

Mitigating the risk of trust assets being treated as a resource during divorce

Insights - 20/01/2022

| Background:

It is clear that a well drafted and properly administered trust can be an effective asset protection vehicle in the context of divorce. Broadly the test now applied by the Family Division of England and Wales (the "**Family Division**") in relation to trusts is to decide whether the trust should be treated as a resource available to the relevant party – for example, if the husband were to request the trustee to advance to him the whole (or part) of the trust fund of the trust, the trustee would be likely to do so (the "**Charman Likelihood Test**").

Obviously this test raises some interesting issues for trust counsel to consider in the drafting of trusts and letters of wishes. The test also raises some key points for trustees to consider in the practical administration of trusts, notably concerning the need for trustees to exercise their own independent discretion (distinct from direction or influence from the beneficiary/settlor spouse) and, fundamentally, being able to evidence the same.

If the resource line of attack is open and sufficient it is likely that there will be no need for the aggrieved spouse to attack the trust by asking the Family Division to vary the trust under English law matrimonial legislation (e.g. to order distributions or to vary the beneficial class).

Enforcement issues can arise with the variation line of attack if dealing with a foreign law trust outside of the jurisdiction (e.g. when dealing with a Jersey or Cayman trust). In more recent times, and consistent with the resource line of attack, the approach of the Family Division has broadly been to preserve the integrity of trusts and particularly so if there are sufficient assets held outside of the trust.

Of course the facts and circumstances applicable to ultra-high net worth families looking to establish trusts with an eye on asset protection will vary dramatically, and many factors will simply be outside the control of legal counsel and trustee. Ideally all planning would be carried out in advance of marriage or contemplation of marriage for instance, but this is not always

feasible! That said the purpose of this short paper is to pull together some practical pointers on the drafting and administration of trusts so as to ensure, so far as is possible, that a trust is considered to be dynastic in character rather than a resource of the beneficiary/settlor spouse.

Charman still relevant today:

The Charman Court of Appeal judgment from back in 2007 still provides us with helpful guidance today. Indeed the Charman Likelihood Test has been applied in a number of cases most recently by the Hong Kong High Court in *LCYP v JEK [2019] HKCFI 1588*.

Background on Charman

- At the time it was the biggest divorce payment (£48 million to the wife) in British legal history (now dwarfed by a £453 million payment in 2016!).
- Total matrimonial assets in the region of £131 million were divided 36.5% to Mrs Charman and 63.5% to Mr Charman because of his “special contribution”.
- Approved by the Court of Appeal and Mr Charman lost his right of appeal to the House of Lords (as then known).

Of interest to us:

1. Included within the matrimonial assets were the assets of an offshore discretionary trust amounting to nearly £70 million. Among others, the husband, the wife (who was named), their 2 sons, any future children and remoter issue of the husband were beneficiaries.
2. The court looked through the trust and held that the trust was a resource of the husband and therefore fell into the ‘pot’ of matrimonial assets to be divided on divorce. Fundamentally Mr Charman's argument that the trust was dynastic in character was rejected.
3. N.B. The court focussed on the Charman Likelihood Test: “ *if the husband were to request the trustee to advance to him the whole or part of the capital or income of the trust, the trustee, acting in accordance with its duties, would on the balance of probabilities, be likely to accede to that request.*” Answer on the facts: “ *Yes*”.
4. Factors relevant to the court’s decision to treat the assets of the trust as a resource of Mr Charman included, among others:
 - (a) Mr Charman was the settlor of the trust and his letters of wishes stated that he wished to be considered the primary beneficiary. Indeed the first letter of wishes stated that he wished to have the fullest possible access to the capital and income of the trust including the possibility of investing the entire trust fund in business ventures

undertaken by Mr Charman. Both letters of wishes were inconsistent with a dynastic trust analysis.

(b) Mr Charman retained a large degree of control over the trust (he had the power to remove the trustees).

(c) As regards income, the trustees informally regarded the trust as an interest in possession trust for the benefit of Mr Charman, with no distribution of income to any beneficiary other than Mr Charman.

(d) The wealth in the trust had been built by investment in accordance with Mr Charman's instructions. Mr Charman's requests had led the trustee to make multiple investments in the insurance sector (for the most part highly successful).

(e) The practical reality – the trust was a key component in Mr Charman's overall financial and tax planning.

Considerations on drafting trusts:

We assume an appropriate asset protection strategy has been formulated for the UHNWI taking into account the assets and relevant jurisdictions and further that the establishment of a dynastic trust is part of the strategy (perhaps in tandem with a pre-nup). What are the relevant considerations on drafting?

These are general pointers and of course every matter will differ on the facts.

1. Consider the number of trusts required – it may be sensible to ring-fence certain assets in a separate trust (or potentially sub-trusts) for the founding patriarch or matriarch (for want of a better phrase "sacrifice assets") and have a distinct dynastic trust for children and future issue holding the bulk of the family wealth.
2. Consider the extent of your beneficial class – of course this will be fact-specific but ordinarily you would want to ensure a wide beneficial class so as to avoid connecting the trust to one particular marriage, i.e. you would include children and future issue in the beneficial class, but you would be unlikely to include spouses and may well not include settlor or children at specific "risk" of divorce (consider ring fencing).
3. Consider the dispositive provisions – ideally the trust should be discretionary in nature. If the beneficiary divorcing is entitled to a fixed interest in a trust, then that fixed interest is far more likely to be considered a resource of that beneficiary.
4. Consider any reserved powers carefully – no reserved powers vested in those at "risk" of divorce (e.g. power to remove trustees as in Charman). Generally you would want to limit the use of reserved powers if asset protection is a key driver.

5. If you have the luxury of drafting at the beginning – confirm the trust's purpose in the recitals as being a dynastic trust to benefit children and future generations of the family. Of course this needs to dovetail with the practical reality of the administration (see below)!
6. Consider more robust drafting on the requirement for beneficiaries to have a pre-nup (or equivalent) in the terms of the trust – this is draconian but increasingly common. In short, if a beneficiary marries with no pre-nup then they will get no conferral of benefit from the trust.
7. Key boilerplate clauses – exclusion of community property rules.

Considerations on drafting letters of wishes:

1. Make clear the dynastic purpose of the trust – to benefit children and future generations.
2. Align the letter of wishes to the dynastic character of the trust – wish for pre-nups and preservation of trust fund for children and future generations.
3. Make clear how benefit should be conferred on children and future generations.
4. Avoid wishes detailing specific and regular distributions to particular beneficiaries and particularly those at risk of divorce.
5. Avoid language which suggests the settlor is pulling all the strings! It's key the trustees can show independent discretion.

Considerations on the practical administration of trusts:

1. Be very aware that trust documents, letters of wishes, trustee minutes and communications could all be disclosed on a divorce. Always have in mind the Charman Likelihood Test – likelihood of advancement of all the trust assets.
2. The trustee must exercise and be able to evidence that it has exercised its powers and discretion independently and free from a controlling influence by beneficiary / settlor spouse.
3. Evidence this independent discretion by maintaining clear trustee minutes setting out why a power is being exercised and the benefit being conferred. Important on all material distributions.
4. Match up the practical reality with the dynastic drafting of the trust – avoid a regular pattern of distributions to say one beneficiary.
5. It's not necessarily an issue to accede to a request for a distribution, but consider each request on its own merits. For most family trusts it is likely to be the case that requests are

acceded to. Document each decision making process. (see explanation in Re Esteem on acceding to requests).

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