THE LEGAL REALITIES OF RESERVED POWERS TRUSTS

Nicholas Jacob[1]

Introduction

Setting up a trust is, for most settlors a significant leap of faith. Unless the family has experience of trusts having been set up, and working well, the settlor or settlors will be concerned about losing control over the assets and all the main areas of control that the trustees will have. Needless to say, the importance of the choice of trustee where any powers are to be reserved is crucial. Searching questions need to be asked of the prospective trustee.

Even if the leap of faith is made and an appropriate trustee chosen, there is then the question as to how powers are to be reserved, to what extent they should be reserved and how reserved powers should be exercised.

It is, however, generally far better for the powers to be reserved to be specified in the trust deed rather than just understood between the trustees and the settlor, which has often been the experience in the past. This gives neither party any great comfort, and has, in many cases, been a very unsatisfactory method of operation and unnecessary disputes. Indeed if there is no express provision in relation to any powers to be retained by the settlor, the trustees are at risk of claims against them for breach of trust through blindly following the settlor's wishes.

For many years Powers of Appointment have been reserved by settlors. The Reserved Powers Trust is in many ways simply an extension of this principle.

We will call the Reserved Powers Trust the RPT.

---

1 Partner, Lawrence Graham LLP

1 What are reserved powers?

Reserved powers trusts are often called "Settlor Directed Trusts", or some such similar phrase. The concept of a settlor directed trust is really anathema to the concept of the trust as a whole, and suggests that, in reality, the trustee is purely the nominee of the settlor in terms of holding the legal title to the assets whereas the settlor exerts all the power. In this case there will be no real intention to set up a trust, and therefore no trust created at all. However, in practice, many so called settlor directed trusts will have only certain powers reserved to the settlor and in reality they are RPTs in all but name.

As to really what are reserved powers, they are powers reserved by the settlor, in setting up the trust, whereby the settlor wishes to retain the power to carry out certain actions. Those actions may be dealing with the investments, removing the trustees, appointing beneficiaries, dictating distributions, dictating changes in the administrative provisions or even the dispositive provisions of the trust, or dictating a change in the proper law of the trusts. It may also extend to powers over a protector. If all these powers are granted then there is unlikely to be a trust created at all. If, however, one or two of those powers are reserved, and the wording in the trust deed is drafted carefully to ensure that a proper trust is created, then there should be adequate validity in the trust and a full understanding as to who is to do what.

One of the biggest dangers in respect of a reserved powers is that the trustees have overall responsibility in respect of all aspects of the trust, which will include aspects over which there may be reserved powers. Thus, if the settlor reserves the power to manage the trust's investments, which is quite common, then unless the wording in the trust deed is drawn up appropriately, the trustees will still have overall responsibility in respect of the investments and they will ultimately be accountable. That clearly is an absurd scenario if the settlor has purported to reserve the power to manage the investments to himself. The importance of the drafting of this arrangement whereby the trustees' duty should be no more than the obligation to ensure that the settlor is carrying out the duties which he has reserved, cannot be over estimated. I have seen very few well drawn up trust deeds in this respect and precedents have not been carefully thought out in this arena.

Likewise, the power to remove trustees is fraught with certain problems of its own. For example, is there to be an automatic indemnity that will apply to the trustee to indemnify him or it from any liabilities he or it incurs by virtue of having been a trustee? Very often that is an argument that takes place on removal, but of course the trustee is in a weak position at that stage. Indeed the settlor would not wish the removed trustee to have an appropriate indemnity, but this is

likely to be wrong in principle. The trustee should be entitled to an appropriate discharge and indemnity, but it will be very difficult to negotiate. One way round this is to ensure that there is an appropriate indemnity incorporated within the trust deed itself that will automatically be given to the removed trustee. The only real danger here is whether that indemnity is actually given, and whether, through the passage of time, it might have become outmoded and inadequate. Nevertheless the trustee will have signed up to that when he first takes on the trusteeship. This is discussed further below.

For many years we have had powers given to a protector, which are very much akin to reserved powers. There again, in very many instances, inadequate attention is paid to the powers given to the protector and whether they are appropriate in every case. If the protector is, in fact, the settlor, then they are quite clearly reserved powers to the settlor, although may be passed on to a third party protector at some stage in the future. These powers should also be looked at very carefully in the context of the overall trust.

At the end of the day, the trustees must be in ultimate control of the trust assets, even though that control is subject to certain limitations.

2 When might they be suitable?

To those who have been brought up on the "plain vanilla trust", the fact that settlors may now be more powerful than the trustees, or trustees be unable to run the trust without the input of the settlor, is of serious concern. Historically we have been used to seeing powers of consent or veto, but other powers are now required. Usually we have seen these powers in the hands of the Protector, who is often totally separate from the trustees, although usually they will want to take the settlor's views into account.

Why is it that there has been such an increase in demand for RPTs? It is actually quite difficult to tell. For traditionalists, one cannot help feeling that if

they are not happy to accept the "normal" type of trust, maybe they should not be setting up a trust at all. However there is no doubt that many settlors do see the benefit of a trust; it is just that they want the benefit without giving up too much control. In other words they want their cake and to eat it. It may be also that some trustees over the years have not served their beneficiaries well, and that has led to a sense of nervousness over allowing the trustees complete control.

In addition, if the settlor has some skill, such as managing investments, there may be a good reason to retain the power to do so.

2.1 Testamentary Dispositions

In some states in the US, I understand that it is not unusual in a revocable trust for the settlor to have the power also to amend and vary the trust deed, to remove capital from the trust and to require distributions of income and/or capital. On the death of the settlor, the trust becomes irrevocable and effectively becomes a testamentary disposition. In the UK it would be likely to be treated as a disposition on death as the equitable interest will remain with the settlor during his lifetime. Thus the trust must comply with the Wills Act to be effective as a testamentary disposition. In the Cayman Islands and the Bahamas specific statutory provisions have been enacted to prevent such trusts from failing (see below).

If the settlor reserves too many powers, "the 'core content' of the trust may be so diluted that it is no longer a trust at all". In *Cock v Cooke* [1866] LR1P, the judge said that

> "*it is undoubted law that whatever may be the form of a duly executed instrument, if the person executing it intends that it shall not take effect until after his death, and it is dependent on his death for its vigour and effect, it is testamentary".*

3 Jurisdictions that have reserved powers legislation

I discuss below the concerns that trustees should have in taking on RPTs.

One of those concerns is that a trustee acting in a situation which is unclear as to whether there is a real trust or a nomineeship. Under the Cayman Islands

trust law there is a specific provision in the Trusts (Amendment) (Immediate Effect and Reserved Powers) Law 1998 (now in Part III of the Trusts Law (2001 Revision) that *"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."* Thus this created a presumption of lifetime effect and also specified powers that *may* be reserved to the settlor of a Cayman Islands trust.

Cayman also includes:

3.1 a power to revoke, vary or amend the trust instrument as acceptable;

3.2 a general or special power to appoint either income or capital;

3.3 limited beneficial interests in the trust property;

3.4 a power to act as a director or officer of any company wholly or partly owned by the trust.

Some of these powers may be dangerous in higher tax jurisdictions, as they may lead the entity to be classed as resident in that jurisdiction for tax purposes. However the law was intended to give a higher degree of certainty for settlors and the courts in respect of validity of the trust.

Section 3 of the Bahamian Trustee Act 1998 is very similar to the Cayman provision set out in italics above.

Some commentators have criticised the Cayman and Bahamas legislation for making what is not properly a trust into a trust valid under those jurisdictions. The provisions do provide clarity, but other jurisdictions will survive quite happily relying on the common law position in relation to intention and the sham trusts argument.

Singapore has a provision stating that a trust will not be invalid just because the settlor has reserved any or all powers of investment or asset management function (s.90).

Jersey is considering amending their trust law to make such clauses valid and protect the trustees to a greater level.

4 Drafting reserved powers

4.1 Powers on the face of deed

One of the advantages of the RPT is that all the powers reserved are put in on the face of the settlement deed, and ideally in detail. This is far better than the old way of operating whereby the settlor gave the trustees full authority and then effectively asked the trustees to operate differently either verbally or through a letter of wishes.

I am also seriously concerned about the level of the trustees' exposure where the power to direct investments is retained. The drafting is usually inadequate to fully protect the trustees. I deal with this in more detail in 4.8 below.

4.2 Investment powers

Looking in more detail into the reservation of the power to direct investments, it does seem consistent with a valid trust for some investment powers to be retained. In fact in two quite old English cases the concept was specifically approved. In *Vestey's Executors v IRC* (1949) 31 TC 1, the settlor and his brother had powers of investment reserved to them; the House of Lords ruled that this power was a fiduciary one and that it could therefore not be used to give them enjoyment of the income (and therefore they were not taxable on it). Likewise in *Re Hart's Will Trust* [1943] 2 All ER, the life tenant could direct the trustees as to how to invest the trust fund.

4.3 Reserved powers fiduciary or not fiduciary?

It might be worth considering making the powers of the settlor, particularly in relation to investments, not fiduciary. In this way the trustees may feel less of a sense of obligation to interfere if they perceive the settlor is not performing adequately in his task. The point is that if the power is a fiduciary one, then a trustee who suspects that the settlor was not exercising his powers in a fiduciary manner would be obliged to go to court to seek directions. This arose in *Lord Vestey's Executors v Commissioners of Inland Revenue* (1949) 31 TC 1. However there is an argument which says that the power should be fiduciary, to avoid arguments that the trust is really for the benefit of beneficiaries in circumstances where the settlor is able to direct investments for his benefit (and not theirs) with impunity.

4.4 Releases and Indemnities

Ideally the trust should state that the settlor is managing the assets on behalf of the trust and not as his own assets. The assets should also be registered in the name of the trustees.

In relation to any powers reserved, it would be desirable to ensure that appropriate releases and indemnities are obtained to relieve the trustees of any possible liability. Indeed the exculpation clause must be very carefully considered in the light of the reserved powers.

In addition, the trustee should also ensure that there is an anti-*Bartlett* clause, so that the trustee has no risk of liability if the settlor does not carry out a duty which would normally be that of the settlor, and to avoid any exposure in relation to the trustees' duty to oversee the settlor's actions.

So far as the beneficiaries' position is concerned, the trustees must take action if they consider that there has been actual fraud. Indeed the beneficiaries can themselves make an application to the court if they feel the settlor is abusing his powers.

One of the very difficult decisions for trustees is where they have been asked to take over an existing trust, and that trust does not have all the exclusions and trustee protections that the trustees should have. In the interests of commerciality, the trustees are keen to take on the business, but in liability terms they should not. One solution is to transfer the assets to another trust with the right protections in it, but this can generally be done only if there is specific power to do so. It should be noted that if the trust is drafted poorly from this point of view, it can be difficult for the original trustees to pass the trust on to other trustees in the event of their wishing to retire. Furthermore there are likely to be difficult arguments over the extent of the indemnity on retirement. Thus the advantage to the trustees of getting everything well drafted to protect them is crucial and usually underestimated.

4.5 Typical Reserved Powers

Some of the Reserved Powers that are often used are:

- to remove trustees;
- to appoint new trustees;
- to revoke the trust, either wholly or partially;
- to add or exclude beneficiaries;
- to amend or vary the terms of the trust;
- to amend the administrative provisions of the trust;
- to change the proper law of the trust;
- to change the forum for the administration of the trust;
- to appoint income or capital to any beneficiary;
- to act as the investment manager or adviser;
- to prevent the sale or direct the retention of certain trust assets, such as private company shares or a ship or aircraft;

- to restrict the exercise of the trustees' discretion.

If all these powers are reserved, it is almost certain that there would be no valid trust, but rather a nomineeship. It would be rare that all these powers would be sought to be reserved; generally some of them would be sufficient to give the settlor the comfort that he feels he needs.

4.6 Indemnity on power of removal

Most common amongst the reserved powers seem to be the power to manage the investments and the power to remove trustees and appoint a replacement. Some of the issues relating to the power to manage the investments are dealt with in 4.8 below. However the issue of power to remove trustees raises a concern rarely considered when the trust is set up. If the trustees are removed, they have very little leverage to negotiate a suitable indemnity. It is very advantageous for a suitable indemnity to be drafted into the trust deed so that it applies automatically on removal, and obliges any new trustees to give that indemnity contractually to the removed trustees as a condition for their taking on the trusteeship. In this way, while relationships are cordial, the trustees can negotiate a proper indemnity, and make sure they will, in fact, receive it.

4.7 Power to Revoke

It is often very attractive for the settlor to be able to get the assets back into his hands by using a power to revoke. However this may have consequences that he did not foresee. For example, a court in a claim by creditors or on a divorce, may say that as he has power to revoke, he has the ability to control the assets, and they will be treated as his own. There are also often tax disadvantages, in that the power of revocation is interpreted as meaning that the settlor still has the asset value in his hands, that he has not alienated himself from it, and it is treated as his for tax purposes. On the other hand, revocable trusts are common in the US under their tax regime.

4.8 Power of Investment

Whether this is the power to manage or advise, it may not be unreasonable for the settlor to reserve the power if he is expert in the field. However, this power is likely to be fiduciary, and the trustee should make it known if he is unhappy with the performance. This begs the question as to whether he should be monitoring the performance, and this issue should be covered in the drafting of the reserved power.

Often the investment powers will be through an underlying company, wholly owned by the trustees, but in respect of which the settlor is a director. Here the obligations will be imposed by an agreement between the trustees and the company, and it is crucial that the trustees can control the company as investment manager and remove it from that role if the investments are not performing adequately. The trustees cannot simply turn a blind eye and say that it is only the company that has to be concerned. Sometimes the agreement will be an annex or schedule to the trust deed

If the direct investment powers give a problem, there are some other possibilities, such as replacing the direction making powers with consent powers, or giving the settlor powers of direction, but, unless and until exercised, leave the trustee in control, or if neither of these is feasible, to arrange matters so that the trustee must implement the settlor's directions, and give the trustee a role in policing those directions. It may be possible to devise a limited but more substantial role than the role the trustee might otherwise occupy.

5 Pitfalls and areas of concern

5.1 Was there an intention to create the trust?

There is clearly a fine line between an RPT and a sham, where the settlor really only wanted the pretence of a trusteeship, by way of the assets held in the name of the trustees, but virtually no power in their hands. Or it may be that he had no real intention to create a trust, and thus none is created. In this context, one should always have in mind the oft quoted judgment of Lord Justice Millett in *Armitage v Nurse* [1997] 3 WLR 1046 where he said that "the duty of 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". I discuss this further in the section on "Effect on validity or administration" below.

If there is no valid intention to create a trust, the assets will still belong to the settlor, with all the consequences that will bring in terms of taxation, divorce issues, bankruptcy and property law.

5.2 Settlor/beneficiary undermined by his own powers

By reserving certain powers, the settlor may well be demonstrating that he or she is still in real control of the trust. If he is challenged by creditors or on a divorce, the powers reserved can be ordered by a court to be exercised. This is a serious weakness in the concept of the reserved powers, and is rarely appreciated by settlors wanting to remain in control.

One case where the settlor came to grief is *Re Stephen Jay Lawrence* (US Court of Appeal 2002). Here the settlor retained the right to remove and appoint trustees, and to add and exclude beneficiaries, and the court found him in contempt as they felt he had real control over the trust and refused to exercise it for the benefit of his creditors. This type of case is likely to be repeated many times over in the future, and it is my view that settlors should be warned about this risk in no uncertain terms when the trust is set up.

In the Australian case of *In the marriage of Ashton* 1985/6 11 Fam LR 457, the trust was clearly under the control of the husband in a divorce case. The court found that he was in de facto control. He owned, or had under his control, the shares in the trust company, and he was appointor with power to remove and appoint trustees, he had the ability to apply all income and capital for his benefit. As a result, the husband had to make a large payment to his wife from the trust assets. It is implicit in the judgment that had he not had such overriding control, he would not have had to make such a large payment to the wife in the divorce.

5.3 Too much control in high tax jurisdiction

Just as with Protectors with too much control being resident and exercising that control in a high tax jurisdiction, the same concerns exist with a settlor retaining too much power. I discuss this further in the section on "Effect on validity or administration" below.

If the investment management is carried out in an underlying company, the powers of the settlor under the trust deed, the trustee of which acts as shareholder, if he is in real control, will by virtue of that fact, make the company resident and therefore taxable in his country of residence. Likewise if he controls the company by virtue of his directorship or shadow directorship, he will make the company tax resident in his country of residence. This might also mean a benefit in kind charge on the settlor.

5.4 Settlor liable to tax on income

In some countries, notably the UK, a settlor may be taxable to all income arising where he is "*able in any manner whatsoever, and whether directly or indirectly, to control the application of the income.....*" *of the settlement*. This can unwittingly lead to tax on income which had not been anticipated.

5.5 Settlor may be liable to Inheritance/Gift/Estate Tax

The powers reserved to the settlor may well have a value as they are held by him beneficially, and may be liable to estate taxes unless they are exempt (for example

excluded property for UK IHT. If the settlor is or becomes UK domiciled or deemed domiciled for IHT purposes, the settlor's powers cannot be excluded property and will form part of his estate. If this scenario might arise, caution must be exercised.

5.6 Trustees' liabilities increased

One of the major concerns I have in relation to RPTs is the clarity of the trustees' position. Reserved powers may alter the nature of the obligations which the trustees owe to the beneficiaries. Indeed the obligations may be more onerous.

If the settlor has reserved the power of investment, the trustees must make sure that they cannot be held liable if the investments do not perform. Their duty is to ensure that the arrangement that the settlor has given them and they have accepted in the trust deed is carried out – ie that the settlor is actually carrying out his duties, rather than the quality of those duties. Once they intermeddle in the performance of the investments, they are probably clothed with the normal duties of trustees in relation to investments. The drafting is absolutely crucial, and yet rarely considered carefully enough in my experience.

Some think that just because the settlement requires the trustee to follow directions from the settlor, as the trustee has no choice, he cannot be held liable (*Re Hurst* (1891) 63 LT 665), but I would not like to rely on that now unless the exclusion of liability drafting was very clear.

Another concern for trustees is that if there is no real trust – either because there was no intention or there was a sham – then if they are nominees they must be accountable to the settlor for all assets they have held as nominees. Furthermore if they were nominees then they would, not have been entitled to exercise any discretions, and if they have purported to do so they may have to account to the settlor for any assets that are no longer there – such as distributed assets. This is to some extent covered by the Cayman Islands legislation, in respect of which see section 3 above.

Indeed if this is the case, any trustees' fees would have been inappropriately obtained, and would have to be returned. Most trustees would rather know this in advance than after the event.

It is crucial that all appropriate meetings are held between the settlor and the trustees to be clear that responsibilities are being carried out and properly monitored.

5.7 Letters of wishes

There is a danger that if the settlor writes a Letter or Note of Wishes, particularly where he asks the trustees to regard him as the primary beneficiary during his lifetime, and there are significant reserved powers, the arrangement is likely to be regarded as a bare trust, whereby the trustees hold the assets for the settlor absolutely.

5.8 Fees

There is a danger that if the trustees agree a lower fee on the basis that the settlor is doing a lot of the work, there is a greater risk that there will be evidence that no valid trust was set up. This certainly does not help the argument that there was every intention to set up a valid trust. Furthermore, if the obligations are more onerous (see 5.6 above), the supervision and administration costs may be higher.

6 Effect on validity or administration

6.1 Validity

Article 2 of the Hague Convention on the Recognition of Trusts states that

> "*……the term "trust" refers to the legal relationships created…….by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose.….the trustee has the power and the duty, in respect of which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed on him by law……".*

It is interesting to note the "*the reservation by the settlor of certain rights and powers is not necessarily inconsistent with the existence of a trust."*

The question of balance is crucial. If the trustee's authority is compromised, there is always an argument that there was no intention to create a trust (and thus no valid trust) or the trust is a sham. So, one falls back on an analysis as to how extensive the powers reserved to the settlor are.

6.2 Administration

The concern that the settlor is effectively controlling the trust and therefore administering it in the jurisdiction in which he is resident is a serious concern from a tax point of view. From a UK perspective, for example, this might mean that the

trust is administered in the UK, or that the settlor is, in fact, effectively a trustee; as a UK resident, this might mean the settlement could be liable to UK Income and Capital Gains Taxes.

By the same token, if the investment management is reserved to the settlor through an underlying company, the fact that the settlor is a UK resident, or resident of a high tax jurisdiction, may make the company fully taxable as resident in that jurisdiction, notwithstanding the fact that the company is incorporated in an offshore jurisdiction.

Even if the reserved powers purport to allow the trustee to rely completely and unconditionally on a direction from the settlor, and to act upon it, a trustee must still exercise its judgment as to whether the power exercised by the settlor is within his powers. For example, some might class a loan at interest as an investment. If the settlor has power to direct investments, then if the loan argument is right, he has power to direct that a loan be made. That might not have been within his original contemplation and the trustees must ascertain whether they consider that a proper exercise of his power.

7 Conclusion

As long as the trustees have proper legal control over the trust assets, and has some powers over which to exercise its judgment or discretion, and indeed does so, there should be a valid trust. The trustee must be able to look after the best interests of the beneficiaries.

It is interesting to try to analyse why there has been such a growth in interest in RPTs. It suggests that there is an increasing distrust of trustees to do the right thing. Otherwise it seems strange that settlors have only just woken up to the fact that they lose control when setting up a trust.

Another angle is that the trustees see this as a marketing opportunity to get more trust business in from settlors who would not otherwise set up a trust. The problem is that they are hoist by their own petard, as other settlors, who

might in the past have set up “normal” trusts, do not see any reason why they should not now have the comfort of some reserved powers.