The Private Wealth & Private Client Review

Fifth Edition

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John Riches

Law Business Research

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John Riches

Law Business Research Ltd

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Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK
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ISBN 978-1-910813-26-3

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

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ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

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EDITOR'S PREFACE

The first six months of 2016 have been characterised by turbulence for the world in general, and particularly for those holding significant private wealth. The key development of 2016 to date has been the publication of the 'Panama Papers'. The response to the publication from governments and the Organisation for Economic Co-operation and Development (OECD) has reinforced trends seen in prior years towards greater transparency and regulation in the domain of cross-border holding structures and in the context of beneficial ownership information.

i Panama Papers

Many have pointed to the irony surrounding the approach taken by the International Consortium of Investigative Journalists (ICIJ) in Washington in the context of its publication of the Panama Papers. The ICIJ's website sets out an elaborate procedure for whistle-blowers to provide information to them on a 'confidential' basis and the organisation has been resolute in its assurances that it will keep its sources confidential. So while the ICIJ argues for full transparency of information about the holding of private wealth, it does not consider that this standard should apply to those who provide information about wealthy families, even if the information is secured by unlawful means. Clearly, the Panama Papers have highlighted some issues concerned with offshore structures being used to provide a veil of secrecy to allow unlawful activity to go undetected and there is no sympathy for those whose unlawful acts have been exposed. Of deeper concern, however, is those who have sought to defend their privacy and yet have been accused of wrongdoing on a completely false basis – the case of Emma Watson who placed her home in the name of an offshore nominee to protect herself against stalkers serves to illustrate this trend. What has been striking from a UK perspective is the extent to which journalists from respected media organisations comment on issues relating to offshore structuring using language that is sensationalist in tone and frequently wildly inaccurate. The apparent furore over the former prime minster David Cameron's holding in an entirely conventional offshore fund structure established by his late father for third-party investors was reported by the BBC as an 'offshore fund trust'. The impression

one gained from this reporting was that the journalist concerned was merely including as many words in the article that he felt had negative connotations to achieve maximum effect, regardless of their technical inaccuracy.

While the Tax Justice Network asserts in a 28 June 2016 report that 'trusts become the preferred choice by tax dodgers, corrupt officials or money launderers' to avoid transparency, there is precious little evidence of the large-scale use of trusts that has been unearthed by recent revelations such as the Panama Papers. A perspective that will not be published in any newspaper in the context of the Panama Papers is to explain that the vast majority of offshore trusts are used by tax-compliant families for legitimate wealth structuring and intergenerational succession planning. However, we should not assume that this will silence those who oppose trusts as a matter of principle. The party line of the Tax Justice Network and others is that the reasons trusts escape frequent references in the context of scandals is because they are so effective in hiding wrongdoers and so are very difficult to detect. They clearly have no idea about the depth of scrutiny a family is subject to in terms of anti-money laundering or know-your-client procedures to establish a trust in a well-regulated offshore finance centre.

I do not suggest that we can afford to be complacent about the scope for misuse of offshore vehicles in any way, but it is essential we take every opportunity to explain to policymakers the entirely legitimate purposes for which the overwhelming majority of families employ trusts and similar structures as part of their succession planning and wealth structuring.

ii The Common Reporting Standard (CRS) update

We are now fully in the era of the CRS, which became effective on 1 January 2016. Certain aspects of the CRS are causing a degree of confusion in terms of implementation, especially in the trust arena. Many of the difficulties here stem from the basic conceptual framework, copied over from the Foreign Account Tax Compliance Act (FATCA), which treats a trust fund as a 'financial account'. The most notable 'glitch' in this framework is in identifying those persons connected with trusts who need to be reported on. When trustees self-report as reporting financial institutions, the concept of an 'equity interest' does not name protectors. Alternatively, if one turns to the parallel list for trusts that are passive non-financial entities, protectors are expressly named. The OECD's own position set out in a recent FAQ is that the protector should always be named, but the formal legal basis included in the CRS model treaty is doubtful. It is to be hoped that in the second half of 2016 it will be possible to obtain clearer guidance on many areas of ambiguity so that all parties are fully prepared for the first wave of CRS-related disclosure for the 2016 financial year, which will be required before May 2017.

One silver lining to this confusion and uncertainty on protectors is a renewed focus on the choice of an appropriate person to serve in a protector role. In some cases, families are electing to formalise governance processes around fiduciary holding structures and introduce independent professional protectors in place of close relatives or family friends whose understanding of their duties may have been somewhat limited.

There already appears to be a two-speed world in the context of CRS with an enthusiastic group of early adopters who have signed the Multilateral Competent Authority Agreement so as to be able to exchange information with as many nations as possible, while a more reticent group of nations plan to adopt CRS on a bilateral treaty-by-treaty basis. The EU and Crown Dependencies and Overseas Territories are in the first group, while notably the Bahamas, Hong Kong, Singapore and Switzerland are in the second.

There is an emerging trend of consolidation of offshore structures into single jurisdictions to reduce complexity and multiple service provider compliance. It will be interesting to

see which jurisdictions win out in this time of transition and, in particular, whether those international finance centres such as Jersey and Cayman that have placed themselves in the early adopter group will benefit from this stance. It is becoming apparent that many clients are keen to demonstrate their commitment to working in a transparent environment to forestall the type of ill-informed criticism unleashed in the wake of the Panama Papers.

iii Exchange of Beneficial Ownership Information (EBOI)

EBOI is the latest initiative being promoted by the G5 in Europe (the UK, Germany, France, Spain and Italy) and was a direct response to the Panama Papers' publication. EBOI builds on the same concepts that underpin the CRS and FATCA. The aim is, in parallel to the tax-related disclosure generated by FATCA and the CRS, to require the annual provision of beneficial ownership information on companies, trusts, foundations and similar legal arrangements or entities. The starting point is to require all jurisdictions that participate to maintain an accurate register in the hands of competent authorities to identify the beneficial owners of all such legal entities and arrangements.

The OECD is due to report back on the framework for potential implementation of EBOI in October 2016. What is increasingly apparent from the initial proposals is that their scope could well be significantly wider than the CRS framework. Where EBOI could widen the disclosure of information further is in requiring every single entity within a holding structure to have its own beneficial ownership register. If one takes, for example, the disclosure that relates to the holding structure ultimately held through a trust, the current rules under the CRS enable trustees that are themselves reporting financial institutions to take overall responsibility for reporting on the entire structure. If all underlying entities held within the trust are themselves reporting financial institutions or active non-financial entities (NFEs), only a single report is provided in relation to the trust as a whole. However, under EBOI, it may well be necessary to make multiple disclosures on all holding entities in a trust even though they have a common set of beneficial owners. The same rules could also apply for multiple layer holding structures ultimately held by individuals.

At inception, the proposals for EBOI are based around the idea of access being provided to 'competent authorities' such as regulators and law enforcement agencies. Predictably, there are already calls from NGOs for such registers to be made public. While many jurisdictions (for example, Jersey and Bermuda) have required beneficial ownership information on companies to be provided to them for many years, the effect of the EBOI proposals seems likely to require the creation of trust registers in many jurisdictions for the first time. It remains to be seen how these registers would work in practice. It is proposed that there will be an annual requirement to update the register to note any material changes. Potentially, this annual update will need to be provided in parallel to CRS and FATCA-type data, which tax authorities required by the end of May, with reference to the position as at the end of the prior calendar year.

iv Public registers of beneficial ownership

The UK's People with Significant Control (PSC) register has been operational since 30 June 2016. It will be interesting to see the approach taken by EU jurisdictions in implementing the Fourth Anti-Money Laundering Directive. The PSC register substantially implements that directive in the UK, although its terms are not completely aligned with the Fourth Anti-Money Laundering Directive.

It is already apparent, in considering the information to be provided for the PSC register, that the ultimate quest to name natural persons rather than entities can give rise to some unexpected results. As with the CRS, particular difficulties arise where a UK company is ultimately controlled by a trust. This is because in considering the application of the rules in a trust context, one does not name, for example, corporate trustees. One is required to look to individuals who control those corporate entities. This means that the information provided with respect to those natural persons is unlikely to have any meaningful connection with stated objectives of the legislation in providing greater clarity for third parties dealing with the company as to who, ultimately, influences its activities. It is also striking that in cases where the corporate trustee is owned by a listed group or controlled by a private equity firm, there may, in some circumstances, be no ultimate PSC required to be named.

If one contrasts the position here with that applicable to the French Trust Register, (ironically, made public on the same date, 30 June 2016), the information required to be made public under the French Register is extensive and, unlike the PSC register, requires one to provide details of the beneficiaries as well as the names of the trust. There is also a separate requirement to file a stand-alone 'event-based return' if the terms of a trust are modified in any way during the course of a calendar year.

The EU has recently published proposals to amend the Fourth Anti-Money Laundering Directive in the wake of the Panama Papers. In this context, it seems likely that the initial decision taken in 2015 not to require details of trusts to be placed on a public register will be reversed. If this proposal gains wider support (as seems likely), it will be interesting to see whether it will be modelled on the French register or will be more analogous to the UK PSC register.

iii Conclusion

In closing, it has never been more important for advisers to give balanced and considered advice to families on how best to structure their arrangements, not just in the light of prevailing family circumstances and tax considerations, but also in the knowledge of the likelihood that information about the holding structure will be subjected to greater regulatory, government and potentially public disclosure in the years ahead. The paradigm that currently prevails in Western Europe is markedly different from that applicable in Asia, the Middle East and Latin America.

It remains to be seen whether, in the long term, many international families who have compliant structures that are fully disclosed to tax authorities will favour the United States as a tax-favoured jurisdiction from which to administer their family structures. This is on the basis that with a thriving domestic trust industry, the US could well be seen as a reputable jurisdiction which protects families from unwarranted public intrusion into their personal affairs to a greater extent than traditional offshore finance centres if beneficial ownership registers do become public in due course.

John Riches
RMW Law LLP
London
August 2016

Chapter 5

MODERN TRUST DESIGN

Todd D Mayo[1]

I INTRODUCTION

Designing a trust entails understanding a settlor's aspirations, wishes and objectives and melding them into an organisational regime that may last many generations. The design process requires an understanding of trust law – an area of law that is continuously evolving – as well as tax law and ancillary legal matters. Those too continue to evolve. For the international private client, an array of US and non-US jurisdictions thankfully provide options, offering progressive trust laws.

Trust design involves many facets. This chapter explores several of the key aspects of modern trust design. Specifically, it considers the following questions:

a What is the optimal governance structure for the trust?
b How can a family-controlled entity play a role in the governance structure?
c How can we preserve settlor intent?
d What are the appropriate dispositive terms?
e What is the appropriate duration for the trust?
f How can we mitigate litigation risks?

Each of those questions focuses on an essential part of a trust. Addressing each question involves thoughtful drafting, as well as thoughtful situs selection. A clear, well-drafted trust deed is vital to any trust. Likewise, the selection of an appropriate situs is vital to ensuring that the trust has the right legal environment in which to grow.

1 Todd D Mayo is a principal and general counsel of Perspecta Trust LLC, and he is an attorney with Vanderwal Martens PLLC.

II TRUST GOVERNANCE MODELS

The design of a trust's internal governance is one of the most important aspects of trust design. The governance structure determines who is responsible for each aspect of administering a trust. For trusts, there are four governance models:

a unitary trustee;
b directed trust;
c divided trust; and
d hybrid model.

These models represent an evolutionary progression. Beginning with the unitary trustee model, the directed trust emerged in an effort to improve upon the unitary trustee model. Likewise, the divided trust evolved from the directed trust, again in an effort to improve upon its predecessor. Although it can potentially be a sensible design in some cases, the hybrid model tends to be an evolutionary anomaly. This evolutionary progression has been more pronounced in the leading US jurisdictions.

i Unitary trustee

In the unitary trustee model, the trustee is vested with all of the trustee powers. The unitary trustee model is the traditional model. The trustee has the power to make distributions, the power to invest the trust property, and the power to administer the trust. If there is more than one trustee, the trustees share those powers.

A trustee may delegate certain powers to a co-trustee or an agent. For example, a trustee may delegate investment powers to a professional investment manager. The delegation must be prudent. The trustee must monitor the delegate, ensuring that the delegatee is acting within the scope of the delegation and ensuring that the delegatee is acting prudently. Thus, a trustee who delegates powers does not fully absolve themself of liability arising from the exercise (or non-exercise) of the delegated power. To the extent that the delegation may have been imprudent or the trustee fails to monitor adequately the delegatee, the trustee is potentially liable for any harm that the delegatee causes.

ii Directed trusts

In a directed trust, the trustee is vested with all of the trustee powers, but, with respect to certain powers, the trustee only acts in accordance with another person's direction. For example, a person other than the trustee may have the power to direct the investment of the trust property. The person who has the power to direct the trustee may be the settlor, a beneficiary, or another person. In contrast with the traditional unitary trustee structure, in which one or more trustees are vested with all trustee powers, a directed trust is a multiparty governance structure.

Advantages

As a multiparty governance structure, a directed trust offers the potential benefit of assigning trust powers to two or more persons in a manner that better achieves the trust's purposes. At least in theory if not always in practice, a directed trust allows a settlor to assemble a team of persons who are collectively better able to achieve the trust's purposes than a single trustee. A settlor may wish to appoint an institutional trustee to make decisions concerning discretionary distributions and handle administrative matters, such as record keeping, reporting and tax

compliance. The settlor, however, may prefer to have someone else – perhaps an investment management firm with which he or she has a long relationship – manage the trust property. A directed trust allows the settlor to create that structure for governing the trust's internal affairs.

A directed trust avoids the limitations associated with delegation. A trustee generally cannot delegate its discretionary distribution power, because the power is generally viewed as a non-delegable trustee power. With a directed trust, a person other than the trustee can have the power to direct the trustee to make distributions. A directed trust mitigates the risks associated with delegation. A trustee can delegate only to the extent that the delegation is prudent, and the trustee has an ongoing duty to monitor the delegatee. Thus, for example, a trustee may be reluctant to delegate investment powers to a beneficiary who lacks investment management skill or experience. With a directed trust, the trustee is not selecting the person exercising a specific power, and thus is not liable for an imprudent selection. For example, the trust deed may specify that a beneficiary has the power to direct the trustee concerning the investment of the trust property.

Disadvantages

A directed trust poses some administrative inefficiencies, and it may not entirely eliminate the trustee's liability with respect to the powerholder's exercise or non-exercise of the powers that he or she holds. With a directed trust, the trustee is in the middle of the action. A powerholder directs the trustee to take a certain action – say, make an investment – and the trustee generally must act in accordance with the direction. This two-step process – direction and action – is administratively less efficient than an arrangement in which the decision-maker is also the person taking the action. Since the trustee is in the middle of each action, the trustee remains an attractive target when something goes wrong. A disgruntled beneficiary is likely to argue that the trustee should have taken steps to prevent the alleged harm caused by the powerholder's action or failure to act, or at least taken steps to warn the beneficiary. A trustee, in fact, may be tempted to communicate to the powerholder its concerns about the powerholder's actions; as illustrated by the *Mennen* case, succumbing to that temptation may invite questions about whether the trustee assumed certain duties to the beneficiaries.[2]

Some critics of directed trusts (and divided trusts) assert that they can eviscerate the concept of a trust. By shifting the decision-making about distributions or investments from a trustee to a person who may or may not be a fiduciary or who may or may not have any liability exposure under the terms of the trust, there may be no one who can be held accountable if something goes awry. This criticism is more properly directed toward the design of specific trusts, rather than a broadside against the governance model. Directed trusts (and divided trusts) are not immune from poor design and poor implementation.

Some critics also complain that directed trusts (and divided trusts) create confusion, because two or more persons are involved in administering the trust and sometimes it can be unclear who is responsible for what. Here again, the criticism is more properly directed toward the design of specific trusts, rather than a broadside against the governance model. In

2 *Mennen v. Wilmington Trust Co*, No. 8432-ML (Del. Ch. Apr. 24, 2015). The administrative trustee settled with the beneficiary before trial, so the court did not address whether the administrative trustee had assumed any investment-related duties.

some circumstances, a unitary trustee governance model is optimal. For example, the unitary trustee model is often perfectly adequate for a trust that only holds a modest portfolio of publicly traded securities. As the complexity of the trust's objectives and the value of the trust property increases, however, a more sophisticated governance model usually is warranted.

Non-US jurisdictions

In non-US jurisdictions, the reserved powers trust is an example of a directed trust. The Bahamas, the British Virgin Islands, the Cayman Islands, Guernsey and Jersey recognise reserved powers trusts. Under the statutes recognising reserved powers trusts, the settlor generally may reserve certain enumerated powers. In contrast to the leading US jurisdictions, it can be unclear whether, during the settlor's life, a person other than the settlor may have one or more of the powers and whether, upon the settlor's incapacity or death, another person can succeed the settlor in possessing and exercising a power that the settlor had reserved to himself or herself.

Leading US jurisdictions

The leading US jurisdictions recognise directed trusts. Delaware, New Hampshire and South Dakota have comprehensive statutes governing directed trusts. Notably, each of those states ring-fences the trustee's and the powerholder's respective powers and duties. In those states, a trustee does not have any duty to monitor a powerholder's conduct, advise the powerholder, or warn a beneficiary concerning any matter in which the trustee might exercise a power in a different manner than the powerholder. To the extent that the terms of the trust provide that a trustee must follow another person's direction, the trustee is not liable for acting in accordance with that direction. A trustee is not liable for the powerholder's acts or omissions.

Delaware, New Hampshire and South Dakota notably recognise trust advisers and trust protectors. A trust adviser or trust protector is a person who is not a trustee and who has one or more trust powers. In a directed trust (or a divided trust), a trust adviser or trust protector has the power to direct the trustee to take (or refrain from taking) certain actions. For example, a trust adviser may have the power to direct the trustee to make an investment, or a trust protector may have the power to veto a distribution.

Other US jurisdictions

Many other US jurisdictions recognise the power to direct, but the statutory authority fails to address many critical issues. The Uniform Trust Code, which a majority of states has adopted in some form, recognises the power to direct, unless the direction is manifestly contrary to the terms of the trust or the direction is a serious breach of a fiduciary duty that the powerholder owes to the trust's beneficiaries. Thus, a trustee has a duty to monitor the powerholder's exercise of the power to direct and make an independent assessment of whether the exercise is proper. The trustee likely also has a duty to warn the beneficiaries if it determines that the exercise or non-exercise of the power to direct may be improper or otherwise may be detrimental to their interests. For many trustees, the imposition of those ongoing duties are unattractive because the directed trust does not lessen the trustee's potential liability.

Most US jurisdictions do not statutorily recognise trust advisers and trust protectors, and there is a dearth of common law concerning those roles. In the absence of developed law in those jurisdictions, there is considerable uncertainty concerning the nature and scope of the duties and powers that a person designated as a trust adviser or trust protector may have. Depending upon the nature and scope of the powers with which a trust adviser or

trust protector is vested under the terms of a trust, a court could potentially conclude that the trust adviser or trust protector is a *de facto* trustee. Florida does not statutorily recognise trust advisers or trust protectors. In 2015, a Florida appellate court recently recognised the role of a trust protector. California and New York do not statutorily recognise trust advisers or trust protectors.

In the US, the Uniform Law Commission is working on a uniform act governing directed trusts. The Uniform Law Commission is an association of academics and practitioners who work to develop model laws that US states can adopt. The directed trust act is currently in the drafting phase. The drafting committee anticipates that the commission will promulgate the final act in the summer of 2017. If that timetable holds, US jurisdictions likely will begin considering its adoption in 2018.

US tax considerations

The settlor's retention of powers can have US income, gift and estate tax implications. The settlor's retention of certain powers may cause the trust to be classified as a grantor trust for US income tax purposes. With a grantor trust, the settlor is the deemed owner of the trust property and is taxable on the income and capital gains derived from that property. The settlor's retention of certain powers may also cause the trust property to be includible in the settlor's gross estate for US estate tax purposes. Although there is more flexibility in designing a trust in which a beneficiary has the power to direct, potential income, gift and estate tax issues lurk there too. If a non-US person possesses a power to direct, the trust may be classified as a non-US trust for US income tax purposes. For US income tax purposes, a trust that is classified as a non-US trust is taxable only on certain US-source income. In light of the various tax issues, the settlor and his or her advisers must take care in structuring a directed trust in a manner that avoids undesirable tax consequences.

iii Divided trusts

The divided trust is an increasingly popular governance model. The divided trust entails the division of trustee duties and powers among one or more trustees and other persons. Like a directed trust, a divided trust is a multiparty governance structure. The design of a divided trust requires consideration of the division of the powers and duties among those parties, the points at which those parties' duties intersect and how the trust's administration should function at those points, and the manner and extent to which the parties are insulated from the other parties' acts and omissions.

A divided trust empowers each person who is a part of the trust's governance to take direct action. In contrast, in a directed trust, a powerholder acts indirectly, directing the trustee to take a specific act.[3] In a divided trust, each powerholder acts independently and acts directly. For example, in a directed trust, the settlor may have the power to direct the trustee on matters concerning the investment of the trust property. When the settlor wishes to buy

3 In practice, some people bypass the trustee of a directed trust. Under the theory that the powerholder is acting as the trustee's agent or in some cases with less forethought, an accommodating trustee sometimes allows a powerholder to take the action directly (for example, taking the actions necessary to buy the asset). That approach is not without risk. The trustee may be breaching its fiduciary duties depending upon the terms of the trust and the applicable law.

an asset, the settlor must direct the trustee to buy the asset, and the trustee subsequently will take the necessary action to buy the asset. The trustee will execute the requisite documents, deliver the funds to the seller, and accept receipt of the newly acquired asset.

Advantages
Divided trusts share the advantages of directed trusts, but generally are more efficient to administer, because each person involved in the trust's governance can act directly.

Disadvantages
Divided trusts generally share the disadvantages of directed trusts, except that divided trusts generally avoid the administrative inefficiencies inherent in directed trusts. Divided trusts can be more challenging to draft than directed trusts. In a directed trust, the trustee is vested with all of the trust powers, so the trustee unilaterally can exercise any power to the extent that another person does not have the power to direct the trustee with respect to that power. In a divided trust, there is a risk that the drafting attorney will fail to assign a trust power to a person.

Non-US jurisdictions
Non-US jurisdictions have yet to embrace the concept of the divided trust. The leading US jurisdictions are on the vanguard of this evolutionary development of trust law.

Leading US jurisdictions
The leading US jurisdictions recognise divided trusts. Delaware, New Hampshire and South Dakota have comprehensive statutes governing divided trusts. Notably, each of those states generally ring-fences the powers, duties and liabilities of the trustees, trust advisers and trust protectors.

New Hampshire's highest court was the first US court that expressly upheld divided trusts. In the *Tamposi* case decided in 2013, the New Hampshire Supreme Court affirmed the division of investment and distribution powers between a two classes of trustee, which, under the terms of the trust, were called 'investment directors' and 'trustees'.[4] Under the terms of the trust, the trustee had the power to make distributions, and the investment directors had the exclusive power to invest and manage the trust property. One of the settlor's daughters sued both the trustee and investment directors for breach of trust, alleging in part that the investment directors had improperly managed the trust property. In construing the terms of the trust, the court concluded that the trustee did not have any duty with respect to investment matters, because the investment directors were exclusively vested with the investment powers. The court similarly concluded that the investment directors did not have any duties with respect to distributions, because the trustee was exclusively vested with the discretionary distribution powers.

Other US jurisdictions
Nevada, Tennessee and Wyoming recognise divided trusts. In many other US jurisdictions, the statutes do not provide clear authority for divided trusts. California, Florida and New York are among the states that lack clear authority for divided trusts. The Uniform Law

4 *Shelton v. Tamposi*, 64 N.H. 490 (2013).

Commission is working on a uniform act that will govern divided trusts. The commission may promulgate the act in the summer of 2017, in which case state legislatures will likely begin considering the adoption of the act in 2018.

US tax considerations

The division of trust powers can affect the trust's status for US income tax purposes, and it can affect whether the person vested with certain powers may be subject to US income, gift and estate taxes. Accordingly, the settlor and his or her advisers must take care in structuring a divided trust in a manner that avoids undesirable tax consequences.

iv Hybrid governance model

A hybrid governance model incorporates elements of a directed trust and a divided trust. For example, a trust instrument may grant to a person the power to direct the trustee to make distributions, while granting to another person the exclusive power to manage the trust property. Too often, a hybrid governance model arises by accident, as the product of inartful drafting. A drafting attorney may attempt to create a divided trust using a trust deed for a directed trust as a precedent, but fail to address fully the division of the trust powers.

III USE OF FAMILY-CONTROLLED ENTITIES IN TRUST GOVERNANCE

Some families seek to include family-controlled entities in the governance structure of the family's trusts. Those entities include a family-controlled holding company under the trust, non-bank trust advisers and trust protectors, and private trust companies.

i Holding companies

In both US and non-US jurisdictions, a common technique for enabling the settlor or other family members to control investments is the use of a holding company. The trust generally holds an operating cash account and the interest in the holding company. The trustee uses the operating cash account to pay trust expenses and make distributions. The holding company holds the investments, either directly or indirectly through one or more subsidiary companies. The settlor or one or more family members serve as the directors or managers of the holdings company and any subsidiary companies. In their capacity as directors or managers, the settlor and the family members control the investments.

The use of a holding company minimises the trustee's involvement in any investment activity, because the investment activity is occurring one or more levels below the trust. At the trust level, a key consideration is the waiver of the duty to diversify, so that holding an undiversified portfolio (an operating cash account and an interest in a holding company that may or may not hold a diversified portfolio) is not a breach of any fiduciary duties. In the case of a directed trust or divided trust, a person other than the trustee may be vested with the investment powers and thus would make any determination whether to retain the interest in the holding company.

ii Non-bank advisers and protectors

New Hampshire and South Dakota expressly allow a non-bank company to act as a trust adviser or trust protector (i.e., possess certain trust powers). Those states have statutory safe

harbours that, subject to certain conditions, permit a company to act as a trust adviser or trust protector without obtaining a charter as a bank or trust company. Coupled with a divided trust, a non-bank trust adviser or trust protector enables a family to create a structure that generally emulates a private trust company, while avoiding the regulatory and compliance issues involved in forming and operating a private trust company.

New Hampshire's safe harbour applies only if the company's trust powers are limited (e.g., only discretionary distribution powers); South Dakota's safe harbour allows the company to have a broader array of trust powers. South Dakota requires the company to register with the state's banking commission; New Hampshire does not.

Unlike New Hampshire and South Dakota, Delaware does not have a statutory safe harbour for non-bank companies that act as trust advisers or trust protectors. Nonetheless, some practitioners form Delaware companies that act in those capacities.

iii Private trust companies

A private trust company is a company that is qualified to exercise trust powers for the members of a family and their related trusts, companies and charities. A private trust company can be attractive because it enables a family to have a family-controlled institutional trustee for their trusts, develop governance and succession plans within a single entity (rather than across many trusts) and potentially develop a more professional system for administering the family's trusts and managing its wealth.

Non-US jurisdictions

The Bahamas, the British Virgin Islands, the Cayman Islands, Guernsey and Jersey allow private trust companies.

Leading US jurisdictions

New Hampshire and South Dakota allow the formation of private trust companies. New Hampshire does not require a private trust company to maintain an office within the state or have a resident director. Although maintaining an office in the state is unnecessary under New Hampshire law, it often is advisable for purposes of mitigating the risk that the private trust company is treated as a resident in another jurisdiction under a mind and management test or another legal standard. Notably, New Hampshire also allows a private trust company formed in another jurisdiction, including a non-US jurisdiction, to operate within the state. Delaware does not allow the formation of private trust companies.

Other US jurisdictions

Florida, Ohio, Nevada, Tennessee and Wyoming allow the formation of private trust companies. Nevada and Wyoming allow the formation of unregulated private trust companies. An unregulated private trust company is not subject to the supervision of the state's banking commission. An unregulated private trust company must register as an investment adviser with the US Securities and Exchange Commission, unless it qualifies for the family office exemption.

California and New York do not allow the formation of private trust companies.

IV SETTLOR INTENT

For some settlors, the preservation of his or her intent is critically important. Other settlors are less concerned with whether his or her specific wishes and mandates will be strictly applied to future generations, who will largely comprise individuals the settlors will have never met or known. Even for a settlor who counts himself or herself in that latter group – and in some ways more importantly, the trustees and other persons charged with administering a trust – the preservation of settlor intent is important, because it may affect the efficacy of the settlor's modification or waiver of certain duties, such as the duty to diversify or the duty to inform.

i Non-US jurisdictions

Compared to the leading US jurisdictions, non-US jurisdictions generally are less rigorous in protecting settlor intent. For example, many non-US jurisdictions allow the beneficiaries to terminate a trust. Subject to some variation, the *Saunders* rule is generally applicable in non-US jurisdictions.[5] Under that rule, the beneficiaries of a trust can terminate the trust by unanimous agreement. Generally, all of the beneficiaries must be adults and must be competent.

ii Leading US jurisdictions

New Hampshire and South Dakota protect settlor intent. Within the US, New Hampshire may offer the strongest protection of settlor intent. New Hampshire's tradition of respecting settlor intent is long-standing, and it infuses the state's statutory regime. In *Burtman*, the state's highest court wrote, 'probably no jurisdiction has stood more steadfastly for giving effect to the intention of the [settlor] rather than to arbitrary rules of law than New Hampshire.'[6] In *Lowy*, the court stated that, 'when we construe a trust, the intention of a settlor is paramount.'[7] New Hampshire has incorporated this paradigm into its statutes. In interpreting or construing the terms of a trust, New Hampshire's statutes provide that, 'the settlor's intent shall be sovereign to the extent that the settlor's intent is lawful, not contrary to public policy, and possible to achieve.'[8] Similarly, in applying and construing the New Hampshire Trust Code, New Hampshire's statutes provide that a court must give 'primary consideration […] to the preservation of the settlor's intent as expressed in the terms of the trust'.[9]

iii Other US jurisdictions

US jurisdictions have historically rejected the *Saunders* rule. Instead, US jurisdictions have generally applied the material purpose test that was articulated in *Claflin*.[10] Under that test, the beneficiaries could not terminate a trust so long as the trust's continuation was necessary

5 *Saunders v. Vautier*, EWHC Ch J82 (1868).

6 *Burtman v. Butman*, 97 N.H. 254, 258 (1952). Although the *Burtman* case involved the construction of a will, New Hampshire's courts take the same approach for settlor intent as they do for testator intent. *Katz v. Katz*, 104 N.H. 478, 481-482 (1963).

7 *In re Lowy*, 156 N.H. 57, 61 (2007). See also *Shelton v. Tamposi*, 164 N.H. 490 (2013).

8 NH RSA 564-B:1-112.

9 NH RSA 564-B:11-1101.

10 *Claflin v. Claflin*, 149 Mass. 19 (1889).

to achieve a material purpose of the trust. More recently, many US jurisdictions have adopted a variation of the *Saunders* rule, allowing the modification or termination of a trust even if the modification or termination would violate a material purpose of the trust. In some states, the settlor's agreement is necessary to modify or terminate a trust in violation of a material purpose of the trust. Many US jurisdictions have also adopted (or at least have not expressly rejected) the benefit-of-the-beneficiary rule, which elevates the beneficiaries' interests over settlor intent.

V DISPOSITIVE TERMS

i Discretionary distributions

Discretionary distributions provide flexibility to address changing circumstances. With discretionary distributions, the trustee can make distributions – and, importantly, refrain from making distributions – as appropriate based on the beneficiaries' circumstances at the time. So long as property remains in a (properly designed) trust and distributions are discretionary, the property is generally outside the reach of a beneficiary's creditors and, in the case of a person subject to US estate taxes, potentially excluded from his or her gross estate for US estate tax purposes. In addition, with discretionary distributions, a trustee is able to refrain from making distributions that may support a beneficiary's addictive behaviours (e.g., gambling or substance abuse). In the context of a divorce, for example, a beneficiary's right to receive a mandatory income distribution may be treated as marital property and, thus, subject to division.

Mandatory income distributions also can restrain the trustee's investment of the trust property. A fully discretionary trust enables the trustee to invest for total return. A trust that contains mandatory income distributions generally forces the trustee (or whoever has investment powers) to invest the trust property in a manner that generates reasonable income, which, especially in the current interest rate environment, may be less than the income generated by a portfolio invested for total return.

In the trust deed, the settlor ideally would include a statement of intent or some precatory clauses, so that the trustee has some guidance concerning the purposes, timing and amounts of distributions that the trustee should make. Alternately, the settlor would provide a letter of wishes, again for the purpose of guiding the trustee in its exercise of its power to make discretionary distributions.

ii Power to add beneficiaries

The power to add beneficiaries can provide additional flexibility. The use of the power is more common in trusts that have situs in non-US jurisdictions. The less frequent use of the power to add beneficiaries in a US-situs trust likely stems from the attitudes of settlors and their advisers toward control. There also is a potential tax implication. The trustee's power to add beneficiaries will cause the trust to be classified as a grantor trust for US income tax purposes (subject to additional conditions if the settlor is not a US person). Thus, the settlor would be taxable on the trust's income and gains. That result often is desirable, because it can yield more tax-efficient wealth transfer after taking into account US gift and estate taxes.

VI TRUST DURATION

In many jurisdictions, a settlor can create a perpetual or quasi-perpetual trust. The practical effect of perpetual trusts is the elimination of an arbitrary limit on the duration of trusts. Without any limit on a trust's duration, a settlor can allow the trustee to determine the proper time to terminate a trust, taking into account the beneficiaries' circumstances and the costs of administering the trust. For example, the trustee can refrain from making a terminating distribution at a time when a beneficiary is emotionally or financially immature, is suffering injurious addictive behaviours, such as gambling or substance abuse, or faces the likely loss of the distributed property to spousal claims, creditor claims or taxes. By its nature, a multigenerational trust will likely reach practical limitations on its efficient administration. As the beneficiary class expands from generation to generation, the trust may become too unwieldy to administer, or it may divide into many subtrusts that are economically inefficient to administer. In either case, the lack of any limitation on the trust's duration enables the trustee to assess the administrative costs and complexities and terminate the trust when those costs and complexities outweigh the advantages that the trust offers.

i Non-US jurisdictions

The Bahamas, Guernsey and Jersey allow trusts of unlimited duration. The British Virgin Islands limits the duration of trusts to 360 years. The Cayman Islands allows a STAR trust (its form of purposes trusts) of unlimited duration, but otherwise limits the duration of non-charitable trusts to 150 years.

ii Leading US jurisdictions

New Hampshire and South Dakota allow trusts of unlimited duration. Delaware allows a trust of unlimited duration, except to the extent that the trust directly holds real property. Delaware limits the duration of a trust that directly holds real property to 110 years. Through proper planning, Delaware's durational limitation on trusts holding real property is avoidable. The limitation does not apply to a trust to the extent that the trust indirectly holds real property, such as through a limited liability company or partnership.

iii Other US jurisdictions

Nevada limits the duration of trusts to 365 years, Tennessee limits their duration to 360 years and Wyoming limits their duration to 1,000 years. A recent scholarly article, however, questions the validity of those states' statutes allowing for quasi-perpetual trusts.[11] In each of those states, the state constitution expressly prohibit perpetuities. The article's authors assert that the statutes purportedly allowing quasi-perpetual trusts violate those constitutional prohibitions, because the statutes deviate too substantially from the traditional limits on the deferred vesting of property interests. If their analysis is correct, trusts created under those statutes may be limited in duration by the rule against perpetuities or may possibly be invalid.

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11 Steven J Horowitz and Robert H Sitkoff, 'Unconstitutional Perpetual Trusts,' 67 Vanderbilt Law Review 1769-1822 (2014). The authors also question the validity of similar statutes in Arizona and North Carolina.

In *Bullion Monarch Mining Inc*, Nevada's highest court recently held that the rule against perpetuities does not apply to a royalty provision in a commercial contract.[12] In the opinion, the court mentions the 365-year period applicable to trusts, and it recognised the legislature's role in articulating current public policy. The ruling may give some people comfort. The court, however, did not expressly address whether, as it applies to trusts, the statutory 365-year rule is valid under the state's constitution.

California and Massachusetts continue to apply the rule against perpetuities, but have adopted wait-and-see statutes that mitigate the rule's harsh effects. New York applies the rule against perpetuities.

VII DISPUTE MITIGATION & RESOLUTION

i Governance structure

The design and implementation of the governance structure plays a critical role in mitigating disputes. The trust deed should specify the qualifications of trustees, trust advisers, and trust protectors. An inexperienced trust adviser can wreak havoc with a trust. A governance structure that includes appropriate checks and balances helps to keep the trustees, trust advisers and the trust protectors accountable. A trust's governance structure should include procedures for removing and appointing trustees, trust advisers and the trust protectors. In some trusts, term limits and age limits are beneficial.

ii No-contest provisions (forfeiture provision)

A no-contest provision is a provision that terminates a beneficiary's interest in a trust if the beneficiary contests the trust or the trustee's actions. A no-contest provision – also called an *in terrorem* clause or forfeiture provision – can serve as a deterrent to litigation.

A no-contest provision changes the economic calculus. In the absence of a no-contest provision, a beneficiary's downside cost of contesting a trust may be limited to the beneficiary's own legal fees. In some US jurisdictions, that cost may be nearly nil, because some attorneys are willing to pursue trust contests on a contingency fee basis, collecting a fee only if the attorney succeeds in obtaining some financial benefit for the beneficiary. With a no-contest provision, the beneficiary's economic analysis changes. The beneficiary's downside cost is the loss of his, her or its interest in the trust. Thus, a rational beneficiary must have a higher degree of confidence in his, her or its claim. Of course, not all beneficiaries are rational, and a beneficiary who unsuccessfully challenges a trust that contains a no-contest provision and consequently loses his or her interest in the trust may turn on his or her advisers.[13]

Non-US jurisdictions

In non-US jurisdictions, there is limited case law on the enforceability of no-contest provisions. In *AB Jnr & Another v. MB & Others* (18 December 2012), the Cayman court enforced a no-contest provision. The case followed *AN v. Barclays Private Bank & Trust (Cayman) Ltd* [2006] CILR 365, in which the Cayman court likewise enforced a no-contest provision.

12 *Bullion Monarch Mining Inc v. Barrick Gold Strike Mines Inc*, 345 P.3d 1040 (2015).

13 See, e.g., *Shelton v. Tamposi*, 164 N.H. 490 (2013).

Leading US jurisdictions
Within the US, the leading trust jurisdictions enforce a no-contest provision. Delaware, New Hampshire and South Dakota enforce no-contest provisions. Delaware and New Hampshire enforce a no-contest provision, even if the beneficiary acts in good faith or with probable cause in contesting the trust. In contrast, South Dakota will not enforce a no-contest provision against a beneficiary who acts in good faith or with probable cause in contesting the trust. In addition to its statutory enforcement of no-contest provisions, New Hampshire expressly authorises a trustee to suspend distributions to a beneficiary who may have violated a no-contest provision.

Other US jurisdictions
New York enforces no-contest provisions, even if the beneficiary acts in good faith or with probable cause in contesting the trust. California enforces no-contest provisions, unless the beneficiary acts in good faith or with probable cause in contesting the trust. California courts, however, seem reticent to enforce no-contest provisions. Notably, Florida does not enforce no-contest provisions. Florida views a no-contest provision as contrary to public policy, because it limits a beneficiary's right to challenge a trustee's actions. Florida has codified its prohibition against the enforcement of no-contest provisions.

iii Nonjudicial dispute resolution

Many wealthy families value privacy. Even families whose business or philanthropic expose them to significant public attention often wish to preserve the privacy surrounding their wealth and the manner in which they structure the disposition of that wealth. Thus, for many wealthy families, the private resolution of any trust disputes is an important aspect of trust design. In addition to avoiding the publicity that a judicial proceeding may entail, they wish to ensure that they have greater say in the qualifications of the individuals who decide any matters affecting the family's wealth.

The leading US trust jurisdictions expressly recognise nonjudicial dispute resolution provisions in trust deeds. New Hampshire recognises nonjudicial dispute resolution procedures. The procedures must be reasonable, and they may govern any matter except the determination of a trust's validity or the determination of a trust's material purposes. Delaware and South Dakota also recognise nonjudicial dispute resolution procedures.

Other US jurisdictions generally do not expressly recognise nonjudicial dispute resolution provisions in trust deeds. For example, California, Florida, New York and Wyoming do not expressly recognise nonjudicial dispute resolution provisions.

iv Lifetime approval of trusts

A settlor who anticipates the possibility of a dispute concerning the validity of his or her trust may value the ability to obtain a declaratory ruling affirming the trust's validity. For the settlor as well as the court, a key benefit of the settlor seeking the determination is the settlor's availability as a witness. In many instances, a challenge to a trust's validity arises after the settlor's death, at which point the best witness is unavailable. In the US, New Hampshire statutorily allows a settlor to seek a court's determination of a trust's validity.

Appendix 1

ABOUT THE AUTHORS

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Todd D Mayo is a principal and general counsel of Perspecta Trust. In those roles, he works with clients in designing and implementing trust and wealth strategies, and he oversees legal matters within the company. Todd also is an attorney in Vanderwal Martens, where he focuses on private client matters.

Todd is the principal author of several portions of New Hampshire's trust laws. In addition, as a member of a public-private working group that revised the state's banking laws, he was a principal author of the New Hampshire Trust Company Act and the New Hampshire Family Trust Company Act.

Todd is a member of the Society of Trusts and Estates Practitioners, a former president of the New Hampshire Trust Council, and a former chair of the New Hampshire Bankers Association's Trust Committee.

Todd is the author of *New Hampshire Trust Laws: Statutes and Commentary*, an annotated reference on the state's trust laws.

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