



# The Trust of as the Modern Vehicle for Investment and Estate Planning in Common Law and Civil Law Countries

The Honourable Mr Justice David Hayton,  
Judge of the Caribbean Court of Justice

**Remarks by Mr Justice David Hayton on 'How has the trust come to have a role in civil law jurisdictions at the CALCA Conference**

St Maarten  
27 October 2016

The Caribbean Academy for Law and Court Administration (CALCA) prepares an annual programme of activities based upon an assessment of need and successfully staged four biennial conferences. CALCA programmes include participants drawn from various professions and fields of endeavour associated not only with courts but also from sectors that have some interaction with courts. Special seminars, workshops and lectures were delivered by experts in the CARICOM region, and further afield, and Judges and senior officials of the Caribbean Court of Justice.

**Remarks**

**By**

**The Honourable Mr Justice David Hayton, Judge of the Caribbean Court of Justice,**

**on the occasion of**

**The CALCA Conference in St Maarten**

**27 October 2016**

The catalyst for trusts developing a much greater role in civil law jurisdictions in the last twenty-five years was The Hague Convention on the Law Applicable to Trusts and their Recognition<sup>1</sup>. This private international law convention was a response to the increasing use of English or New York trust law to govern property held on trust in civil law jurisdictions to further commercial or financial purposes and also to the practice of common law testators, who owned property situated in civil law countries, to make wills leaving such property on fixed or discretionary trusts for the benefit of their families. The Trusts Convention<sup>2</sup> therefore provided good guidance as to how trusts should be dealt with in civil law jurisdictions as a matter of private international law but it could not dramatically change domestic civil law. It could not introduce as a new property concept equitable rights of beneficiaries in property that could bind successive owners of such property.

Thus the Convention in its application to civil law countries had to be limited to the obligations loyally owed by a trustee to beneficiaries, but it became appreciated that substantial features of common law jurisdictions' proprietary trusts could be achieved by what may be termed

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<sup>1</sup> See D Hayton, 'Reflections on The Hague Trusts Convention after Thirty Years' (2016) 12 JPIL 1 and <http://dx.doi.org/10.1080/17441048.2016.1139658>

<sup>2</sup> Implemented by Australia, Canada (other than Ontario & Quebec), Hong Kong, Italy, Liechtenstein, Luxembourg,

obligational trusts. Once foreign proprietary trusts could to a significant extent be given effect to as obligational trusts as in the case of *trusts interni* in Italy<sup>3</sup>, why could there not be local obligational trusts, as, indeed had been created by a 1926 statute<sup>4</sup> in Malta, Monaco, The Netherlands, San Marino, Switzerland, and the UK (Bermuda, British Antarctic Territories, British Virgin Islands, Falkland Islands, Gibraltar, Guernsey, Isle of Man, Jersey, Montserrat, St Helena, South Georgia, South Sandwich Islands, and Turks & Caicos Islands). Cyprus, France and the USA have signed the Convention but not implemented it. The Convention's guidance, however, is normally influential for trust matters in countries that have not actually implemented it.

Liechtenstein by a far-sighted legislature? Moreover, the greater the extent to which these obligational trusts could replicate the versatile protective features of proprietary trusts, that had led to extensive multifarious uses of such trusts, the more worthwhile could be the use of these obligational trusts in civil law jurisdictions.

Why, therefore, could there not be an obligational trust where the beneficiaries have the benefit of a specially preferred obligation in respect of particular property of an owner-trustee so that the beneficiaries are specially preferred creditors in the insolvency of the trustee? After all, if the trustee could be prevented from having recourse to the trust property for his own benefit why should his creditors or heirs have recourse to it for their benefit? Thus the beneficiaries' monetary claims relating to the value of the trust property have priority over the trustee's creditors and heirs, but they have no rights against third parties to whom the trustee had made a *gift* of the property. In

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<sup>3</sup> See A Braun, Chapter 15, 'Italy: the trust *interno*' in D Hayton (ed) *The International Trust* 3rd ed Jordan Publishing Ltd 2011 and M Lupoi, *Istituzioni del Diritto dei Trust negli Ordinamenti di Origine e in Italia*, 3rd ed Wolters Kluwer 2016.

<sup>4</sup> Personen und Gesellschaftsrecht.

the case of *sales* by the trustee they will, however, have rights in respect of the proceeds of sale and property purchased with such proceeds. It could also be the case, as essentially under Luxembourg and French law, that the trustee would need to be a regulated financial intermediary, most unlikely to commit a breach of trust by giving property to persons who were not beneficiaries.

Before considering the multifarious uses of proprietary trusts such that some may substantially be achieved by way of obligational trusts in civil law countries, the legal underpinnings of proprietary trusts need to be noted. After those two topics the lesser legal underpinnings of obligational trusts will then be considered to see how they can substantially further similar uses to those provided by proprietary trusts.

#### The legal underpinnings of proprietary trusts to see how they further multifarious uses

Underpinning the multifarious uses of proprietary trusts in common law countries, is that at the core of a trust is the ring-fenced fund that is the trust property managed by the owner-trustee loyally for beneficiaries and in which beneficiaries have proprietary rights<sup>5</sup>. These rights entitle them to trace and recover the trust property in its traced substituted form unless owned by a third party who is a bona fide purchaser of it for value without notice of the beneficiaries' rights. As well as such *in rem* rights, the beneficiaries have *in personam* rights against the trustee for a breach of trust and against any third party who knowingly received trust property in breach of trust. The trustee's 100% ownership of trust capital and income can be "sliced and diced" for the beneficiaries in whatever fashion the settlor of the trust set out in the trust instrument when creating the trust. Indeed, a term in the trust instrument may empower the settlor or another specified person to change the terms of the trust.

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<sup>5</sup> See Underhill & Hayton, *Law of Trusts and Trustees* (19<sup>th</sup> ed) 2016, Butterworths LexisNexis, para 1.1

There are no rigid formal requirements for the creation and operation of trusts (unlike companies), so that the settlor is able to arrange whatever management structure he likes (e.g. including an advisory family council) in order to achieve any lawful, commercial or dynastic purpose, taking account of taxation advantages or disadvantages. The disadvantage of a trust having no legal personality, the trustee being the legal person to sue or be sued, is not a problem when one considers a trustee can be a limited company or can own as the trust property the shares in a limited company which then as owner manages very valuable assets by way of investment or trade. Common basic uses of the trust are as follows, but they can be used for whatever lawful purposes the fertile mind of man can devise for the versatile protective features of the trust. The multifarious uses of trusts

### **Dynastic family trusts**

In the nineteenth century successive life interests were common, though only continuing for a maximum perpetuity period of 21 years from the death of a particular person alive when the trust was created. Nowadays, wealthy settlors create discretionary trusts under which the beneficiaries have no rights to income or capital, only hopes that they may receive some in due course. The trustees have extensive discretion as to who, amongst a large class of relatives, their spouses and cohabiting partners, from time to time receives income and, even, perhaps, a part of capital, until all the trust property has been distributed. This must occur normally within a perpetuity period varying for periods from 125 years upwards in different jurisdictions, while a few jurisdictions have no limits. A settlor's non-legally-binding letter of wishes will provide the trustees with guidance as to how to exercise their discretionary powers or the trust instrument may create an advisory committee for the trustees. These trusts can satisfactorily provide for family members

who turn out to be spendthrifts or drug addicts or to suffer from Alzheimer's disease or other disabling illnesses.

### **Trusts for particular mentally or physically handicapped individuals**

Family money is normally used for looking after specific handicapped family members with the benefit of advantageous tax treatment, but money of a tortfeasor or his insurers is also used for looking after personal injury victims of negligent drivers or doctors.

### **Trusts of controlling or majority shareholdings in family businesses**

A person whose lifetime has been spent on creating and running a successful family business can transfer his controlling shares in the family company to trustees of a discretionary trust so that the business continues instead of his shares passing under his will to a variety of family members who could sell out their shares, so that the business passes out of family control.

Where, say, five persons between them hold a 54% shareholding (perhaps a father, a mother and three adult children) and do not want the value of the majority shareholding to be diluted by sales, they may transfer the shareholding to a trustee for them to vote the shares as directed by particular shareholders but, in the case of an offer to buy the shares, only to sell them if the majority of shareholders by value agree. Their contract will usually contain a provision that no beneficiary can in his or her lifetime dispose of his or her equitable interest in the shares unless first offering it to the other beneficiaries at a fair value to be fixed by an independent valuer if not agreed.

### **Charitable trusts**

There is a colossal range of charitable trusts for the benefit of the public in a great variety of ways.

### **Trusts for non-charitable purposes**

The traditional position is that there can only be a valid trust if there are human or legal beneficiaries who can enforce beneficial rights against the trustee unless the trust is for charitable (viz public-benefiting) purposes enforceable by the

State's chief legal officer, the Attorney-General, or a statutory Charities Commission created as the number of charities mushroomed. As a result, offshore jurisdictions have enacted legislation to permit valid non-charitable purpose trusts where there is a designated enforcer with power to enforce the trust obligations.

### **Pensions for employees and share incentive plans for employees**

To ensure funding of pensions for retired employees, pursuant to the employment contract money is paid by the employer and the employee to trustees to manage as a segregated fund (or as part of a larger industry fund e.g. for UK university employees) charged with paying out to the employee a percentage of his final salary. Alternatively, the employer and employee can pay money to trustees to invest with a regulated life insurance company so that the employee in due course is credited with a lump sum to be used to purchase an annuity.

There can also be tax-advantageous employee share ownership plans for shares to be allocated to a trustee for distribution in due course to particular hardworking employees. Additionally there may be tax-advantageous employee share incentive plans to encourage employees to buy shares in their employer to be held collectively for them until leaving employment.

### **Unit trusts as collective investment schemes**

A trust is used as an open-ended collective investment vehicle (with no fixed or irreducible capital base) in which the value of the units held for a particular unitholder investor is directly related to

the value of the trust assets. These are held by a custodian trustee to the order of the managing trustee.

### **Custodian trustees in stock markets**

To facilitate speedy efficient dealings in stocks and shares, many such securities are held by a corporate custodian, often for a sub-custodian which holds for a broker who holds for a client. There can be no bailment of intangible property so that the custodian will hold the fungible pool of securities as owner-trustee on trust for the sub-custodian which holds its interest on trust for the broker, which holds its interest on trust for a family trustee, who holds his interest for the family beneficiaries.

Say Nominee plc is owner of 10 million shares and Subcustodian plc is interested in 2 million shares and sold 200,000 to a broker which sold 50,000 to a trustee, T. No-one actually owns a particular 2million or 200,000 or 50,000 shares. T has an equitable proprietary interest in a quarter of the broker's one fifth equitable interest in Subcustodian plc's one fifth equitable interest in Nominee plc's legal title to 10million shares. Thus the parties below Nominee have equitable proprietary interests rather than merely having the benefit of a debtor-creditor relationship.

### **Collective security trusts for holders of bonds or debenture stock**

The trustee has the benefit of a borrower's promise to repay a loan collectively provided by a group of lenders and holds particular assets of the borrower as security for repayment of the lenders. These rights of the trustee and the fruits of such rights are held on trust for the lenders who, as beneficiaries, have rights that they can sell to others. Where more money may need to be borrowed, there will be a syndicated loan trust where the trustees of a collective security trust will have power to afford subsequent lenders the same priority as earlier lenders, or even a higher priority if agreed upon by a specified proportion of earlier lenders.

### **Subordination trusts**

For practical commercial reasons one creditor, the junior or subordinated creditor, agrees not to be repaid until a senior creditor has been paid, but on the debtor's insolvency the rule is that *pro rata* distributions are required to creditors. To avoid this, a trust deed is executed under which the junior debt is payable by the debtor to the trustee who is to hold any payment made in respect of the junior debt on trust first for the senior creditor to the amount of the senior debt and, then, if any money remains, for the junior creditor. The senior creditor thus obtains as much protection as possible in respect of the insolvency of the debtor or the junior creditor.

### **Debt securitization vehicles**

A bank owed mortgage debts and credit card receivables wishes to sell these securities for a capital sum so as not to need to make accounting provision for possible non-payment of future income. It creates a corporate special purpose vehicle ( 'SPV'), the shares in which are held on charitable trusts or a foreign noncharitable purpose trust and not by it, because, if so, the SPV's accounts would have to appear in its consolidated balance sheet. It then sells the securities to the SPV and agrees with the SPV to administer them, holding receipts on trust for the SPV as soon as received and forwarding them to the SPV.

The SPV pays for the securities by borrowing the money by way of issuing bonds to investors, the loan being secured by way of a trustee for the bondholders having a fixed and floating charge over the SPV's assets, in particular its receivable securities. The bondholders are repaid by the moneys collected by the Bank from its debtors and forwarded to the SPV. Various credit enhancements may be provided to make the securitization more marketable to investors.

### **Trusts of future income when received so as to secure loans for financing projects immediately**

If Lender Ltd lends \$20million to Borrower Ltd on Borrower contracting to hold on trust for Lender all the money Borrower expects to receive from a particular source of future income (e.g. three years of receipts from season tickets to a football club or from a car park or from a quarry) until repayment of the loan with interest, then such money as soon as received by Borrower is held on trust for Lender. This is so even if Borrower has become insolvent during the period of the loan.

### **Temporary purpose trusts until a debtor-creditor relationship arises**

Lender Ltd can transfer \$20million to Borrower Ltd on trust to use it for a particular purpose e.g. to pay a dividend to Borrower's shareholders or to buy a luxurious penthouse apartment, but to hold the money on trust for Lender till the dividend has been declared or the conclusion of the contract to buy the apartment. Once such event has occurred there is only a debtor-creditor relationship but until then Lender is safe if Borrower becomes insolvent since Lender is beneficially entitled to the money under the trust.

### **Client accounts**

Where X is an attorney or real estate agent or insurance broker or other person accustomed in his business or profession to receive clients' moneys which are to remain their moneys until used for a particular purpose, he will have a client account with his bank as well as his own office account so that he can segregate client moneys from his own. In the event of his insolvency or misuse of clients' moneys his clients will have prior claims over his creditors in respect of moneys remaining in the client account and in respect of property wrongfully purchased with client moneys as the traceable product of such moneys.

### **Sinking fund trusts**

Where it is known that major expenditure will be required in a distant period money can be paid regularly until that time to ensure that an adequate amount of money will be available to fund that expenditure e.g. for major renewals for a block of flats or heritage property or for land reclamation after working out of a mine.

### **Retention trusts in building contracts**

Under a building contract the employer of the management contractor sets up a retention trust fund into which it pays, say, 4% of each amount certified by the architect as due from the employer to the contractor. Half of this is payable to the contractor when the architect issues the certificate of practical completion and the other half upon the issue of the certificate of completion of making good defects. The employer has a measure of security to ensure the building is properly completed and the contractor has some protection against the insolvency of the employer.

### **Trusts of shares to separate voting control from ownership of a company**

A and B may be 60:40 shareholders in a joint venture company but their contractual deal is that B is to have 75% of the voting rights, which is fine if A honours the contract by voting 35% as B directs. But if A breaks the contract and votes his 60% to block B's plans the votes would have been validly cast and bind the company. To prevent this possibility, the shares of A and B are transferred to an independent trustee to vote 75% as directed by B but otherwise to benefit A to the extent of 60% of the dividends etc.

### **Partnership protection via life assurance trust**

To deal with the death of a partner and possible adverse repercussions, there can be a partnership buy-sell agreement funded by a life assurance policy held by a trustee for the partners. The

insurance money will provide funds to enable the surviving partners buy the interest of the deceased partner, thereby avoiding sale of partnership assets which might jeopardise the business.

### **Miscellaneous uses**

Enforcement of competition laws could require a conglomerate to sell off a company it owns and controls within a short period such that a satisfactory price could not be obtained on such a forced sale. This disadvantage can be avoided by vesting the company in an independent trustee until an advantageous sale can be obtained within a longer period.

What then is the nature of obligational trusts that could enable some of the above uses of proprietary trusts to be carried out to some extent?

### The legal underpinnings of obligational trusts to see what multifarious uses might be made of them

One might have thought that the trust concept was such a quintessential product of the common law in permitting legal and equitable ownership of property that civil law jurisdictions would not be able to develop and exploit a similar concept within the Roman-law-based taxonomy in their Civil Codes that have a Law of Persons, a Law of Obligations and a Law of Property. A trust cannot fall within the Law of Persons because a trust is not a person capable of suing or being sued, the trustee being that person (though the trust property cannot be used to pay off his private creditors). If English law had a civil code the trust would be dealt with under a chapter headed 'Property' concerned with *in rem* claims that are claims to rights in specific property. Nevertheless, substantial elements of the English proprietary trust concept have found their way into numbers of civil law jurisdictions, but as part of the law of "Obligations" concerned with *in personam* monetary claims.

Several non-common-law jurisdictions e.g. Liechtenstein<sup>6</sup>, Louisiana<sup>7</sup>, Luxembourg<sup>7</sup>, Quebec<sup>8</sup>, Italy<sup>9</sup>, France<sup>10</sup>, Taiwan<sup>11</sup>, China<sup>12</sup>, Japan<sup>13</sup>, Hungary<sup>14</sup> and the Czech Republic<sup>16</sup> have enacted a domestic obligational trust concept that, while to some extent restricted<sup>15</sup>, confers upon beneficiaries an *in personam* claim against the trustee in respect of the trust property that has priority over *in personam* claims of the trustee's creditors, heirs or spouse<sup>16</sup>. As Italian case law shows<sup>17</sup>, this is also the general impact of implementing the Hague Convention on Trusts, requiring foreign trusts to be recognised.

It is thus immaterial that the English trust is rooted in England having had common law courts administering common law and creating legal rights, but supplemented, to prevent injustice from the rigid application of the common law, by a Chancery Court administering equity and creating equitable rights capable of prevailing against legal rights. As a result of this history, trustees owning trust property have legal rights in such property that bind all third parties, and trust beneficiaries have lesser equitable rights in the trust property that bind everyone but bona fide

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<sup>6</sup> *Personen und Gesellschaftsrecht* 1926, Arts 897-932 <sup>7</sup> Revised Code Title 9, sections 1721 et seq.

<sup>7</sup> Grand-Ducal Regulations of July 19 1983 and July 27 2003.

<sup>8</sup> Civil Code 1995 Arts 1261 et seq.

<sup>9</sup> Art 2645-ter Civil Code inserted by Law Decree No 273 of December 30 2005, limited to the destination of registered property: L Fumigalli, 'National Report for Italy' in S Kortmann & D Hayton (eds) *Towards an EU Directive on Protected Funds*, Kluwer Law Publishers, 2009 pp 213-217.

<sup>10</sup> La fiducie law of Feb 19 2007 as amended by law of Aug 4 2008.

<sup>11</sup> Trust Law 1996.

<sup>12</sup> Trust Law 2001.

<sup>13</sup> Trust Act 2006.

<sup>14</sup> Civil Code Act V of 2013 paras 36.310 et seq; CE Rounds & I Illes, 'Is a Hungarian Trust a clone of the AngloAmerican trust or just a type of contract?'. (2015) 6(2) *Jo of Int Comm Law* 153; A Menyhei, 'Development of the estate planning industry through the introduction of the trust in Hungary', (2016) 22 *Trusts & Trustees* 659. <sup>16</sup> Civil Code ss 1448 et seq; K Ronovska & P Lavicky, 'New Czech Foundation and Trust(like) Law; initial experience and reactions', (2016) 22 *Trusts & Trustees* 641.

<sup>15</sup> E.g. trustees may be restricted to credit institutions, investment companies, insurance companies, lawyers and in France, donative transfers to trustees are not permitted to be 'fiducies'.

<sup>16</sup> See M Graziedei, U Mattei & L Smith, *Commercial Trusts in European Private Law*, Cambridge Univ Press 2005; S Kortmann & D Hayton (eds) *Towards an EU Directive on Protected Funds*, Kluwer Law Publishers 2009; STEP France, *Trust & Fiducie: concurrent ou complements?* Academy & Finance SA, Geneva 2008; L Smith(ed) *The Worlds of the Trust*, Cambridge Univ Press 2013; L Ho & R Lee, *Trust Law in Asian Civil Law Jurisdictions*, Cambridge Univ Press, 2013; F Schurr (ed) *Trusts in the Principality of Liechtenstein and Similar Jurisdictions*, Dike Verlag AG, Zurich, 2014.

<sup>17</sup> See fn 3 above.

purchasers of the legal rights without notice of the beneficiaries' rights. The lesser force of equitable rights is needed to protect purchasers who often will justifiably believe themselves to be dealing with the full absolute owner of property.

Civil law systems have a concept of undivided ownership of rights respecting property whereby an owner of particular property must have the right to use it, the right to benefit from it and the right to dispose of it. Moreover, such systems have a fixed limited menu of property rights (*numerus clausus*). Thus, they could not cope with a new concept of split legal and equitable ownership of rights respecting property. Nevertheless, to a greater or lesser extent, it is possible for civil law systems to incorporate into domestic law the substantial features of trusts without going so far as to confer upon beneficiaries a proprietary *in rem* right in trust property.

The new Hungarian Civil Code providing in 2014 for a “fiduciary asset management contract” (a ‘FAM’) has gone the furthest in providing a functional equivalent to the Anglo-American proprietary trust. The FAM has created reinforced *in personam* rights in respect of property owned by a manager for the benefit of beneficiaries, such that beneficiaries interested in the managed trust property have priority over the manager-trustee’s creditors, heirs and spouse. Indeed, the beneficiaries can sue a person, other than a bona fide purchaser, to whom the manager-trustee wrongfully transferred trust property, though the extent of this right has been left to the courts to develop.

The “contract” exists independently of the parties, so the incapacity, death or dissolution of a party or a change in the manager-trustee does not terminate the “contract”, which is enforceable by the settlor as well as the beneficiaries. Civil law contracts, unlike common law contracts, do not require consideration to be enforceable. Thus there can be enforceable FAMs flowing from donative lifetime transfers, while the legislation provides for testamentary FAMs and for an enforceable

FAM to arise from an owner declaring himself manager-trustee for beneficiaries in respect of segregated property of his, even though a person cannot contract with himself.

Sensibly, the FAMS section of the Code is principles-based so as to leave the details to be worked out by the judiciary so that the FAM can develop incrementally and efficiently in response to the practice of practitioners and family or commercial needs.

### Incorporated trust features

#### *Ownership management not agency management*

A common law trust is not a legal person but its creation requires a trustee having ownership-management of segregated trust property. Such management is more efficient than agency-management of an owner's property because third parties dealing with the agent need to check that he has express or ostensible authority to act for the owner. They also need to check that he has any necessary formal authorisation from the owner to execute a transfer of the owner's property and give a receipt for the proceeds of sale in the case of a sale.

Trust law is geared to making things much easier for purchasers because if they do not know they are dealing with a trustee they receive full title to the purchased property from the owner thereof – as in the case of shares in English companies, where the fact that a shareholder holds shares as trustee cannot be recorded on the company's share register. Special provision is made to assist purchasers of English land. When purchasing from two trustees or a trust corporation, purchasers, even if knowing of beneficiaries' rights, automatically become full owners of the land free from the beneficiaries' rights, which are “overreached” by being detached from the land and attached to the purchase money.

Where civil law systems have obligational trusts of property owned by trustees, the trustees will normally be full owners with full powers as such<sup>18</sup> since the beneficiaries only have contractual *in personam* rights. It may, however, be necessary for prospective purchasers, lessees or mortgagees to protect themselves by checking that the trustees are duly empowered to enter into the relevant transaction where the register of title to the relevant property records that the registered proprietor is a trustee. Such an entry on the register is normally required (e.g. in Italy but not Hungary) if the property is to be segregated property immune from claims of the trustee's own creditors, heirs or spouse.

**Managed ownerless property: “le patrimoine d’affectation” (“Zweckvermögen”)**

Quebec, the sole civil law system amongst the provinces of Canada, has introduced into its Civil Code in sections 1260 -1298 a trust known as “*la fiducie*”. This results from a transfer by a settlor of property within his patrimony to another patrimony constituted by him which he appropriates to a particular purpose and which a trustee undertakes by his acceptance to hold and administer. The transferred property constitutes a patrimony by appropriation, autonomous and distinct from that of the settlor, trustee or beneficiary and in which none of them has a real right (*droit réel*). Thus the trustee has no right of ownership, though having the power to deal with the trust property as if having all the powers involved in a right of ownership. “*La fiducie est établie par contrat*” which can be for value or gratuitously or by will or by operation of law. The trustee (“*le fiduciaire*”) has the control and the exclusive administration of the trust patrimony, the titles relating to it are drawn up in his name, and he has the exercise of all the rights pertaining to it. He is entrusted with full administrative powers (“*chargé de la administration pleine*”) but must comply with the

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<sup>18</sup> But under the French Civil Code Art 2018.6 the contract of *la fiducie* must set out the extent of the *fiduciaire*'s powers of administration and of disposition, so that they could be less than absolute powers. In dealing with third parties, by Art 2023 the *fiduciaire* is reputed to have the fullest powers of disposition unless the third party had knowledge of a limitation on the *fiduciaire*'s powers. The *fiduciaire* is therefore treated as if operating a *patrimoine d'affectation* or *Zweckvermögen*, on which see below.

obligations imposed on him by the settlor in creating the trust and act within the powers conferred on him.

The Czech Republic followed this approach in sections 1448 et seq of its new 2014 Civil Code.

**Segregated ring-fenced trust property: a separate fiduciary patrimony (“Sondvermögen”)**

Since the trust beneficiaries have equitable proprietary rights preserving for them the exclusive economic benefit of the trust property, the trustees need to segregate the trust property from their own private property. Their own property is subject to claims of their creditors, heirs and spouses, but the trust property is not because it belongs beneficially to the beneficiaries. Sometimes, however, the trust property may consist of a pool of assets held in fractional shares for a group of beneficiaries and a trustee may manage several segregated pools of assets.

If the trustee in breach of trust does not keep the trust property segregated from his own but mixes it with his own, the beneficiaries’ rights are traced into the mixture. If half the mixture represents the value of the beneficiaries’ input into the mixture, then half the mixture belongs beneficially to them. If, however, the value of the original mixture has fallen to, say, 60% of its value at the time of the wrongful mixing of assets, the beneficiaries have an equitable charge over the mixture to secure their claim to the sum representing half the value that the mixture originally had.

In civil law systems the beneficiaries’ preferential claims over those of the trustee’s creditors, heirs and spouse need to be preserved in respect of the segregated obligational trust property owned by the trustee as a separate fiduciary patrimony (*Sondvermögen*) or managed by him as an autonomous *patrimoine d’affectation* (*Zweckvermögen*). For this purpose a trustee’s fiduciary patrimony or the *patrimoine d’affectation* must be kept separate from his own private patrimony and he must take appropriate steps to segregate these patrimonies. This will involve recording his

ownership as trustee in appropriate registers of property where lack of such an entry on the register relegates the preferential claims of beneficiaries to claims of ordinary creditors in respect of the registered property owned by, or held in the name of, the trustee at the time of such claims.

To deter a trustee from wrongfully mixing trust property with its own there may well be criminal sanctions or regulatory sanctions against a company licensed to be a trustee. Otherwise, it seems that by a process akin to proprietary or real subrogation if a trustee's mixture of trust property with its own property leads to half the value of the mixture representing the value input of the trust property, the preferential rights of the beneficiaries will relate to half the value of the mixture. Query what the position will be if the mixture had fallen in value. It may be that the beneficiaries' monetary claim to half the value of the original mixture might prevail over ordinary creditors' claims.

### **Trust property as a fund of fluctuating assets**

The trust property is actually a trust fund comprising the original trust property and subsequently added property, together with substituted property subsequently from time to time representing that property whether rightfully, as in authorised investment management activities, or wrongfully, and also the fruits of such property. Wrongfully acquired property that is part of the trust fund includes secret commissions or bribes or profits acquired by trustees in their trusteeship activities and property purportedly acquired by a trustee for his private patrimony though using trust monies for this purpose. If this were not the case the value of the trust fund could easily be depleted and the ring-fenced protection at the core of the trust would be completely undermined e.g. a trustee by selling the trust property and using the proceeds to buy property purportedly for his private patrimony, would thereby make all the trust property available for satisfying the trustee's private creditors, heirs and spouse! The trustee cannot take advantage of such bad conduct to benefit

himself and his creditors. By virtue of being a trustee he cannot deny that he was a good man who acquired the relevant property for the benefit of his beneficiaries. The substituted assets take on the nature of the assets for which they were substituted.

In civil law jurisdictions the property from time to time substituted for the original or added property should be determined by principles similar to proprietary or real subrogation principles that can be used to determine what is marital property or commercial partnership property or the patrimony of a deceased person when accepted by heirs with the benefit of an inventory.

### **Rights against third parties who wrongfully received trust property**

The key feature of a proprietary trust is that beneficiaries have *in rem* proprietary rights entitling them to recover for the trust fund – or for themselves if absolutely entitled to the trust fund - property that had been transferred in breach of trust to a third party. This right extends to traceable property representing such transferred property, as where a trustee wrongfully makes a gift of O Ltd shares to X who happens to sell them in order to buy P Ltd shares, which X later gives to Y who sells them to buy a painting. The painting can be recovered from Y because Y is bound by the beneficiaries' equitable proprietary rights in the traced painting since Y was merely the recipient of a gift, and not a bona fide purchaser, of the P Ltd shares without notice of the beneficiaries' rights under a trust.

In civil law jurisdictions, whether under their normal Roman-law-based systems or under recent legislation, beneficiaries do not have *in rem* proprietary rights falling within the chapter of the civil code headed 'Property'. Thus, beneficiaries will need to place reliance upon submitting that, if the trustee and X knew that the trustee could not lawfully give the O Ltd shares to X, the transfer to X should be regarded as a nullity and, by virtue of proprietary or real subrogation principles, the P Ltd shares should be regarded as trust property recoverable from X if he still owned the shares,

rather than X merely being liable to a monetary *in personam* claim on unjust enrichment principles. It seems Y would be safe unless she knew of the wrongfulness of the original gift to X e.g. if, as X's spouse, she had kept an eye on what he was doing.

Hungary, however, has a broad statutory provision in its Civil Code entitling the settlor and the beneficiaries to equitable relief in the event of a wrongful transfer of FAM property to a person who is not a bona fide purchaser of the property. This deliberately affords scope for the judiciary, assisted by advocates, to develop civil law concepts of the obligation *propter rem* and proprietary or real subrogation to provide remedies using a tracing process.

#### Commercial/investment focus of obligational trusts in civil law countries

Considerations of efficiency and competitiveness in financial markets and business have led to the above obligational trust features appearing to a greater or lesser extent in the commercial or investment sphere in civil law countries e.g. respecting pension funds, collective investment schemes, collective security trusts and debt securitization. Initially, this was a result of ad hoc legislation in a few countries and then by implementation of EU directives concerning financial intermediaries.

#### Dynastic family trusts undermined by civilian forced heirship rules – use of offshore trusts

The civil law inheritance laws strongly militate against estate planning for future generations of a family. Thus, if a wealthy man dies survived by three children, three quarters of his patrimony has to pass to those three children, receiving a quarter each. If he made gifts to a third party, including a trustee, within a period of years running from five to thirty years before his death, the value of the gifted property has to be added back to his estate to determine the value of the three quarter shares to which his three children are entitled. The children then sue the recipients of gifts, recent

ones before earlier ones, in order to recover the full value of their forced heirship rights. Children are entitled to their indefeasible shares and to enjoy them even if the family's wealth can then go "from rags to riches to rags" in three generations.

Very wealthy persons who are subject to a civil law *lex successionis* and do not want their children each to receive large capital sums, have thus utilised foreign trusts in their lifetimes to transfer most of their assets to trustees to look after their descendants and their spouses or partners and, incidentally, allow payments to be made to further philanthropic purposes. These assets, however, must not be discovered to be located in a civil law jurisdiction because such a jurisdiction will be prepared to give effect to the indefeasible shares of heirs once the heirs discover the position. Steps are thus often taken to utilise complex structures so as to hide the connection between the settlor and the relevant assets. The offshore jurisdictions, the laws of which govern the trust, make it clear that the trust is a valid trust and no foreign court orders purporting to give effect to forced heirship rights will be recognised or enforced<sup>19</sup>.

Offshore discretionary trusts have been much used by civil law and common law settlors for family businesses not located in civil law jurisdictions so that the business will progress through succeeding generations under a structure governed by the terms of the trust instrument. Such trusts have also been extensively used to receive the proceeds of sale of a business invested in a portfolio of assets not located in a civil law jurisdiction. Offshore jurisdictions are advantageous because for historical reasons they normally have no income tax or capital gains tax or have very low rates of income tax so as to be good places in any event for family trusts – or for the commencement of

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<sup>19</sup> See D Hayton & A Duckworth, Chapter 14, 'Forced heirship and the trust' in D Hayton (ed) *The International Trust*, 3<sup>rd</sup> ed Jordan Publishing Ltd 2011.

joint business ventures. The trust fund, however, will normally be invested in mainland non-civil law countries.

### Dealing with wide-ranging problems caused by offshore trusts

Major countries, however, to prevent large losses of tax revenue toughened up their tax rules relating to foreign jurisdictions, but then found it was difficult to ensure that there was full compliance with those rules because there appeared to be huge amounts of hidden assets held offshore<sup>20</sup>, whether of lawful or unlawful origin and whether for lawful or unlawful purposes. Anti-money-laundering and anti-terrorist financing legislation could then make information available to revenue authorities and financial intelligence units so as to help with the collection of tax, as did exchange of information under Double Taxation Treaties and then Tax Information Exchange Agreements. In the EU full information then became available under the Directive on Administrative Co-operation<sup>21</sup> ensuring close co-operation between tax administrations with provision for automatic exchange of financial information. Most recently, more transparency for taxation purposes has been provided for by the USA Foreign Accounts Tax Compliance Act (FATCA) and the broader OECD Common Reporting Standard for Automatic Exchange of Financial Account Information(CRS)<sup>22</sup>.

### The impact of FATCA and the CRS and information in the Panama Papers

By virtue of Inter- Governmental Agreements (IGAs)between the USA and other countries FATCA requires US taxpayers' financial assets in those other foreign countries to be reported to the US IRS by Foreign Financial Institutions (FFIs) either directly to the IRS under Model 1IGAs

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<sup>20</sup> At least 8% of the world's wealth, US\$7.6 trillion, is estimated to be held in offshore tax havens according to G Zucman, *The Hidden Wealth of Nations: The Scourge of Tax Havens*, University of Chicago Press 2015.

<sup>21</sup> Council Directive 2011/16/EU as amended by 2014/107/ EU

<sup>22</sup> See H Christensen & J Tirard, 'The amazing development of exchange of information in tax matters: from double tax treaties to FATCA and the CRS' (2016) 22 *Trusts & Trustees* 898

or, in most cases, under Model 2 IGAs to the local revenue authority which then shares the information with the IRS. If FFIs do not comply with FATCA a 30% withholding tax applies to US income payments to the FFIs.

The IGAs, however, are very one-sided because under their terms the obligations of US financial institutions in respect of foreign taxpayers do not extend to reporting foreign entities holding a cash account in the US or foreign individuals or entities holding a non-cash account that is blocked from holding US investments. Thus, foreigners can hide assets in US accounts if having a US resident trustee of a trust that is a non-US trust for US tax purposes<sup>23</sup>. If the trustee, however, were resident in a country subject to the CRS then full disclosure of such accounts would be required.

The US is not a party to the CRS for three reasons. First, its financial institutions do not report information about such foreigners' accounts to the IRS so that such information is not currently available to be shared with foreign revenue authorities. Second, this is unlikely to change since it makes US financial institutions more attractive than non-US financial institutions and, indeed, it would significantly harm the interests of such US institutions if the US adopted the CRS so that invested capital fled from the US. Third, becoming a party to the CRS would not bring in an extra cent to the US Treasury which receives all the information it needs from FATCA to tax its taxpayers<sup>24</sup>.

The CRS lays down a global standard for reciprocal automatic exchange of financial account information between revenue authorities. It requires adoption by participating countries in bilateral or multilateral competent authority agreements. Over 100 countries have already agreed to

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<sup>23</sup> See P Cotorceanu, 'Hiding in Plain Sight' (2015) 21 *Trusts & Trustees* 1050.

<sup>24</sup> It seems likely that someone will challenge it by relying upon the EU Data Protection Directive 1995/46/EC to be replaced in 2018 by the Data Protection Regulation 2016/679 of the European Parliament and European Council: see P Baker. 'CRS/DAC, FATCA and the GDPR' [2016] BTR249.

implement the CRS in 2017 or 2018 and more are expected to agree on such implementation in 2018. Where the CRS is in force information on the financial accounts of a foreign taxpayer is collected from local financial institutions and exchanged with the foreigner's home tax authority on an annual basis. In agreeing to the CRS with another country a country needs to make provision for restricting disclosure of information to revenue authorities or financial intelligence units. It should also consider how sophisticated is the data protection system and how it might help to have it improved so as to keep financial information safe from hackers, like those who accessed the Panama papers from the Panamanian law firm, Mossack Fonseca.

Clearly FATCA and the CRS, coupled with anti-money-laundering legislation, have made it more difficult to hide the beneficial ownership of assets so as to evade paying due taxes or to pay them but preserve privacy. There are, however, still plenty of reasons to use trusts and pay relevant tax. Indeed, FATCA and the CRS are irrelevant so far as concerns most of the commercial/financial uses of trusts discussed above. They are relevant to family trusts but there remains the need to do something with large amounts of wealth, whether in the form of a significant business or a significant portfolio of investments built up from the proceeds of sale of a business or from the profits of a successful business. The settlor and the beneficiaries just have to accept that they have to pay their fair share of tax and continue with their wealth management trust structures though they may justifiably take advantage of the loophole that the USA has refused to adopt the CRS so that they can preserve the privacy of their arrangements but still pay due tax. They would be foolish to take the risk of abusing that privacy to evade tax.

The significance of the Panama Papers is to make taxpayers more conscious of that risk because those Papers made private confidential information public, but the public disclosures in the Papers

has also made possible the targeting of persons now discovered to be wealthy by kidnappers, by importunate relatives and others hoping for some share of the wealth.

This is at odds with the right to respect for one's private and family life under Article 8 of the European Convention on Human Rights. This important right was, indeed, recently relied upon by the French *Conseil d'État* on 22<sup>nd</sup> July 2016 to suspend a French law to have a public register of trusts<sup>25</sup> containing details supplied to the tax authority only for its purposes. On 21<sup>st</sup> October 2016 the *Conseil Constitutionnel* declared the public nature of the register made it unconstitutional and banned it. It will, however, be open to have a register restricted to a class of people officially involved in activities such as anti-moneylaundering and anti-terrorist-financing.

A further result of the Panama Papers is that any settlor with a civil law *lex successionis* who had attempted to evade claims of forced heirs by trying to hide the fact that via an offshore trust he was indirectly (via foundations or companies) the settlor of assets located in a forced heirship jurisdiction, will find that this is likely to be discovered. If not happy with this he will need to change his habitual residence<sup>26</sup> to a jurisdiction the succession law of which has no forced heirship provisions.

Where the Panama Papers reveal that a person is involved as a settlor or significant beneficiary in a trust containing difficult-to-explain wealth, that is actually the product of his criminal activities, he will now face the increasing likelihood that the origins of this wealth will come under scrutiny, so that he could be "outed" and jailed or, if a politician, fall from power. Indeed, if a politician pushing the principle of the moral need to pay fair taxes and not strive to find legal loopholes to

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<sup>25</sup> Decree No 2016-567 of 10 May 2016.

<sup>26</sup> See EU Succession Regulation No 650 of 2012.

avoid tax is discovered as a settlor or beneficiary to be involved in tax avoidance or worse still, tax evasion, he will find that this lack of integrity ruins his political career.

Ultimately, the utility of FATCA, the CRS and the Panama papers ought to be to encourage persons to act on the basis that, if their activities were exposed to the tax authority or the anti-money-laundering financial intelligence unit or to the public, they would not be exposed to any sanctions for their behaviour. In such fashion they can then sleep soundly in their beds and enjoy a contented life.

It is clear that if people have guilty consciences Revenue authorities will prey upon them. In the UK tax advisors and financial institutions are required<sup>27</sup> to provide their clients with a standard letter from the HMRC warning taxpayers, in the light of CRS disclosures to be made in 2017 or 2018, to ensure that their affairs are up-to-date and complete with full disclosures having been provided. Otherwise, the letter states, **“Come to us before we come for you.”**

I hope you all have no worries with your tax authorities and will sleep well tonight!

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<sup>27</sup> The International Tax Compliance (Client Notification) Regulations SI 2015 878 as amended by SI 2015 1839 and by SI 2016 899.