Onslow, ready to act as a football hooligan to further Lords' reform, who pointed the moral when he said:

' ... this is a perfect example of why this House should be properly reformed. When it is properly reformed, we can use the powers that we have with legitimacy and pride rather than be blackmailed because we are told that we are all idiots of hereditary Peers.'

The Bill to abolish the right of hereditary peers to be members of the House of Lords was introduced in the House of Commons on 19 January. In a statement to both houses, the government confirmed that it was minded to accept an amendment to the Bill, when it reached the Lords, to temporarily reprieve some hereditary peers until there is a fully reformed second chamber. That depended, however, 'on the extent to which the normal conventions relating to the government's legislative programme are being observed' – a euphemism for not blocking the Bill. (This amendment to reprieve 92 hereditary peers has now been passed in the Lords.) The statement accompanied a White Paper setting out the government's proposals for Lords' reform both in the short term (the transitional house) and longer-term reform, which would be considered by a Royal Commission to report by the end of 1999 on the role, function and composition of a second chamber. The terms of reference make it clear that the House of Commons must remain the pre-eminent chamber of Parliament. Ominously, the government, in setting out its own views on the powers of a reformed second chamber, considers that they should be reduced, rather than restricting their exercise by 'institutionalising the understandings' under which the house now operates – understandings which were evolved precisely because the house was unreformed. In other words the government does not envisage that a second chamber endowed with greater legitimacy should act as a better check on the Commons. The Commons will still normally be dominated by the government formed from the party with a majority of MPs, unless there is electoral reform more radical than that proposed by the Jenkins Commission. *Plus ça change, plus c'est la même chose.*

Professor Gabriele Ganz

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Misplaced trust?

by Peter Willoughby

Peter Willoughby

The trust concept has been used for more than 800 years as a mechanism to protect and conserve family wealth. However, in recent years, failure to set up trusts correctly and to administer them scrupulously has resulted in litigation. Professor Peter Willoughby outlines the dangers and pitfalls of setting up and administering trusts.

Over the last 30 years there has been widespread and increasing use of trusts as a way of holding personal wealth. The trust concept is one with more than 800 years of development, originally in England but more recently in many other jurisdictions. Trusts have been created for many reasons but generally the overriding need is the protection and conservation of family wealth. One of the most important advantages of a trust is that it provides a convenient and flexible way of ensuring that the benefit of assets is enjoyed by members of a family through more than one generation, without the inconvenience, publicity and expense that can occur where it is necessary to obtain a grant of probate or letters of administration or the equivalent, in several jurisdictions, on the death of a wealthy person. It may be that other advantages can be obtained, such as the mitigation of tax liabilities and the sheltering of family assets from potential creditors.

Unfortunately in more recent times trusts have all too frequently been marketed as 'products' by banks, accountancy firms and even lawyers, without proper attention to the essential legal requirements of a valid trust. In many instances, aggressive marketing by people who have not understood the need to set up trusts correctly and then to administer them scrupulously has resulted in litigation which is often multi-jurisdictional and very expensive. The practical implications of matters such as heirship and creditors' rights, together with the dangers of retaining direct or indirect control in the person creating the trust, have been underestimated. This has resulted in challenges by creditors, disinherited heirs, former spouses and revenue authorities.

In the case of a trust which was set up to protect assets from creditors, the challenge normally occurs within a year or so of the creation of the trust. In the case of other claims, these usually occur when the person who created the trust, the settlor, dies. In the latter case this may, of course, be many years after the trust was created. For example, in one recent case in New Zealand, the litigation did not start until more than 40 years after the creation of the trust. In a recent case in England the litigation occurred more than 30 years after the creation of the trust, even though the problems which gave rise to the litigation should have been noticed much sooner because they arose from failure to draft the trust in the way the settlor had intended.

WHAT IS A TRUST?

In order to understand why there have been so many problems with trusts in recent times, it is necessary to go back to first principles and define the essence of a trust. The leading text on the law of trusts is Underhill and Hayton *Law of Trusts and Trustees*. David Hayton QC defines a trust as:

' ... an equitable obligation, binding a person (who is called a trustee) to deal with property over which he has control (which is called the trust property), for the benefit of persons (who are called the beneficiaries ...), of whom he may be one, and any one of whom may enforce the obligation.'

It must be stressed that for a valid trust to exist, the control, and nearly always the ownership, of the trust property must be transferred to the trustees. Many settlors creating trusts are understandably reluctant to transfer control of their assets to trustees who are unknown to them. Moreover, where the trustee is a bank trust company the settlor may be alarmed not only because control has to be transferred but also because it has to be transferred to trustees based on the other side of the world whose trust officers are unknown to the settlor. The commercial solution to this problem is sometimes to 'touch wood', ignore the requirement of control and allow the settlor to have an express power to deal with the trust assets or to direct the trustees as to how the trust assets are to be administered. Alternatively, a mechanism may be provided whereby the settlor retains indirect control through a protector (sometimes called an 'appointor' or a 'guardian') or by having control over companies, which own the trust assets with the shares of those companies held by the trustees. If the settlor then has power under the trust deed to dismiss the trustees he will have effective control over the trust assets. An arrangement of this sort is most unlikely to survive a challenge on the basis that either the trust is a sham, that is to say not a true trust but some other legal relationship, such as a nominee arrangement, or on the basis that the settlor did not understand what was required of a true trust and therefore had no intention to create a trust. Sometimes, it is also clear that the trustee did not understand the true nature of a trust either!

A challenge to the validity of a trust on either of the above grounds can often be made on the basis that the trust was a formal sham from the outset, (i.e from the terms of the trust deed it is apparent that the trustees were never intended to have control), or that the trust has become a sham in substance because it is apparent from the trust records that all key decisions have been taken by the settlor or someone, such as a protector, acting on his/her instructions. The position will often be made worse by marketing documentation issued by the trustees at the time the trust was created that shows that the trustees were happy to leave control of the trust assets with the settlor, who is frequently referred to in memoranda of meetings and telephone calls as 'the client'.

It is understandable for a bank trustee to refer to a settlor who has been a long-standing customer of the bank as 'the client' whenever decisions affecting the trust assets are taken after consulting the settlor. Nevertheless, this is not good practice, because the trustee owes its legal obligations to the beneficiaries and not to the settlor. It will often also be apparent that the settlor frequently refers to the trust as 'his trust' or 'my trust', when in reality the persons entitled to the enjoyment of the trust property are not the settlor but the beneficiaries. This implies that the settlor does not understand the nature of a trust. In general even when the settlor is also a beneficiary it is safer to refer to 'the family trust'.

Sometimes the position is made even worse because the settlor has been led to believe that the family trust is a form of 'living will'. Under this sort of arrangement, the settlor is allowed to have complete control over the trust assets during his lifetime, with the trustees only exercising control of the trust assets on the settlor's death. Very often correspondence with the trustees will record the settlor as referring to the family trust as 'my will'. Where records show that this is the situation not only will it usually be possible to have the trust set aside as a substantive sham, it will also be apparent that the settlor never understood the nature of a trust because he thought that the trust was a will.

PITFALLS OF 'PRODUCT' MARKETING

... trusts have all too frequently been marketed as 'products' by banks, accountancy firms and even lawyers, without proper attention to the essential legal requirements of a valid trust. In many instances, aggressive marketing by people who have not understood the need to set up trusts correctly and then to administer them scrupulously has resulted in litigation which is often multi-jurisdictional and very expensive.

The law requires a bona fide intention to create a trust if there is to be a valid and enforceable trust relationship between the trustees and the beneficiaries. If, when the settlor executed the trust he thought that the trust deed was a will, he cannot have had any true intention of creating a trust. There have been a number of cases where arrangements of this sort have been attacked on the basis that what the settlor executed was an invalid will – invalid, that is, because the document had not been executed in accordance with the formalities required for a will – result with the that there is, neither a valid trust nor a valid will, and the so-called trust assets will pass on intestacy on the settlor's death.

LETTERS OF WISHES AND PROTECTORS

As a consequence of the need to ensure that control is with the trustees, but at the same time to give the settlor comfort by giving him a means of influencing the administration of a trust, it has become common practice to use letters of wishes and protectors. A letter of wishes should never be a legally-binding document but merely a list of guidelines for the trustees, in the hope that they will take them into account when administering the trust. Provided that a letter of wishes is no more than that there should be no problems. In practice, however, some letters of wishes are drafted in mandatory terms and even where this is not so it is quite often the case that the trustees do not exercise any independent discretion but blindly follow the wishes of the settlor as set out in the letter of wishes. Where this is so the trust will, at worst, be in danger of being set aside as a sham. At best the trustees will be guilty of breach of trust.

There are many problems which can arise from letters of wishes, usually after the death of the settlor when the next generation starts to take an active interest in the way in which the trustees are administering the trust. Disappointed relatives who want to attack the validity of the trust may argue that the settlor has continued to direct the administration of the trust assets from his grave and that therefore the trust is a sham. Other beneficiaries may claim that the trustees have not administered the trust in accordance with the letter of wishes and may claim that it is, in substance, part of the terms of the trust and therefore, enforceable as such. It should not, therefore, be assumed that a letter of wishes is a wholly satisfactory solution for a settlor who wishes to continue to influence decisions of the trustees.

A common alternative to a letter of wishes is the appointment of a protector. Very often a protector will be given power to appoint new trustees and the right to be consulted by the trustees before key decisions are taken in relation to the administration of the trust assets. Until recently it had always been assumed that a protector owed duties to the settlor and that in practice the protector's function was usually one of liaising between the settlor and the trustees. As a result of recent court decisions, however, it is now clear that a protector owes a duty to the beneficiaries to exercise his powers for their benefit and not for the benefit of the settlor. It follows that, in the event of a family dispute, the exercise by a protector of his power under the family trusts may be challenged if the result is to benefit the settlor or one group of beneficiaries at the expense of another.

DANGERS IN DESIGNER TRUSTS

A jurisdiction is entitled to create whatever institutions it chooses, but it is not entitled to assume that other jurisdictions must necessarily recognise what has been done as creating a trust. For example, designer trust legislation which allows a settlor to retain control of the trust assets is, in reality, providing for a nominee arrangement or an agency but not a trust. To continue to call such an institution a trust is misleading. It should be appreciated that these so-called designer trusts will not be accepted as trusts in other jurisdictions where, for example, the trust assets are physically situated or where the settlor, beneficiaries or trustees are physically present.

Increasingly it now appears that the use of letters of wishes and protectors is not really a substitute for choosing a competent trustee who will provide a first class service. Unfortunately modern marketing pressures can make it difficult for prospective settlors to know how to choose a good trustee, particularly if the settlor has no clear idea of how a trust should be set up and administered.

CERTAINTY AND INTENTION

Reference has already been made to the importance of the settlor of having intention to create a trust. This is related to the issue of certainty, which traditionally involves the need for certainty of the terms of a trust, certainty as to the property which is to be held by the trustees and certainty as to the beneficiaries who are to enjoy the benefit of the trust property. All too often there is failure to appreciate the importance of these fundamentals, both by prospective trustees and by prospective settlors. A recent case from the Isle of Man illustrates the problems that can flow from failure to observe the fundamentals and ensure that those creating the trust understand what is required of a trust. The case concerned eight Sikhs who wished to invest £20,000 each in a joint deposit with the Isle of Man branch of the Bank of Credit and Commerce International. For some reason they were advised to use an off-the-shelf trust (never good practice) which showed the only identified beneficiary as the International Red Cross. Two of the Sikhs were trustees, and the trust deed gave them power to nominate other beneficiaries. The intention, presumably, was that they would nominate themselves and the other six Sikhs as beneficiaries. It seems that that was not explained to them, although there was never any intention of benefiting the International Red Cross or indeed of informing them their existence as a beneficiary. The reason for including the International Red Cross was to ensure that there was one identified beneficiary with the identities of the eight Sikhs remaining confidential. Unfortunately the bank (BCCI) failed and the eight Sikhs lost their joint deposit. The Isle of Man, however, set up a compensation scheme which allowed £15,000 to be paid to each claimant. The eight Sikhs assumed that they would each receive £15,000. Unfortunately the effect of the rules of the compensation scheme was to allow only one claim to be made by the trustees on behalf of the trust, which was treated as a single claimant. It is almost certain that the eight Sikhs would never have agreed to a trust in the form adopted if the possible result had been properly explained to them. The report of the decision does not make clear what the two trustees did with the one claim of £15,000. If the trust was valid they presumably passed it to the International Red Cross, which was never the intention when the trust was created. But was the trust invalid because the International Red Cross was not a genuine beneficiary and no other beneficiaries had been appointed?

The case of the eight Sikhs should not be regarded as isolated. There are many thousands of these so-called Red Cross trusts, which became fashionable in the 1970s in Hong Kong and elsewhere. Many are probably not trusts at all, some are trusts which have either given, or will give, rise to serious consequences when the settlor dies. In the case of British subjects, there may be horrendous inheritance tax liabilities which date back to the date when the trusts were established.

TRUST ADMINISTRATION

References have already been made to the importance of proper trust administration. The law imposes a duty on trustees to safeguard trust assets, to provide information for beneficiaries when requested, and to keep proper accounts and be prepared to produce their accounts when asked for by beneficiaries. The areas of trust administration which have given rise to the greatest problems have concerned the proper investment of trust assets and the duties of trustees where the sole or main trust asset is a majority shareholding in a family business.

The duties of trustees administering investments vary little between jurisdictions. Generally speaking, the investment powers of trustees must be exercised as a prudent man of business would exercise them. The traditional approach has been to expect trustees to preserve the capital of the trust fund, but the effects of inflation from the 1970s until the mid 1990s has required trustees to exercise prudent portfolio risk management to ensure that the fund is not eroded by inflation. This involves investment in equities as well as in fixed-interest investments.

There are often situations in which a settlor will wish to continue to exercise control over the investment of trust funds. There is authority for saying that provided that the trust deed is explicit, the retention of such a power by the settlor will not invalidate the trust. It will, however, be important to ensure that any other powers retained by the settlor do not result in a situation in which the settlor is in overall control of the way in which the trust is administered. That could result in the trust being set aside as a sham.

Trusts which have as a main asset a majority shareholding in a family business present particular problems for trustees. The probability is that the business will be run by members of the family and not by the trustees. If the members of the family who are running the business commit the business to a speculative venture which fails and results in major depletion of the value of a trust assets, the question that will then arise is whether a beneficiary can sue the trustees for breach of trust. There have been cases in which litigation against trustees for breach of trust has been successful, where the trustees have knowledge of the existence of a speculative venture but have failed to question its suitability. It seems clear that in this sort of situation a trustee cannot escape all responsibility for what proves to be a disastrous business decision taken by the board of directors of a family business. The cases do not, however, decide that a trustee must always step in and interfere but merely that a trustee cannot stand idly by, while speculative decisions are taken. Usually, a trustee in this sort of situation will seek to include wide exclusion clauses in the trust deed, to the effect that they will not be responsible for losses to a business unless they have actual knowledge of dishonesty by those running it. The scope of such a clause is uncertain. On balance, even in the absence of knowledge of dishonesty, a professional trustee will probably be held to account where it has remained entirely passive and not taken steps to ensure a regular flow of information from the board of directors.

The more general question of the validity of clauses in trust deeds which exempt trustees from liability is also uncertain. It seems clear that a clause can never exempt a trustee from dishonesty and in some jurisdictions it is not possible for a trustee to exclude liability for recklessness or 'gross' negligence. This seems to be the position in the United States, Jersey and Guernsey, and Scotland. In these jurisdictions it appears that a widely – drawn exemption clause may be set aside as being repugnant to the trust concept or, in the case of Jersey and Guernsey, as contrary to the local trust laws. In other words, the nature of trusteeship is such that a high level of competence is inherent in the office and to seek exemption from liability for recklessness or gross negligence is not permitted by the law.

There are further problems with exemption clauses in trust deeds, indeed with any other clauses in a trust deed, which benefit a trustee. A professional trustee is under a duty to ensure that a prospective settlor fully understands the effect of clauses which benefit the trustee and which therefore are to the possible detriment of the beneficiaries. A prudent professional trustee entitled to remuneration under the terms of the trust deed should always ensure that a prospective settlor has obtained independent legal advice before executing the trust deed. It is very unwise for both a prospective settlor and a trustee to omit this step with the short-term object of saving costs.

DESIGNER TRUST LEGISLATION

The failure of many trusts to withstand litigation has resulted in a number of small jurisdictions enacting trust legislation which is designed to overcome the need for meeting the strict legal requirements for the creation of valid trusts. This is an unfortunate development. A jurisdiction is entitled to create whatever institutions it chooses, but it is not entitled to assume that other jurisdictions must necessarily recognise what has been done as creating a trust. For example, designer trust legislation which allows a settlor to retain control of the trust assets is, in reality, providing for a nominee arrangement or an agency but not a trust. To continue to call such an institution a trust is misleading. It should be appreciated that these so-called designer trusts will not be accepted as trusts in other jurisdictions where, for example, the trust assets are physically situated or where the settlor, beneficiaries or trustees are physically present. If these other jurisdictions are orthodox trust jurisdictions the designer trust will be required to meet the exacting legal requirements of orthodox trust laws.

Another development in relation to designer trust law concerns the misuse of the term 'asset protection'. Trusts have always been concerned with asset protection, but over the last 20 years this term has been hijacked by a number of American law firms to mean debtor protection or, perhaps more accurately, creditor-defrauding trusts. It is regrettable that a number of jurisdictions, notably the Cook Islands, have devised legislation which is specifically designed to attract debtor-protection trusts. This normally involves very short limitation periods within which a creditor must bring an action if the trust is to be successfully set aside. Any one who is concerned to ensure that assets are preserved from attacks from future creditors would be wise to have other reasons for setting up a trust and also to use a reputable jurisdiction which has not gone out of its way to attract trusts designed to frustrate creditors. It is now the position that where certain jurisdictions are used there is a presumption that the trust was set up to avoid creditors.

FURTHER READING

See *Amicus Curiae*, Issue 17, May 1999, p.31, for an article on sham trusts by Naomi Lawton.

CONCLUSION

There is no doubt that a trust, properly implemented and administered, provides a flexible and valuable means of safeguarding assets and providing continuity for family assets without the disruption that the death of the head of the family can cause. Nevertheless, the requirements of the trust concept must be more clearly understood than has been the case over the last three decades. Attempts to achieve ends which are inconsistent with the fundamentals of a valid trust should be resisted, however great the commercial pressure to distort them. Where possible, existing family trust structures should be reviewed regularly to ensure that those involved understand what is required of a valid trust. While there are ways in which a settlor can continue to have some indirect influence over the administration of trust assets by trustees, the ultimate control must always remain with the trustees. It should be recognised that this is so as a matter of substance and not form alone.

Professor Peter Willoughby OBE, JP, LLM, TEP

The selection of arbitrators

by Charles Molineaux

The January 1999 issue of Amicus Curiae carried an article by David Winter on 'The Selection of Arbitrators', to which a response by Dr K V S K Nathan ('The selection of arbitrators: another view') was published in Issue 17, May 1999. The following letter by Charles Molineaux has been received by the editor.

These articles consider a very important aspect of international arbitration. While there are valuable points in Dr Nathan's article, two comments are controversial indeed.

First, Mr Winter had made the observation that a most important point in relation to the selection of arbitrators is that an arbitrator must be 'psychologically comfortable' with parties from other countries, understanding their culture and method of presentation. This comfort, he suggests, might be evidenced by travel and an interest in other cultures.

Surprisingly, Dr Nathan responds by saying that 'most Europeans' when they live abroad tend to interface with the locals only 'infrequently at formal occasions if at all'. He continues: 'Those who have lived abroad can develop a strong bias against the indigenous people. Generally they do not trust them ... '. Then, escalating the rhetoric, he makes the accusation that there is a 'higher standard of proof often demanded by international arbitrators from a party and witnesses from a developing country'.

Perhaps this charge is too outrageous to warrant discussion. On its face it urges that one-time colonial attitudes toward the natives are not a thing of the past, but of the present. If it were taken seriously, which it should not be, it would mean that the growth of international arbitration, to facilitate development and trade, is misconceived and based on a false expectation of an honourable effort to search for truth and resolve disputes according to law.

(As an anecdotal comment, this writer participated in two substantial cases just within the past year in which unanimous awards in favour of the developing country entities were rendered by Western, or first-world-dominated tribunals.)

The other point warranting discussion is the charge by Dr Nathan that the use of a list of arbitrators as a basis for tribunal selection to be agreed to by both parties (as contrasted with the party-appointed arbitrator approach) is 'an attempt to weaken the autonomy of the parties'. This is simply silly. The parties are free to write up whatever procedure they like. One distinct advantage of a list procedure (as set forth, for example, in the new international rules of the American Arbitration Association) is that both parties have a voice in the selection of all three arbitrators. Assuming a carefully-developed list, prepared by the arbitral institution or by the parties themselves, and assuming that counsel for the parties do their job in vetting that potential arbitrator list, this is a procedure which can instil more confidence in the parties in the arbitral process generally and in the tribunal itself in particular. Nor is there any basis for the further charge that a list procedure 'enables the stronger party in terms of power and influence to prevail in the selection of arbitrators'. How this would happen is not explained.

The list procedure avoids the problem of defining the attitude of the party-appointed arbitrator (i.e. is he to be truly neutral or a second-tier advocate for the party appointing him?), avoids the problem of the proper scope of the 'interview' or 'beauty contest' conducted by the party to select the party-appointed arbitrator, and avoids the possibility of leaks, or the suspicion of leaks, to the appointer during the process.

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