

# BENEFICIARIES OF TRUSTS AND FOUNDATIONS

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Foundations are not a new invention. They have a long existence: they were used particularly as structures to hold property for religious purposes in the Medieval period in continental Europe. The Catholic Church, and its various manifestations, existed as foundations. In countries like Austria, Germany and Liechtenstein we have had *Stiftungs*, and, in the Netherlands, we have had *Stichtings*, for many hundreds of years.

Most of those foundations were set up for religious or charitable purposes. The more recent development though – and that is the one that I am focusing on – is the development of private foundations for family members. I suppose that the Ph.D thesis that is latent here is: how far is it possible to develop an institution, which originated for charitable and religious objects, into an institution for private family members?

You can chart this more recent development through the history of recent legislation. Most of this legislation is in the *Private Foundations Handbook*<sup>1</sup>. The starting point is, of course, the 26<sup>th</sup> January 1926 *Personen und Gellschaftsrecht* of Liechtenstein, which introduced the Liechtenstein trust, the Liechtenstein *Anstalt* and, of course, the *Stiftung* – the Liechtenstein foundation. If anybody wants to read a critical appraisal from the early 1990s of foundations, there is an interesting book by an American academic,

Ramati, called *Liechtenstein's Uncertain Foundations*, where he raises queries about the nature and formation of *Stiftungs*.

I put a query against the Cyprus law, because it strikes me that the Cyprus law is more of a law for organisations rather than for private foundations, though it may well be that, in fact, Cyprus foundations have been established for families rather than for a purpose.

I suppose the big lift comes in 1995, when Panama introduced legislation on private foundations, and then it has really picked up in the Caribbean in the last five years – St. Kitts in 2003, the Bahamas and Nevis in 2004, Anguilla, Antigua, and an amendment to the law in Malta in 2006, and, as Nigel Goodeve-Docker and Michael Betley say, Jersey and Guernsey are presently considering introducing foundation legislation, perhaps later in 2007 or in 2008.

I imagine many people will know that the key to a foundation is that it is a separate legal entity: it has separate personality, and it owns assets in its own right; the assets in the fund belong to the foundation. And, just like other companies, it is incorporated by entry on a register – maintained, generally, by the Registrar of Companies, and the Registrar normally issues a certificate with the name, registration number and various other details about the foundation.

A key feature is that, unlike other companies, there are no shareholders: the entity is, in a sense, ownerless. It has a founder who has contributed the assets, though the

existence of “accommodation founders” (people who lend their names to setting up a foundation) is not unusual, and the founder can reserve for himself or herself various powers – powers to revoke, powers to change the by-laws, powers to add or remove beneficiaries, powers to remove the Foundation Council. So, generally, the founder has substantial control - if he wishes it – through the constituent documents. There is a Foundation Council or Board (there is no common terminology as yet), and they have the responsibility of managing the assets and utilising them for the purpose of the foundation - maintaining the beneficiaries or advancing the particular purpose. It is said (and I shall come back to this later) that the duties of the councillors are contractual – not fiduciary, and that they are to be distinguished from the duties of trustees – who are clearly fiduciaries. As I have indicated, the foundation may have a purpose (though it does not have to be a charitable purpose), or it may have named beneficiaries. Or it may have beneficiaries who are members of a class, and it is that type of foundation I am primarily interested in here.

A foundation requires certain constituent documents. It must have a charter, a declaration – something like a company’s memorandum and articles combined – which establishes the foundation. Generally, it will have sub-rules, by-laws, rules, articles – variously known: that is not an absolute requirement. Many of the laws say that it must have a charter but does not need to have – though it usually will have – by-laws. These will often contain information about the beneficiaries and the

administration of the foundation. Because they are not generally established in common law jurisdictions, or in those jurisdictions that are common law but do not apply the perpetuity rules, none of the foundations as far as I have seen are subject to a perpetuity period. On the other hand, many of the laws (for reasons I shall come on to explain) provide for the foundation to be under a degree of official control or scrutiny. The Financial Services Commissioner (or his equivalent) has the power to investigate, to appoint investigators, and to look into the affairs of a foundation. Most of the laws require the foundation to have a registered agent and provide that there can be a protector, a guardian or an adviser, who watches over the Foundation Council. Quite a lot of the laws have the rather clever provision that the foundation can continue in another jurisdiction, or move into the jurisdiction from another jurisdiction.

“Why would anyone – given the availability of the trust (the greatest invention of the common law world) – consider ever using a foundation?” I take that quotation from the discussion document in Jersey. In Jersey, the main reason given was that it is believed there is a strong commercial demand for foundations, particularly from clients in civil law jurisdictions, who may not feel comfortable with trust structures. I have heard comments like that made for twenty years or so. I have to say, I am not sure I believe them. My own experience with potential settlors of trusts is that most people contemplating setting up a trust are not that unsophisticated. I bear in mind a particular experience recently in establishing two extremely complicated

structures on behalf of settlors, both of whom came from civil law traditions, but who were very comfortable with the trust concept. I wonder whether high-net-worth individuals these days really are that uncomfortable with the trust structure. I think sometimes they may be rather more uncomfortable with the trustees rather than with the trust structure, but I leave that for separate discussion.

No doubt, among the reasons for creating foundations, is the ability of the founder to retain significant rights. But, of course, that has inherent dangers, including the possibility of a conflict between the founder and the Foundation Council, and the probability of conflict between the founder and those who thought they were to be the beneficiaries of the foundation.

The lack of shareholders is another attraction – the idea of an entity that really is ownerless, so that the only owner of the assets is the entity, and there is nobody above that. I suspect that one of the features that may be seen as attractive is the lack of rights for beneficiaries, which I shall come on to in a moment. But it is worth bearing in mind that, looking at the legislation, it seems to me that there has been a *quid pro quo*: for the lack of shareholders, the lack of rights of beneficiaries, the legislature has said, “Who then is to control the Foundation Council?” There are no shareholders who ultimately own the assets and the beneficiaries have limited rights. The answer has been in the form of public scrutiny and official supervision, and it seems to me that

that is the *quid pro quo*. The founder has the choice. Does he want to have beneficiaries supervising the trustees? Or does he want to have official supervision by the Financial Services Commissioner or his investigator instead?

How would one characterise a foundation? Is it a company? Is it a settlement? The answer, I suspect, is that it can probably meet the definitions of both. It is a body corporate, and so I expect it would come within the definition of a company in any jurisdiction. On the other hand, if you look at the definition of a settlement for UK inheritance tax purposes: a disposition of property, property held for persons in succession subject to a contingency, then – depending on the actual terms – I imagine a foundation could come within that definition as well. It is a concern that I have had with *Anstalts*, and it is certainly a concern I have with *Stiftungs* and other foundations, that some revenue authorities could choose to apply either the provisions dealing with companies, or the provisions dealing with trusts – whichever would give them the best result. That certainly has been my concern in the United Kingdom – that, on capital gains, you could have s.13 TCGA 1992 or you could have ss.86 and 87 applying at the choice of the revenue authority, depending on the actual terms of the particular foundation itself. Are they opaque or transparent? Would the income be seen as flowing through to the beneficiaries? That, I think, must depend upon the actual terms of the foundation itself.

What about the nature of a founder's rights? Would the founder be treated as really having alienated the assets, if the founder has retained substantial control? In particular, might those rights be characterised as a general power of appointment over the assets, which take them back – certainly for inheritance tax purposes – into the founder's estate? Those are a number of issues that would need to be addressed if one was ever contemplating a foundation, and it being viewed from a country like the United Kingdom or the United States.

It is said that the Councillors' duties are contractual. I have a bit of a difficulty with that, because I ask the question: contract with whom? Is it a contract with the founder? Probably, initially yes, but what happens when the founder dies? Who then can enforce the contract? Is it a contract with the entity? Hardly, because the Foundation Council controls the entity. How can they, in effect, control a contract with themselves? I think it is pretty clear that it is not a contract with the beneficiaries, so I am left with this slightly uneasy feeling that it is a contractual obligation, but a contract without a counter-party.

If you look at the laws on foundations, I think you will agree that there is a real paucity of provisions dealing with the rights and interests of beneficiaries. Some laws are, effectively, silent on this point – Cyprus for example, though, as I said, I do not think that really has family foundations in mind. There is one exception: Malta has quite a comprehensive provision, at page 226 of the *Handbook*, dealing with the rights and interests of

beneficiaries. The draftsman was clearly inspired by the concept of the trust, and has adopted many trust ideas. But with those exceptions, generally the provisions for beneficiaries are fairly thin and rather limited. You may, of course, say that if I looked at the 1925 Trustee Act in the United Kingdom, I would find little that talks about the rights of beneficiaries, but, of course, that is set against the context of 400 years of court cases, defending the rights of beneficiaries. You do not have this 400 years of litigation and elaboration as a background to foundations.

Let me take some of these points in some detail. What is the nature of the rights of a beneficiary under a foundation? Is it a proprietary right? Most of the laws say that a beneficiary has no rights in the assets of the foundation until they are actually distributed to the beneficiary. Anguilla is a good example: a beneficiary has no right *in specie*, though Anguilla does provide that a beneficiary can enforce the foundation, but by an action *in personam*, not an action *in rem*. The law in Malta (again in a sense following the trust analogy) says that the rights of a beneficiary are property, and they are moveable property. On the other hand, if you look at the law in St. Kitts, which is a very good example (and a number of other jurisdictions have followed it), that says quite specifically, that the assets of the foundation are not the assets of the beneficiaries until they are distributed.

Many of the jurisdictions have focused on protecting beneficiaries by giving them the right to

information, so the beneficiary is entitled to know about the assets held in the foundation. But, in most cases, that is subject to the terms of the charter or declaration, which I read as saying that if the founder is so minded and so advised, then the beneficiaries will have no right to information. The general rule is that the statutory right to information can be wholly or partially excluded by the foundation's constitution. I would be very nervous about advising a founder to exclude completely the rights of beneficiaries to information: it is an invitation offered by the laws which I would say very strongly should be rejected. And there are exceptions to the rule. In the Bahamas, the Law provides that a beneficiary who has a vested right in the property is entitled to receive accounts and information.

Most of the laws do not give the beneficiary a right to enforce the foundation, and any possible enforcement can be excluded. Again, there are exceptions. In Anguilla, if there is no other provision for removing the Foundation Council, then the beneficiaries can apply to the Court to remove them, but otherwise there is nothing about enforcement. Malta (again perhaps following the trust concept) expressly authorises beneficiaries to enforce. In Nevis, an absolute beneficiary – one who has an absolute vested interest – can require the Foundation Board to meet, but otherwise there is nothing specific about enforcement. Interestingly, Panama has what are probably the strongest provisions, allowing beneficiaries to apply to the Court for removal of the Council, and the right to contest its decisions, but in most of the other laws there is silence or – as we will see in a moment – *in*

*terrorem* possibilities, which would exclude beneficiaries from enforcing the foundation. It is exceptional to find specific reference to beneficiaries enforcing.

I come now to what I find perhaps the most worrying provisions. I know that – at times – settlors want to exclude the possibility of their beneficiaries contesting the trust. They want to do so, either because they do not trust the beneficiaries, or they hope that by doing so, they will avoid the family becoming embroiled in decades of litigation. But I have a feeling that some of the provisions on foundations go too far. It is not my term – calling them *in terrorem* provisions. It is how they are actually referred to in the Bahamas. If you look at the Bahamas legislation (page 180 of the *Handbook*) you will find a section headed “*In terrorem*”. It is the possibility of excluding challenge by the beneficiaries. Anguilla has an understandable provision: if the terms of the charter so provide, a beneficiary who challenges the establishment of a foundation, the transfer of assets, the declaration or the by-laws, can lose his or her claim under the foundation. But, several jurisdictions have then gone further, and said if a beneficiary (or a would-be beneficiary) challenges any decisions of the Foundation Council or the protector, then again, he or she can be excluded by the terms of the charter: Antigua, Nevis and St. Kitts all have that provision. We are looking at an institution that has no shareholders, the founder of which may be dead, or may be in disagreement with the Foundation Council or the beneficiaries, and the beneficiaries – if they challenge the Foundation Council

– will lose their rights. Again, that is an invitation in the legislation that I would recommend people reject. The Bahamas here, I think, has a more acceptable provision. It says, “Beneficiaries can lose their rights if they challenge a decision, but only if it is a decision that does not damage their rights or interests.” So, beneficiaries can challenge if the decision harms them, but otherwise they cannot challenge the decision of the Foundation Council, if the charter so provides.

That is a run-through of what the legislation says on the rights of beneficiaries. I emphasise, again, my view that there is a paucity of provisions in the law dealing with the rights of beneficiaries, and I think I have said enough to indicate – from a trust law background – I find significant concerns in the form of *in terrorem* provisions that are offered, and the provisions on supplying information.

Before I leave the rights of beneficiaries, let me perhaps add a dose of realism. There are assets in a foundation: who really owns them? Is it the founder? In theory, no. The founder is supposed to have completely alienated the assets. But I worry that, if the founder does reserve powers of revocation, that he remains – for many purposes – still the owner. Is the entity the owner? As a matter of law, yes, but as a matter of reality, the entity cannot enjoy the assets. The assets cannot benefit the entity; it is not the real, *beneficial* owner. Is it the Foundation Council? Please no. If the members of the Foundation Council start to think that the assets belong to them, then you really have a recipe for problems.

Ultimately, as trust lawyers realised 400 or 500 years ago, it has to be the beneficiaries: they are the people the founder wanted ultimately to benefit. They are the ones who have to be regarded as having ultimately the beneficial ownership of those assets, and I am worried that the foundation ignores that reality.

It is not without reason that we have a beneficiary principle for trusts – the principle that there have to be identified beneficiaries who can enforce the trust. Charities have always been the exception, because the Attorney General can enforce the trust. Another exception today is the purpose trust, because there is always a protector or an enforcer who can enforce it. These exceptions apart, there have to be identified beneficiaries who can enforce the trust. The trust can be enforced by beneficiaries (or on their behalf if they are minors). All beneficiaries have a right to enforce the good administration of the trust, and the Court of Chancery developed a specific remedy for this purpose – the action for account. You do not claim damages against trustees, you claim from them an account of their administration of the trust funds. As a consequence of that right, beneficiaries – either individually or collectively – have been regarded as having an equitable interest in the property. These rules have evolved out of 400 years of case law on this area, and that is what makes the trust such a strong and well-developed institution.

I shall just highlight briefly some of the recent cases on the law of trusts. Interestingly, the first two

cases<sup>2</sup> are a nice contrast, looking at the same question. They are looking at the nature of the interest of a class of beneficiaries under a discretionary trust. Do discretionary beneficiaries have a future interest in the trust property? The question arose for limitation periods under the Limitation Act in New Zealand, and in the Cayman Islands. Though the two Courts do not say exactly the same thing, both of the Courts emphasised – the New Zealand Court of Appeal, the Grand Court in the Cayman Islands – that in the case of a discretionary trust one thing is clear: discretionary beneficiaries have a right to go to courts to enforce the proper administration of the trust against the trustees. Whether that is to be regarded as a future interest or not, the Courts slightly differed, but they emphasised the nature of that right.

*Wendt v. Orr*<sup>3</sup> is not a massively significant case concerning the profits of share trading, but what it did emphasise is the importance of distinguishing between income and capital in a trust, and the importance of recognising the different interests of life tenants with an interest in income, and remaindermen with an interest in capital. Were the profits of share trading income or capital? In that case, they were income and benefited the life tenant.

*CIPC v. Churchill Int. Property Group*<sup>4</sup> is a commercial case, but it emphasises the rule in *Saunders v. Vautier*<sup>5</sup> – the rule that beneficiaries, all adult and under no disability, can together agree to end the trust because, ultimately, they are the real beneficial owners, and, even though the trustee had real misgivings, the

Court gave preference to the beneficiaries over the trustee because of the rule in *Saunders v. Vautier*.

Finally, I come to some comparisons: they are not really comparisons, but more points that you should bear in mind when you are thinking about beneficiaries of trusts and beneficiaries of foundations. Consider that with beneficiaries there are conflicting interests between life tenants and remaindermen. Trust law has developed to recognise those interests; I do not see anything in the foundation laws that have recognised that. At times, the trustees need to know who is in the class of beneficiaries: there need to be class-closing rules. Trustees need to know about fiduciary obligations in terms of adding and removing beneficiaries. We have those developing for trusts, not for foundations. Remember who is going to supervise the Foundation Council, and contrast that with supervision of trustees. Remember that the key to fiduciary obligations is the conflict between the duty of a trustee and their personal interest: how does that survive in a contractual environment, rather than a fiduciary one? Consider what might happen to a foundation if there are claims by third parties – ex-spouses, ex-girlfriends, etc. We have trust case law on that, but not yet foundation case law.

If you have a settlor who is absolutely set on creating a foundation (and I think there will be people like this), what should you consider? First of all, I think you should consider drafting very detailed by-laws, foreseeing – if you can – some of these problems, and I suspect that you will find yourself turning, again and

again, to trust precedents when you are drafting them, because you will recognise that these issues have been considered in the trust concepts. Do not be tempted – whatever the founder says – to ignore the rights of the beneficiaries. They are ultimately the ones who will benefit from the fund; their rights need to be more respected. Do not accept some of the invitations that the legislation offers to you. I suspect that it is going to be particularly vital to ensure that there is a protector and, quite probably a professional protector, overseeing the Foundation Council. Finally, and as a litigator myself I smile at this, but I am not certain anybody else should, I foresee that if we do have a growth in foundations, there is going to be in the future an active role for litigators in this area.

I started my consideration of this topic with scepticism: it is the scepticism of a trust lawyer. I end it in the same way. It is not because I feel that something that originated in Liechtenstein via Panama cannot be a good entity – I think it could be, but I have real concerns about this issue of the rights of beneficiaries under foundations as compared with trusts.

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<sup>1</sup> Edited by Milton Grundy, ITPA 2007.

<sup>2</sup> Johns v. Johns (2004) 8 ITEL 287 (NZCA); Lemos v. Coutts (Cayman) Ltd (2005) 8 ITEL 153 (Grand Court)

<sup>3</sup> (2005) 8 ITEL 523.

<sup>4</sup> (2006) 9 ITEL 157.

<sup>5</sup> (1841) Cr & Ph 240.