

Bermuda Trusts and asset protection – How much control will tip the balance?

Briefing Summary: On occasion, when settlors instruct us to draft trust deeds governed by Bermuda law they may seek to retain extensive powers. It is then for us to advise on how retaining powers may impact on the asset protection qualities of the trust.

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In summary, in most jurisdictions, trust assets will be more vulnerable to attack from a settlor's creditors in the following scenarios:

1. A settlor's retention of dispositive powers (particularly positive powers e.g. powers to direct the trustee in contrast to a power to veto a trustee's proposal) generally renders a trust more vulnerable to attack by creditors. Retaining powers to revoke the trust and/or a general power of appointment (i.e. to direct distribution of trust assets to anyone including the settlor) render trust assets particularly vulnerable as a settlor's creditors may seek to compel the exercise of those powers to access trust property to discharge the debt owed to them. A key case on this point is *TMSF v Merrill Lynch* [2011] UKPC 17. The trust's vulnerability to being set aside is increased where the settlor assumes the role of trustee, particularly a sole trustee, as in *DQ v BQ* [2010] SC (bda) 40 Civ.
2. A settlor's retention of a large number of powers (e.g. a mixture of dispositive and even administrative powers and whether positive or veto powers) may also render trust property vulnerable to attack by a settlor's creditors. *JMP Bank v Pugachev* [2017] EWHC 2426 (Ch) and *Rahman v Chase Bank (C.I.) Trust Co. Ltd.* [1991] JLR 103 are key cases that considered scenarios of this nature.
3. If a settlor transfers of property into a trust with the dominant intention of defeating particular creditors it is vulnerable to attack from claims from those particular creditors.
4. A trust may be set aside as a "substantive sham" if a settlor transfers property to a trustee to hold on trust but, irrespective of the trust's terms, the settlor intends and continues to treat the property as the settlor's own and the trustee is recklessly indifferent to, or complicit with, that intention. *Snook v London & West Riding Investments* [1967] 2 QB, *Pugachev's case and Re Esteem* [2003] JLR 188] all considered scenarios of this nature.

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Generally, the fewer powers reserved by the settlor, the better from an asset protection perspective. By comparison, a settlor's retention of investment/administrative powers (as opposed to dispositive powers), generally render trust assets less exposed to creditor attacks. Again, by comparison, a settlor's retention of veto powers (i.e. where trustee requires the settlor's consent to exercise the power) as opposed to positive powers (e.g. powers that enable the settlor to direct the trustee to exercise a power), generally render trust assets less exposed to creditor attacks.

Bermuda's trust legislation includes extensive reserved power provisions that seeks to protect a settlor's transfers of property into trust from being set aside (and thereby more readily accessible to the settlor's creditors) only because the settlor retains one or more powers. Bermuda also has modern "firewall legislation" that essentially does not permit a Bermuda Court "to give effect" to foreign matrimonial, heirship and insolvency laws and orders that are inconsistent with Bermuda's firewall provisions. Complex conflict of law issues often arise in such cross-border circumstances. The protection of a Bermuda trust's assets in these types of scenarios is strongest where the trust assets are situated in Bermuda. However, if trust assets are situated in another jurisdiction, a creditor may seek to utilise laws in that other jurisdiction to obtain a judgment against the settlor and seek to enforce against the trust assets. For example, if a UK resident settlor establishes a trust (under the laws of Bermuda) holding UK situs assets but is divorced in the UK and a UK matrimonial court orders a variation of the terms of the Bermuda trust to confer its interest in the UK property to the settlor's former spouse. In those circumstances it may be difficult to utilise Bermuda's laws and courts to prevent enforcement of the UK Court's order over the UK situs property. Also, one cannot always have faith that another jurisdiction's courts will apply Bermuda's trust laws in a way that we might expect a Bermuda Court to.

1. Low asset protection – (I've attempted to, insofar as possible, set this out on a scale from most vulnerable to attack from creditors to least vulnerable). The below focuses on creditor attacks other than those from a spouse in a divorce situation and does not specifically address issues arising from the situs of trust property- both of which are touched on above. A settlor's creditors may pursue a several pronged attack in their attempts to access trust property to discharge a settlor's judgment debts.

i) Retaining powers to revoke or general power of distribution (i.e. dispositive powers) – If a settlor retains powers under the terms of the trust that are "tantamount to ownership" (e.g. power without restriction to revoke the trust or a general power to direct the distribution of trust property to anyone in the world including himself/herself) a court might order that those powers be transferred to the settlor's bankruptcy trustee to exercise to discharge the settlor's judgment debts. This is essentially what was decided in relation to a Cayman Island's trust by the Privy Council (Cayman Island's highest appellate court) in the *TMSF and Merrill Lynch* case mentioned above, which involved a Cayman law trust. A similar approach would likely apply under Bermuda law (and in courts of most common law jurisdictions).

When drafting a trust deed with such powers one might consider including some restrictions on the circumstances when the settlor can exercise those powers (e.g. to preclude the settlor from exercising the power in circumstances where the settlor is bankrupt or subject to bankruptcy proceedings). Doing so may make it more difficult for a creditor who has judgment against the settlor to seek to utilise these powers to access trust property.

ii) Settlor has fixed interest in trust fund – A settlor’s creditors may be able to access trust property in which a settlor has a fixed interest e.g. where a trust includes provisions whereby the trustee is required to pay the trust income and/or capital to the settlor for life, without restriction (i.e. the settlor having to meet a certain criteria to continue to receive such distributions). Provision can be included in a fixed interest trust to terminate a fixed interest upon the occurrence of particular events, thereby making it more difficult for a creditor to access trust property through the settlor’s fixed interest.

iii) Reservation of other extensive positive powers – If the settlor retains extensive positive powers (e.g. powers to direct the trustee to e.g. amend the trust, or) that enable the settlor to control and access trust property, a court might be more likely to reach a conclusion that the settlor did not divest himself of (beneficial) ownership of the property transferred to the trustee (a trust is often referred to as being a “formal sham” in this scenario) and that the trust property should be available to the settlor’s creditors. In the *Rahman* case, the court deemed the trust to be a sham in circumstances where the settlor retained extensive powers, in particular to distribute the entire income and capital of the trust fund to anyone including himself and powers to veto the trustees selection of trust investments for the trust fund. Further, the settlor referred to the trust fund as his own property and other beneficiaries were not advised of their interests. It may be more difficult to establish reckless intent where the original trustee is a licensed trustee.

iv) Reservation of extensive powers (dispositive and/or administrative, positive and/or veto powers) – Creditors may argue that the cumulative effective of a number of reserved powers ought to lead to a conclusion that the settlor failed to transfer his beneficial interest in the assets to the trustee. That argument is generally stronger if the settlor is a beneficiary, even a discretionary beneficiary. This is essentially what the UK High Court held in respect of some New Zealand trusts in the *Pugachev* case. In this scenario, a trust is also often referred to as being a “formal sham”. Unlike New Zealand trust law, Bermuda’s trust legislation contains extensive reserved power legislation that would assist a settlor to avoid an outcome as that in the *Pugachev* case. Nevertheless, the *Pugachev* decision and a subsequent decision of the Privy Council in *Webb v Webb* [2020] UKPC 22, which, following the background of Cook Islands matrimonial property division proceedings, dealt with even more extensive settlor reservation of control in respect of some Cook Islands law trust, are a cause for concern for settlors who wish to retain extensive powers over trusts.

v) Transfers intended to defeat certain creditors' interests – If a settlor transfers assets into a Bermuda trust at an undervalue with the dominant intention of defeating “eligible creditors’” claims, then an “eligible creditor” may be able to have the transfer into the trust set aside and thereby access the trust property to discharge the debt owed to the eligible creditor. An eligible creditor would have to make the application to set aside a transfer into a trust within the statutory limitation periods– often 6 years of the transfer, but longer in some cases. These laws can operate to set aside transfers into a trust irrespective of whether the settlor is a beneficiary of the trust or retains powers. The creditor needs to show that it is an eligible creditor and prove on the balance of probabilities (i.e. more likely than not) that, when viewed objectively, the settlor had the dominant intention of defeating the creditor (or a class of persons containing the creditor) when transferring property into the trust.

vi) Substantive sham – If the settlor actually intended from the outset that the trust would be administered as though the trust assets continued to be his own irrespective of the trust’s terms and the trustee was recklessly indifferent to that intention, then a court might consider the trust to be a “substantive sham”. The informality with which a trust is administered and the fact of the trustee habitually complying with the settlor’s demands/requests may be used as evidence after the fact to help make out a substantive sham argument. It may be difficult to prove the existence of a substantive sham, but it should not be discounted as an avenue that a settlor’s creditors may pursue.

2. Moderate asset protection

i) Retention of limited veto powers – Under Bermuda law (subject to 1 (v) and (vi) above), trust property may be moderately protected from creditor attacks, where a settlor only retains the power to veto a small number of powers of a discretionary trust (particularly powers that cannot be readily exercised to enable the settlor to access trust property e.g. investment/administrative powers). A discretionary trust that, provides the trustee discretionary powers to make distributions of trust income or capital with the consent of the settlor or provides the settlor the power to appoint and/or remove trustees and veto amendments, might nevertheless be regarded as providing moderate asset protection.

As above, but powers retained are vested in an independent protector rather than the settlor – Retention of veto powers by an independent protector would ordinarily provide the trust property greater asset protection than a trust where those powers had been retained by the settlor.

3. Discretionary trust with no retention of powers

At the other end of the spectrum, it will generally be far more difficult for a settlor’s creditor to access trust property of a Bermuda trust where the:

- settlor created the trust at a time when no creditors’ claims were looming;
- trust is discretionary (i.e. the trustee has discretion regarding whether to make distributions, which beneficiaries to make distributions to, what property to distribute and when to make distributions i.e. the trust does not grant the settlor a fixed interest in the trust assets);
- settlor does not hold any powers;

- trust is properly administered by an independent licensed trustee; and
- the trustee and trust property are situated in Bermuda.

What influence might a settlor have over the administration of a trust in this scenario? A trustee is required to administer the trust in accordance with its terms, taking into account the best interests of the beneficiaries generally.

Trustees have duties to properly consider the exercise of discretionary powers, taking into account only relevant considerations. A settlor's wishes (e.g. contained in a letter of wishes or other communications with the trustee) are important considerations for trustees but not the only considerations.

Where a settlor or settlor's family have a U.S., UK or other onshore residency or citizenship, the tax laws in those jurisdiction often are also influential when considering what powers may be retained and who should hold such powers etc. in order to avoid adverse/unintended tax consequences in that jurisdiction.

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