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Six Key Steps For Trustees as Recession Looms

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Introduction

"It is only when the tide goes out that you learn who has been swimming naked". This quote – usually attributed to Warren Buffett – resurfaces when economic conditions worsen, but what does it mean? In the context of the financial system, it means that a recession can leave a struggling business exposed and with nowhere to hide. Litigation, being largely counter-cyclical, usually increases. Defendants include businesses (those that fail as a result of the tougher economic conditions and those that default on contractual and other obligations) and also the people running and owning those businesses. Counter-intuitively, divorce rates in many jurisdictions dipped slightly during the so-called Great Recession, but then increased as the global economy started to improve.

Many current economic forecasts make for grim reading: "A recession in America by 2024 looks likely" (the Economist, 2 June 2022); "Bank of England warns the UK will fall into recession this year" (BBC News, 5 August 2022); "Goldman Sees Euro-Area Recession in Second Half of This Year" (Bloomberg, 27 July 2022); "IMF slashes global growth forecast and raises inflation projections" (Financial Times, 26 July 2022).

So, as financial conditions deteriorate and inflation rises, what should trustees be doing with their structures? In this Article we list six things that trustees should consider to make sure their structures are "recession ready". This is by no means a comprehensive list of the things that trustees need to consider but trustees who work through this list may find that some of their trusts need attention.

Checking that investment direction mechanisms have been "triggered"

We are regularly asked to advise trustees on their liability where trust assets – usually a family business – are retained in a trust over many years whilst falling in value. The trustees have retained the assets, which often make up all or most of the value of the trust, in the mistaken belief that they were required to do so. However, upon closer analysis (which usually takes place after the fall in value, not before!), it emerges that whilst the trust includes an "investment direction" mechanism, that mechanism has not been triggered and no direction has been received.

It is a worthwhile pre-recession planning exercise for trustees of trusts containing investment direction mechanisms to ensure that they have in place valid and appropriate investment directions which cover all relevant assets. It is especially valuable to perform this check before the assets in question fall in value.

Make Trusts irrevocable

Many settlors establish revocable trusts. This allows them to get back the trust assets at any time and provides the comfort of knowing that they are always – ultimately – in control. However, revocable trusts offer little or no asset protection to the settlor, and for good reason. If a settlor can take back the assets of the trust at the push of a button, or the stroke of a pen, why should those assets be protected from the settlor's creditors? Whilst the mechanism for allowing creditors of the settlor to gain access to the assets of a revocable trust differ between jurisdictions, the end result is usually the same and those creditors will be able to use trust assets to meet claims brought against the settlor.

In many cases, trusts start their lives as revocable whilst the settlor gets used to the concept of a trust and builds a relationship with the trustee. The

intention is that the settlor will later release the power of revocation and the trust will become irrevocable. The planned release often does not happen.

With the threat of recession looming, now is a good time to have the conversation with settlors. Releasing powers of revocation before there are creditors with claims against the settlor typically provides much greater protection to trust assets than releasing those powers after such claims have arisen, or look likely to arise.

Release other powers

It is not only powers of revocation that should be reviewed and possibly released as part of pre-recession planning. Case law from multiple jurisdictions over the last 10 years or more makes it clear that the holding of certain combinations of other powers can also leave trusts vulnerable to attack by creditors of the settlor. For example, a settlor with a power to remove and replace a trustee and a power to add and remove beneficiaries, might be treated as retaining the ownership of the underlying trust assets.

Whilst the case law on these points is far from settled, an early release of potentially problematic powers – where they are no longer considered essential by the settlor – can avoid the need for long and complicated legal arguments later.

Helping settlors to retain the right level of control

Not all settlors will respond well to a discussion about removing their control by releasing their retained powers over a trust. In many cases, a wider discussion about the appropriate level of, and mechanism for, retained control might be more appropriate. This might include discussions around moving some settlor reserved powers into the hands of a third party protector, or discussions around whether the settlor would benefit from using a Private Trust Company (PTC) as a trustee so that he/she could be on the board of that PTC, along with a professional co-directors. Properly established, PTC structures can be an effective mechanism for allowing settlors to remain involved in decision making whilst protecting trusts from attack by creditors of the settlor.

Dividing Structures to separate out business and non-business assets

It is not uncommon for settlors to establish a trust and, as the years pass, for the trust to become the owner of both business and personal assets. Often there are asset protection benefits arising from a separation of the business assets and the personal assets. By holding these classes of asset in separate structures or, at least, separate companies within the same structure, the risk of the personal assets being used to meet liabilities of a failed or failing business is further reduced.

In-laws as Beneficiaries

Whilst divorces seem to dip during recessions, that is countered by a spike as recessions end. The biggest threat to many trusts comes when a beneficiary is going through a divorce. This problem can be magnified where the in-laws are themselves members of the class of beneficiaries of a trust as they will have – in most cases – rights to information about a trust and its assets.

When divorce proceedings are issued, trustees have to be careful in their response and simply removing the divorcing “in law”, as an automatic response, can lead to claims that the trustee acted inappropriately.

Reviewing the beneficial class of trusts, before recessions begin and before divorce proceedings are issued, can allow appropriate changes to be made at a time when those decisions will be less contentious.

Conclusion

Recessions are an inevitable part of the economic cycle and trustees need to be alive to the risks that they bring to structures. By spending a few hours reviewing structures in advance of a recession, trustees can reduce the risk that the next time the tide goes out, they are the ones who are found to be swimming naked.

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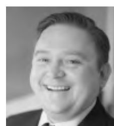

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