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To serve and protect?

Russian settlors, wary of the trust concept, may be tempted to appoint Swiss protectors with broad powers to safeguard their interests. But such a strategy is not without perils of its own, warns Dmitry A Pentsov.

Despite the fact that the trust concept has been in existence in common-law jurisdictions for centuries,[1] the underlying proposition that an individual (the settlor) transfers all their rights to certain property to another person (the trustee) can sometimes be met with a degree of scepticism by people from different social, cultural and legal backgrounds, notably wealthy Russians.

Put simply, when considering setting up a trust, a prospective Russian settlor, not altogether familiar with the practical implementation of the concept, may well be fearful of the possibility that, having handed over their assets, the trustee could have second thoughts and start using the assets to their own advantage, or, worse still, run off with the money. Generally speaking, these irrational fears have not become a major stumbling block for many wealthy Russians who are still contemplating setting up trusts. However, they have prompted settlors of Russian trusts to seek out measures for preserving a certain level of control over the trustee's activities.

When defining the protector's powers, a Russian settlor should never assume that their protector owes all their loyalties to the settlor alone, and not to the beneficiaries

One measure for achieving this control could be the appointment of a protector, usually defined as a person who is not a trustee, but upon whom the trust deed confers a watchdog role in respect of the administration of the trust by its trustees.[2] In the case of a Russian trust involving a Swiss trustee or a Swiss bank account, it would make sense to appoint a Switzerland-based protector. The activities and responsibilities of the protector will essentially be governed by the law applicable to the trust itself; but, during the protector selection process, the settlor, together with their advisors, needs to consider the possibility of the simultaneous application of provisions of Swiss domestic law to the protector. Ignoring this consideration could result in negative consequences for the settlor, and frustrate the intended objectives of the protector's appointment. The following analysis presents some typical problems that may arise.

Choosing the right protector

A Russian settlor who takes the irrational fear of misappropriation of trust assets to the extreme would, in all likelihood, appoint themselves as protector for their own trust. While one person wearing two hats may be permissible from the point of view of the law governing the trust, from a Swiss law perspective, it could lead to non-recognition of the trust by a Swiss court. This is what happened in the landmark case of *Dmitry Rybolovlev* v *Elena Rybolovleva*, considered by the Swiss Supreme Court in 2012.[3] In this case, the court took into account Dmitry Rybolovlev's self-appointment as protector of his two Cypriot trusts when it decided to apply to these trusts the theory of transparency (*Durchgriff*). From the perspective of Swiss law, any contemplated combination of these two roles (settlor and protector) should, as a rule, be avoided. Nevertheless, since Swiss law does not impose any limitation

on the personalities being elected to the role of protector (other than possession of legal capacity and the ability to exercise civil rights), a settlor may choose from a wide range of potential candidates, including relatives, trusted friends, lawyers and other professional advisors.

Avoiding an over-zealous protector

Let us assume that our Russian settlor decides not to appoint themselves as protector – this does not imply that the settlor's obsession with maintaining the highest degree of control over the trustee's activities has lessened. In such a case, the settlor may consider attributing broad supervisory powers to a protector, thus enabling the protector to ensure that the trust is run in the strictest observance of the settlor's wishes. Nevertheless, a competent advisor would invariably bring to the settlor's attention a coherent body of judicial decisions, rendered in major trust jurisdictions, such as Bermuda, Jersey and the Isle of Man, according to which, in cases of dispute, a court may well deem the protector's powers as fiduciary and to be exercised not in the settlor's favour, but in favour of the trust's beneficiaries.[4] Furthermore, according to *In the matter of the A and B Trusts*, a 2012 Royal Court of Jersey case, under certain circumstances a court may remove an 'over-zealous' protector, who, for instance, had insisted on the exercise by the trustees of their discretion in accordance with the settlor's wishes, but to an extent that was seen to be detrimental to the trust's ultimate beneficiaries.[5]

Against this background, a Russian settlor, still anxious to ensure that their wishes are strictly observed, may also be tempted to conclude with their Swiss protector a mandate agreement under Swiss law, which would impose upon their protector a specific obligation as to the diligent and faithful performance of their duties in the settlor's favour.[6] Notwithstanding its apparent appeal, this option may not necessarily deliver the desired results. Under article 6(2) of the Hague Trust Convention (the Convention), to which Switzerland is a party,[7] where the law chosen by the settlor does not provide for trusts or the category of trusts involved, this choice will not be effective and the law with which the trust is most closely connected will apply.

It should be noted that, under article 9 of the Convention, a severable aspect of the trust may be governed by a different law. Although the protector's activities and responsibilities may be considered a 'severable aspect of the trust', under article 6(2) of the Convention this 'different law' still cannot be the law of a non-trust country, such as Switzerland.[8] As a result, the choice of Swiss law as the law governing the protector's activities will not be valid. Consequently, while defining the protector's powers, a Russian settlor should never assume that their protector owes all their loyalties to the settlor alone, and not to the beneficiaries. The settlor should avoid trying to come up with creative solutions (such as choice of law of a non-trust country) in order to overcome their fear of misappropriation; such solutions will not, in the long run, render the desired results.

Anti-money laundering obligations of a Swiss protector

In addition to attributing broad supervisory powers to a protector, a Russian settlor may also wish to grant discretionary powers relating to the management and investment of the trust's assets – for example, the power to direct the trustees towards investment in certain types of assets and/or sale of certain types of assets.[9] When making this decision, the settlor should take into account the risk that a protector with such powers may subsequently qualify as a 'financial intermediary' within the meaning of the Swiss *Federal Act on Combating Money Laundering and Terrorist Financing in the Financial Sector* (LBA).[10] Indeed, a broad definition of this term in article 2(3) of the LBA covers protectors authorised to take decisions in the financial domain instead of the trustee or together with the trustee. On the other hand, if the protector's powers are limited to the change or supervision of the trustee, or possession of the right to veto, allowing only opposition to investment and distribution decisions taken by the trustee, under the LBA the protector will not be considered a financial intermediary.[11]

A prospective settlor should also be aware that the qualification of a protector as a 'financial intermediary' will result in the imposition on the protector of obligations in the event of suspected money laundering, including a duty to immediately file a report with the Money Laundering Reporting Office Switzerland,[12] and immediately freeze all assets entrusted to them in connection with their report,[13] as well as a prohibition on informing persons affected by the decision to freeze assets, or third parties to the report.[14] Although the exercise of these obligations by the protector/financial intermediary could potentially have adverse effects on the settlor, especially in the case of an asset freeze, a diligent Russian settlor could actually turn them to their own advantage. Indeed, when a settlor appoints as protector a competent person familiar with the anti-money laundering legislation, such as an attorney, this person could prevent the settlor from committing any violations in this area, before the duty to report actually arises.

The appointment of a Swiss protector may ensure the smooth operation of Russian trusts with a Swiss element. Nevertheless, before any appointment takes place, a prospective Russian settlor should carefully analyse the scope of powers which they may be willing to attribute to their protector; a protector possessing broad powers may not necessarily be the best solution. This analysis should also focus on the protector's personality, professional qualifications and ethical standards, as these factors are crucial in the process of setting up the checks and balances system for a Russian trust.

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1. 1 *AJ Oakley, Parker and Mellows: The Modern Law of Trusts, 9th ed (2008), pages 1-6*
2. 2 *David Hayton J, The International Trust, 3rd ed (2011), page 195*
3. 3 *Decision 5A_259/2010 (26 April 2012). The text in French is available at: www.bger.ch*
4. 4 *Von Knieriem v Bermuda Trust Co Ltd (1994); Rawcliffe v Steele [1993–95] Manx LR 426; In the matter of the A and B Trusts, 2012 (2) JLR 253*
5. 5 *In the matter of the A and B Trusts, 2012 (2) JLR 253*
6. 6 *Swiss Code of Obligations, article 398(2)*
7. 7 *The Hague Convention on the Law Applicable to Trusts and on their Recognition (July 1, 1985). For a complete list of parties to the Hague Trust Convention, see: www.hcch.net/index_en.php?act =conventions.status&cid=59*

- [8] Alfred E von Overbeck, ‘Explanatory Report’, sections 95–96, in Hague Conference on Private International Law: Proceedings of the Fifteenth Session; Vol. II: Trusts – Applicable Law and Recognition, (1985)
- [9] Andrew Holden, Trust Protectors, (Jordans, 2011), pages 77–78
- [10] Dated October 10, 1997 (RS 955)
- [11] Practice of the Control Authority in the Area of the Fight against Money-Laundering Related to Article 2(3) LBA: Scope of Application of the Anti-Money Laundering Act in the Non-banking Sector (October 29, 2008), section 2.6.6. The text in French is available at: www.finma.ch/archiv/gwg/f/dokumentationen/publikationen/gwg_auslegung/pdf/59402_f.pdf
- [12] Article 9 LBA/
- [13] Article 10 LBA
- [14] Article 10a LBA

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