Trusts – and they lived happily ever after

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"Once upon a time…" Of course, everyone remembers this introduction to fairy tales and legends. Indeed, legends are often the way in which trusts are perceived. By the same token, the beginnings of trusts go back as far as the historical roots of fairy tales. They trace their origins back to the feudal system of medieval England. As proprietor of the entire country, the king would grant to the members of his entourage the use of his property as long as they provided designated services and paid the taxes due. Meanwhile, these latter would lend a part of the freehold property to their subjects. During the Crusades of the 12th and 13th centuries, many vassals would transfer their properties under civil ownership to trustees while retaining their beneficial use for their wives and children until their return. The advantages of the transfer of ownership to a person of trust, usually a member of the family or a friend, are easily demonstrated and remain convincing even today: the trusted third party tends to the tedious management of the transferred property which the other party would be incapable of taking care of, while benefiting the family members.

Although the most profuse development of the trust occurred during the period of the Crusades, its true origin remains obscure. There are indications that its roots can be traced back to the Germanic Salmann, a sort of trust administration. Other sources indicate that it was the islamic endowment system (Waqf) that, over time, found its way to England. Entities resembling trusts can be found as early as 2500 B.C. under the name of the Egyptian Pharaoh Menkaure, the builder of the third Pyramid of Giza. Entailed estates were to be found under Roman law; a sort of instruction in the will, they outlined the release to a third party of an inheritance for the heirs, after a certain period of time, in whole or in part, and thus display features similar to those of trusts.

While it may be impossible to conclusively determine the historical roots of trusts, the sheer number of possible origins shows that the essence of trusts arises from a universal need. Today, this is also evidenced by the fact that not only do England and a multitude of Caribbean and Pacific Island countries have their own trust laws, but so do the United States, Canada, Australia, New Zealand, Japan, China or South Africa. Moreover, trusts are recognised as such in many other countries as well.

On the nature of trusts

A trust is a legal relationship created – inter vivos or on death – 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 rights in respect of the trust's assets are in the trustee's name. The trustee has the power and the duty to administer, to use or beyond that, to dispose of trust assets in accordance with the special trust provisions imposed upon him by law.

Notwithstanding the transfer of assets to a trustee and the conclusion thereby of the founder's power of disposition, the founder is allowed to retain certain rights and powers under trust law. Especially because of the fact that the founder of a trust can retain rights, trusts have encountered increasing criticism in recent times. It is often assumed that trusts disguise the actual disposition of property relationships to provide instruments for fiscal fraud, money laundering or for undermining divorce and legal claims to property of spouses, inheritance claims from heirs to a statutory share and insolvency rules for claims from creditors.

Such reservations regarding trusts do no justice to the essence of the trust. There are three reasons why a trust is usually established. Firstly, assets require long-term management in the hands of a qualified person in a position of trust. Secondly, these assets should be preserved and not fall apart in the face of strokes of fate – such as death, divorce, bankruptcy and illness. Thirdly, the parties benefitting from the assets shall be determined. Fiscal considerations are rarely decisive when establishing a trust. Trusts thereby combine functions which often exist in countries that are unfamiliar with the trust as well – asset management contracts, marriage and testamentary contracts, missions of preparedness, setting up companies. It is however characteristic for trusts to combine the elements of professional asset management, long-term wealth preservation and the flexible provision of a property to the beneficiaries. Trusts thus facilitate nothing other than that which national legislators in non-trust countries provide as well.

In order to ensure the legal validity of trusts as well as their recognition in the place of residence of spouses, heirs to a statutory share or creditors, the "trust must be played out" and control of assets surrendered to a trustee. Those who would transfer assets to a third party whom they would continue to control will be disappointed – trusts are not suitable for such. A large number of decisions by the courts indicate that undue control of the trustee by the founder is being sanctioned and actual or effective recognition of the trust is lacking. This explains why trusts in which a founder pulls the strings of a trustee as though he were a simple marionette with the trustee merely acting as a front man are useless for asset planning.

Requirements for a trust to be valid

In order for trusts not to be qualified as invalid, the following must be avoided:

• The settlor must not have any *control* or *influence* over trust assets, and thereby (I) the settlor is authorised to transfer trust assets to himself, even when the formal acceptance of the trustee is required to do so, (II) the trustee can transfer trust assets to the settlor under omission of the safeguarding of the interests of the beneficiaries, (III) the trustee in the meantime needs the settlor's consent for essential management and investment decisions, (IV) the settlor is authorised to appoint an investment advisor and the trustee; in the event he complies with the investment advice, he is himself released from any responsibility for the success of the investments, (V) the trustee requires the settlor's consent for the appointment of an investment advisor, (VI) the trustee sets up a bank account for the trust and (a) the settlor has the possibility of making direct investment decisions regarding assets at the bank, (b) the settlor negotiates the costs of administration mandates of the trust with the bank and determines the investment strategy, (c) the settlor submits investment decisions directly to the bank, thus circumventing the trustee or (d) the bank makes itself directly available to the settlor or their representatives and the trust portfolio is considered as belonging to the settlor, (e) the settlor directly conducts banking business, (VII) the settlor wants the trustee to transfer the assets of the trust to another bank and the trustee does not ask any further questions and simply complies, (VIII) the settlor negotiates a bonus arrangement with the bank, (IX) large sums are added by the settlor via the bank to trust assets or have been withdrawn from it, particularly within a short period of time, without the trustee's knowledge, (X) the settlor more generally designates the trust assets as his own, (XI) the settlor designates the trust as a testamentary disposition, (XII) the settlor's wishes have absolute priority and in no way form an apparent independent basis for decision on the trustee's part, (XII) the trust is deemed "private", (XIII) different "Letters of Wishes" exist for various purposes and (XIV) more broadly, the trustee gives the settlor free rein in his dealings while maintaining a purely passive relationship.

• *A trust is not a matter of a disguised testamentary disposition, and this is reflected by the fact that* (I) the settlor continues to exert control over the assets and treats the trustee as his representative, (II) the settlor can relieve the trustee of his responsibilities, (III) the beneficiaries have no rights to demand accountability from the trustee regarding his activities or information on the trust's assets, (IV) the trust shares are held by a company and the trustee has been refused any influence over the company without the consent of the settlor, (V) the settlor can cancel the rights of his spouse or his offspring.

• The trustee shall not require the consent of the primary beneficiaries prior to making an investment decision and, conversely, should he obtain it, be held harmless.

• The beneficiaries of a discretionary trust shall not readily have the right to request disbursements from the trustee for themselves.

• The trustee shall not be replaced at any time by a protector that has been appointed by primary beneficiaries.

• The trustee's remuneration shall not form the object of an agreement with the primary beneficiaries.

• The trustee's task shall not automatically be finished upon the occurrence of certain events, as for instance when official or legal measures find fault with the trust or threaten to wind it up or the transfer of trust assets may be limited; in this case the trust assets must be immediately transferred to other trusts.

• The settlor shall not exert *considerable and effective control* over the trustee; *de facto control* does not however suffice, as when the trustee seeks to include the beneficiaries' wishes when making a decision.

• Where applicable, transactions with third parties must be made "at arm's length" and trust transactions are sufficient for capitalising.

• The businesses controlled by a trust shall distribute dividends to the trustee and not directly to the settlor of the trust.

• The trust assets must not be mixed in with those of the settlor.

• No contract of mandate shall be concluded between the settlor of the trust and the trustee containing supervisory authority or prescriptions regarding any future preferential treatment.

• The trust deed must not contain any provisions by which the founder of the trust may amend the trust deed at any time without prior notice.

In addition the assets of a trust should not be ultimately qualified as *available resources* for a beneficiary since he may expect that the trustee will always exercise his powers of asset allocation in his favour. The danger that trust assets will be assigned to the settlor on this basis is particularly present in divorce procedures. Long-term asset planning is necessary in order to avoid exposure to attack, and this provides a good example of why a trust should not be established shortly before an upcoming divorce. Furthermore, it is necessary to ensure that all asset transactions are neatly documented and that the trustee's powers are respected.

The significance of trusts today

The basic principles of trusts are the same today as they were at their beginnings. However, a few things have changed. While initially, friends and family members, in particular, fulfilled the function of trustee, it is primarily professional third parties or special trust companies that do so today. While formerly trusts were primarily concerned with holding property, today a multitude of assets – liquid assets, stocks, complex financial instruments, interest in family and publicly listed companies, real estate, works of art etc. – are transferred to trusts.

Yet one of the major advantages of trusts today is the painstaking management and investment of these assets by the trustee. On the one hand, the trustee is under an obligation to administer the assets according to the founder's instructions, while on the other hand, in many trust jurisdictions, precise and modern guidelines exist by which the trustee must invest the assets according to such principles. Thus, it is not surprising that it was first clearly prescribed in U.S. trust law that when the trust invests assets, it shall take into consideration the principles of modern theory of capital markets. It is thus purported that speculation is forbidden, there is a requirement that investment must be diversified according to the latest findings of theory of financial markets and the assets must be aged in a productive manner.

Thus, when someone transfers assets to a trustee, they can be sure that the trustee will be under obligation to uphold the highest standards regarding the investment and management of the assets and that he will be held responsible for any breach of duty. In combination with regulations regarding preferential treatment, for example, family members who themselves do not have sufficient aptitude or knowledge in the management of assets or who simply have no interest for such, while they are pursuing other activities, have a largely carefree indulgence, and at the same time they have the guarantee that the substance of the assets is neither squandered nor carelessly invested.

Anyone who creates a trust and respects its essential nature can therefore skirt adverse financial consequences of strokes of fate, avoid disputes within the family and safeguard the continued existence of assets, for oneself, one's family and future generations. This always was and still is the main advantage of creating a trust. And after the creation of a trust and the appointment of a suitable trustee, just like in fairy tales, the trust beneficiaries will then live happily ever after.

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