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Trusts and Estates Forum

Peter Protector in Trust Neverland
The Real Story of the Trust Protector[1]

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The unprecedented popularity of the use of trust protectors motivated the authors to share some of this important information, if for no other reason than to dispel the popular belief that a sprinkling of protector "fairy dust" over a trust permits both the trustee and protector alike to fly away to a trust neverland where traditional fiduciary responsibility is dispensed with.

So, just what is a protector and why has it become the darling of trust drafters? Briefly, a trust protector is an individual (or committee or entity) who is not a trustee but who is nevertheless granted powers under the trust that supersede corresponding powers of the trustee. While there is no universal definition of a protector, the first legislative definition of protector can be found in Section 3 of the Cook Islands International Trust Amendment Act 1989, and protector definitions are contained in numerous offshore trust acts, including Nevis, which defines the

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protector as "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 a discretion and includes a person who is the holder of a power of appointment or dismissal of trustees." Section 9(1) of the Nevis international Exempt Trust Ordinance 1994. This definition, perhaps, could have been condensed to: "A protector is a powerholder." And that is about the sum of it, or rather, the beginning of it. That is to say, the protector's power over the trust could be negative, such as a veto power over some proposed trustee act, or positive, such as the power to remove and replace trustees or add beneficiaries, or amend the trust, or even the power to terminate the trust.

It is easy to see how advisors who habitually draft trusts with only the "accepted" forms of flexibility (viz., the removal of trustees or the inclusion of a power of appointment) could get carried away with this new form of super flexibility that virtually reverses the traditional concept of a settlor thoughtfully establishing a trust for specified classes of beneficiaries with specified terms and specified trustees, and instead permits the protector to undertake his own periodic spring cleaning and revise trust provisions. Unfortunately, it is this nascent super flexibility which seems to allow advisors and settlors alike to deal with virtually every conceivable future circumstance (including the excusing of shortcomings in drafting) that makes this position of protector so increasingly popular.

At the same time, however, it is this flexibility "hook" that can cause advisors to casually include powers that may do little more than result in conflicts between the protector and the trustee, and which will result in costly legal disputes, unnecessary tax exposure, the possible deletion of beneficiaries that may have been important to the settlor, and even a distortion of, or worse, a diversion from the original trust purposes. Thus, planners and settlors should be extremely discreet and circumspect in the granting of powers to the protector, and should understand the consequences of each protector power.

What powers then should be given to the protector? The settlor may be tempted to give the protector as many powers as possible to provide for the ability to contend with any future changes in circumstances, the law, or the beneficiaries. Such an approach can be dangerous, if

not reckless, however, and just the opposite approach is often better. That is, having in mind the purposes of the trust, and using history as a guide, the settlor and the advisor should attempt to reasonably anticipate the powers that would likely assist in carrying out the trust purposes which would be better held in the hands of someone other than the trustee. For instance, a very common protector power is the ability to remove and replace trustees. To give this power to one or more beneficiaries is not usually conducive to an objective evaluation of whether a trustee holding discretionary powers should or should not be removed, since many beneficiaries would hasten to remove a trustee who didn't accommodate their every wish or at least accede to what the beneficiaries viewed as "reasonable" requests. If the settlor wished the beneficiaries to be involved in trustee selection, the power to remove and replace trustees may be held by the beneficiaries, but subject to the approval of a protector.

While the list of powers which could be given a protector is extensive, the authors believe an equally important concern is the nature and extent of the relationship between the protector and the trustee, and to a great extent the answer to this question depends upon whether the protector is deemed to be a fiduciary. This is because if and to the extent the protector is not a fiduciary (i.e., where the power in question held by the protector is a personal power rather than a fiduciary power) then the trustee's position *vis a vis* the protector will be quite different than if the protector herself is considered a fiduciary. That is, an individual holding a personal power cannot be forced to exercise it and in fact need not even consider whether to exercise it. And if she does exercise such a power, she may do so on a whim, or even for a spiteful or malicious reason, so long as she does not commit a fraud on the power or violate public policy. See Pitman v. Pitman, 314 Mass. 465, 50 N.E.2d 69 (1943). Therefore, a trustee who must in some way consider or react to a personal power is under no duty to look behind the exercise (or non-exercise), or review the motives for or reasonableness of its exercise, so long as the terms governing the exercise have been satisfied. Restatement (Second) Property sec. 18.2.

On the other hand, if the protector's powers are fiduciary, which the authors believe is far more likely the case, then the trustee is in a much more delicate position, and the delicacy of the position will be increased where the trust contains an exculpatory clause such as: "The trustee shall not be held liable for acting or for not acting in following the directions of the protector

pursuant to the powers given the protector hereunder." Even a brief reflection on the import of such a provision reveals how troublesome and misleading it can be in a fiduciary setting. Would any advisor with a trustee as a client assume from this provision, for instance, that a trustee can freely follow a protector's direction which is patently improper, though technically within the protector's powers? Conversely, can a trust state that a trustee is exculpated if such trustee proposes an improper act which is only carried out because the act was given the required consent of the protector? It is the authors' opinion that regardless of the extent of the powers of the protector and the extent of exculpatory language relieving the trustee of duty or responsibility, the trustee must nevertheless recognize and honor his fiduciary obligations and question the protector where called for. To advise otherwise, the very premise of the trust would fail, and to paraphrase one author, the trustee would not be a trustee at all but rather an agent for the protector. Lupoi, *Trusts: A Comparative Study* (Cambridge University Press 2000).

In some cases, it may be that the relation of the person or entity that serves as protector may dictate one result over another. For example, say that the protector is given the power to add or delete beneficiaries, without restriction, and in the first instance, the settlor names his daughter, Wendy, as protector. Pursuant to the power, Wendy proceeds to delete her siblings and their issue from the pool of beneficiaries and adds her spouse and her child as beneficiaries. Under these circumstances it is likely that the settlor would have contemplated that Wendy could and in fact might well exercise the power in such a way, and so the power would be considered a <u>personal</u> power and Wendy's exercise would be appropriate. On the other hand, say that the settlor's attorney was named protector and given the same power (a member of the Barrie?). Would it be appropriate for the attorney to delete the settlor's children and grandchildren as beneficiaries and substitute his own? In the latter case, of course, the power would not be construed as a personal one, and the attorney would clearly have a duty to consider the intentions of the settlor and the purpose of the trust, in a <u>fiduciary</u> capacity. Any exercise of the power that benefited the attorney in such a case, directly or indirectly, would be subject to rescission and would expose the protector to damages for breach of fiduciary duty.

It should be clear, then, that as to the question of whether the protector should be viewed as a fiduciary, considerable inference can be drawn from the settlor's choice of protector (as well as

successor protectors), as well as the particular powers granted. As a general rule, if the appointed protector is a beneficiary or a person who would likely be an object of the settlor's bounty and there is no language or facts to dictate otherwise, then to the extent the exercise of a particular power could benefit the protector, there is likely to be a presumption that it is a personal power. Hayton, David, *English Fiduciary Standards*, Vanderbilt Journal of Transnational Law Vol. 32:555,580. If the protector is someone in an advisory capacity to the settlor or someone the settlor would be unlikely, under normal circumstances, to name as a beneficiary, the power will likely be a fiduciary one. Of course, an easy way to avoid the question would be to include appropriate language in the trust, perhaps simply providing that the protector's powers must be exercised in a fiduciary capacity.

Unfortunately, many advisors have come to believe that the inclusion of language to the opposite effect, that the protector shall <u>not</u> be deemed to be a fiduciary, will conclusively settle the question. This is a little like saying, "regardless of what type of dog runs through the park, it will be deemed to be a Newfoundland." While such a statement is bound to be correct if enough dogs run thorough the park, why would we not want to correctly identify each dog, or in this case each protector, or each power? And as a general rule, most advisors would have to admit that despite language denying fiduciary status, the huge majority of protectors <u>are</u> in fact intended and expected to exercise their powers for the furtherance of the trust and not for themselves. The attempt to have it both ways is undoubtedly to prevent potential protectors from being "scared off" by the assumption of possible liability, which is similar to the reason for the language exculpating a trustee for submitting to the powers of the protector. Other than that concern, however, and in the absence of a personal power, it is a challenge to imagine why a settlor would grant extensive powers to an individual (or committee or an entity) for any purpose other than to see to the proper carrying out of his wishes in establishing the trust. What would be the sense of it? If, for instance, a protector is given the power to change the situs and governing law of the trust, would anyone conclude that the power was given so that the protector could simply tinker with the trust and arbitrarily and for no apparent reason shift the situs from one jurisdiction to another just for the fun of it? Or would it rather be that while the settlor felt the original jurisdiction seemed a good choice at the inception of the trust, being unable to foresee the future

he wanted to allow for a change of jurisdiction if it appeared to be in the best interests of the beneficiaries and the trust?

And what about the power to remove and replace trustees? Couldn't that be some sort of neutral power, not necessarily fiduciary in nature, as many attorneys thought? This very issue was raised in a 1994 case heard in Bermuda. Von Knieriem v. Bermuda Trust Co., Ltd., 1 BOCM 116 (Bermuda High Court 1994). In that case a protector was given the power to remove and replace the trustee, the Bermuda Trust Company. Bermuda Trust, as trustee was asked to vote shares it held in favor of the settlor remaining on the board of directors of the subject company. Before complying, Bermuda Trust understandably wanted additional information as well as time to consider it, but the impatient protector decided not to risk it and exercised its power to remove Bermuda Trust as trustee, appointing a successor corporate trustee. Bermuda Trust 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 asking that Bermuda Trust be ordered to transfer the shares to the successor trustee.)

In its consideration of the case, the court centered on the key question of 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. In addressing this issue, the court first noted that it would depend on the facts of the particular case and in some respects on the nature of the power. In this case the court pointed out that the power to remove and replace trustees was viewed to be essential to the integrity of the trust and the interests of the beneficiaries (when would it not be?), quoting (in part) 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 to the best of his ability the best people he can find for that purpose." In re Skeats Settlement, 42 ChD 522, 526 (1889). The court, nevertheless, did conclude that the protector's selection was reasonable and approved the protector's exercise of the power.

Another factor which argues convincingly in favor of the fiduciary status of a protector is where the trust establishes the position of protector as an office, as it is with the trustee, rather than as

the appointment of an individual per se. That is, where the trust provides for the office of protector, including the appointment, removal, and resignation of a protector, the appointment of one or more successor protectors, the powers and compensation of the protector, etc., it would be extremely difficult, at best, to refute the argument that the powers attach to the "office" and not to the individual holding the office. Such a structure would unquestionably require the office-holder to act reasonably and not for personal motives, having in mind the purpose behind the creation of the office: to protect the integrity and carry out the purposes of the trust. When one considers the extent of the powers often given the protector over the trust, the trustees, and the beneficiaries, evidence that the powers are personal rather than fiduciary would have to be overwhelming and near incontestable before a court would refuse to interfere, especially where the effect of the protector's acts or refusal to act could clearly conflict with the purpose of the trust or the purpose of the protector's appointment in the first place.

In the Canadian case of In Re Rogers, 63 O.L.R. 180 (Ontario 1928), for instance, the instrument provided that the trustee was prohibited from acting on a certain investment without the advice of a named individual (effectively, a protector). No successor "protector" (called an "advisor" in the instrument) was provided for, and the settlor gave the power to him "exclusively". Further, the provision granting the power expressly released the trustees "from all liability for any action that may be taken" at the protector's request. After the settlor's death, the protector acquired, for his own account, an interest in the investment held by the trust and entered into negotiations with other parties that conflicted with the interests of the trust. In effect, the protector would be able to sell his shares but withhold his consent to a sale of the trust shares by the trustee if it affected his (the protector's) sale. If the power were truly a personal power, the protector, who was otherwise unconnected to the trust, would have been free to withhold consent, as he did. The trustee petitioned the court to intercede, since it desired to sell the shares held in the trust and distribute the proceeds to the trust beneficiaries (the children of the settlor), but pursuant to the power given to the protector, the trustee was prohibited from negotiating on its own without the protector's consent. The protector contended that his power to give or withhold consent was conclusive (i.e., personal), and that the court had no authority to override it. The court disagreed, and in ordering that the trustee could act without the required consent, the court stated, "to contend that the so-called control over the management of the estate given him can hamper or

limit the power of the Court to advise the trustees and to give directions for the due administration of the estate is to place Beaton [the protector] in the extraordinary and quite unknown position of a sort of super-trustee who is neither responsible to the trustees or the beneficiaries nor subject to the control or direction of the Court."

In sum, and at the risk of oversimplification, if the protector was in fact appointed to "protect," then she has to be regarded as a fiduciary as to the powers falling into that category and she cannot be released from her obligations merely by language stating the contrary. If she accepts the position knowing the powers granted her, she must consider whether or not to exercise those powers and she must act reasonably, having in mind the interests of the trust and the beneficiaries – it is not like deciding whether to read a newspaper or to attend the theatre.

There are numerous other issues that face the advisor who contemplates the use of a protector in a trust. For example, the settlor must understand the extent of court supervision of the protector; the protector should be advised to obtain legal advice regarding his rights and obligations; the tax implications of the role of the protector must be outlined; and the settlor should be advised of the complications of trust administration which the protector often entails. It should be clear, then, that the thoughtful drafting of provisions to govern the protector is not for the uninitiated. It is not, to paraphrase Peter Pan, a simple case of "faith and trust and little bit of pixie dust."