

Beware the Estranged Spouse¹

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I recall having read a very thought-provoking article by Philip Baker in the March 1996 edition of *Offshore Red*² entitled 'Offshore Trust Litigation: The Coming Flood', which accurately predicted what John Goldsworth³ would describe as 'the unhappy lot' of a contemporary trustee who finds himself embroiled in trust litigation. The article was inspired by the evolution of the sham trust doctrine, which made its debut in the now infamous Jersey case of *Rahman v Chase Bank (CI) Trust Company Limited and Others*.⁴

Today, it would seem that the most fashionable and indeed effective way to attack an offshore trust is to allege that it is a 'sham', ie that the trust documentation does not in fact reflect the true intention of the parties, to the extent that the settlor never intended to relinquish control of the trust assets and continued to treat them as his own.

If the plaintiff can show a *good arguable case* that the primary beneficiary of a trust has treated the trust as his 'alter ego', then a court may be persuaded to lift the 'veil' of the trust to determine to what extent the trust fund is to be considered the beneficiary's, thus rendering the trust assets susceptible to a *Mareva* injunction and other forms of interlocutory relief. In these circumstances, correspondence referring to the settlor as the 'customer' or 'client' together with an absence of any other documentation to demonstrate an independent exercise of discretion are not of great assistance to a trustee faced with the allegation that the settlement has merely 'danced to the settlor's bidding'.⁵

English courts have also shown themselves willing to adopt the 'alter ego' approach for the purposes of lifting the veil of incorporation in circumstances where, on the facts of the case, the company in question appears to have been unduly influenced by a dominant shareholder.⁶

¹ This article is based on an article first published in [2001] *Trusts and Trustees* 7 (Gostick Hall Publications) and [2001] *International Legal Practitioner* 26 (International Bar Association).

² Published by Camden Publishing Limited.

³ Editor, *Trusts and Trustees*.

⁴ [1991] JLR 103.

⁵ *Grupo Torras SA and Torras Hostench London Ltd v Sheikh Fahad Mohammed Al-Sabah and Others* [1995] 1 Lloyd's Rep 374, QBD and [1996] 1 Lloyd's Rep 7, CA.

⁶ *Re A Company Ltd; SIB Ltd v Vwagh* [1985] BCLC 333, per Cumming Bruce LJ.

Much of the current trust litigation is aimed at 'asset protection trusts' (APTs), which have proved to be extremely controversial and have succeeded in damaging the reputation of fledgling jurisdictions such as the Cook Islands where even the country's own judiciary could not support what was considered to be aggressive legislation designed to frustrate creditor claims.⁷

It is interesting to note, however, that whilst APTs are generally promoted as vehicles designed to insulate assets from third party creditor claims, many trustees do not appreciate that they may equally be deployed to place assets beyond the reach of estranged spouses. In considering the trusteeship of an APT, trustees are generally concerned with the solvency of a potential settlor and live in fear of becoming involved in a transaction that might be characterised as money laundering. They are less careful to enquire, however, as to the health of the settlor's marriage.

If a spouse should qualify as a creditor for the purposes of the relevant asset protection legislation,⁸ he/she will have the necessary locus standi to bring an action to set aside assuming that the target trust was established, or transfer thereto made, at a time when the marriage had broken down. (Notwithstanding the latter assumption, the onus remains on the plaintiff spouse to demonstrate that the transfer was made with intent to deny him/her of any marital claim that he/she might have to the trust assets.)

The provisions of any such asset protection legislation (and the relevant limitation period within which to commence an action), may not apply at all if it can be established that the plaintiff had a proprietary interest in the assets at the time that they were settled into trust. In other words, if the plaintiff can demonstrate that title to the assets was 'tainted' at the time of the subject transfer, the trust may be rendered void *ab initio* on the basis that the settlor did not have exclusive ownership of the assets.

This will often be the case in allegations of fraud where tracing claims based on 'proprietary' rights are frequently pursued. If the plaintiff can establish grounds for having had some type of equitable interest in the assets at the time of their settlement, then he/she may be able to avoid the application of a limitation period altogether.

In the latter regard, reference may be made to the *Grupo Torras* litigation in The Bahamas⁹ and the judgment delivered by Sawyer J¹⁰ in which she

⁷ See the decision of the Cook Islands Court of Appeal in *515 South Orange Grove Owners Association & Others v Orange Grove Partners & Others (No 1)* (1995) No 208/94.

⁸ For example, Fraudulent Dispositions Act 1991, statute laws of The Bahamas.

⁹ *Grupo Torras SA and Torras Hostench London Ltd v Sheikh Fahad Mohammed Al-Sabah and Others* Supreme Court of The Bahamas, Common Law No 72 of 1994, (1994) No 72/1 OFLR 443.

¹⁰ September 1995.

upheld the application of a worldwide *Mareva* injunction and order for discovery in respect of assets held subject to a Bahamian trust in favour of the plaintiff. In delivering her decision she appeared to be influenced by the judgment of Mance J in earlier related proceedings in the UK,¹¹ in which Mance J referred to the substantial and effective control that the principal defendant (Sheikh Fahad) appeared to have exercised over the assets of a Jersey trust. Whilst it may indeed be debatable as to whether the exercise of influence by Sheikh Fahad (in the manner described in the Bahamian proceedings) constitutes 'substantial and effective control' for the purposes of lifting the veil of the Bahamian trust and granting interlocutory relief in respect of the assets thereof, the international interest that was generated by Sawyer J's ruling was not in fact derived from her evaluation of what would constitute such 'control'. Instead, it was her response to a submission by the defendants that the plaintiffs' failure to disclose the existence of a limitation defence under the Bahamian Fraudulent Dispositions Act 1991 constituted a material non-disclosure which justified the discharge of the injunction, that became the focus of international scrutiny.

Section 4 of the Act provides that a disposition of any property made with intent to defraud and at an undervalue is voidable at the instance of a creditor thereby prejudiced. The section also places the onus of proving an intent to defraud on the person seeking to set aside an impugned disposition and provides in s 4(3) that: 'No action or proceedings shall be commenced pursuant to this Act unless commenced within two years of the date of the relevant disposition'.

In determining that the alleged omission did not constitute grounds upon which to discharge the *Mareva*, Sawyer J suggested that the defendants could not avail themselves of the limitation defence, in any event, on the following grounds:

1. Whilst the transfer of the funds to the trust by Sheikh Fahad took place more than 2 years before the plaintiffs applied to join the other defendants as parties to the Bahamian action, any potential avoidance (or set aside) of the transfer into trust would be a matter as between the plaintiffs and Sheikh Fahad himself (rather than between the plaintiffs and the trustee or the other defendants). Based upon this assumption, the plaintiffs' action, if it had been brought under the provisions of the Act as against Sheikh Fahad was commenced well before the 2-year period had elapsed (the original writ having been filed by the plaintiffs on the 24 January 1994

¹¹ *Grupo Torras SA and Torras Hostench London Ltd v Sheikh Fahad Mohammed Al-Sabah and Others* [1995] 1 Lloyd's Rep 374.

- and the trust having been established on the 17 December 1992).
2. The Act did not apply to the plaintiffs' causes of action, as pleaded, since there was no allegation that the trust was established with the intent to defraud (as defined in the Act), nor was it alleged that Sheikh Fahad had actual notice of the plaintiffs' claims against him prior to the establishment of the trust.
 3. The pleadings alleged that the fraud took place prior to the establishment of the trust and that the corpus of the trust fund included part of the proceeds of the fraud.

In support of the latter proposition, Sawyer J made reference to s 7 of the Act, which provides as follows:

- '7. Nothing in this Act—
- (a) shall validate any disposition of property which is neither owned by the transferor nor the subject of a power in that behalf vested in the transferor;
 - (b) shall affect the recognition of a foreign law in determining whether the transferor is the owner of such property or the holder of such power.'

Section 7 is of crucial importance as it delineates the circumstances in which a defendant cannot invoke the protection afforded by the Act. If the settlor's title to assets is tainted at the time of the transfer thereof into trust, the transfer will be invalid. Section 7 therefore highlights the distinction that should be drawn between pure creditors' claims against which the Act is designed to insulate assets and tracing claims in respect of which the Act cannot be invoked.

Tracing claims are a source of considerable concern for trustees because they have no way of determining at the time of acceptance of the trusteeship as to whether the trust assets might be susceptible to a claim of constructive trusteeship.

This is particularly relevant in the context of a marriage where an estranged spouse may have an ownership interest (and therefore a tracing claim) based on 'community property' laws or other matrimonial property rights that give rise to a constructive trust. The success of the plaintiff spouse will necessarily depend upon whether the jurisdiction in which a claim is ultimately pursued (to set aside the trust itself or a transfer of assets to it) recognises the community property interest (or other marital claim) that is being asserted over the disputed assets.

In the latter regard, reference may once again be made to the laws of The Bahamas and the provisions of the Trusts (Choice of Governing Law) Act 1989. Pursuant to s 8(b) (as amended) of the 1989 Act no trust governed by the laws of The Bahamas and no disposition of property to be held on trust that is valid under the laws of The Bahamas is void, voidable or liable to be set aside by reference to a foreign law, because the trust or disposition avoids or defeats an interest conferred by that foreign law upon any person by reason of a personal relationship with the settlor. 'Personal relationship' is defined so as to include marriage. The result, broadly speaking, is that an action premised on community property rights will not be entertained by a Bahamian court. Reference has been made above to the potential qualification of a spouse as a 'creditor' for the purposes of bringing an action to set aside a transfer into trust under the Bahamian Fraudulent Dispositions Act 1991. How is the latter provision of the Trusts (Choice of Governing Law) Act 1989 reconciled with the provisions of the Fraudulent Dispositions Act 1991? According to s 8 of the 1991 Act 'nothing in this Act shall create or enable any right, claim or interest on behalf of a creditor or person which right, claim or interest would be avoided or defeated by the Trusts (Choice of Governing Law) Act'. Pretty clear – or is it? Whilst the Bahamian legislation will be of assistance in the avoidance of such marital claims where they are pursued in domestic proceedings, courts in the United States (US) have already demonstrated their reluctance to uphold foreign trust arrangements where there is evidence to suggest that the structure has been effected to frustrate marital claims.¹²

Indeed, when it comes to foreign trusts, US courts have demonstrated no hesitation whatsoever in assuming jurisdiction over the arrangement if either the settlor, beneficiaries or subject assets are resident on US soil.¹³ Practical remedies have been adopted by the courts to circumvent any innovative provisions in the offshore trust instrument designed to resist an action to remove the trustee or repatriate the trust assets, if made under duress. The Andersons,¹⁴ for example, found themselves in a Nevada jail after failing to adhere to a court order to repatriate trust assets. They were unable to avail themselves of the 'impossibility of performance' defence as they had the power to repatriate the subject funds as at the time of the relevant court order. The fact that the power was subsequently lost when they tipped off the foreign trustee in relation to their situation of duress (the foreign trustee thus removing

¹² In the *Reichers Case* (1998, WL 68662, NY Co Ct), a doctor established an asset protection trust in the Cook Islands from which his wife was excluded from benefit. In subsequent matrimonial property proceedings the New York court had no difficulty in declaring the trust assets subject to equitable distribution in New York.

¹³ See: *Re Larry Portnoy* (1996, 201 Bankr 685), and *Duttle v Bandler Kass* (1992, 82 Cir 5084 (KMW)).

¹⁴ *Federal Trade Commission v Affordable Media LLC, Denyse Linda Anderson and Michael K. Anderson* No 98-16378, US 9th Circuit, CAs [1998] 4 *Trusts and Trustees*.

them as trustees and rendering them incapable of repatriating the trust assets) was held to be irrelevant.

In the English case of *Browne v Browne*,¹⁵ a wife who failed to make payments ordered to be made to her husband out of foreign assets also found herself subject to a committal application. Notwithstanding that her interest in the foreign assets was as a discretionary beneficiary only, the English Court of Appeal was willing to find that the said assets qualified as financial resources available to her for the purposes of the relevant matrimonial property legislation. It is interesting to note that the judge at first instance was of the opinion that as sole beneficiary under the trust arrangements, the wife had effective control of the trust funds. Reference was also made to the fact that she had been in receipt of regular payments from the trustee.

As can be seen from the case-law above, the extent to which an offshore trust or transfer thereto is rendered vulnerable will depend on a number of different factors, not least of all, the location of the debtor.

Careful attention should also be paid to the situs of the trust assets themselves, the jurisdiction of incorporation of any relevant holding company and the identity of its management. If the settlor is found to have retained de facto control over the trust fund by maintaining executive control of a captive trust company or asset holding vehicle then such evidence may indeed constitute ammunition for an attack based on there being a sham arrangement.

Residents of common law jurisdictions consider freedom of testamentary disposition to be a God given right and many have made good use of the opportunity to dispossess their heirs. Certain offshore centres have pioneered legislation designed to afford clients from civil law jurisdictions the same opportunity through the use of an offshore trust governed by laws that specifically resist claims to set aside the trust premised on forced heirship rights (as is the case under the aforementioned Bahamian Trusts (Choice of Governing Law) Act 1989).

Litigation in the Cayman Islands¹⁶ has suggested however that legislative provisions seeking to frustrate the succession laws of the settlor's domicile may be of limited effect. Unfortunately, the case was settled and so the relevant Caymanian statutory provisions and the extent of their application was not subject to conclusive judicial scrutiny (although important interlocutory matters dealing with the inspection of trust documents and the right of the trustee to seek reimbursement from the trust fund were resolved).

There are also important practical considerations. For example, if the

¹⁵ [1989] 1 FLR 291.

¹⁶ *Re The Lemos Trust Settlement* [1992-93] CILR 26, and *Lemos v Coutts & Co (Cayman) Ltd and Others* [1992-93] CILR 5.

jurisdiction in which the trust assets are situated (the 'host jurisdiction') is different to the governing law of the trust, then the host jurisdiction may not recognise the validity of the trust or the transfer of the disputed assets or the relevant anti-forced heirship provisions on the grounds of *public policy*. It would not be the first time that such an argument has been adopted by the court of a host jurisdiction. In another New York proceeding,¹⁷ a Cayman Islands trust established during divorce proceedings was declared invalid as being 'in violation of the public policy of the State of New York'. And let us not forget that even where a holding company is interposed, incorporated in the offshore territory of the trustee or another jurisdiction with equivalent laws, there is no guarantee that the 'alter ego' theory will not be applied for the purposes of setting aside the transfer and thereby restoring the challenged assets to the estate of the settlor.

All of this complex litigation serves to leave the modern trustee in an extremely precarious position.

If a claim to set aside the trust as a sham (or on the basis of an ownership claim/forced heirship claim or otherwise) is successful, then the trustee is left without having had the requisite authority to either make distributions from the trust fund or to extract his professional fees.

As if to add insult to injury, a trustee may not be entitled to an indemnity from the trust fund in respect of litigation costs and expenses unless he has taken the precaution of obtaining a pre-emptive order for costs often referred to as a *Beddoe* order after the case of the same name.¹⁸

In any dispute over ownership of the trust assets it is *imperative* for the trustee to seek directions from the court before taking any action whatsoever either to defend the trust fund or to preserve the position of an interested party. Since the trustee will generally be named as a defendant (irrespective of whether there is an allegation of breach of trust), the directions of the court are crucial in terms of justifying the trustee's subsequent actions and preserving the trustee's entitlement to an indemnity for any costs necessarily incurred.

In conclusion, it would seem that the current wave of litigation highlights the age old rule that a trustee must know his client. Unfortunately, this does not necessarily mean that it is adequate to have a good working relationship with the settlor. A trustee must familiarise himself with the circumstances of the other beneficiaries including the settlor's spouse (irrespective of whether he/she is named as a beneficiary. Indeed if the spouse is excluded from benefit then the trustee should enquire why). He must consider any potential claims

¹⁷ The case of *Papson* heard recently in Queens County, New York.

¹⁸ *Re Beddoe* (1893) Ch 547.

that may be made against the trust property by relatives seeking to establish themselves as creditors. He must resist the settlor's natural inclination to retain excessive control notwithstanding that some jurisdictions have introduced statutory provisions designed to dilute the potential risks associated with maintaining such influence over the trust assets.¹⁹ He must further resist the appointment of a protector with excessive powers, particularly if the protector is found to be resident in a potentially hostile jurisdiction. And last, but by no means least, the trustee must be satisfied that title to the trust assets has been effectively transferred to him and that if corporate holding vehicles are used to own assets, their control, to the greatest extent possible, remains with the trustee.

It will be interesting to observe whether the 'retail' type short-form offshore trusts of the 1970s and 1980s that were so successfully marketed in regions such as Latin America pass the above tests, particularly in light of the fact that many arrangements have been entered into without the settlor having had the benefit of independent legal advice or even a proper translation of the trust instrument's provisions. As the old saying goes: 'You get what you pay for'.

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¹⁹ For example, Trustee Act 1998, s 3, statute laws of The Bahamas.