to assign or delegate the powers to the receivers (and, in default, to order that the assignment or delegation may be executed on his behalf by the receivers or other person appointed by the court). In assessing this question, the PC focused on whether there is a distinction between a 'power' and 'property' and whether the powers were delegable.

In reaching its conclusion, Lord Collins on behalf of the PC noted that '*The powers of revocation are such that in equity, in the circumstances of a case such as this, Mr Demirel can be regarded as having rights tantamount to ownership*', and '*. . .where there is a completely general power in the widest sense, that is tantamount to ownership*'.

The PC held that the appropriate order would be that Mr Demirel should delegate his powers of revocation to the receivers, so that they can exercise them and that there was no impediment to the court making such an order. It was not necessary for the judgment creditors to establish that Mr Demirel has a duty to delegate the powers.

In relation to the nature of Mr Demirel's power of revocation, Lord Collins added that:

> In the present case the power of revocation cannot be regarded in any sense as a fiduciary power. . .The only discretion which Mr Demirel has is whether to exercise the power in his own favour. He owes no fiduciary duties. As has been explained, the powers of revocation are tantamount to ownership.

The PC held that it was unnecessary to decide the question of whether the court has the jurisdiction (instead of ordering the delegation of the powers of revocation to the receivers) to order that Mr Demirel revoke the trusts, with the result that he would have substantial assets of which the receivers could take possession.

4. [2011] UKPC 17.
5. [2008] EWCA Civ 303, [2009] QB 450.

JSC Mezhdunarodnly Promyshlennly Bank v Pugachev

Mr Pugachev founded one of Russia's largest private banks, Mezhprom Bank. After his Bank collapsed in 2011 he fled Russia after criminal investigations were opened against him.

Mezhprom Bank went into liquidation and a Russian Court entered judgment against Mr Pugachev for US$1bn. A worldwide asset freezing injunction was obtained against him and he was required to disclose information about five New Zealand trusts, the assets of which were said to be worth about $95million. Mr Pugachev and his children were discretionary beneficiaries and he was the 'Protector' of the trusts. In an attempt to recover funds, the liquidators argued Mr Pugachev beneficially owned the assets held in the New Zealand trusts.

The trusts were structured so that Mr Pugachev as Protector had very wide powers. The Judge said that the powers he held as Protector were not held in a fiduciary capacity and he could exercise them selfishly. If, in the alternative the powers were to be regarded as fiduciary, it was held that the trusts were shams since Mr Pugachev always intended to retain control of the assets that were ostensibly 'owned' by the trustees and the trustees were party to a regime by which he could recover legal control of the assets whenever he wanted.

The Court held that Mr Pugachev's veto powers as Protector allowed him to prevent any discretionary beneficiary from receiving a distribution from the trust, other than himself, and that his power to appoint and remove trustees was intended to be exercised freely, in his own interests. The powers were unfettered and therefore personal.

The Court concluded that on their own terms the trusts did not divest Mr Pugachev of the beneficial ownership he had in the assets transferred into trust. Mr Pugachev's intention was to use them as a pretence to mislead third parties by hiding his control. The true effect of the deeds was held to be wrong and therefore they were held to be shams and should not be given effect to.

Clayton v Clayton

Mr and Mrs Clayton commenced a relationship in 1986, were married in 1989 and divorced in 2009. Shortly before the marriage, they entered into a contracting out agreement. However, as part of the proceedings that was set aside due to serious injustice. The Clayton assets were primarily held in a number of trusts which were settled during the course of the relationship and afterwards.

The principal claim in the proceedings was against the Vaughan Road Property Trust and the Claymark Trust, where Mrs Clayton claimed that the trusts were either shams or illusory, and therefore the assets could be taken into account in the division of relationship property. In the alternative, if the Vaughan Road Property Trust was valid, then Mrs Clayton claimed that the rights and powers held by Mr Clayton under the trust deed themselves amounted to relationship property. Mrs Clayton also argued that the Claymark Trust was set up during the marriage and that she had an expectation of benefit under the trust such that it was a nuptial settlement for the purposes of the Family Proceedings Act 1980 (however, in the interests of brevity, that is not discussed further here).

The Supreme Court (SC) decided Mr Clayton had intended to create a trust when he established the Vaughan Road Property Trust, and therefore it is not a sham. The SC also noted that despite submissions to the contrary '*there is no basis to extend the sham concept to encompass a trust created under a document that was not intended to be a pretence but that the Court considers is otherwise reprehensible in some way.*' Because the SC concluded that the powers held by Mr Clayton were relationship property, they did not need to determine whether the Vaughan Road Property Trust was illusory. The Vaughan Road Property Trust was therefore a valid trust.

Mr Clayton had extensive powers under the trust deed of the Vaughan Road Property Trust including to exercise any power without considering the interests of beneficiaries, to exercise discretion in his favour, to resettle the trust fund, and to exercise a power of appointment to remove beneficiaries.

The Court observed these provisions mean that '*Mr Clayton is not constrained by any fiduciary duty when exercising the Vaughan Road Property Trust powers in his own favour to the detriment of the Final Beneficiaries. The fact that he cannot remove the Final Beneficiaries does not alter the fact that he can, unrestrained by fiduciary obligations, exercise the Vaughan Road Property Trust powers to appoint the whole of the trust property to himself.*'

The SC, applying the reasoning of the PC in *TMSF*, noted that a general power of appointment is usually viewed as tantamount to ownership and can be treated as property for particular purposes. The SC decided that while the relevant power under consideration was not on its own a general power of appointment which would allow Mr Clayton to effectively revoke the trust, the combination of powers and entitlements of Mr Clayton as Principal Family Member, Trustee and Discretionary Beneficiary of the Vaughan Road Property Trust amounted in effect to a general power of appointment in relation to the assets of the trust.

These powers were therefore considered to be property, and as the trust was established during the relationship and the powers were acquired at that point, the property was relationship property, to be divided between Mr and Mrs Clayton.

Webb v Webb (Privy Council)

The appellant, Mr Webb and the respondent, Mrs Webb were New Zealand citizens and married in New Zealand on 2 December 2005. Mr Webb was an entrepreneur who conducted business activities through a complex structure of companies and trusts.

Shortly after they married, Mr Webb established the Arorangi Trust for the purpose of acquiring land and other assets in the Cook Islands. Mr Webb was the settlor and he appointed himself as trustee, and himself and his son as beneficiaries. In February 2006, the Arorangi Trust acquired a leasehold interest in a property in the Cook Islands and subsequently other interests in property.

In 2011, the New Zealand Inland Revenue Department (IRD) began an investigation into Mr Webb's business affairs which led to the issuance of default assessments, including shortfall penalties for the 2001–2009 tax years. As of 15 September 2017, the amount that remained unpaid was in excess of NZ$26m.

The parties separated in April 2016 and Mr Webb returned to New Zealand and began a relationship with Ms Brenda Dixon. Mr Webb arranged for the establishment of a new trust, the Webb Family Trust of which he and Ms Dixon were trustees. The settlor was a Mr Ellison. Mr Webb, with his son and daughter were named as beneficiaries. Mr Webb also transferred some of the assets from the Arorangi Trust into the new trust for a nominal consideration.

In May 2016 Mrs Webb issued proceedings in the High Court of the Cook Islands for matrimonial property orders claiming that the Arorangi Trust and the Webb Family Trust were invalid because they lacked core obligations necessary for a trust to exist and the settlor did not intend to relinquish control of the beneficial interest in the trust property.

The High Court found that the trusts were valid and Mrs Webb appealed to the Court of Appeal (COA).

The COA found that the trusts were invalid because the two deeds of trust failed to record an effective alienation of the beneficial interest in the assets in question and awarded the Arorangi property to vest in Mrs Webb. She was happy to forego any claim against other matrimonial assets.

Mr Webb appealed to the PC and argued the trust property was held validly in trusts and that the COA had erred and misinterpreted the trust deeds. He also argued that his liability to the IRD completely extinguished any property in his hands so there was no matrimonial property to divide (not discussed further).

The PC reviewed the terms of the trust deed of Arorangi Trust noting that:

- The power Mr Webb had to remove beneficiaries without notice including to nominate himself as sole beneficiary in place of existing beneficiaries enabled him to become settlor, trustee, consultant and sole beneficiary. He enjoyed this power as settlor and therefore not subject to fiduciary duty.

- Mr Webb as sole trustee, had uncontrolled discretion to advance capital and income for his personal use as a beneficiary to the exclusion of others. He also was not obliged to preserve the assets or income.
- Mr Webb as trustee had the power to resettle the assets of the trust upon the trustees of any trust as long as he was a beneficiary and with written consent of the Consultant (effectively an advisor to the trusts) being himself.

In delivering the opinion of the majority of the judges, Lord Kitchin held that the trusts should be set aside on the grounds that Mr Webb "*had rights in the trust assets which were indistinguishable from ownership*" and that he "*had the power at any time to secure the benefit of all the trust property to himself. . .regardless of the interests of the other beneficiaries.*" The COA was correct in finding that the trust deeds failed to record an effective alienation by Mr Webb of any of the trust property and that the bundle of rights which he retained is indistinguishable from ownership.

The PC did not add any further points on the argument that the trusts were shams and did not criticise the factual finding in the courts below save to say that an acceptance "*that Mr Webb intended to create trusts does not in any way preclude a finding that he reserved such broad powers to himself. . .that he failed to make an effective disposition of the relevant property*".

What do these decisions mean for trusts with reserved powers?

These decisions and particularly *Webb v Webb* are difficult to reconcile and create some uncertainty as to how trusts with reserved powers will be treated going forward. The law is now in a state of flux and issues arise as to:

- Whether the existence of wide ranging reserved powers will cause a trust to be invalid (as was the case in *Webb*); and
- Whether reserved powers will be treated as 'property' over which a receiver can be appointed in order to access trust assets (as was the case in *TMSF*) or otherwise be available for division on the basis the powers represent relationship property (as was the case in *Clayton*); and
- Whether a slightly different conclusion will be reached (as was the case in *Pugachev*).

These decisions and particularly Webb v Webb *are difficult to reconcile and create some uncertainty as to how trusts with reserved powers will be treated going forward. The law is now in a state of flux*

The most troubling aspect is that the PC came to a completely different decision in *TMSF* as it did in *Webb* (albeit the PC made reference to *TMSF* in recognising that a general power of appointment can be tantamount to ownership). In the former, there was no suggestion the trusts were not valid and the PC analysis focused on the extent to which the personal power of revocation could be deemed to be property. However, in the latter, the PC ruled that the personal powers of the settlor meant that the trusts were not trusts at all.

Confusingly, while the PC drew the distinction between powers being property versus the trusts being invalid, it noted that the outcome was said to be the same regardless of which route was taken. Thereafter the PC seems to have conflated the two scenarios in deciding that the key question was whether Mr Webb's powers under the deed were such that he can be regarded as having rights in the trust assets which were indistinguishable from ownership to support a conclusion that the trusts were not valid (rather than a valid trust but with the powers constituting property as was found in *TMSF* and *Clayton*).

Webb certainly appears to provide a footing to allege that assets of a trust with personal powers in favour of the settlor are in fact held on bare trust for the settlor on the basis the trust is not valid at all. This decision may lead to doubt over the effectiveness of trusts with

reserved powers and, importantly, whether revocable trusts (which have long been considered to be valid) are trusts at all given the decision in *Webb* where the PC held that the trusts should be set aside on the basis that the settlor '*had the power at any time to secure the benefit of all the trust property to himself. . .regardless of the interests of the other beneficiaries*' something which arguably describes all revocable trusts.

Webb certainly appears to provide a footing to allege that assets of a trust with personal powers in favour of the settlor are in fact held on bare trust for the settlor on the basis the trust is not valid at all

A further wrinkle in light of *Webb* is the existence in Cayman and in other jurisdictions of statutory reserved powers legislation. For example, in Cayman section 14 of the Trusts Act (2020 Revision) provides that the reservation of various powers, including a power of revocation (which will almost always be regarded as non-fiduciary), shall not invalidate the trust. It is therefore interesting to consider whether the decision in *Webb* would have been different had it concerned Cayman trusts where it is difficult to imagine the PC concluding that the trusts were invalid due to reserved powers expressly provided for in legislation (even if those powers were ruled to be personal).

All of this leads to the conclusion that trusts with reserved powers, if those powers can be considered personal, may be subject to attack in a variety of scenarios, such as insolvency/bankruptcy or marital disputes, and calls into question their effectiveness as asset protection vehicles. Based on *Webb*, the breadth of any reserved powers appears to be a material consideration.

Practical guidance

Having highlighted the issues which arise as a consequence of the decisions detailed above, it is worth discussing the ways in which unintended consequences in the reservation of powers may be mitigated. In no particular order, and noting that these will not always be practical or desirable, here are some of the authors' suggestions:

- Careful and holistic drafting is required in terms of the objectives behind the structure balanced against the benefits of using reserved powers.
- As an extension of the previous point, reserved powers should be kept to the minimum necessary to avoid a situation where the powers retained are so extensive they lead to a conclusion there has been no effective alienation of the trust property.
- Negative powers or rights to veto decisions of trustees may be a safer option than taking the power out of the hands of the trustees altogether by the reservation of powers to the settlor.
- The inclusion of a clear statement as to whether powers reserved to settlors or other persons are fiduciary or personal. Some of the risks highlighted above will be cured by recording reserved powers as being fiduciary however many settlors may not have the appetite to hold fiduciary powers given the duties which come with it.
- Based on *Webb v Webb*, a settlor should avoid appointing themselves as trustee and beneficiary, particularly where they also hold a power of revocation.
- An independent power holder, with no interest in the trust property could be considered to mitigate the risk that the trust assets are deemed to be the property of the power holder. This is unlikely to be applicable for powers of revocation.
- A corporate power holder or power holder committee may be an option but again this would not appear to solve the problems associated with powers of revocation.
- Given the difficulties in addressing the risks associated with powers of revocation, consideration could be given to making that power in particular subject to the consent of a third party such as a protector. It is difficult to see a court concluding that a power of revocation the exercise of which is

subject to protector consent could be regarded as property of the settlor or that there has not been an effective alienation of the trust property. The same should presumably apply to powers of appointment.

- For existing trusts with reserved powers, if troubles are encountered, such as the risk of looming insolvency, it may be necessary to consider releasing those powers. That is a step which would require careful consideration and an express power in the trust deed, and thought would need to be given to whether the release itself might be challenged if it was deemed to be a deliberate action to defeat creditors.

Reserved powers should be kept to the minimum necessary to avoid a situation where the powers retained are so extensive they lead to a conclusion there has been no effective alienation of the trust property

Having made these suggestions, the facts of the Anderson case[6] in California in 1999 are a stark reminder that no asset protection structure is impregnable. Mr and Mrs Anderson were the settlors of a trust established in the Cook Islands, of which they were co-trustees together with a Cook Islands licensed trust company. They became defendants in litigation in the US and were ordered by the court to produce financial information pertaining to the trust and procure the repatriation of the trust fund to the US so that it could be made available to creditors. As a consequence, and in order to protect the trust fund, the Cook Islands trustee removed Mr and Mrs Anderson as co-trustees and refused to comply with the US court orders. In response and to obviate complex conflict of laws issues, the judge simply imprisoned Mr and Mrs Anderson and held them in contempt of court!

Conclusion

Whilst the authors do not consider that these decisions, notwithstanding that uncertainty which arises, are the death knell for reserved powers trusts, it is more important than ever to ensure trust instruments are carefully considered and the inclusion of any reserved powers appropriately stress tested from the perspective of asset protection. Less is likely more!

Chris Duncan *is Counsel in the Cayman Islands Trusts and Private Wealth team at Carey Olsen where he specialises in high value and cross-border wealth structuring, advisory matters and dispute resolution. He has been admitted as a solicitor in New Zealand, England & Wales, and as an attorney in the Cayman Islands. E-mail: chris.duncan@careyolsen.com.*

Henry Brandts-Giesen *is a Partner and Head of Private Wealth at Dentons Kensington Swan where he specialises in wealth structuring and dispute resolution for domestic and international private clients and families. He has been admitted as a solicitor in New Zealand, Cook Islands, England & Wales, and the British Virgin Islands. E-mail address: henry.giesen@dentons.com.*

6. FTC v Affordable Media 179 F.2 13130 (9th Cir 1999)