

BERMUDA PURPOSE TRUSTS A NEW FEATURE OF OFFSHORE TRUST PLANNING

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A Bermuda Innovation - Purpose Trusts

While Bermuda has the well established reputation of being a conservative off-shore business jurisdiction, its new trust laws offer modern legal concepts and creative structures for financial advisors to private clients. One of the most interesting recent developments in offshore trust practice in Bermuda has been the statutory creation of private purpose trusts.

This article outlines the characteristics, uses and benefits of purpose trusts which I have recently seen in practice. As will be described below, the purpose trust structures are employed, depending on the planning goals to be achieved, in relation to asset protection arrangements (for the benefit of individuals and corporate lenders) or the provision of family control and continuity of a family business.

Features and Requirements of Law

The concept of a purpose trust was introduced into law in the Trusts (Special Provision) Act 1989 ("the Act"), passed in early 1990. The "purpose trust" is essentially a trust which is established for the benefit of "purposes" as opposed to being for the benefit of individual beneficiaries or specific companies.

The Act requires the purposes of a valid purpose trust to be specific, reasonable, possible, and not immoral, contrary to public policy or law. One of the difficulties encountered by draftsmen is the requirement that the "purposes" must be "specific" but they cannot be defined so as to be seen to clearly benefit a particular person, persons or companies. However, this can be overcome by appropriate drafting. The trust deed creating the purpose trust must provide for (i) the appointment of an enforcer who has the ability to ensure the terms of the trust are adhered to and (ii) the disposition of surplus assets of the trust upon its termination.

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There is no provision in the Act that requires the enforcer to be independent of the trustees or the settlor. Accordingly, the enforcer is usually appointed by the settlor, in the deed, as a trusted "protector" of the purposes of the trust. The enforcer is someone who is usually related to the settlor, depending on the rationale for establishing the trust. In some cases independence will be all important (e.g., asset protection planning) yet, in other cases, not so relevant (e.g., quasi-charitable purposes).

Purpose trusts may continue for a duration of 100 years or such shorter duration specified in the deed. The profits or income of the purpose trust can accordingly be accumulated for a relatively short period (e.g., 5 or 10 years) and then distributed out to a specified person or company or, alternatively, distributed in accordance with a decision to be taken by the trustees at that time.

It can certainly be argued that, if an individual or company is named as the beneficiary to receive a distribution on termination, the trust is a private trust and not a valid purpose trust (since there is a contingent remainderman beneficiary). However, the legislation is new and there is no case law which clarifies the point. It is my view that a trust can be a valid purpose trust with an individual contingent remainderman as long as the purpose trust receives benefits from the trust prior to termination (i.e., there must be a bona fide properly administered trust).

For What Purposes?

1. Creation of Philanthropic Trusts Whether Charitable or Not

The original rationale for the introduction of a purpose trust was to provide the ability to create a valid trust where the purposes are quasi-philanthropic in nature but which do not fall within the technical legal definition of "charitable" or "exclusively charitable". Under general principles of English law followed in Anglo-Saxon based legal systems, a purpose trust is not valid unless it is for exclusively charitable purposes (other than a few exceptional cases). Accordingly, a purpose trust may be established to promote the benefit of specified political parties or certain philanthropic purposes which may not be permitted under law because of not conforming to the legal definition of "charitable". It is interesting to note that a purpose trust can also be a charitable trust at the same time.

There are also other very useful circumstances where the purpose trust can assist in achieving specific planning goals. Examples of the uses of a purpose trust other than of a philanthropic nature are set out below but this list is not exhaustive.

2. Holding Shares of Companies

- A. A purpose trust can be created for the purpose of acquiring and retaining specific shares of a particular company. This may be done for a variety of different planning reasons as indicated below. The trust purposes might include the object of ensuring the proper and efficient management of the company through the election of its directors and to maximise the profits of the company. As noted above, on termination of the trust, the shares, or proceeds of sale, can be distributed to a named beneficiary (who may be a person or a company as opposed to being a purpose), since the trust no longer exists at that time.

Such shares can be those of any particular type of company, including a private trustee company (see further comment below on such companies) or

any holding or investment company. It may be advantageous for two parties to a joint venture to relinquish actual ownership of the relevant venture company to a purpose trust, either for tax reasons or for the simple reason that the parties do not wish to be in actual control of the voting power.

B. Corporate Financing - Protecting Assets Held by a Subsidiary as Security for the Lender

Purpose trusts are being used to protect lenders in corporate financing transactions in respect of the purchase or construction of aircraft and ships.

As an example, a parent company which would otherwise enter into a loan with a bank will be able to allay some of the fears of corporate lenders by settling purpose trust which owns the shares of a subsidiary which are pledged as security by the trustees for the loan to the trust (rather than to the parent company). The shares are held in trust until the loan has been satisfied and as the subsidiary owns the aircraft or ship, the leasing income generated by the asset flows to the subsidiary, to the trustees and then to the lender. The lender will be protected in that (i) the ownership of the subsidiary cannot change during the loan and (ii) any creditors claiming against the original parent (or the lessor of the asset if it or the lessor became insolvent) will not be able to set aside the trust which owns the subsidiary's assets. The cash flow of the subsidiary is protected from the creditors of the parent/settlor.

Recently the structure has been employed to own Bermuda companies which qualify as foreign sales corporations ("FSC") under US laws pursuant to the Exchange of Information Treaty 1986 between Bermuda and the United States. FSCs receive certain tax breaks on withholding tax to the US.

A typical structure would be as follows:-

- (i) a United States parent company acts as grantor/settlor of the trust by contributing, say, approximately 20% of the required financing for the project (e.g., acquisition of an aircraft, ship or similar asset) to the trustees of the purpose trust;
- (ii) the trustees borrow the remaining 80% from the lending institution and funnel the funds to the FSC as its capitalisation;
- (iii) the trustees pledge the shares or the wholly owned subsidiary FSC to the lending institution as security in respect of the borrowing;
- (iv) the trust will contain provisions which define the purposes of the trust, for example:
 - to acquire and retain the shares of FSC Company Limited;
 - to ensure the proper and efficient management of the said FSC Company Limited;

There would also be a provision that would enable the lender to be required to give its consent before any payment was ever made to the settlor/parent company (i.e., before the termination of the trust or before the settlor is made a beneficiary). Normally the trust would provide that after a certain number of years or after the financing had been paid off, the trust assets would then be held on trust for the settlor.

The perceived benefits of this structure are:-

- (1) there are United States tax benefits in using Bermuda incorporated companies as Bermuda is designated as a FSC jurisdiction;
- (2) there is protection of the income stream of the subsidiary from the creditors of the parent/settlor company in the event of its bankruptcy.

This sort of structure gives additional comfort to the lender where the parent/settlor company's financial position is perceived as relatively weak.

It is also thought that there can, in some circumstances, be a "segmenting" or isolating of liability achieved for major commercial activities by arranging the ownership of asset-holding companies (e.g., owning ships or aircraft) in separate purpose trusts.

C. Holding Voting Stock

A purpose trust can be used to hold the voting stock of a company where an individual does not wish to hold the control of the voting of the relevant shares. A settlor who does not wish to hold voting control will often wish to keep the voting power of the family business from other family members until they reach a particular "mature" age or simply to keep such controlling stock outside his estate. If the original owner is not a beneficiary, then he will not have any legal right to apply any pressure on the trustees as to what he may wish the trustees to do. However, a Trustee Advisory Committee mechanism can be included in the purpose trust in order to allow a measure of influence to be asserted by the settlor, if desired.

D. To Own Shares of Private Trustee Company

A purpose trust may be the best owner of shares of a private trustee company simply because no one person or group can be said to own the company. Whether the purpose trust suits the structure proposed will depend on the client's estate planning needs. A useful discussion about these trustee companies is only possible after defining what they are, which follows herein below.

A "private trustee company" is a company incorporated with the corporate capacity to act as the trustee of certain specified family trusts or other specifically related trusts.

The procedure for incorporation is the same process as required for any Bermuda company. The application to incorporate must include a submission to the Bermuda Monetary Authority of financial information, names, addresses and occupations of those persons who will beneficially own the private trustee company. It will also be necessary to disclose the name of the family which will constitute the class of beneficiaries although each individual would not need to be named. All such information is treated as confidential by the Bermuda Monetary Authority.

The memorandum of association of a private trustee company must contain objects which specifically cite the name given to the trust (which need not be the family name or any name which is related to the beneficiaries of the trust). The memorandum of association may provide, for example, "to act as a trustee of the XYZ Trust and of such other trusts as the Minister of Finance may approve".

Advantages of Bermuda Private Trustee Companies

There are several good reasons for considering the use of a Bermuda private trustee company, a few of which I have described below:-

(a) Professional Trustee Liability

In circumstances where the subsidiaries of a proposed trust are to engage in trading activities which potentially could involve substantial liability for a professional trustee, the incorporation of a private trustee company by the client may be advisable. The professional trustee is then in the position of being able to provide management and administration services to the trustee company. The professional trustee would also be able to provide directors or officers to serve on the board of the private trustee company if desired by the client.

(b) Control by the Client

The shares of a private trustee company can be owned either by members of a family who are interested in the trust or, alternatively, held in a purpose trust, charitable trust or other private trust. Bermuda advisors have found that certain clients, particularly in the case of Far Eastern clients (who tend to be very concerned about keeping a closely held grip on control over their assets), may wish to own the shares of the trustee company or have them held in separate trusts for the benefit of the patriarch of the family. This arrangement allows the client to have a greater measure of control over his own trust where appropriate. Of course, proper legal advice is needed to ensure that the client does not retain so much control that he impugns the trust structure. However, as a general principle, if the trusts and the trustee companies are run properly (rather than being administered as agencies of the settlor/client) the structure will be valid.

Private trustee companies allow families to, in effect, provide trusteeships for their own family members' trusts offshore, by maintaining control of the trusteeships without actually holding a power to appoint or remove trustees, and without actually acting as trustees themselves.

(c) The cost of administration of a private trustee company and its related trusts depending on the activities and time spent by service providers, can often work out to less than the amounts required by an institutional trustee, especially with respect to large trusts (i.e., in excess of \$5/10 million).

The Bermuda costs of incorporating a private trustee company will vary between \$5,000 to \$10,000 depending on the level of complication and time spent by professional advisors.

This basic description of the use of purpose trusts and private trustee companies is presented as an example of the innovative approach to offshore trust practice which has developed in Bermuda. Bermuda's bankers and law firms have been conducting offshore trust business for over fifty years and, while cautious and conservative, have worked to ensure that the laws are kept up-to-date with modern concepts. For example, there are provisions in Bermuda's trust laws dealing with conflict of laws issues relating to the capacity to create trusts, involving foreign laws governing matrimonial property and inheritance rules.