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## **The Trust Protector**

### **Are they friends or fiduciaries? And should every trust have one?\***

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Although trusts are, by many theories, hundreds of years old, it is interesting to note how their provisions have changed more in the past thirty years than in the three hundred years before that. This is due not only to increased complexities in the laws but also due to trusts becoming more multi-jurisdictional. Evidence the recent rise of the trust protector, a term virtually unheard of before the widespread use of international trusts. The problem is that the estate planning bar has adopted the use of the trust protector a bit too hastily and without adequate research and circumspection. This article addresses what I believe to be the true role of the protector, some of the more serious problems seen in drafting and practice where a trust protector is involved, and suggested solutions.

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\* This article is excerpted in part from the chapter on the same subject in *Asset Protection Strategies Volume II*, edited by Alexander A. Bove, Jr., published by the American Bar Association, 2005.

### **What is a protector?**

In its use under a trust, a protector is an individual (or a committee of individuals, or an entity) with specified powers with respect to the trust but who is not a trustee and therefore never holds or administers trust property. The protector's powers may be very narrow, such as the power to remove and replace trustees or the power to veto discretionary trust distributions, or they may be very broad, such as the power to add or remove beneficiaries, or to amend the trust. Since these powers generally override those of the trustee it is easy to see how practitioners are inclined to view the role of protector as a panacea for numerous trust problems. For instance, where it is discovered that an irrevocable trust is lacking an important provision or contains one that is improperly or ambiguously drafted, it appears that a protector with powers to amend can address the problem virtually immediately with a minimum of expense and without court involvement. And where it becomes "advisable" to add or delete beneficiaries or even modify the dispositive provisions of a trust consistent with the settlor's original intentions and the purposes of the trust, a protector could be empowered to do so. Without question, a corporate or other professional trustee would never take it upon itself to carry out any of the foregoing acts without seeking a court's approval of a reformation of the trust if, in fact, such a petition would be successful. But can a protector with such powers really exercise them with impunity? Isn't he bound by a duty, like a *fiduciary* duty?

### **Is the protector a fiduciary?**

Unfortunately, many practitioners, misled by the laws of a number of jurisdictions, have been under the mistaken impression that a protector need not be regarded as a fiduciary, especially if the trust declares that he is not. This is a little like declaring, "Regardless of the type of animal that passes through these gates, it will be deemed to be a horse." Unless the protector's powers are personal, meaning that he would be an interested party and a potential if not an actual beneficiary, it is naive and thoughtless to argue that the protector is not a fiduciary simply by stating that he is not. Even the proposed Uniform Trust Code states: "A *person, other than a*

*beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries.”*<sup>1</sup>

The attempt of some practitioners to have it both ways is to prevent potential protectors from being “scared off” by the assumption of fiduciary liability. Where the protector’s powers are not personal, it is truly a challenge to understand how anyone could conclude that a settlor would grant extensive powers to an individual (or committee) protector for any reason other than to carry out the purposes of the trust (a *fiduciary* role). Otherwise, what would be the sense of it? If, for instance, a protector is given the power to change the trust situs or governing law, would anyone conclude that the power was given so that the protector could arbitrarily bounce the trust from one jurisdiction to another just for the fun of it? Or that the protector could, for no apparent reason repeatedly change trustees at the expense of the trust and choose trustees who were not suitable for the position?

This very issue was raised in a 1994 Bermuda case. In *Von Knieriem v. Bermuda Trust Co., Ltd.*<sup>2</sup> a protector was given the power to remove and replace the trustee, the Bermuda Trust Company (BTC). BTC as trustee was asked to vote shares it held in a particular way, but before complying, wanted additional information. The impatient protector decided not to risk it and removed BTC as trustee, appointing a successor trustee. BTC questioned the protector’s actions and petitioned the court for instructions before it would turn over the shares. (Note that at the same time, the protector petitioned the court to order BTC to transfer the shares to the successor trustee.)

The court considered whether the protector was a fiduciary, or at least whether the power to remove and replace the trustee must be exercised in a fiduciary capacity. The court observed that the power to remove and replace trustees was essential to the integrity of the trust and the interests of the beneficiaries (when would it not be?), quoting from an English case, stating, “The power of appointing trustees...imposes on the person who has the power...the duty of selecting honest and good persons who can be trusted with the difficult...duties which the trustees have to perform. He is bound to select ... the best people he can find for that purpose.”<sup>3</sup> Finding that the

position of protector was a *fiduciary* one, the court concluded that the protector's selection was reasonable and approved the protector's exercise of the power.

Stated simply, if the protector was in fact appointed to "protect", then he has to be regarded as a fiduciary as to the powers falling into that category. He cannot be released from his obligations merely by language stating the contrary. If a protector accepts the position knowing the powers granted him, he must consider whether or not to exercise those powers, and he must act having in mind the interests of the trust and the beneficiaries – it is not like deciding whether to read a newspaper or go to the movies.

### **Is the protector subject to court supervision?**

If the protector is a fiduciary, then it must follow that he is subject to court supervision. Such supervision would presumably include the power of the court to surcharge a protector and even to remove or appoint a protector under appropriate circumstances. In the 1995 Isle of Man case, *Steele v. Paz. Ltd.*,<sup>4</sup> a trust provided that the protector of the trust was to consent to the selection of beneficiaries, and was to consent to all distributions to beneficiaries. The problem was that no protector was named, nor was there a provision in the trust to name one. The court decided that the protector's powers were fiduciary powers; the protector was therefore a fiduciary, and it was clearly within the court's power to appoint a fiduciary rather than abandon the trust.

As to the right to surcharge a protector who is regarded as a fiduciary, this must follow if it is acknowledged that the courts have supervision over protectors. In U.S. courts the question has actually been answered through the courts' treatment of trust "advisors," a position used fairly often here, and although not typically thought of as a "protector", it amounts to exactly that. Further, the position of trust advisor has almost invariably been held to be a fiduciary position, demanding a duty of "loyalty and impartiality." As one Harvard Law Review commentary observed in addressing the responsibilities of a trust advisor who is not a trustee, "No less care will be expected of an advisor with such... powers than of the trustee himself, and the advisor should be surchargeable for failure to [employ such powers] prudently."<sup>5</sup>

## **What are the rights of the protector?**

An interesting question that necessarily follows the fiduciary issue is whether the protector, if deemed to be a fiduciary, has the rights of a fiduciary, and if the protector is not a fiduciary, whether he has any rights at all. If the protector's powers are personal then even though his responsibilities to the trust or to the beneficiaries are practically non-existent, he nevertheless would have the right to information necessary to knowledgeably exercise the power, as well as the right to enforce a properly exercised power.

If and to the extent the protector is considered to be a fiduciary, however, it should follow that he has rights similar to those of a trustee, but due to the paucity of cases on the subject the extent of such rights is not very clear. Nevertheless, some rights would have to be implied, and there are a few cases which recognize such implied rights. For instance, in *Von Knieriem* noted above, the court considered an action *brought by the protector* to force the removed trustee to transfer the trust assets to the new trustee appointed by the protector. And in *Sheldon v. The Trust Company of The Virgin Islands, Ltd.*<sup>6</sup> a trust protector was approved by the court *as a plaintiff* in an action against a trustee for breach of trust. In neither of these two cases did the court suggest that the protector, since not a trustee, had no standing to exercise the right of a fiduciary to petition the court or prosecute a case.

How far would the protector's rights extend? Could the protector (who is a fiduciary) seek an order: For compensation? Or indemnification by the trust? To employ agents? To redress a trustee? Once again, it will depend upon the circumstances of the case and the language governing the protector. In the *Sheldon* case, the court clearly acknowledged the protector's right to remove a trustee and seek an accounting and possible surcharge of the previous trustee.<sup>7</sup>

There may be some actions that might be beyond the implied powers of a protector in carrying out his function (such as the right, without express authorization, to employ agents), but other rights should be apparent. For instance, if a protector is acting pursuant to his powers on behalf of the trust, there should be little or no question that he is entitled to reasonable compensation

and reimbursement for his reasonable expenses, and although one leading commentator seems to take issue with this, courts both in the U.S. and offshore have unequivocally upheld the right of a non-trustee who was deemed to be a fiduciary to receive compensation for services and expenses reasonably incurred in carrying out his duties. Accordingly, unless the protector's powers are purely personal, he should be compensated for services and reimbursed for reasonable expenses for acting in furtherance of the trust, and as with any fiduciary, whether in an express or implied position, the court has inherent jurisdiction to award costs and compensation where appropriate. In fact, where the protector is a fiduciary, it should follow that he would have a *lien* on the trust assets for his reasonable fees and expenses.<sup>8</sup>

### **What are the U.S. tax implications of the role of protector?**

First, if the trust is a foreign trust,<sup>9</sup> little if anything will change for the settlor from the standpoint of U.S. income or estate taxes. This is because for income tax purposes section 679 of the tax code cause the offshore trust to be treated as a grantor trust as to the settlor if there are *any* U.S. beneficiaries. As to estate taxes, in virtually all cases, since the offshore trust is typically irrevocable, the settlor will retain a special testamentary power of appointment over the trust property to avoid making a completed gift on transfers to the trust,<sup>10</sup> which in turn will cause the trust property to be included in the settlor's estate.<sup>11</sup> Thus the basic tax results, except as noted below, are that the typical offshore trust is ignored both for income and estate tax purposes during the settlor's lifetime.

If the protector is someone other than the settlor, it raises the question of whether there will be tax consequences on the granting of powers to the protector which depends to a considerable extent upon whether the power is personal or fiduciary. If the power is over principal and can be exercised in favor of the protector the power is likely to be treated as a general power of appointment held by the protector,<sup>12</sup> and, depending on the remaining provisions of the trust, the protector may be treated as the owner of the property for U.S. estate tax purposes.<sup>13</sup> In either event, under IRC section 679 the settlor will be treated as the owner of the trust for income tax purposes. If the power cannot be exercised by the protector for himself or for his benefit, then the power will be treated as a special power, and with limited exception, there would be no gift

or estate tax consequences to the protector regardless of whether the power is personal or fiduciary, unless the protector is also a beneficiary of the trust and the power is exercised by the protector in a manner which causes a reduction of benefits that would otherwise be paid to the protector/beneficiary.<sup>14</sup>

If the power is held in a fiduciary capacity but could nevertheless be exercisable in favor of the protector or for his benefit, it could result in negative U.S. income and estate tax consequences for the protector after the death of the settlor unless the power is limited by an ascertainable standard.<sup>15</sup> In the typical offshore case utilizing a protector, a settlor would almost never specify a standard, such as “health, education, maintenance, and support,” and therefore, when a power can benefit the protector, there is the risk that the protector could face unwanted tax consequences after the death of the settlor just by holding the power. In addition, if the protector is deemed to have been given a general power of appointment, this would be treated as a completed gift by the settlor to the extent of the funding of the trust,<sup>16</sup> although the income tax consequences would not change during the settlor’s lifetime.<sup>17</sup> Nevertheless, I believe that where the power, both by inference and fiduciary duty, could not be exercised in favor of the protector or for his benefit, even though not so restricted in its language, the power would not be held to be a general power, and adverse tax consequences would not result. For instance, if the settlor’s attorney or other professional advisor were given the power as protector to add or delete beneficiaries, this certainly would not suggest that the attorney or advisor could delete the settlor’s children as beneficiaries and insert his own. Therefore, despite the lack of a “standard”, the protector who is a fiduciary generally should not be deemed to possess a general power of appointment for U.S. tax purposes.<sup>18</sup>

There could also be adverse estate tax consequences to a protector who could not exercise the power for his own benefit but could exercise the power in favor of someone to whom the protector owed a legal obligation of support. In such a case the property would be included in the protector’s estate for estate tax purposes unless the power is clearly subject to an ascertainable standard or the equivalent as explained above.<sup>19</sup>

Thus, for tax purposes one must be cautious about appointing the settlor's spouse, children, or other close relation as protector with powers to benefit the protector himself or his dependents, because in such cases the inference may be that the power is a personal one, and the attendant adverse tax consequences would follow.

### **What special drafting issues are brought into play along with a protector?**

Since the very position of a protector is unique and in some respects new to the trust concept, special drafting considerations must apply.

For instance, unless the protector's powers (or any of them) are intended to be purely personal, why complicate matters and generate needless expense by declaring that the protector shall not be a fiduciary? And why leave open the question as to whether a protector (who is a fiduciary) is entitled to reasonable fees and expenses? Or whether he can employ agents to help carry out his responsibilities? Or whether he can seek indemnification from the trust before acting? Or engage tax counsel to determine the consequences of his acts? Or whether he is entitled to access to all trust records, documents, and accounts? Even in cases where the protector's powers are limited, it would seem that consideration of every one of the foregoing issues would eliminate otherwise unavoidable questions and therefore expense. Thus, they should each be addressed in drafting provisions relating to the protector.

Of course, the more apparent questions also must be thoughtfully covered, including appointment of successor protectors as well as removal of a protector, if desired. (A practitioner must always be mindful that some of these choices may have tax and/or fiduciary ramifications.) Other drafting issues include what constitutes the protector's consent when such is required, and in the case of a veto power, when the trustee may act if the protector does not respond. And should every transaction by the trustee be subject to the protector's veto or consent? Consideration should be given to allowing the trustee to administer the trust without such disruption and only require approval in larger or significant transactions (for example, over a specified dollar amount, or on the sale of certain property or closely held business interests).

With regard to the veto power, one approach commonly seen with which I *strongly* disagree, is where the trust gives the protector the authority to give the trustee a blanket consent to all actions taken by the trustee unless and until such *carte blanche* is withdrawn by the protector. If the protector's power is a fiduciary power, why wouldn't such a blanket consent be a *prima facie* breach of fiduciary duty by the protector? A blanket consent arrangement does little more than render the protector impotent, contradicting and defeating the very purpose of the appointment of a protector by the settlor, yet it doesn't seem to stop drafters from including such a provision.

Finally, the trust should contain provisions allowing the trustee to act during any period where there is no protector serving, as well as provisions allowing a protector to resign the office, and how this is accomplished.

### **Should every trust have a protector?**

One commentator has stated, "the strongest criticism of trust protectors is that their involvement complicates the trust administration and makes it more expensive."<sup>20</sup> This comment may be correct, but the administrative issue is only one factor in considering a protector in the first place, and any such complication and expense can definitely be outweighed by the inclusion of well thought-out and carefully drafted trust provisions which can allow the protector to deal with trust problems that the trustee would not or could not deal with or that would otherwise require court action. On the other hand, many trusts may go smoothly along without even needing a protector. No one can tell whether and when a protector may be needed, so I propose the idea of a "springing" protector, which our firm uses extensively, offering the best of both worlds.

### **The springing protector**

A trust with a springing protector is one where there is no protector unless and until that position is created pursuant to the terms of the trust, so that until such terms are implemented or triggered, no protector is appointed; the office simply does not exist. Once the appointment becomes effective, however, the office "springs" into being. The terms could provide for appointment of an independent protector by the trustee when it felt the presence of a protector

would be helpful, or by the beneficiaries, or by an outside party such as the settlor's law firm or other advisor. It could provide that the protector's appointment would be for a specified period of time, or for a specified event (for example, resolution of a dispute between the trustees or between the trustee and beneficiaries). The appointment could be revocable or permanent and may provide for appointment of successors. Thus, the idea of a springing protector may offer the best of both worlds – a trust without a protector until and so long as one is needed, and the powers given to the protector could be up to the party creating the position at the time it is created.

## **Conclusion**

I believe that a protector can add important flexibility to the administration and objectives of a trust, saving time, trouble and expense, but there is a good deal of confusion and misunderstanding among advisors over the role of the protector.

When one considers the reported case law on the subject, knowledgeable commentary, the history of fiduciary law, and the very purpose of having a protector, the question of the role of the protector as a fiduciary (in other words, to *protect*) should hardly be a question at all.

Despite its perceived value and the apparent flexibility offered by a protector, however, the rush to protect is oftentimes hasty and overdone by practitioners. Protectors are not necessarily needed in every trust and even where one may at some point be advisable, consideration should be given to the idea of a springing protector, rather than requiring the presence of one from the beginning to the end of the trust with more powers (and expense) than may be appropriate or necessary. In any event, with careful drafting, thoughtful selection of the protector and successors, and deliberate selection of powers, it would be a rare trust that would not benefit from the advice and assistance of a competent independent protector.

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<sup>1</sup> Uniform Trust Code § 808(d) (2001).

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- <sup>2</sup> *Von Knieriem v. Bermuda Trust Co. Ltd.*, 1 BOCM 116 (Bermuda High Court 1994).
- <sup>3</sup> *In re Skeats Settlement*, 42 ChD 522, 526 (1889).
- <sup>4</sup> *Steele v. Paz, Ltd.*, Manx LR 102 426 at 119-120 (High Court, Isle of Man 1993-95).
- <sup>5</sup> *Trust Advisors*, 78 Harvard Law Review 1230, 1231 (1965).
- <sup>6</sup> *Sheldon, et. al. v. The Trust Company of The Virgin Islands, Ltd.*, 535 F. Supp. 667, 671 (D. Puerto Rico 1982).
- <sup>7</sup> *Ibid.*
- <sup>8</sup> Austin Wakeman Scott, William Franklin Fratcher, *The Law of Trusts*, § 242.3 (4<sup>th</sup> Ed. Little Brown 1989).
- <sup>9</sup> IRC §§ 7701(a)(31)(B) and (a)(30)(E).
- <sup>10</sup> Treas. Reg. § 25.2511-2(b).
- <sup>11</sup> IRC § 2038.
- <sup>12</sup> For a more detailed discussion of the tax implications of powers of appointment, see Alexander A. Bove, Jr., *Powers of Appointment – More (Taxwise) Than Meets the Eye*, Estate Planning, Vol. 28 No. 10 (October 2001).
- <sup>13</sup> IRC § 2041(a).
- <sup>14</sup> Bove, *supra* note 12, at 500, and note the exception that would apply in certain jurisdictions where a special power is exercised in a manner that would postpone vesting beyond the applicable rule against perpetuities. *See* IRC § 2041(a)(3).
- <sup>15</sup> IRC § 2041(b); Treas. Reg. § 20-2041-1(c)(2), and IRC §§ 674(b)(5) and 674(d).
- <sup>16</sup> Treas. Regs § 25.2511-2.
- <sup>17</sup> IRC § 678(b).
- <sup>18</sup> *See e.g., Matter of Stillman*, 433 N.Y.S. 2d 701 (1980). Further, some states prohibit the exercise of such a power for the powerholder’s benefit, e.g., N.H. Rev. Stat. Ann. § 564-A:3(IV) (2000), and *Allan v. Nunnally*, 180 F.2d 318 (5<sup>th</sup> Cir. 1950), citing New York law.
- <sup>19</sup> Treas. Regs. § 20.2041-1(c)(1).
- <sup>20</sup> Anthony Duckworth, *Protector – Fish or Fowl Part II*, 5 Journal of International Trust & Corporate Planning 1, 32 (1996).