

Exploding STAR Trusts

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Whether you know it or not, you have probably all come across something called “the Kübler-Ross model”. You may not know it by that name. But I suspect most of you will recognize it immediately when I return to it at the end of this talk. For the moment, I would just ask you to keep the name at the back of your mind.

It is now over ten years since STAR trusts were introduced by the Cayman Islands Special Trusts (Alternative Regime) Law 1997 — now consolidated in Part VIII of the Trusts Law (2001 Revision). As many of you may remember, STAR trusts were greeted at first by some noisy raspberries blown from jurisdictions accustomed to more traditional trusts. In one article, written in 1997, Professor Paul Matthews described STAR trusts as “semi-wacky”. They failed his test for complete “wackiness” because, as he put, “locals are permitted to use them”.

There were a number of criticisms, but I would like to concentrate on the two that seemed the most serious. The most radical, or innovative, features of the STAR trust are—

1. that the beneficiaries have no locus to enforce the trust; and
2. that the objects of the trust may be or include “purposes” that are not necessarily charitable.

These features in particular were said to be inconsistent with the basic principles of trust law. Accordingly, it was argued, they would not be recognized outside the Cayman Islands.

Ten years on, it seems reasonable to ask whether these dire predictions have proved correct. Let me begin by saying that I am not aware of any decision in the UK—or, for that matter, elsewhere—that has authoritatively considered these issues. STAR trusts have not exploded, or imploded, or been blown up. At least not yet. In the absence of any definitive case law, the questions remain open.

From the perspective of a trust litigator, the most immediately shocking characteristic of a STAR trust is the powerlessness of the beneficiaries. I recently led Andrew Child in a case in the UK in which we removed some trustees from office. It was a conventional discretionary trust, and our clients were two of the principal beneficiaries. The other principal beneficiary was also one of the trustees. For those of you who are interested in the details of the case (it's called *Jones v Firkin-Flood*), I have given a slightly lengthier summary of the facts in the handout, but for present purposes all you need to know is that the trustees were proposing to distribute the whole of the fund (then worth about £20 million) by giving the lion's share to the one beneficiary who also happened to be a trustee himself.

Now, as you know, a simple exercise of discretion by the trustees is extremely difficult to challenge. But the administration of this particular trust had been truly appalling. As the trial progressed, more and more evidence came to light of sheer incompetence. There had not been a single trustee meeting for over seven years. The accounts

were a shambles. The trustees had no idea about exercising their powers as shareholders to control the business that represented the trust's only investment. They were blissfully innocent of the self-dealing rule.

Much of the blame rested on the one professional trustee. As the judge damningly put it, "The most charitable explanation for [his] failure in that regard is that, despite his legal qualifications, he also was ignorant of the nature and extent of the Trustees' duties." With this character as their guide, the lay trustees didn't really stand a chance; and the court had no hesitation in removing all but one of them and installing an independent professional. This had the effect of blocking the unfair distribution.

Well, with that experience fresh in my mind, my reaction on turning to the STAR legislation was that I must have overlooked something. Would there *really* be nothing that the beneficiaries could do if they found themselves in a similar position under a STAR trust? Staring at

the legislation didn't help. Holding it up closer, shaking it, listening to it, sniffing it, even tasting it—none of the specialist techniques of construction at the disposal of a Chancery practitioner seemed to help. The legislation could hardly be clearer or simpler: “A beneficiary of a special trust does not as such have standing to enforce the trust or an enforceable right against the trustee or an enforcer, or an enforceable right to the trust property.”

What about the “beneficiary principle”? What about the “irreducible core” of trust obligations? What about Millett LJ's dictum in *Armitage v Nurse*, that “If the beneficiaries have no rights enforceable against the trustees, there are no trusts”? Is this thing a trust at all?

Well, having exhausted myself with the effort, I have come to the conclusion that there are perfectly good answers to these questions. Or at least sufficiently good answers. First, merely because the STAR regime *permits* a settlor to place the powers of enforcement exclusively in the hands of the enforcer, it does not follow that he

must do so. He may, if he wishes, appoint one or more of the beneficiaries to be enforcers; and if he does not do so, it is presumably because he did not want them to have such power.

I suspect that most advisers would caution strongly against setting up the trust in this way, at least in the vast majority of cases. The settlor would be told that even if he had absolute confidence in the probity and skill of the enforcer, there would always be a possibility that his chosen appointee might die or retire and be replaced by someone less suitable. The settlor would have to weigh up the risks of an incompetent or even dishonest enforcer against his reasons for not wishing to give enforcement powers to the beneficiaries themselves. But surely allowing a settlor to make an informed decision is merely to treat him as a responsible adult? It is, after all, his money.

Secondly, even where the beneficiaries are not given the power of enforcers, their rights under a STAR trust *are* enforceable—just not by them. Lawyers accustomed to conventional common law trusts

may find this separation of rights of enjoyment from rights of enforcement profoundly disturbing, or at least counter-intuitive. I confess that that was my own initial reaction. But I suspect that this is merely a matter of habit. It is, on reflection, considerably less strange than the division of property rights into legal and beneficial ownership, which is at the core of the traditional trust.

So what happens if the settlor does decide to place his faith in an enforcer who, like the professional trustee in *Firkin-Flood*, doesn't have a clue how to run or supervise a trust? What then?

Well, the beneficiaries will undoubtedly be in a much weaker position than they would under a traditional trust. Outright misappropriations by the trustees acting in collusion with a dishonest enforcer are probably not going to be the problem: there are extensive criminal sanctions to prevent them. But, as *Firkin-Flood* illustrates, the kind of maladministration more commonly encountered usually falls short of simple theft. Trustees may be incompetent or negligent in all sorts of

ways that fall short of outright dishonesty. These will be outside the control of the beneficiaries.

On the other hand, the beneficiaries of a STAR trust are protected in ways that the beneficiaries of traditional trusts are not. At least one of the trustees must be a Cayman trust corporation licensed to conduct trust business. The kind of incompetence Andrew and I encountered in *Firkin-Flood* is probably much less likely to arise in the first place.

And, as you all know, the Cayman Islands Monetary Authority has extensive powers to intervene if it is of the opinion that the licensee is carrying on business in a manner detrimental to the beneficiaries.

There seems to be nothing to prevent dissatisfied beneficiaries from bringing the matter to the attention of the Authority and inviting it to take up the matter on their behalf.

What about the second feature of STAR trusts, the possibility of creating trusts for purposes, including purposes that are not charitable? It seems to me rather chauvinistic to object to this feature

of STAR trusts. It is not as if the UK rules as to what is and is not charitable are exactly intuitive—how many UK gifts have been struck down, to disappointment of the donor and the delight of some unintended beneficiaries, because they failed to fall within one of the categories laid down in 1601 in the Statute of Elizabeth?

So, how would the UK courts react if a beneficiary under a STAR trust brought an action in the UK seeking some remedy against the trustees? For these purposes I will assume that the trust instrument does not give any of the beneficiaries the powers of an enforcer. I will also assume that the trust has been properly constituted in the first place.

So far as the UK courts are concerned, any challenge to a STAR trust would have to get past the Hague Convention on the Recognition of Trusts, which forms part of UK law under the Recognition of Trusts Act 1987. I do not think that there can be any serious doubt that a STAR trust falls within the definition of “trust” in the Convention.

Prima facie, therefore, the UK courts would have no choice but to recognize it as a trust; a trust, moreover, governed by Cayman law.

Let me deal at once with Millett LJ's dictum about the "irreducible core", which is recited like a magic spell by every critic of STAR trusts. When Millett LJ said that if beneficiaries had no rights enforceable against the trustees, there was no trust, he was of course speaking of *English* trusts. It is trivial to say that a STAR trust in which none of the beneficiaries has the power of enforcer is not a "trust" under English law. Of course it isn't. It wouldn't be a trust under Cayman law either if it were not for the statute. The whole point of the Hague Convention is to compel the recognition of structures that would not otherwise be recognized as trusts; and for the purpose of the Convention, these are called "trusts" even though they would not otherwise qualify as trusts under domestic law. The question is not whether a STAR trust satisfies the English requirements for a valid trust—manifestly it does not—but whether it satisfies Cayman law, as to which there can be no doubt that it does.

I therefore suggest that to argue (as some academics have) that Millett LJ's formula somehow trumps the Hague Convention is to put things back-to-front. The purpose of the Hague Convention would be defeated if every jurisdiction could refuse recognition of valid foreign trusts on the grounds that they were not valid trusts under domestic law. The use of the word "irreducible" is merely rhetoric in this context.

What if the assets of the trust consist exclusively, or even perhaps only principally, of property within the UK? It has been suggested that in those circumstances an English court would not give effect to the trust because, if the Hague Convention *did* compel recognition of the trust in such cases, it would lead to the improbable result that a settlor could create a trust in England that would be invalid under domestic law simply by selecting as its proper law the law of some other jurisdiction where different rules applied.

Professor Matthews, one of whose articles I referred to earlier, has suggested that the UK courts might rely on Article 18 as a reason for declining to apply the Convention: that is to say, on the grounds that its application would be contrary to public policy. I agree that there may be *some* STAR trusts that offend against public policy. For example, if the subject matter of the trust was land in the UK, I would imagine that a UK court might well refuse to recognise a STAR trust that rendered the land inalienable by means of a perpetual purpose trust.

But I think such examples would be rare. It is certainly not a reason for refusing to recognise *all* STAR trusts. The mere fact that the powers of enforcement are given to someone other than the beneficiaries does not seem to me to come with any sensible meaning of “public policy”. But it seems to me that the emphasis must be on *public* policy. The inability of a beneficiary to enforce the trust obligations is an entirely *private* matter. Nor does it help matters to fall back on the fact that what has been created would not qualify as a trust under UK

law, as nothing that would qualify in that way would have any need to invoke the Hague Convention in the first place.

There is, in fact, a provision in the Convention that enables a convention State to refuse recognition of a trust if the “significant elements” of the trust are more closely connected with States which do not have the institution of the trust or the category of trust involved. In other words, a State that does not recognize trusts in its own domestic law, or which does not recognize a particular kind of trust, is not compelled under the Convention to apply foreign law if there is no real connection with the foreign jurisdiction other than the choice of law, place of administration, or residence of the trustees.

This provision is contained in Article 13. It seems to me that Article 13 is precisely the provision that would give effect to the argument that the UK courts are not obliged to recognize a STAR trust if the “significant elements” are more closely connected with the UK than with Cayman.

There is, however, a small problem for those who seek to rely on this argument. Article 13 is excluded from the text adopted in the UK under the 1987 Act. I suggest that the deliberate omission of Article 13 from UK law disposes once and for all of the argument that the UK can apply UK law merely on the grounds that the principal assets of the trust are situated in England.

At the start of this talk I mentioned something called the “Kübler-Ross model”. It may be more familiar to you as “The Five Stages of Grief”. According to this notion of popular psychology, the process by which people deal with catastrophic personal loss falls into five distinct phases. While I was preparing this talk I found that the model applied equally to my own reaction to STAR trusts. The stages are as follows.

1. Denial. This is not a trust. It won't be recognized in other jurisdictions.

2. Anger. It's not fair. The beneficiaries have no rights. The trustees can steal the money.

3. Bargaining. We'll apply to court. We'll ask for information. We'll ask to mediate.

4. Depression. It's hopeless. Let's just give up.

5. Acceptance. STAR trusts are still here, and they have been working fine for ten years. There is no evidence that they have gone wrong, or that they have been refused recognition in other jurisdictions. They are actually rather clever.