Discretionary trusts provide, at least in theory, a way to shelter family assets from the disruption which can be caused by the death of a high net worth individual. Hong Kong assets settled on the trustees of a properly established discretionary trust can avoid Hong Kong estate duty if the settlor survives for three years. Indeed, there should be no estate duty on the trust assets in the event of the death of one of the discretionary beneficiaries.

Discretionary trusts avoid probate delays, provide confidentiality (probate is a public process) and prevent fragmentation of the family assets on death. They also provide a degree of flexibility and asset protection that no other structure can match.

Notwithstanding all of the theoretical advantages, in practice, things may not go as smoothly as they should on the death of the settlor who has put all of his assets into trust. It is suggested that there are two main reasons for this:

• not enough thought is given to the impact of the death of the settlor on the trust structure; and
• trust structures are often not properly maintained once constituted, and there is no ongoing review.

We are all familiar with the practice of establishing discretionary trusts with what is supposed to be a non-binding letter of wishes provided by the settlor to the trustees. Very often the trustees will have a relationship with the settlor or the protector (even if they are not a beneficiary) but not the beneficiaries. It is possible that the beneficiaries are not told about the trust and that there is a clause in the trust deed which provides that the trustee is under no obligation to inform the beneficiaries of the existence of the trust or to provide them with accounts.

Unfortunately it seems to be the case that some professional trustees may try to exclude, by an express clause in the trust deed, any obligation to inform the beneficiaries of the existence of the trust or any duty to provide the beneficiaries with copies of the trust accounts. The settlor is presumably happy with this arrangement while he is still alive on the basis that he does not want the children interfering in “his” affairs. But once the settlor is gone, the beneficiaries need to know about the trust and need to be able to demand an account from the trustee in order to enforce the trust.

Strangely enough, this type of arrangement seems to show the settlor trusting the trustees more than his own family.

If the settlor has established a “blind trust” so that the “intended” beneficiaries are not even named as potential beneficiaries in the trust deed, the settlor may really have left them with nothing. If they are not even named in the trust deed they have no rights at all against the trustee. This assumes the blind trust can be held up as a valid one in the first place, over which there is now doubt.

If it is assumed that the “real” beneficiaries can be added to a blind trust at a later point, it should be realised that there has been considerable criticism of cases such as Re Manisty’s Settlement [1974] Ch 17 and Re Hay’s Settlement Trusts [1981] 3 All ER 786 which upheld the validity of a power to add to the class of beneficiaries. That is to say, there is a risk that this type of power to add further beneficiaries at a later date might subsequently be held by a court to be invalid.

In this article, written from the perspective of trust practice in Hong Kong, the issues surrounding the provision of instructions to trustees is looked at. The administration of a discretionary trust may become hazardous in the event of the settlor’s death: at worst, beneficiaries will not discover their interest...
away all the family assets to some charity.

Frequently the trustees will just hold the shares in an asset holding company which is controlled by the settlor. The trustees might have no involvement in the affairs of the asset holding company, notwithstanding their duties as spelled out in Re Lucking's Will Trust [1967] 3 All ER 726 and Bartlett v Barclays Bank Trust Co Ltd [1980] Ch 515.

There are some who would suggest that the above arrangement might not even amount to a valid trust. But on the assumption that there is a valid trust in place, the death of the settlor in such circumstances can give rise to a number of problems.

There are problems with having all of the trust fund held through a holding company administered by the settlor. Still assuming the trust is a valid one, what happens if the trustee has no idea what the settlor has been up to with the holding company? If the funds have been loaned to third parties, or if the company has any rights in action against any third parties, will the company records be in good enough order to enable the trustee to step in and start recovering these assets once the settlor is gone?

If the trustee holds shares in the family company and the settlor dies, who is going to run the company?

If the family members are too young or are not experienced enough, the trustee will either have to sell the company or bring in a manager. How does the trustee make this decision?

How does the trustee know who (if any) amongst the family members, has the ability to run the company profitably?

In theory the death of the settlor should have no relevance at all to the trustees’ administration of the trust if the settlor is not a beneficiary. This is because the duty of the trustee is to look to the interests of the beneficiaries and not those of the settlor or protector. However, in order to be able to act in the interests of the beneficiaries the trustee has to know them. Often this is not the case which is why the letter of wishes is so important in practice. If the trustee does not have a relationship with the beneficiaries how can the trustee administer the trust?

The first problem is that the settlor and the trustees may not have stopped to think about what is to happen when the settlor dies. The worst case is that where there is no guidance provided to the trustees as to what to do after the death of the settlor, ie the letter of wishes is silent on the point. Strangely enough this can happen, especially when the settlor is relatively young.

Notwithstanding that the trustee should act in the interests of the beneficiaries and should be aware of their circumstances, in practice, on death of the settlor, the trustee might look to the protector for guidance. Unfortunately, it is likely that the chosen protector is of the same generation as the settlor’s and it is not long after his death that the protector dies as well (if not before the settlor).

Thus, if there is no thought given to nominating a successor protector, the trustee may find that there is no protector to guide him in what to do.

To try to overcome these problems, the following “checklist” is offered:

(a) tell the beneficiaries about the trust and let them know where they can find copies of the documentation;

(b) do not under any circumstances use a blind trust. If you have one, the practical solution will be to change it now while the settlor is still alive (although note the concern mentioned above that a power to add further beneficiaries possibly might be challenged as being invalid);

(c) make sure the letter of wishes is revised on a regular basis;

(d) make sure the letter of wishes clearly deals with events following the death of the settlor;

(e) establish a relationship between the trustee and the beneficiaries;

(f) make sure the trustee is accountable to the beneficiaries;

(g) if there is a protector, make sure there is a clearly defined chain of successors to that office;

(h) where there are asset holding companies or the trustee holds shares in the family company, proper records and accounts must be kept for the company and details provided to the trustee. Even if the company is a tax haven company which may not be required to prepare accounts, accounts should still be done;

(i) give the trustee guidelines on whether the family company should be sold on the death of the settlor or details on...
who might be suitable to manage the company;

(j) if possible, ensure that the chosen successor to control the administration of the family company is already appointed as a director; and

(k) have a business plan in place for the company, and make sure the trustee is aware of it.

Even if the above checklist is complied with, it is still likely that problems with discretionary trusts on the death of the settlor will arise. The settlor will usually want to establish a degree of certainty which a discretionary trust cannot provide but also maintain the advantages which the uncertainty of a discretionary trust does provide.

For example, the settlor will usually want to indicate the share of the income and capital that should be attributed to each child, or to the settlor or the settlor’s spouse. The settlor may go further and wish to provide for vesting of all or part of the trust fund at different times, eg upon a beneficiary turning a certain age.

The usual approach is to set all of these “guidelines” out in a non-legally binding letter of wishes which is given to the trustee. However, the trustee of a “standard” discretionary trust has a duty to consider the exercise of its discretion from time to time.

The trustee must, in addition to a periodical consideration of whether to exercise its power to appoint income or capital or not, consider the extent or range of the class of possible beneficiaries and the appropriateness of distributions in favour of particular beneficiaries. It is quite acceptable for a trustee to consider the wishes of the settlor in such cases. In fact, the exercise of a trustee’s power of appointment in a fashion which is irrelevant to any sensible expectation of the settlor will not be valid.

However, if the trustee fails to exercise any discretion, for example, the trustee simply signs all documents put to it by the settlor, such a purported exercise of their power will not be valid. This occurred in Turner v Turner [1984] Ch 100.

Therefore, the risk arises that any actions of a trustee which simply follows the terms of the letter of wishes without considering the exercise of its own discretion will be invalid. The trustee in such a case may also be accused of not considering the circumstances of the individual beneficiaries.

In summary, while a letter of wishes is quite acceptable, the trustee which blindly complies is heading for trouble. The trustee must still be able to demonstrate some independent thinking on its own part.

It can be concluded that relying on the use of a letter of wishes is not the right approach for the settlor who does want some certainty. Tax or estate duty factors which may favour the use of a purely discretionary trust would have to be weighed up against the desire of the settlor for a degree of certainty.

From the perspective of trying to implement a succession plan in cases where the settlor has very fixed views, the conclusion is that a discretionary trust coupled with a non binding letter of wishes may not be the best approach and potentially might lead to litigation against the trustee once the settlor has passed away (ie litigation of the kind in Turner v Turner).

Where the settlor wants certainty as to what will happen after his death, he should consider creating protected life interests in favour of his nominated beneficiaries.

A protective trust is a fixed trust that can automatically convert into a discretionary trust on the occurrence of certain specified events (eg bankruptcy of the beneficiary). For so long as there is a fixed interest the trust provides the certainty required by the settlor. But because of the ability to convert into a discretionary interest, it can at the same time, provide some of the protection which a purely discretionary trust offers.

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