The role of protectors in offshore trusts

Jan Dash and Herman Liburd set out some of the practical issues regarding the appointment and the powers of protectors

To many, the word, "protector" conjures up an image of a student who intervenes to help a weaker classmate in a battle with the school bully or a superhero fighting the never ending battle against evil. The dictionary defines the word, "protect" as follows: *"v., guard against, shield, defend"*.[1] While in general terms, a protector may be one who guards against, shields or defends, in trust and estate law, a protector is the person or entity that exercises limited authority over the actions of a trustee, or is provided certain other functions by the trust deed.

In some offshore Territories, the appointment of a protector is required to enforce a purpose trust.[2] For non-purpose trusts, the appointment of a protector is optional and the majority function without this office. However, this position may be included when a trust is settled in order to oversee the trustee's performance of its duties. Protectors are growing in popularity offshore and in fact, they are now appearing more frequently onshore. Legislation in South Dakota now recognizes the role of a protector:

> "'Trust protector,' any disinterested third party whose appointment is provided for in the trust instrument"[3]

In some offshore jurisdictions, the role of a protector is provided for in the Act or Ordinance which governs trusts and trustees. The relevant clauses state that a trust deed has the option to establish the office of protector, and also provide statutory guidance for the position's responsibilities. For example, the Trustee Ordinance of the British Virgin Islands refers to the role as follows:

> "... a trust may contain provisions by virtue of which the exercise by the trustees of any of their powers... shall be subject to the previous consent of... some... person, whether named as protector... or any name...".[4]

As is shown by the British Virgin Islands Ordinance, the person or entity which fulfills this role may be known by a name other than that of "protector". The role is sometimes called: "adviser", "appointor", "management committee" and "beneficiary representative";[5] however, the term "protector" is the most popular.

The Nevis International Exempt Trust Ordinance uses the following definition of a protector:

> "... in relation to a trust means a person who is the holder of a power which when invoked is capable of directing a trustee in matters relating to the trust and in respect of which matters the trustee has discretion and includes a person who is the holder of a power of appointment or dismissal of trustee".[6]

The trust laws of a Territory usually provide suggestions as to the authority that a protector may possess, instead of actually outlining the office's powers. The British Virgin Islands Trust Laws states that some of the following powers may be conferred on the Protector:

> "The power to change the forum of administration of the Trust;
> The power to exclude any Beneficiary from benefiting under the Trust;
> The power to include any person as a Beneficiary of the Trust".[7]

The Nevis Trust Laws state:

> "The protector shall have the... power... (unless the terms of the trust shall otherwise provide)... to remove a trustee and appoint a new or additional trustee..."[8]

The place to determine the duties of a protector with regard to a particular trust are the words of the actual deed itself.

> "There may be conferred on the... protector... by the instrument creating the trust, any powers..."[9]
> "The protector shall have such... powers as are conferred on the protector by the terms of the trust...".[10]

While the protector may be able to exercise power over the trust corpus and the trustee, it is not the legal owner of the assets held in trust.

> "If all that a person holds is a power over property, not an... interest, he cannot be a trustee".[11]

Only the trustee is the lawful holder of the trust assets.

> "[A Trustee] is the holder of title to property subject to an equitable obligation to... use the property for the benefit of another".[12]

The separate duties of trustee and protector are codified in the trust legislation of the British Virgin Islands and Nevis, respectively:

> "A person exercising any of the powers... of [a Protector] shall not by virtue only of the exercise of the power be deemed to be a trustee".[13]
> "In the exercise of his office, the protector shall not be accounted or regarded as a trustee".[14]

While a settlor can draft a letter of wishes to provide guidance for the trustee in the exercise of its discretion, such a document has no legal status and the trustee is not obligated to follow the letter's dictates. Since offshore trusts are controlled by trustees which are located in jurisdictions which are generally far away from the settlor and beneficiaries, the person drafting a trust may wish to involve a protector to provide a certain level of comfort for the settlor and beneficiaries.

The protector can place the settlor and beneficial class at ease because it can act as a restraint on the trustee's power. This office can also be used as a precaution against a trustee which may become incompetent, uninterested or dictatorial. The protector can be used to alleviate the settlor's concerns with respect to the seizure of the trust corpus by confiscatory legislation which could be enacted in the trustee's jurisdiction. If such legislation is passed, or in the case of sudden conflict in a Territory, most trust deeds have "flee clauses", which allow the governing law and the forum of administration to change. Since these clauses are activated in emergency situations, their enactment should be automatic and the trust should be immediately transferred to a new Territory. The protector should have the power to determine if the "flee clause" should be cancelled and if the trust should be returned to its original Territory. In today's world, it is very unlikely that such a clause would ever be activated, but the settlor's concerns about what may happen in a small remote locale, with which he is unfamiliar, may be alleviated by the inclusion of a protector.

The protector can act as a liaison between the settlor and trustee, to ensure that the trustee is fulfilling its duties pursuant to the settlor's intentions. The protector can also be used as a liaison between the trustee and beneficiaries. If dialogue between the trustee and beneficiaries becomes strained, the protector can communicate the beneficiaries' needs to the trustee and can also explain the rationale behind the trustee's actions to the beneficiaries.

The protector should not however act as the puppet strings for the settlor to exercise control over the actions of the trustee. Such action would usurp the trustee's fiduciary responsibilities and the trust could be declared a sham. Under the decision in *Rahman*,[15] a trust would be considered a sham if so much of the powers over the day-to-day administration were retained by the settlor, that it could not be said that the settlor had divested himself of his interest in the corpus.

If the trust was declared a sham, then the trustee would not have the freedom and independence to manage the trust corpus as is required in the trust concept. Therefore, the dispositive provisions of the trust would become ineffective and the trustee would be stripped of its power since it would be unable to make distributions. The assets would be considered to be actually held by the settlor

and would be subject to the tax and bankruptcy laws of the settlor's domicile. These are the types of situations which one seeks to avoid when settling a trust.

Recent amendments to Cayman Islands trust and estates law have narrowed *Rahman*, and now several powers may be reserved by the settlor without endangering the validity of the trust, including but not limited to the following:

> "a power to add or remove a beneficiary;
> a power to appoint or remove a Trustee or Trust Protector;
> a power to limit the exercise of a Trustee's discretion by requiring the Trustee solely to act with the consent of the Settlor..."[16]

Although as it applies to Cayman trusts, the sham trust doctrine has been somewhat restricted, it is still wise to utilize a protector when establishing an offshore trust. While a settlor may reserve powers over the trustee for himself, a court that has personal jurisdiction over the settlor may force him to use such powers in favor of a creditor or a litigious tax authority. However, if such powers are held by the protector, the settlor has removed himself from any interest in the trust and cannot be forced to do anything with regard to its corpus.

For most trusts, not only is the appointment of a protector optional, but the types of powers granted to the protector may vary depending on the desires of the settlor, the advice provided by legal counsel and the skill of the person drafting the trust deed. Whichever powers are granted to the protector, they should be in keeping with the trust concept and must be allowable by the governing law. A protector cannot be used to replace the supremacy of the highest court of a jurisdiction in settling disputes. Thus, the protector cannot have the following powers:

> "Power to release the trustees from liability for breach of trust
> Power to veto the exercise of beneficiaries' rights
> Power to settle... disputes concerning the administration of the trust"[17]

There are two types of powers that a protector possesses; those which require the consent of the trustee, and those which the protector can enforce unilaterally. When a change in the trust is planned and the present trustee will remain in office, the trustee and the protector should both consent to the exercise of power. This avoids a situation where management is usurped by the protector and the trustee is forced to fulfill a task with which it may not concur. More importantly, as it cannot be argued that the trust is controlled by someone other than the trustee, a court of competent jurisdiction would be unable to find that the trust is a sham. However, if a change in the trust is proposed and the trustee is to be terminated, the protector should act alone.

We are of the opinion that the Protector's function should be limited to the following seven powers, which are outlined below.

The powers for which the Trustee and the Protector should both consent, should be limited to the following:

1. The power to approve or disapprove amendments to the trust deed; and
2. The power to approve or disapprove a trustee request for increase in fees; and
3. The power to approve or disapprove additions to or exclusions from the beneficial class
4. The protector should have the power to solely remove and appoint the trustee.

To effectuate this power, the protector should also have the following powers:

5. The power to change the governing law of the trust; and
6. The power to change the forum of administration; and
7. The power to cancel a "flee clause".

The trustee's application to the protector to utilize some of its powers is sometimes referred to as "necessary sanction". Approval is obtained when the trustee prepares, executes and forwards a deed to the protector for its signature, which is signed and returned to the trustee. Necessary sanction should be required if the beneficial class is altered and if the trust deed is amended. Such action would constitute a major change to the status of the trust and the interests of the beneficiaries; accordingly it should be reviewed and approved by a neutral observer.

Over the life of a trust, the costs of doing business will increase and the trustee may need to raise their fees accordingly. Although the trustee has a fiduciary responsibility to the beneficiaries and is prevented from using trust assets for its own purposes, the protector's necessary sanction should be required to ensure that any increase is not exorbitant and is in keeping with market conditions of the industry.

The power to remove and appoint the trustee is the protector's ultimate power and is used to ensure that the trustee fulfills its duties. The protector should have the power to fire the trustee, with or without cause, but should be prohibited from appointing himself on a full-time basis to avoid a conflict of interest.

If a trustee is terminated, if the Territory becomes undesirable because of an outbreak in violence or because of the enactment of new laws, the trust may have to leave the jurisdiction. The protector should have the power to change the governing law and forum of administration since the trustee is being dispossessed of some of its powers or it may be under duress because of situations outside of its control. If this is the case, the trustee may not be willing or able to relinquish control of the trust and may have to be forced to do so.

In the case of sudden outbreak of violence in a Territory or if new legislation is enacted, the protector should have the power to cancel a "flee clause". In such a situation, it still may be desirable to have the trust remain in the jurisdiction, either because the outbreak of violence is temporary or because the new legislation will be repealed. The determination whether the trust should remain in the Territory should be placed in the hands of the protector instead of the trustee, because the protector is away from the governing Territory and to avoid the possibility or mere appearance that the trustee is placing its own economic interests ahead of the fiduciary interests of the beneficiaries. The protector may be allowed to act as the trustee in this situation, but only on an interim basis until a new trustee can be appointed.

It is not a wise choice to appoint the settlor, a family member or a close friend of the settlor as protector. Ideally, this role should be filled by either an uninterested party, preferably a resident offshore professional, either a person or an entity. If the settlor or friend acts as protector, it could be arguable that the person is a "dummy protector", a person who is acting as the settlor's alter ego rather than one who is seeking to protect the best interests of the beneficiaries. A court of competent jurisdiction could decide that the trust was actually controlled by the settlor and it would be declared a sham. Such a decision could have negative tax or estate planning consequences for the settlor and beneficiaries.

It is probable that the trust structure is managed across many diverse Territories and requires the awareness of differing areas of law. The settlor and beneficiaries may live in the United States, the trustee may be based in the British Virgin Islands and the trust assets may be managed in Bermuda. In order to fulfill the duties of a protector, the holder should have some knowledge of tax planning, the law of trusts and estates, the duties and role of a trustee and the duties and role of a protector, all on a multi-jurisdiction basis. These are concepts which an average lay person would presumably not possess.

In order to maintain the independence of the protector, it is wise to appoint one which is located in a jurisdiction other than that where the settlor or trustee are located. It is important to avoid having a resident onshore protector, since the local court would be able to exercise personal jurisdiction. As has been shown by the *Anderson* case,[18] the court could order the protector to make the trust corpus available to a creditor of the settlor or beneficiary.

The protector and trustee can be located in different jurisdictions without placing the proper governing law of the trust into controversy. The governing law is specified in the deed and is usually the law of the jurisdiction where the trustee is situated. In fact, a protector who is located in a jurisdiction other than that of the trustee is usually not licensed as a trustee by the governing law's Territory. In this case, it would be easy for them to defeat a potential claim that they are the de facto trustee and the trust is actually a sham.

The protector should not have any powers with regard to investments or tax planning. This power should be maintained

by the trustee, but the day-to-day decision making should be delegated to an investment advisor or tax advisor. A trustee's duty is to administer a trust, while the protector's duty is to watch the trustee. The financial markets fluctuate constantly while changes in tax laws are less frequent, but can be almost as volatile. The decisions with regard to a trust's investments and its overall tax plan should be made by those who not only have expertise in those areas, but also have the ability to keep current with the changes. While a tax attorney or an investment advisor can act as the protector, it is advantageous to keep the positions separate in order to maintain safeguards and to avoid a concentration of power.

As indicated above, one of the main reasons for the appointment of a protector is the fear of an uninterested or incompetent trustee. A trustee is a professional or entity which usually requires a license and has certain duties to the beneficiaries and must fulfill its tasks based on standards which are acceptable to the position. The same is true for the protector, and recent case law also suggests that the holder of the position has a fiduciary duty to the beneficiaries.[19] It is generally wise to specify in the trust deed or in the "protection memorandum", which is explained below, whether the protector does indeed have such duties so that it cannot act whimsically or maliciously.

Even if such language is not included, the protector is still obliged to exercise a duty of care with regard to the interest of the beneficiaries which is, "*... the same as that required of the trustee*".[20] If the protector shirks his responsibilities, all is not lost since the beneficiaries may still apply to the courts for relief. The court will generally uphold a decision of a protector unless it finds such action to be arbitrary and capricious.

> "[If] the Protector has acted in a way which he genuinely believes to be appropriate to serve... his power, the court will not interfere... unless... the decision is so extraordinary that the court finds it to be 'irrational, perverse or irrelevant to any sensible expectation of the settlor'".21

To avoid possible future conflict between the protector and trustee with regard to their duties, some experts in the field have suggested that the settlor should prepare a separate document addressed to the trustee, which is similar to the letter of wishes. This document which is called a "protection memorandum" can explain the settlor's reasons for appointing a protector, the duties which have been given to the protector, the duties which have been given to the trustee, and the reasons for giving certain powers to the protector instead of the trustee. If such a document is prepared, it would offer, "*...clear demarcation lines between... [the] respective powers and obligations...* [of the Trustee and Protector]".[22]

Before accepting an appointment as protector, one should ensure that they have certain rights, which should be enumerated in the trust deed. The protector should review copies of the deed and any supplemental deeds before agreeing to the position and should also receive financial statements on an annual basis thereafter. The protector should also have the right to employ advisors at the expense of the trust and have the right for indemnification of any expenses incurred in fulfilling this task. Although, the laws of many jurisdictions now recognize the status of a protector, they do not provide for remuneration for the position. The protector should ensure that he has the right to charge a fee and to demand a raise depending on market conditions, changes in legislation, a change in responsibilities or an increase in the value of the assets held in the trust.

While a protector does complicate trust administration and increase its expense, it can be an invaluable tool to ensure the smooth operation of an offshore trust. A protector can provide a measure of security to the settlor and beneficiaries as it can act as a buttress against a trustee's potential abuse of power or malpractice. A protector should be independent of the settlor and outside of its sphere of control, or the validity of the trust could be questioned. If the trust is challenged, there would be negative consequences for the settlor's tax liability. While there is no limit on the scope of powers which can be granted to the protector, they should not be so complete that the trustee's ability to manage the trust is stifled. When considering whom should be appointed as protector, an offshore resident who is located in a territory other than that of the settlor or trustee should be chosen. The offshore resident may be a person or entity and can ensure the autonomy of the protector. This would place the position outside of the legal jurisdiction of potential creditors, potential tax authorities and other third parties.

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