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Tasarruf Mevduati Sigorta Fonu (TMSF) v Merrill Lynch Bank & Trust Co (Cayman) Ltd: How the Game has Changed for Creditors



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☞ Appointments; Cayman Islands; Creditors; Equitable execution; Judgment debts; Receivers; Revocation; Trusts

This article explores the decision of the Privy Council in Tasarruf Mevduati Sigorta Fonu (TMSF) v Merrill Lynch Bank & Trust Co (Cayman) Ltd¹ and its ramifications for asset protection trusts.

The use of discretionary trusts to keep assets out of the reach of creditors is commonplace. Frequently, however, the settlor prefers not to be parted from his property and to retain a degree of formal control over it. Attempts have been made to meet this requirement through legislation (for example, in BVI, VISTA trusts, which divorce the trustee from responsibility for, and control over, trust assets), but also by the settlor's reservation of powers enabling him to terminate the trust at a time of his choosing.

Such powers usually take two forms: a power of revocation, by exercising which the settlor may revoke the trust and recover the trust property; and a general power of appointment, by which he may direct to whom trust property should be made over.

In *Tasarruf Mevduati Sigorta Fonu (TMSF) v Merrill Lynch Bank & Trust Co (Cayman) Ltd*² the Privy Council considered whether a judgment creditor could, through the appointment of a receiver by way of equitable execution, utilise a settlor's power of revocation for the benefit of creditors.

Background

Mr Demirel controlled a Turkish bank called Egebank. Egebank collapsed in 2000 after substantial sums were misappropriated from it by Mr Demirel and his family. In November 2001 the Turkish courts gave judgment against him personally in the sum of US \$30 million in respect of his involvement in fraudulent

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¹ *Tasarruf Mevduati Sigorta Fonu (TMSF) v Merrill Lynch Bank & Trust Co (Cayman) Ltd* [2011] UKPC 17; [2011] 4 All E.R. 704.

² [2011] UKPC 17; [2011] 4 All E.R. 704.

loans. The right to enforce the judgment was acquired by TMSF, an agency of the Turkish state with responsibility for managing the affairs of failed banks.

In 2006 TMSF discovered that in 1999 Mr Demirel had settled US \$24 million in two trusts in Cayman, whose trustee was Merrill Lynch Bank and Trust Company (Cayman) Ltd. TMSF sued Mr Demirel in Cayman on the basis of the Turkish judgment, obtaining a Caymanian judgment against him for US \$30 million.

Tasarruf Mevduati Sigorta Fonu's application

The trusts which Mr Demirel had established were in standard form which included a power reserved to the settlor to revoke, amend, vary or alter the terms of the settlement simply by delivering a deed containing his instructions to the trustees. TMSF regarded this arrangement as tantamount to ownership of the US \$24 million in the trusts and sought to enforce its judgment against that money by applying for the appointment of receivers by way of equitable execution over those powers, coupled with an order that Mr Demirel assign or delegate the powers to the receivers, so that the receivers could exercise them, and a provision that if Mr Demirel failed to execute the assignment or deed of delegation, it be executed in his name by an officer of the court. This was, so far as we are aware, the first application of its kind.³

TMSF relied on the Grand Court Law (2008 Revision) s.11(1), which is in the same terms as what is now the Senior Courts Act s.37(1) in England:

"[T]he court may by order grant an injunction or appoint a receiver in all cases in which it appears to the court to be just and convenient to do so."

The application therefore tested the extent of the discretion conferred by this section.

In that regard TMSF relied on the judgment of Lawrence Collins L.J. in the Court of Appeal in *Masri v Consolidated Contractors International (UK) Ltd (No.2)*.⁴ In *Masri* a judgment creditor sought the appointment of receivers by way of equitable execution over debts that might become payable to the judgment debtor in the future. The judgment debtor argued that a receiver could not be appointed over a future debt. It also contended that s.37, which was originally enacted as part of the Judicature Act 1873, did not create a new discretion to appoint a receiver in any circumstances where it would not have done so prior to 1873. Since (it was said) no receiver would have been appointed in 1873 on the facts of *Masri*, no such appointment could be made in 2008. That submission was rejected. The court held that the demands of justice were the over-riding consideration, that it was not bound by practice before 1873, and that the jurisdiction to appoint a receiver by way of equitable execution could be developed incrementally by applying old principles to new situations.

The adoption of such a pragmatic and open-ended approach in *Masri* was encouraging to TMSF, given the novel character of TMSF's own application, which was resisted by Mr Demirel on three principal grounds. First, he said that a receiver by way of equitable execution could only be appointed over property, and as a power was not property there could be no appointment. Secondly, he said that the powers of revocation were not delegable. Thirdly, he said that the court had no jurisdiction to order the exercise of the powers.

Giving judgment at first instance in the Grand Court of Cayman, Smellie C.J. dismissed the application, principally because as he saw it a receiver could only be appointed over an asset that is in the nature of property. Emphasising the long-standing distinction between power and property, he quoted from *Re Armstrong Ex p. Gilchrist*⁵:

³ For a recent application of the decision in *TMSF see Blight v Brewster* [2012] EWHC 165 (Ch).

⁴ *Masri v Consolidated Contractors International (UK) Ltd (No.2)* [2008] EWCA Civ 303; [2009] Q.B. 450.

⁵ *Re Armstrong Ex p. Gilchrist* (1886) L.R. 17 Q.B.D. 521 CA.

"No two ideas can well be more distinct 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 power of a person to appoint an estate to himself is, in my judgment, no more his 'property' than the power to write a book or to sing a song. The exercise of any one of those three powers may result in property, but in no sense are they 'property.'"⁶

The Cayman Islands Court of Appeal upheld the decision. It said that the court's refusal to extend the jurisdiction was essentially one of policy, but it also relied on an 1811 case, *Thorpe v Goodall*,⁷ which decided that the court could not compel a bankrupt to exercise a power of appointment for the benefit of creditors.⁸

TMSF appealed to the Privy Council. The judgment of the Board was given by Lord Collins (as he now is). He thought that the critical point was that although "[t]he traditional view was that a power was distinct from property ... this was not an absolute rule." Thus:

"[W]hile for some purposes a power was not property, for other purposes the holder of a general power could be regarded as being for all practical purposes the owner."

While the Privy Council acknowledged that there were old decisions, such as *Thorpe*, which "in modern terms can be regarded as deciding ... that the court had no jurisdiction to order a power to be exercised," it referred to other cases in which it had been held that "where there is a completely general power in its widest sense, that is tantamount to ownership" (*Re Triffitt's Settlement*,⁹ per Upjohn J.) and that a person having a common general power of appointment "is treated as though he were for all practical purposes the owner [of the property subject to the power]" (*Re Churston Settled Estates*,¹⁰ per Roxburgh J.).

Reference was also made to a number of US authorities where the courts have held that "the settlor [who reserves a power of revocation] retains all the substantial incidents of ownership" and that "it would be excessive obedience to the form in which property is held to prevent creditors from reaching property placed in trust under such terms" (*State Street Bank & Trust Co v Reiser*)¹¹; and to Scott's *Restatement of the Law of Trusts*¹²:

"[T]here is a sound public policy of basing the rights of creditors on the substance rather than the form of the debtor's property rights."¹³

Having determined that the court had jurisdiction, the Board agreed with TMSF's submission that where the holder of a power owes no fiduciary duty to another person in respect of its exercise, it may be delegated. Since Mr Demirel had an absolute discretion as to the exercise of his powers, they were delegable on that basis (see *Re Triffitt's Settlement*). It accordingly ordered Mr Demirel to delegate the powers to receivers who could exercise them for the benefit of creditors. The decision in *Masri*, it said, confirmed that "the demands of justice are the overriding consideration under section 37".

⁶ *Re Armstrong Ex p. Gilchrist* (1886) L.R. 17 Q.B.D. 521 CA per Fry L.J. at 531.

⁷ *Thorpe v Goodall* 34 E.R. 150; (1811) 17 Ves. Jr. 388.

⁸ In 1822 the law was changed by statute, after which a bankrupt's "property" included powers over property that could be exercised for the benefit of the bankrupt.

⁹ *Re Triffitt's Settlement* [1958] Ch. 852; [1958] 2 W.L.R. 927 Ch D.

¹⁰ *Re Churston Settled Estates* [1954] Ch. 334; [1954] 2 W.L.R. 386 Ch D.

¹¹ *State Street Bank & Trust Co v Reiser* 389NE 2d 768.

¹² A.W. Scott, *Restatement of the Law of Trusts*, (American Law Institute, 2007), Vol.3.

¹³ Scott, *Restatement of the Law of Trusts*, (2007), Vol.3, comment e to s.25(1).

Ramifications

The decision in *TMSF* has important implications for the creation of asset protection trusts. The inclusion of general powers in favour of the settlor is widespread (it will be recalled that the powers reserved to Mr Demirel were bank's standard form) and often an important selling point in marketing discretionary trusts. It seems that, up until now, little attention has been paid to the possibility that they expose trusts to attack by creditors.

Further, as has been seen, the touchstone for the appointment of a receiver in *TMSF* was that Mr Demirel's powers of revocation were tantamount to ownership of the underlying assets. The same can equally be said of the reservation of a general power of appointment which equally may allow the settlor to appoint the whole or any part of the trust fund to himself.

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. That analysis was rejected: in the court's view the former was simply a more limited form of appointment. It follows that a receiver by way of equitable execution could equally be appointed over a general power of appointment. Indeed, there seems no reason in principle why an appointment could not be made over a power held, not by the settlor, but by a third party.

Further, in *TMSF* the appointment of receivers depended on the non-fiduciary character of the powers of revocation. It will be appreciated that powers may be beneficial (the donee may exercise the power as he pleases), limited (the power is conferred for the benefit of beneficiaries other than the donee and must be exercised in good faith for the purpose for which it was given) or fiduciary (a duty is owed to the objects of the power to consider from time to time whether and how to exercise it). There can be 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 that could be encompassed, although much will of course depend on the drafting of the trust instrument. If, for instance, a settlement contained a power to add beneficiaries to the exclusion of the power's donee and to appoint assets to them, and that power could properly be construed as a beneficial power, there is clearly an argument for saying that a receiver could be appointed to add a judgment creditor as a beneficiary and appoint assets to him to satisfy the judgment.

TMSF may also be a decision of more than passing interest to warring spouses seeking to attack offshore trusts established by their erstwhile partners. Following decisions such as *A v A & St George Trustees Ltd*,¹⁴ it will be appreciated that any argument that a trust established with professional trustees is a sham is likely to fail because of the difficulty of proving impropriety on their part. *TMSF* potentially provides an alternative route if the settlor has reserved powers of revocation or appointment.

Moreover, there is no obvious reason in principle why in an appropriate case where an injunction is not considered sufficient a receiver could not be appointed before judgment, for example to prevent a settlor from releasing a power or, in the case of a general power of appointment, to prevent him from appointing the trust assets to a third party, e.g. in a matrimonial dispute, a mistress.

One obvious question that arises is whether a trust that is subject to general powers of revocation or appointment may be rendered invulnerable to attacks by creditors by releasing the powers in question. Whilst a donee of a power has the capacity to release it (in England, pursuant to Law of Property Act 1925 s.155 and at common law)¹⁵ any such release might have adverse consequences. If the power is tantamount to property then its release could be construed in any subsequent bankruptcy as a transaction at an undervalue (in England under Insolvency Act 1986 s.339) or, depending on the circumstances, a transaction defrauding creditors (in England, under Insolvency Act 1986 s.423). It also needs to be borne in mind that a trust whose settlor reserves a power of revocation or general power of appointment is fundamentally different from a trust without such reservations. If a trust structure has been sold to a settlor on the basis

¹⁴ *A v A & St George Trustees Ltd* [2007] EWHC 99 (Fam); [2007] 2 F.L.R. 467.
¹⁵ *Re Rose* [1904] 2 Ch. 348 Ch D.

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that he can retain ultimate control of its assets through a power of revocation he may not take kindly to the suggestion that he should now relinquish that power.

Bankruptcy as an alternative?

Bankruptcy legislation in common law jurisdictions generally includes in a bankrupt's "property" powers over property. In England, Insolvency Act 1986 s.283(4) provides that a bankrupt's property includes:

"[A]ny 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."

Frequently, however, 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 (see, e.g. Insolvency Act 1986 s.265(1)). Accordingly, where the trust is offshore it is unlikely that a bankruptcy order can be obtained there. To obtain a bankruptcy order in a jurisdiction with which the settlor is sufficiently connected may also be difficult, for example because the local judiciary may be unreliable. If an order can be obtained in a jurisdiction that treats the power as falling within the bankrupt's estate, the trustee in bankruptcy may seek to execute it, but the trustees of the trust may be disinclined to recognise such execution. In such circumstances the trustee in bankruptcy will need to obtain recognition in the jurisdiction where the trustees of the trust reside, although this may not be difficult to achieve following the Privy Council decision of *Cambridge Gas Transport Corp v Official Committee of Unsecured Creditors of Navigator Holdings Plc*.¹⁶ an appeal from the Isle of Man which concluded that at common law the courts should assist a foreign trustee in bankruptcy, by taking such steps as it could have taken in the case of a domestic insolvency.

There may also be other problems. In *TMSF* itself Mr Demirel had been made bankrupt in Turkey during the enforcement proceedings. However under Turkish law property does not vest in the bankruptcy administration but remains with the bankrupt, and therefore the administration had no title to any of his assets, including any power of revocation.

Further, there are the obvious disadvantages that bankruptcy brings: recoveries are shared with the debtor's other creditors and are net of the often substantial costs of the bankruptcy trustee. In contrast, the appointment of a receiver by way of equitable execution does not require sharing and the costs should, in theory at least, be relatively modest.

Conclusion

The desire to protect assets from creditors whilst retaining ultimate control has resulted in the widespread creation of discretionary trusts which reserve extensive beneficial powers to settlors. What *TMSF* establishes is that, contrary to what might have been supposed, such trusts may be attacked and destroyed by creditors. While, in relation to existing trusts, the position may be capable of improvement by a release of the powers in question, the concomitant relinquishment of control may well be unacceptable. When creating new trusts, trust providers will need to ensure that, in reserving powers, their clients understand that they may also be sowing the seeds of the trust's destruction.

¹⁶ *Cambridge Gas Transport Corp v Official Committee of Unsecured Creditors of Navigator Holdings Plc* [2006] UKPC 26; [2007] 1 A.C. 508.