The Offshore Tax Planning Review

THE MEANING OF THE *RAHMAN* DECISION

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On 6th June 1991 the Royal Court of Jersey delivered the reasons for its judgment in the case of *Rahman v Chase Bank (CI) Trust Company Limited* that the trust established in Jersey by Kamel Abdel Rahman was invalid. The decision has caused some concern amongst trustees and advisers to clients who are considering establishing offshore trusts, and it may be helpful to summarise what the Court actually decided, and why it concluded as it did.

The Facts

Kamel Abdel Rahman ("KAR") established a settlement governed by Jersey law in January 1977. The trustee was a bank-owned trustee company established in Jersey. At the time of the settlement KAR was domiciled in Lebanon. His domicile at his death has not yet been established, but Lebanon, New York and Israel are at present contended for by rival parties. KAR contributed a substantial sum to the settlement. Following his death in 1980 the widow and the estate of his mother attacked the validity of the settlement. The trustee and various beneficiaries, mainly the children, defended the settlement.

Three main grounds of attack were put forward:

(1) The provisions of the trust deed breached the Jersey maxim of *donner et retenir ne vaut*;

(2) The settlement was void as being a "sham";

(3) The settlement was invalid or could not be enforced to the extent that it was intended or had the effect of defeating forced heirship or similar rights under the law of KAR's domicile.

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exclusively to his interests made it difficult to see how the trustee could refuse to pay him capital if he so requested.

The important factor to notice is that the settlement was made in 1977, well **before** Jersey passed a statute to modernise its law on trusts, namely the Trusts (Jersey) Law (1984). That statute specifically permits fully revocable settlements (article 36) and also states that a power of appointment over all or part of the trust fund may be conferred upon any person (article 35). In 1989 an amendment to the law was passed which states specifically:

> "Nothing in the terms of a trust shall cause a transfer or disposition of property to a trust to be invalidated by application of the rule *donner et retenir ne vaut.*"

This part of the *Rahman* case, although of considerable academic interest in establishing whether the rule of *donner et retenir ne vaut* applies to trusts and if so to what extent, is of no application or relevance whatsoever for settlements which people are considering creating today. The law on this aspect, decided by the case, has been overridden by statute.

Sham

This part of the case was not concerned with any special maxim of Jersey law but with principles which are generally applied by courts of common law countries. These are that a court will not allow the "label" put on an agreement by the parties to be determinative of the relationship between the parties if the facts show that the relationship was in truth a different one. Indeed the writer is aware of one well-known English legal commentator who has stated that the result, on the facts of this case, would have been the same under English law. The Court found that in truth the relationship between the parties was that of nominee or agent. It was not that of settlor and trustee.

The following is a summary of matters upon which the Court relied to support this finding:

(a) Directions on Investment Policy

Under the trust deed, responsibility for investment lay with the trustee although the consent of the settlor was required to changes. However, the mandate with the original investment adviser allowed changes to be made upon the instructions of the settlor. Pursuant to the mandate and in practice the investment adviser consulted exclusively with KAR and never with the trustee who was not involved in any investment decisions.

On a later occasion KAR wished, for reasons of political friendliness, to make a deposit with an Arab bank. This could have been done by the

trust itself, by the trust making a loan to KAR for him to make the deposit or by the trust making a capital appointment to KAR for him to make the deposit. The trustee, having pointed out these possibilities, simply wrote to KAR for "instructions" as to which course it should follow.

On the change of investment advisers the trustee wrote to KAR seeking instructions as to whether the same investment guidelines as previously should be applied.

(b) Choice of Investment Adviser

In 1978 KAR appointed new investment advisers. He signed a new mandate and agreed a fee structure. He did all this without reference to the trustee and then simply wrote to the trustee instructing it to arrange for the transfer of the portfolio. This was simply acted upon by the trustee without comment.

(c) Taking Control of the Trust Fund

The main asset settled into the trust comprised of rights under a contract which was assigned by KAR to the trustee. The trustee took no steps to ensure that it obtained all that it was entitled to under the agreement. For example:

(i) US$1 million of the initial payment was diverted by KAR and never reached the trust.

(ii) Interest of over US$300,000 due to the trustee under the contract and paid in 1978 was diverted by KAR. This was repeated on several other occasions. Thus the trust never received this interest, to which it was entitled.

(iii) Rent on a property owned by the trust was paid directly to KAR and not accounted for to the trust.

At no stage did the trustee protest about any of this.

(d) Appointments out of the Trust

All payments out of the trust fund were made on the instructions of KAR. The payments were made without regard at the time to whether they were distributions to KAR or to others or loans and, in the latter case, whether there was any security and whether it was a good investment. If there were distributions, no consideration was given as to whether the distribution was out of income or capital and under which provisions of the trust deed the payment was being made.

(e) Loans on the Direction of KAR

On the instructions of KAR the trustee lent Mrs Rahman US$1 million to buy an apartment in New York. The loan was expressed to be repayable only on the demand of KAR, not of the trustee. The loan was to be forgiven completely on the death of KAR. The trustee wrote to Mrs. Rahman accordingly. Subsequently KAR changed his mind and instructed the trustee that US$500,000 was to be recouped on his death with the balance to remain for the benefit of Mrs Rahman. At no stage did the trustee give any independent consideration as to the matter.

Subsequently KAR instructed the trustee to send a further US$100,000 to Mrs Rahman. The trustee did so and then wrote to KAR asking whether it was a loan or some other form of payment.

KAR instructed the trustee to make a loan to a Dr Chebenne, who was not a beneficiary. The trustee explained to KAR that the payment would have to be regarded as loan for investment purposes but without security and wrote to KAR asking whether his instructions were to proceed.

(f) Dealing with the Assets at the Direction of KAR

The trust owned a Liechtenstein Anstalt which in turn owned real property. KAR instructed the trustee to give a power of attorney to a Mr James to sell the property of the Anstalt "... at a price and terms and conditions which (KAR) has made known to Mr James." The trustee granted the power of attorney even though it had not been told any of the terms of the proposed sale. This event gave rise to the one trustee minute of the whole trusteeship.

(g) Allowing KAR to Deal with the Trust Assets

Under the agreement which had been assigned to the trust, certain shares were to be pledged with Chase Manhattan Bank (Switzerland) as security for the receipt of instalment payments under the agreement. KAR decided unilaterally to reduce the security available to the trust and the trustee was not involved with the decision. Subsequently certificates were released from pledge by Chase Switzerland on the instructions of KAR. The trustee gave no instructions and knew nothing of it.

Subsequently the interest rate payable under the sale agreement was varied. These negotiations were conducted by KAR without the knowledge or participation of the trustee.

The Court had no difficulty in finding on these facts that the true relationship between the parties was one of nominee or agent. The Court summarised its conclusion at the end of its judgment as follows:

> "Therefore, taking into consideration, as we did, the whole of the evidence and documentation, we were able to reach but a single and unanimous conclusion. KAR retained dominion and control over the trust fund throughout his lifetime. The settlement was a sham in the sense that it was made to appear to be what it was not. The "don" was a "don" to an agent or nominee. The trustee was never made the master of the assets. KAR intended to and did retain control of the capital and income of the trust fund throughout his lifetime and used the trust and the deed of appointment made under the trust to make testamentary dispositions. In our opinion, KAR's advisers and the trustee lent their services to the attainment of his wishes.
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> In *Re Knights (Jersey) Limited. Madoc Limited v George Butler (Dudley) Limited* (1950-66) JJ 207 p 210 the Court said that it "will not readily uphold documents which are a fiction in the sense that they bear no real relation to the facts of a transaction, the terms of which they purport to embody..." That is exactly the case here.
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> Accordingly we made the order that the settlement and the gifts to the trustee are wholly invalid and of no effect under the law of Jersey in that, firstly, the powers contained in the settlement breached the maxim or rule of law that *donner et retenir ne vaut* and, secondly, the settlement was a sham which KAR did not intend to have legal effect."

The judgment is unsatisfactory in one respect in that it does not discuss the principles to be applied in assessing whether an agreement amounts to a sham. In particular it does not deal with the required intention on the part of each party. Although *Snook v London and West Riding Investment Limited* [1967] 1 All ER 518 was cited in argument, the Court did not refer to the dicta of Diplock LJ where he said:

> "... for acts or documents to be a "sham", with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating. No unexpressed intentions of a "shammer" affect the rights of a party whom he deceived. There is an express finding in this case that the defendants were not parties to the alleged "sham". So this contention fails."

There is a clear difference between:-

(i) a trust where, at the beginning, both parties intend the relationship to be that of nominee; and

(ii) a trust where a settlor and trustee intend to create a trust but, subsequently, the trustee never exercises a genuine discretion but simply follows the settlor's wishes.

The first example is a classic sham. The requirements of *Snook* are met in that both parties have a common intention to create legal rights which are different to the written document. Examples of these are the cases which have exercised the English courts over the years where parties have purported to create licences in relation to land but the courts have held that in fact they have created tenancies.

The second case is different. It is submitted that you cannot turn a trust, once created, into some other relationship simply because the trustee performs his duties very badly or, indeed, not at all. An example of this is *Turner v Turner* [1983] 2 All ER 745 where family members were trustees of a discretionary trust and made a number of appointments at the request of the settlor. They never independently considered their discretion. The court held that the appointments themselves were invalid but it was at no stage suggested that the trust itself was invalid simply because the trustees had failed to perform their duties properly.

In many cases it may be difficult to be sure of when the line is crossed. Ultimately this is a question of fact for the court. Clearly, the fact that the trustee never exercises a genuine discretion and simply follows the settlor's wishes may be evidence of what was the intention of both the trustee and the settlor at the time the trust was created. It is unfortunate that the Court did not focus on this aspect and make specific findings as to the state of mind at the time of the creation of the trust of both trustee and settlor, particularly as *Snook* was cited to it.

However, it is clear from various passages in the judgments that the Court must have found that it was the common intention of both KAR and the trustee that, at any rate during his life, the trustee would in effect act as mere agent or nominee of KAR. The evidence adduced was extremely compelling and there was certainly ample evidence upon which the Court could conclude that the necessary common intention was present.

Forced Heirship

The issue of whether the trust was invalid by reference to *donner et retenir* and as a sham was tried as a preliminary issue. Because the trust was found to be invalid by reference to these principles, it was not necessary for the Court to move on to hear the argument based on forced heirship or analogous claims.

It is probable that such a claim would have failed. However the matter has now been put beyond doubt by the Trusts (Amendment) (Jersey) Law 1989 which introduced the following as article 8A(2):

> "If a person domiciled outside Jersey transfers or disposes of property during his lifetime to a trust:-
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> (a) he shall be deemed to have had capacity to do so if he is at the time of such transfer or disposition of full age and of sound mind under the law of his domicile; and
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> (b) no rule relating to inheritance or succession (including, but without prejudice to the generality of the foregoing, forced heirship, "legitime" or similar rights) of the law of his domicile or any other system of law shall affect any such transfer or disposition or otherwise affect the validity of such trust."

Accordingly so far as Jersey law and the Jersey court is concerned forced heirship rights cannot adversely affect a Jersey settlement or a gift to a Jersey settlement.

Lessons to be Learned

The judgment is no longer of relevance in so far as it concerns the application of *donner et retenir* to trusts. It remains relevant in showing with clarity what a trustee should **not** do. A trustee must act as a trustee. Thus:

(a) The assets must be vested in the trustee or held under his control; and

(b) when considering any request which comes from the settlor, the trustee must consider carefully what he is being asked to do, whether he has power to do it under the deed and whether, assuming he has the power, he should exercise the power in the manner requested. It must be his decision in the interests of the beneficiaries. He should keep a record of that decision. Provided that the trustee genuinely acts in this manner, there will be no question of a sham.

There is no difficulty about a trustee consulting the settlor even where there is no duty to do so in the trust deed provided that it is the trustee who takes the decisions himself and he has not merely acted on the instructions of the settlor. There is also no difficulty in referring to a letter of wishes provided that the trustee exercises his own judgment on the matters contained therein and does not slavishly follow it without thought.

If the trust deed provides that in certain cases the settlor must consent or may give directions, then of course the trustee must comply with the trust deed and the validity of the settlement will in no sense be endangered thereby. In addition the trustee can of course delegate his powers in accordance with the provisions of the 1984 law and any provisions of the trust deed.

In summary, the facts of *Rahman* were unique and are, hopefully, unlikely to be repeated. The Court found a sham on the application of general principles. However, it is a reminder that trustees must act in accordance with their fiduciary duties. They are not the mere nominee of the settlor. Provided that they remember this and act accordingly, there will be no question of the trust being set aside as a sham.