Trust Disputes - Disputes between Trustees and Beneficiaries

Dr Ben Fok, TEP, ChFC, CFP

Trustees are trusted to make decisions in the beneficiary's best interests and have a fiduciary responsibility to the trust beneficiaries. That is why a Private Wealth Adviser (PWA) will usually work in conjunction with trustees to ensure the desired outcome is achieved. However, when there is a dispute, the PWA has to be concerned about the scope of responsibilities and where the liability lies.

The most common trust disputes usually involve the mismanagement of the trust by the trustee. Other types of disputes that commonly arise are because the beneficiaries disagree over the construction of the trust. Or it could be how the trustee handles and administers the property or assets assigned to the trust. As such, trustees who are involved in setting up trusts for clients will have to deal with the tests and laws of whether a person can make decisions relating to their property and affairs, for example:

- Whether the settlor had legal capacity (e.g., fit mind) to create the trust;
- Whether the settlor was pressured or coerced to form the trust (e.g., undue influence);
- Whether the settlor was affected by fraud or if the signature was forged.

Hence, the more familiar trustees are with a settlor's situation – such as changing family dynamics, including marital break-ups, the more confident their decisions will be. As such, trustees need to review their onboarding process to ensure they do not set up trusts where clients cannot make absolute decisions. That is why understanding trust and case law is vital in helping trustees make informed decisions when there is a dispute. In addition, trustees must keep up to date with reported cases in their jurisdictions and around the world.

Sham trust seems to be a common use of trusts worldwide, yet disputes are increasingly occurring every year. The critical issue was to differentiate the difference between Sham and Illusory trust and when a trustee should submit to a local or foreign court.

Traditionally, most common trust disputes usually involve the mismanagement of the trust by the trustee. For example, the trustee may have failed to provide accurate accounting records of the assets and property held in the trust, or improperly divided and distributed the property or assets to the beneficiaries. In addition, there are trust disputes beyond the trustee's control and knowledge, e.g. not realising the real intention and purposes of the settlor in setting up the trust.

As such, trustees, protectors and other fiduciaries are increasingly likely to face legal proceedings. They may be accused of failing to discharge their duties properly or are being pursued by creditors of the people who set up the trust. Alternatively, there could be problems between them and the trust beneficiaries.

There are plenty of cases involving trust disputes; in Pugachev and Clayton they have created an illusory trust, and in Snook case, it is a Sham trust. The Court decision on Mr Pugachev was he had created an "illusory trust" where the arrangement gives the outward impression of being a trust but is not so because of extensive reserved powers retained in the settlor. The apparent trustee has no power to deal with the trust's property as the settlor retains so much control that, in effect, no trust exists.

The concept of an "illusory trust" differs from the "sham trust". For a trust deed to be a sham, it must be created to mislead third parties by giving a false impression that legal rights and obligations

were created in accordance with the trusts and that assets were held. A sham trust can also be created for unlawful purposes, including tax evasion, defrauding of creditors, and unlawful hiding of assets.

Furthermore, a sham trust is also created so that the settlor (or a "creator" with sham trust) retains ultimate control over the assets. That is why the court's decisions to Pugachev on the construction of the trust documents were not the same as finding of a sham.

The above case demonstrates the various issues of trust disputes. Traditionally, trust disputes tend to be resolved through court proceedings. This is because the administration of trusts is subject to supervision by the court, generally by the court where the trust is administered or the court whose law governs the trust. Provided a beneficiary can demonstrate a real potential of them benefiting from the trust, they will likely be able to invoke the court's supervisory jurisdiction to obtain information about the administration of the trust or hold the trustees to account for decisions taken.

But should a trustee submit to a foreign court? If yes, when should a trustee make an application to court? What is the responsibility of the court? How should a trustee deal with the potential exclusion of a beneficiary? These are questions a trustee needs to ask themselves.

Trustees need to review the facts of each case before deciding whether to submit it to a foreign court. In Poon (Kan Lai Kwan v Poon Lok To Otto and HSBC International Trustee Ltd), the majority of the assets were based in Hong Kong. Therefore, the Hong Kong court had the power to enforce its order against the trust's underlying assets and whether or not the Jersey trustee submitted to the foreign court. The trustee obtained legal advice in Hong Kong to submit to the foreign court. In this way, the trustee would be able to put forward its case and act in the best interests of the beneficiaries.

Unfortunately, many North Asian families, while understanding the benefits of setting up trusts for succession planning, asset consolidation, asset protection and other purposes, are generally not willing to give up too much control to the trustees over the assets placed into the trust. The following issues should be considered by the settlor and the trustee when creating and administering a trust:

- There should be a balance between the extent of powers and functions given to a settlor, protector and trustee. A trust instrument should avoid conferring excessive retention of powers to either the settlor or the protector. Powers reserved to a settlor could be exercised by the trustee in bankruptcy.

- Where possible, the protector should be a third party, not a beneficiary of the trust. Otherwise, the power conferred to such a protector should be less extensive, if any.

- Where possible, the trust should be irrevocable to minimise the risk of being revoked by the settlor's future creditors.

To mitigate future trust disputes, before setting up the trust, the settlor should consider transferring all the intended trust property to a company incorporated or registered in the same offshore jurisdiction as the trust. In addition, they should consider the issue of shares to the settlor and settle such shares into the trust. The property transferred under the disposition will be within the jurisdiction of the court of the offshore jurisdiction.

Trust assets should be kept as much as possible outside the jurisdiction in which there may be a significant risk of attack (e.g. settlor's residence or where the settlor carries on business). The above

considerations are likely to reduce the risks of exposure of the assets of an offshore trust to claims from creditors. However, they are not exhaustive as care must be taken to analyse and arrive at the best possible solution depending on each proposed trust arrangement's specific facts and purposes.

For those in private wealth and trust business will be well aware of 'Anti-Bartlett clauses' in trust deeds. Such clauses are drafted to exclude the duty of a trustee to supervise the business affairs of companies in which the trust holds shares. The Hong Kong Court of Final Appeal has essentially restored the status quo and confirmed that Anti-Bartlett clauses effectively exempt trustees from any liability for losses incurred unless they become aware of actual dishonesty. This decision provides a welcome degree of certainty on the construction of anti-Bartlett clauses in common law courts.

In summary, trustees can make more effective decisions when they are aware of changing family dynamics and trust and case law in their own and other jurisdictions. The importance of acting with prudence can never be underestimated, and trustees should seek appropriate legal advice throughout their length of service.

A trustee must give careful thoughts on giving what powers and interests the settlor should retain. These should be kept to a minimum. The greater the degree of control and interest, the greater the risk that the trust may be found to be illusory. This can be applied to many approaches from clients who wish to protect their assets by using a trust or seeking advice on multigenerational succession planning.

Hence being a trustee carries enormous responsibilities. A trustee must understand clients' objectives in setting up a trust. If not, there could be a reputational risk, professional indemnity claims, return of fees charged and in some cases, criminal conviction for the trustee. These risks are avoidable.

Disclaimer: The opinions expressed in these articles are those of the authors. They do not purport to reflect the opinions or views of AFA(S) or its members