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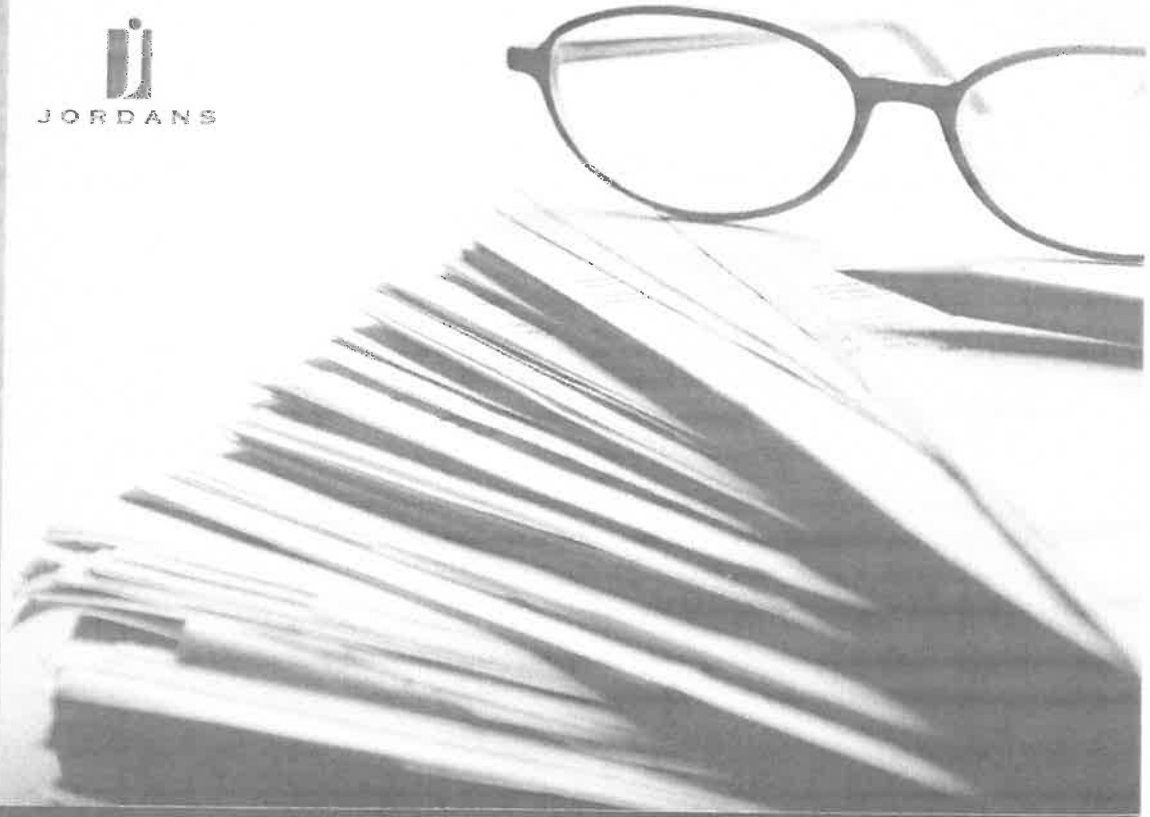

Analysis of New Law

POWER PLAY: ASSET PROTECTION TRUSTS UNDER FIRE

Stephen Moverley Smith QC

INTRODUCTION

The use of discretionary trusts to protect assets from the reach of creditors is of course widespread. However, persuading autocratic entrepreneurs that they should entrust their wealth to faceless trust corporations over which they have no control has proved anything but easy, particularly in jurisdictions where trusts are a relatively alien concept. To address this problem attempts have been made to ensure that as far as possible the settlor retains control, sometimes through legislation (for example, in the British Virgin Islands (BVI), VISTA trusts, which divorce the trustee from responsibility for, and control over, trust assets), but often by reserving to him powers which enable him, should he so wish, to bring the trust to an end. Such powers usually take two forms: an unqualified power of revocation, which enables the settlor, for any reason or for no reason, to revoke the trust and cause the assets to revert to him; and a general power of appointment, which enables him to direct to whom the assets of the trust should be applied.

In *Tasarruf Mevduati Sigorta Fonu v Merrill Lynch Bank and Trust Company (Cayman) Ltd and Others* (*TMSF*)[1] the Privy Council was asked to consider for the first time the question of whether a judgment creditor could, through the appointment of a receiver by way of equitable execution, utilise the reserved powers of a settlor to collapse a trust and attach the underlying trust assets. This article explores that decision and considers the ramifications for asset protection trusts.

BACKGROUND

TMSF is the Turkish banking regulator. It obtained judgment for $30 million in Turkey against a Turkish individual, Mr Yahya Demirel, in relation to a massive

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1 [2011] UKPC 17, 14 ITELR 102.

bank fraud. Mr Demirel had established in the Cayman Islands two discretionary trusts, whose trustees were Merrill Lynch Bank and Trust Company (Cayman) Limited. In relation to each trust he had reserved to himself an absolute power of revocation. The trustees held shares in some Cayman companies, which in turn held nearly $24 million in cash in the Cayman Islands. Summary judgment proceedings were successfully brought by TMSF in the Cayman Islands based on the Turkish judgment. Armed with a Cayman judgment, TMSF then sought to enforce it by a wholly novel route: the appointment of a receiver by way of equitable execution over the powers of revocation Mr Demirel held.

THE ISSUES

In seeking the appointment of a receiver TMSF faced three significant issues. First, was a power the type of interest over which a receiver could be appointed? Secondly, even if a receiver could be appointed over a power, how was the power to be transferred to the receiver so that he could exercise it? Thirdly, even if in theory a receiver could be appointed, was that something the court could properly do? There was no precedent for any such appointment. Indeed, it appeared that the question had never been considered by the courts before, whether in the Cayman Islands or elsewhere.

At the centre of the debate in relation to the first of these questions was the proposition that a power is not property. This distinction draws its significance from an underlying assumption that a receiver should only be appointed over a property interest.

Many of the cases in this area have been decided in the context of particular statutory provisions. For instance, what is perhaps the leading authority, *Re Armstrong, ex parte Gilchrist*,[2] was a decision about the definition of 'property' in the Married Women's Property Act 1882. That said, Fry LJ in that case had no trouble in rejecting the suggestion that a general power of appointment could ever be property, caustically observing:

> 'No two ideas can well be more distinct the one from the other than those of "property" and "power"... A "power" is an individual personal capacity of the donee of the power to do something. That it may result in property becoming vested in him is immaterial; the general nature of the power does not make it property. . . . I am almost ashamed to deal with such an elementary proposition.'

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2 (1886) 17 QBD 521.

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This stark analysis was not always adopted in later cases. For instance in *Re Triffiti's Settlement*[3] Upjohn J considered that a completely general power of appointment could be considered as tantamount to ownership, while in *Re Churston Settled Estates*[4] Roxburgh J thought that the holder of such a power was for all practical purposes the owner of the underlying property. However, there was a body of authority decided in a tax context (*Commissioner of Stamp Duties v Stephen*,[5] *Melville v IRC*[6] and *Morgan v IRC*[7]) which proceeded on the basis that, absent legislation, a general power was not property.

In *TMSF* at first instance, Smellie CJ was particularly struck by the fact that where it was desirable to treat powers as property, express provision was made to achieve this result by legislation (for instance in bankruptcy, in the context of defining the bankrupt's estate). In his view this meant that powers were not otherwise property, with the consequence that they could only be treated as property in the context of equitable receivership if the legislature intervened: absent legislation the court had no jurisdiction.

The Cayman Islands Court of Appeal did not engage with the point, considering it to be ultimately inconclusive, but in the Privy Council the issue was considered in some depth. For Lord Collins of Mapesbury, who gave the judgment of the Privy Council, in considering previous authority context was all important. There was no absolute rule: for some purposes a power was not property, for other purposes the holder of a general power could be regarded for all practical purposes as the owner. In the context of TMSF's application he had no difficulty in accepting that an unfettered power of revocation granted a right that was tantamount to ownership of the underlying trust assets.

As to whether or not a receiver could be appointed over such an interest, Lord Collins of Mapesbury turned to his own judgment in the English Court of Appeal in *Masri v Consolidated Contractors International (UK) Ltd SAL (No 2)*,[8] which considered the English equivalent (s 37(1) of the Senior Courts Act 1981) of the power in the Cayman Islands to appoint a receiver or grant an injunction 'in all cases where it appears just and convenient to do so'.

In *Masri* the question was whether the discretion afforded by s 37(1) was hidebound by pre-1873 practice, that is, whether the 1873 predecessor of s 37(1) had simply

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3 [1958] Ch 852.

4 [1954] 1 Ch 334.

5 [1904] AC 137.

6 [2001] EWCA Civ 1247, [2002] 1 WLR 407.

7 [1963] Ch 438.

8 [2008] EWCA Civ 303, [2009] QB 450.

codified existing law or had created a substantive discretionary jurisdiction. Applying the principle that the overriding consideration was the demands of justice, Collins LJ (as he then was) had concluded that receivers could be appointed (and injunctions granted) in circumstances where no appointment would have been made before 1873 and that the jurisdiction to appoint receivers by way of equitable execution could accordingly be developed incrementally to apply old principles to new situations. The notion to the contrary was based on a misreading of the old case of *North London Railway Co v Great Northern Railway Co*[9] that had been repeated in later authorities. Accordingly, the court in *Masri* was able to appoint a receiver over debts that would become payable to the judgment debtor in future, whether or not that was the practice of the courts before 1873. However, he had also been constrained to accept that the power granted by s 37(1), although expressed in unfettered terms, had been circumscribed by judicial authority dating back many years. While much of that authority related to the injunctive element of s 37(1), similar considerations applied to the power to appoint receivers.

The question therefore, was whether the incremental development of the jurisdiction to appoint receivers, recognised in *Masri*, extended as far as appointing receivers over an asset that was only *tantamount to* property, as opposed to being property itself. This was seen by the Court of Appeal as a policy decision which could only be taken by the legislature. In contrast, Lord Collins of Mapesbury in the Privy Council had no difficulty in concluding both that the Privy Council should determine the issue, and that it should do so in favour of finding that the jurisdiction did extend to rights that were tantamount to ownership.

It is perhaps worth noting that the view that a power of revocation reserved to the settlor is tantamount to ownership of the underlying assets is wholly consistent with the stance currently adopted in the USA. The traditional US position, following the Supreme Court decision of *Jones v Clifton*,[10] had been that a power of revocation was not an interest in property, it could not be assigned, was not a chose in action and accordingly could not constitute an asset. However, more recently the US courts have adopted a far more robust approach. Thus in *United States v Ritter*[11] the US States Court of Appeals concluded that the court should, in the context of a general power 'look beneath the formal niceties of a conveyance to view its plutological reality'; while in *Lynch v Lynch*[12] the Supreme Court of Vermont held, in a matrimonial context, that a power of revocation 'is tantamount to ownership of the trust property and of such a nature that it is subject to the order of the court'.

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9 (1883) 11 QBD 30.

10 (1879) 101 US 225.

11 (1977) 558 F 2d 1165.

12 (1987) 522 A 2d 294.

As to the second issue, the Privy Council chose not to grapple with the question whether the power of revocation was an interest that could be assigned. However, as to whether it could be delegated, a very similar question had been considered in *Re Triffitt's Settlement*,[13] in the context of a general power of appointment. There Upjohn J had held that a completely general power which could be exercised in whatever way the donee of that power pleased could be delegated, because the rights granted were tantamount to ownership. The Privy Council observed that the rights granted to Mr Demirel were equally tantamount to ownership. He owed no duty of trust or confidence to anyone else. The power of revocation was a beneficial power conferred on Mr Demirel for his own benefit: it was in no sense a fiduciary power. In consequence there was no impediment to Mr Demirel delegating the power to the receivers.

The third issue raised a pure question of policy, but it was one hampered by some unhelpful observations in two cases decided at the turn of the nineteenth century. The first, *Holmes v Coghill*,[14] concerned an attempt by creditors of a deceased debtor to persuade the court to treat as the debtor's property £2,000 the debtor had had the power to raise from some property settled on trust, notwithstanding that the power had never in fact been exercised, on the ground that the money was substantially his property. Grant MR held that, while the court had the power to remedy the defective exercise of a power, it had no jurisdiction to intervene where the power had not been exercised at all. The rationale for this conclusion was that 'the rule is perfectly settled ... further than supplying a defect in execution the Court has never gone'. The second decision, decided some 9 years later in the context of bankruptcy was *Thorpe v Goodall*.[15] Assignees in bankruptcy had sought orders from the court requiring the bankrupt to exercise a general power of appointment for the benefit of his creditors. The court refused to make the order, Lord Eldon commenting that unless bound by contract, a bankrupt had never been ordered by a direct decree to do any act. However, on analysis the real question at issue was whether the power of appointment fell within the bankrupt's estate, as defined by the then prevailing bankruptcy legislation.

The decision in *Goodall* led to a change in the law – the Bankruptcy Laws (England) Act 1822, which expressly included in the definition of 'property' all powers vested in the bankrupt which he could execute for his own benefit – and was seized upon by the Court of Appeal in *TMSF* as support for its view that it would require legislation for powers to be considered as a species of property over which a receiver could be appointed. The Privy Council did not feel so constrained. For

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13 [1958] Ch 852.

14 (1802) 7 Ves Jun 499.

15 (1811) 17 Ves Jun 388.

Lord Collins of Mapesbury *Thorpe v Goodall* was an irrelevance, and not a decision on jurisdiction; he dismissed it as having been superseded by legislation and the modern law on injunctions. He approached the question of policy not from the standpoint of whether powers should be considered to be a species of property, but whether the interests of justice required that an order should be made. Having previously determined that Mr Demirel's powers of revocation were such that in equity they could be considered as rights tantamount to ownership and that there was no jurisdictional bar to appointing receivers over such assets, it was perhaps unsurprising that he should then go on to conclude that justice required that receivers should be appointed to make effective the judgment of Cayman Court.

Lord Collins of Mapesbury did not find it necessary to decide the further alternative question which was raised in argument, namely whether it would have been possible simply to have obtained an order directly against Mr Demirel requiring him to execute the powers of revocation. The objections to this course of action were first, the decision in *Thorpe v Goodall*, and secondly *Field v Field*,[16] a decision of Wilson J sitting in the English Family Division. The view Lord Collins of Mapesbury took of *Thorpe v Goodall* is set out above. In *Field v Field* the question was whether a husband could be ordered to elect to receive a lump sum payment from his employer's pension scheme to satisfy an unpaid order made in favour of his wife in ancillary relief proceedings. The right was expressed to be non-assignable. Wilson J expressed the view that while an injunction could be granted in aid of the court's established procedures for enforcement, it could not be a free-standing enforcement procedure in its own right. Although not deciding the point, Lord Collins of Mapesbury expressed doubt as to the correctness of that decision.

CONSEQUENCES

The decision in *TMSF* represents a milestone in the development of the law of receivership by way of equitable execution: for the first time the jurisdiction has been extended to encompass assets which are not current or future property. It may also represent a turning point in relation to the creation of asset protection trusts.

The reservation of general powers in favour of the settlor of a trust is commonplace. Indeed, the inclusion of such provisions is often an important selling point in marketing discretionary trusts. Up until now there appears to have been no focus on the extent to which they make trusts vulnerable to attack by creditors.

It has for long been the case that bankruptcy legislation in most common law jurisdictions seeks to extend the definition of 'property' comprised in a bankrupt's

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[16] [2003] 1 FLR 376.

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estate to include powers from which he can financially benefit. In England, for instance, s 283(4) of the Insolvency Act 1986 provides that property, in relation to a bankrupt includes:

> 'any power exercisable by him over or in respect of property except in so far as the power is exercisable over or in respect of property not for the time being in the bankrupt's estate and (a) is so exercisable after the [release of the trustee] or (b) cannot be so exercised for the benefit of the bankrupt.'

However, it is often the case that the settlor and the trustees of a trust are in different jurisdictions. A bankruptcy order can usually only be obtained in the jurisdiction in which the settlor is present, resides, is domiciled, or carries on business. For example, s 265(1) of the Insolvency Act 1986 only permits a bankruptcy petition to be presented where the debtor is domiciled in England and Wales, is personally present in England and Wales on the day on which the bankruptcy petition is presented, or at any time within the period of 3 years previously has been ordinarily resident or has had a place of residence in England and Wales, or has carried on business in England and Wales (there are further restrictions if the debtor has his centre of main interests in another EU country). Accordingly, where, as is often the case, the trust is offshore it is unlikely that a bankruptcy order can be obtained there.

While it may be that a bankruptcy order can be obtained in another jurisdiction with which the settlor is sufficiently connected, that may not prove to be entirely straightforward, for instance in certain jurisdictions there may be doubts as to the reliability of the local judiciary. If the bankruptcy legislation in that jurisdiction recognises the power as falling within the bankrupt's estate the trustee in bankruptcy may seek to execute it, but it is another question whether any such execution is recognised by the trustees of the trust. If the trustees of the trust do not recognise the foreign trustee in bankruptcy's authority then it will be necessary for him to seek recognition in the jurisdiction in which the trustees of the trust reside. Depending on the jurisdiction in question recognition may be obtained relatively easily: in *Cambridge Gas Transportation Corporation v Official Committee of Unsecured Creditors of Navigator Holdings plc*,[17] a Privy Council decision on appeal from the Isle of Man, Lord Hoffmann held that at common law the Isle of Man court (and by extension any other court in a common law jurisdiction) has the jurisdiction to give assistance by doing whatever it could have done in the case of a domestic insolvency, to enable the trustee in bankruptcy or creditors to avoid having to start parallel insolvency proceedings and to give them the remedies to which they would have been entitled if equivalent proceedings had taken place in the domestic forum.

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[17] [2006] UKPC 26, [2007] 1 AC 508.

In *TMSF* itself Mr Damirel was made bankrupt in Turkey during the course of the enforcement proceedings. However, that did not avail the bankruptcy administration to which he became subject, as under Turkish law on bankruptcy property did not vest in the administration but remained with the debtor. In the event, in order not to undermine the bankruptcy, TMSF volunteered an undertaking that it would pay the net proceeds to the bankruptcy administration to be administered for the benefit of creditors as a whole.

It will be seen that the bankruptcy route is not without its complications and does of course have the obvious disadvantage that any recoveries will have to be shared with all the other creditors of the debtor, as well as being net of what are likely to be substantial costs incurred by the bankruptcy trustee.

The route of enforcing a judgment by appointing a receiver by way of equitable execution over the general powers reserved to a settlor has the obvious advantage that it does not require any resulting proceeds to be shared with other creditors and is likely to be much less costly than bankruptcy. The creditor will of course have to obtain a judgment against the debtor and then seek to enforce that judgment in the jurisdiction in which the trustee resides, by obtaining a local judgment there based on the original judgment. In a number of jurisdictions reciprocal enforcement of judgments is governed by legislation (in England, the Administration of Justice Act 1920, the Foreign Judgments (Reciprocal Enforcement) Act 1933 and the EU Judgment Regulation).[18] Countries included within these statutory regimes include most offshore jurisdictions. Where such legislation does not apply enforcement is achieved by an action on the original judgment, as occurred in *TMSF*. In many offshore jurisdictions rules of court make express provision for service out of the jurisdiction of proceedings seeking to enforce a foreign judgment (see, for example, CPR O.7.3(5) in the BVI; GCR O.11 r 1(m) in the Cayman Islands). Once a local judgment has been obtained the appointment of a receiver can be sought. However, as an order appointing a receiver does not operate to vest assets in him, it will also be necessary to seek an ancillary order requiring the settlor to delegate his reserved powers to the receiver. In most jurisdictions if the settlor fails to comply with such an order the court will have the power to direct some other person (often a court officer) to carry out the delegation on behalf of the settlor (for example, in *TMSF* under GCR O.45 r 8). The steps required by the receiver to revoke the trust are likely to be entirely straightforward – in *TMSF* the receivers simply needed to serve a notice on the trustees – thereafter their role will be limited to receiving the trust assets from the trustees and realising those assets for the benefit of the creditor.

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[18] Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (2000) OJ L 12/1.

As mentioned above, during the course of the *TMSF* hearing in the Privy Council the suggestion was canvassed that an alternative route could have been adopted, namely simply seeking an order directly against the settlor requiring him to exercise his power of revocation, with a similar default provision (exercise by a court officer in his name) in the event he fails to comply. The reason this course was not adopted in *TMSF* was the decision in *Field v Field*,[19] which appeared to preclude the use of a free-standing injunction of that type. In the light of the observations of Lord Collins of Mapesbury, it would appear that *Field v Field* is unlikely to have been correctly decided and that the direct route would have been available to TMSF. The disadvantage of that course is that on revocation the trust assets fall into the settlor debtor's hands rather than into the hands of a court officer, thus providing an opportunity for dissipation in advance of the creditor executing his judgment over them. The risk can of course be mitigated by obtaining an appropriate freezing order but if, as will invariably be the case, the settlor is out of the jurisdiction, the effectiveness of such an order may be questionable, particularly where trust assets are in another jurisdiction.

The touchstone for the appointment of a receiver in *TMSF* was the fact that the power that Mr Demirel had was tantamount to the rights of ownership of the underlying assets. There is very little difference between cash held by trustees in a trust subject to an unfettered power of revocation exercisable at the whim of the settlor and cash held by the settlor at his bank: in either case the money is in essence payable to the settlor on demand. A general power of appointment reserved to the settlor can be viewed in the same light: the settlor can require that the entire trust fund be paid to him without regard to the needs of other potential beneficiaries. In the Court of Appeal in *TMSF* an attempt was made to distinguish between an unfettered power of revocation, which destroyed the trust, and a general power of appointment which operated through the trust. The Court of Appeal rejected the suggestion that there was any significance in the supposed distinction. In its view a power of revocation was simply a narrow power of appointment, the only potential appointee being the settlor (in the Privy Council Lord Collins of Mapesbury noted the Court of Appeal's finding on this point without comment). On this analysis there is every reason to suppose that a receiver by way of equitable execution could be appointed over a truly general power of appointment. Further, while *TMSF* was concerned with powers reserved to the settlor, there seems no reason in principle why an appointment should not be able to be made in relation to a power given to a third party, provided it has the same qualities.

In *TMSF* for a receiver to be appointed it was also essential that the power reserved to Mr Demirel was non-fiduciary. Powers are generally classified as either beneficial

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[19] Ibid.

(where the donee can exercise the power in any way he pleases), limited (where the power is conferred for the benefit of one or more beneficiaries other than the donee and must be exercised in good faith for the purpose for which it was given) and fiduciary (where there is a duty owed to the objects of the power to consider from time to time whether and how to exercise it). There seems little doubt that fiduciary and limited powers are outside the scope of receivership by way of equitable execution, but there may be other beneficial powers which could be encompassed, although much will depend on the way in which the trust instrument is drafted. What, for instance, of a power to add beneficiaries to the exclusion of the donee of that power and to direct the appointment of assets to them? If it could properly to be construed as a beneficial power, could that also be the subject of a receivership application, with the power being delegated to the receiver to add a judgment creditor as a beneficiary and direct the appointment of assets to him in satisfaction of his judgment?

While *TMSF* was concerned with the claims of creditors, it may be a decision of more than passing interest to warring spouses seeking to attack offshore trusts established by their husbands. Following decisions such as *A v A*,[20] any argument that a trust established with professional trustees is a sham is likely to be doomed to failure because the spouse will be unable to show that the trustees were parties to the impropriety. *TMSF* now potentially provides an alternative route if the husband has reserved to himself powers of revocation or appointment.

Further, if a receiver can be appointed by way of equitable execution of a judgment over a beneficial power, there would appear to be no reason in principle why in an appropriate case where an injunction is not considered sufficient he could not be appointed before judgment, for example to prevent a settlor from releasing the power or, in the case of a general power of appointment, to prevent him appointing the trust assets to a third party, for example, in a matrimonial dispute, a mistress.

If a trust is vulnerable to attacks by creditors by virtue of the fact that beneficial powers have been reserved to the settlor or granted to a third party the question which arises is whether it is possible to cure the problem by releasing the powers in question. While a donee of a power has the capacity to release it (in England, pursuant to s 155 of the Law of Property Act 1925 and at common law[21]) such a release might have adverse fiscal consequences (if the power confers a right tantamount to property then its release could be considered as a disposition by the donee of a valuable right) and might be construed in any subsequent bankruptcy as a transaction at an undervalue (in England under s 339 of the Insolvency Act 1986)

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20 [2007] EWHC 99 (Fam), [2007] 2 FLR 467.

21 See *In Re Rose* [1904] 2 Ch 348.

or, depending on the circumstances, a transaction defrauding creditors (in England, under s 423 of the Insolvency Act 1986). Perhaps more importantly, in terms of the rights enjoyed by a settlor, a trust which reserves to a settlor a power of revocation or general power of appointment is fundamentally different from a trust which does not contain such reservations. Settlors who wish to retain control may not take kindly to a subsequent suggestion that they should relinquish the residual right to recover the trust assets.

CONCLUSION

The 'cake and eat it' desire to protect assets from creditors while retaining ultimate control has resulted in the widespread creation of discretionary trusts which reserve extensive beneficial powers to settlors. The decision in *TMSF* establishes that, contrary to what might have been supposed, such trusts are vulnerable to attack and destruction at the hands of creditors. While, in relation to existing trusts, the position may be able to be ameliorated by a release of the powers in question, that will involve a relinquishment of control that may well be found to be unacceptable. In relation to new trusts, trust providers will need to ensure that, in deciding to include reserved powers, their clients are aware of the attendant risk that they may also be sowing the seeds of the trust's destruction.

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