

ONE STRIKE AND YOU ARE OUT: THE VALIDITY OF NO-CONTEST CLAUSES

Shân Warnock-Smith QC

and

Morven McMillan of Charles Russell LLP

We are all familiar with the inclusion of forfeiture or no-contest clauses in wills but it has also become increasingly common to see no-contest clauses in offshore inter vivos trusts, designed to prevent or discourage beneficiaries from litigating over their validity. It was only a matter of time before the validity of such a provision was tested in litigation as it was in ***AN –v- Barclays Private Bank & Trust (Cayman) Limited and others***¹, which was heard by the Chief Justice of the Grand Court of the Cayman Islands in June last year.

Background

As revealed by the reported decision (other facts and issues remain confidential) the background facts were briefly as follows. They relate to two settlements. The claimant is primary discretionary object of one third of the trust fund and the sole beneficiary of that share if she survives until the end of the trust period, 2039 or later. Her siblings have similar interests in the other two thirds of both trust funds. The principal assets of both settlements were shares in an extremely valuable unlisted company (“the Company”) held by the trustee through various holding companies. Each has the same trustee and protection committee.

The Company was for many years owned privately and exclusively by members of the family. The claimant and her siblings retained personal minority shareholdings of about 16% each and the trustee held about 27%. Between them they held a substantial stake and could control the Company if united. The claimant levelled various allegations at the trustee and protectors following the restructuring and public listing of a wholly owned subsidiary of the Company. She attacked decisions and actions of the trustee and protectors on the basis of an alleged failure to balance the interests of the beneficiaries fairly. She complained that they acted in a manner which was prejudicial to her personal interests by allying the trusts’ shareholdings with those of her siblings in a manner dictated, she alleged, by their “hostility” towards her. (She herself had not committed to a particular course of action.) In 2005 she served proceedings on the trustee and protection committee seeking, amongst other things, their removal and a declaration that the identical no-contest clauses in each of the trust deeds were invalid. She obtained ex parte injunctive relief to prevent the trustee acting in support of the planned IPO of the Company’s subsidiary although this was subsequently discharged. Needless to say, the trustee and

¹ [2007] WTLR 565

protectors strongly refute the claimant's allegations and assert that they acted honestly and prudently in supporting the Company's subsidiary through to its highly successful listing, so enhancing the value of the trust funds substantially.

The trustee was not unreasonably concerned that the clause, clause 23 in each of the settlements, may have operated immediately upon the claimant issuing her claim and obtaining injunctive relief, to exclude the claimant as a beneficiary. Consequently, the Court ordered that the validity of clause 23 be tried as a preliminary issue to determine whether the clause could be disregarded in whole or part, or if held to be valid, whether the Court had jurisdiction to grant relief from forfeiture.

The trustee took a neutral position on this particular issue. It was emphasized on behalf of the trustee that the trustee neither contended for, nor welcomed, the actual or possible exclusion of the claimant. There was no doubt that whatever difficult relationships existed among the family members would only be exacerbated by the exclusion of the claimant from benefit from the family trusts. Counsel on behalf of the claimant's siblings, the second and third defendants, took a similarly conciliatory approach but was prepared to argue for the validity of the position.

Clause 23 read as follows:

"Exclusion from benefit

Whosoever contest the validity of this deed and the Trust created under it of the provisions of any conveyance of property by any person or persons to the Trustee to form and be held as part of the Trust Fund, and of the decisions of the Trustee and/or of the Protection Committee shall cease to be a Beneficiary of any of these Trusts and shall be excluded from any benefits direct or indirect deriving from the Trust Fund."

Thus there are three "limbs" to the clause; contests to the validity of:

- 1 the settlement;
- 2 transfers of property to the trustee to be held on the trusts of the settlement; and
- 3 decisions of the trustee and/or protectors.

It was this last limb, limb 3, which went further than many such provisions and which gave rise to the principal difficulties in this case. The Chief Justice acknowledged a settlor's concern to prevent a challenge on the grounds of validity (limbs 1 and 2) having established the structure for legitimate reasons. He went on to say, *"the draconian consequences of mounting such a challenge are also more readily understood – a beneficiary could hardly expect to be allowed at once to challenge the essential validity of the trust or its property and yet be able to claim benefits*

under it.” However, the claimant was not challenging the validity of the trust, nor was she challenging the validity of transfers of property into the trust, so her claims did not fall into limbs 1 or 2. She was seeking to challenge the validity of the trustee’s decisions. While the wills cases had certainly dealt with contests to the validity of the will or gifts vested by it (generally holding them to be valid), none of them had been concerned with challenges to the validity of the will trustee’s decisions. There was no inter vivos trust case which covered the same ground but the textbook view has been that there was no reason to suppose that the position was different.

The Chief Justice identified what he described as the “*conundrum*” at the heart of the question before him. While the clause had clearly been designed to meet the settlor’s concern to protect the trust from attack, it had to be construed in the light of a trustee’s irreducible core duties to its beneficiaries² and a beneficiary’s right to enforce the trusts of the settlement.

Counsel on behalf of the claimant argued that there was a clear contradiction between the two. How can a beneficiary enforce the trusts of a settlement while at the same time, not be able to challenge the validity of decisions of the trustee or protectors? This argument was developed on the three principal grounds on which a forfeiture clause can be set aside:

- uncertainty;
- repugnancy; and
- that clause 23 was void on the grounds of public policy as seeking to oust the jurisdiction of the court.

Each of these areas of argument was developed in turn by analogy with the established common law principles applicable to wills.

Uncertainty

Generally speaking, a forfeiture clause must be strictly construed. It was argued before the Chief Justice that a beneficiary (or the court if called upon to do so) must be able to identify from the terms of the clause exactly what conduct or event will result in forfeiture, the proposition supported, it was said, by the test set out in *Clavering –v- Ellison*³ as applied to the divesting of vested proprietary rights.

The Chief Justice favoured the *Clavering* test, while accepting that he was not dealing with vested proprietary rights in this case, but with a wholly discretionary settlement and as it was put in

² Armitage –v- Nurse [1998] Ch 241

³ (1859) 7 HL Cas 707

argument, *“the exclusion of a discretionary object from the consideration of the Trustee from benefit.”* The Chief Justice found that:

“... these are hugely valuable beneficial interests which also have ascribed to them a bundle of other rights intended to enable their enforcement. They may not be capriciously or unreasonably defeated by the exercise or operation of any power of exclusion under the trusts. There is no compelling reason why any less strict an approach should be taken to the construction of the exclusionary provisions of clause 23, than would be taken to the scrutiny of any other power which may operate or be exercised so as to defeat an existing entitlement to be considered for benefit.”

In this context and for a number of reasons, the Chief Justice concluded that limb 3, construed literally, was too uncertain to be enforced, in view of the difficulty in pinning down the *“defined line of conduct”*⁴ or *“a condition ... such that the Court can see from the beginning, precisely and distinctly upon the happening of what event it was”*⁵ that the interest was to determine. The Judge agreed with Counsel for the claimant that one could not identify what would be meant by *“validity”* when applied to a *“decision”* of the trustee in the context of such complex trust arrangements. A challenging beneficiary, not knowing or being entitled to know the reasons for the exercise of a trustee’s discretion, is most likely to challenge the actions that follow a decision. A challenge to the decision might be implied but it is the challenge to the actions that follow that is readily identifiable.

The Chief Justice also questioned whether it would have been the settlor’s intention for *any* challenge to any decision of the trustee to result in automatic forfeiture and to the extent that the wording of the clause did not provide him with an answer to that question, it was uncertain. When the Chief Justice looked to a contest to the validity of decisions of the protection committee, he found the clause even further wanting in certainty, given the largely advisory nature of the role that the protection committee had in the context of these settlements. He therefore concluded that construed literally limb 3 was too uncertain to be enforced. That was not, however, the end of the matter.

Repugnancy & public policy

It would clearly be most unsatisfactory if clause 23 operated to prevent a beneficiary from properly enforcing the trusts of the settlement: that would be repugnant to the essential requirements of a trust and contrary to public policy.

⁴ Lord Campbell in *Clavering –v- Ellison* (1859) 7 HL Cas 707, at page 288

⁵ Lord Cranworth in *Clavering*, at page 289

The Chief Justice examined the established principles in great detail in his judgment. There was no reason in his view to distinguish for that purpose between a will and an *inter vivos* settlement. There were two cases which played a particularly important part in his analysis, *Evanturel –v- Evanturel*⁶ and *Adams –v- Adams*⁷.

Evanturel developed the principle established in the earlier case of *Cooke –v- Turner*⁸. In *Cooke* the Court of Appeal held that a testator should be free to make “*just what contracts and what arrangements they think expedient as to the raising of questions of law or fact among one another.*” The Privy Council in *Evanturel* built upon this principle. It decided that no-contest clauses should not operate against beneficiaries who brought a *successful* challenge, it following that if there was, for example, a plain defect in execution or the incapacity of the testator was undeniable, the beneficiary could quite properly have the will set aside, along with the forfeiture clause. On the other hand, why should a testator not be at liberty to protect his estate and his right to dispose of it as he sees fit, against unsuccessful attempts to litigate against it?

The Chief Justice accepted the *Evanturel* principle as sound but he did not believe it went far enough to assist him in the conundrum that faced him. Limb 3 did not go to the validity of the settlement; it went to the validity of decisions of the trustee or protectors. Further, the merits of the claimant’s challenge had not yet been decided but the claimant may have already been excluded from benefit.

At this point, we turn to consider the case of *Adams*. In that case, a forfeiture clause sought to prohibit beneficiaries from intermeddling in the management of the estate. The Court of Appeal upheld the clause because it found that the challenge to the management of the estate on the grounds of misappropriation and fraud was “*frivolous and vexatious*”. It found that the challenge had been, not an attempt to enforce rights against the trustee, but to get a receiver appointed and deprive the defendants of their right to manage the estate. It was clearly not, in their Lordships’ view, a bona fide claim.

As the Chief Justice described it, using various phrases from the case, “*note ... the range of the dicta used to describe the qualification upon the draconian effect of the proviso ... that there be a ‘reason to complain’, that the contest ‘not be merely frivolous or vexatious’ but ‘bona fide’, based on ‘probabilis causa’ or ‘an excuse for litigation’.*”

⁶ (1874) LR 6 PC 1

⁷ [1892] 1 Ch 389

⁸ (1846) 15 M&W 727

The Chief Justice did find that clause 23, construed literally and taken on its own, would be void for uncertainty and repugnancy and for being contrary to public policy, as on its face it would operate to deprive a beneficiary from its right to enforce the trusts and thus would oust the court's jurisdiction to supervise the administration of trusts. However, it was an essential part of the Chief Justice's thinking on this point that clause 23 had to be read in the context of the settlements as a whole and not in isolation. Clause 11 of the settlements for example provided not only that the powers vested in the trustee should at all times be exercised by the trustee in order to fulfil the trusts of the settlements but also that the trusts should be enforceable by the beneficiaries. Clause 19 stated that none of the provisions of the deed should be construed as permitting the trustee to act contrary to the laws of the Cayman Islands. The Chief Justice concluded therefore that clause 23 construed in that context was not void for repugnancy or contrary to public policy, finding that:

"... clause 23 is not to be construed as intended to operate contrary to the established principles. Viewed in this way, and making the best I can of the import of the decided cases, clause 23 must be read by implication as allowing not only such contests which are successful, but also contests which are justifiable in the sense of being taken bona fide, not frivolously or vexatiously and with probabilis causa litigandi."

Accordingly, the Chief Justice found that each case merited a careful examination of the facts to ascertain whether there had been a challenge such that would fall within the terms of the no-contest clause. Success would not be the defining factor but whether the claim was "justifiable". The Chief Justice acknowledged that the claimant would perhaps not find what he termed his "*process of implication*" satisfactory and indeed it was submitted on behalf of the claimant that the words "frivolously and vexatiously" were the only possible acceptable qualification to the words in limb 3. The Chief Justice did not accept this, finding the concept of justification an attractive means by which the operation of forfeiture could be avoided.

Nor would it matter that the settlement contained internal machinery for the control of a defaulting trustee. The settlements contained provision for a beneficiary committee that could, with the written consent of the trustee, vote to remove a member of the protection committee. The protection committee in turn had the power to appoint and remove trustees. While these checks and balances within the trust structure might give comfort to a disgruntled beneficiary, the Chief Justice held that they would not justify preventing the beneficiary from access to the court.

Lastly, the Chief Justice found that there was jurisdiction to grant the claimant relief from forfeiture but made it clear that this was the only finding he had to make on this question at this point. The

question of whether the jurisdiction ought to be exercised in the claimant's favour was a question for another day.

Conclusion

There is no doubt that the claimant in the AN case has been left in an uncomfortable position. It may be that she has already been excluded as a beneficiary; it may be that she will be so excluded if she pursues her action or it may be that the trial judge will eventually find that her complaint was "justifiable" whether or not she loses at trial. The Chief Justice did say in his judgment that claimants who go into litigation in the face of a no-contest clause do so with "their eyes wide open" but the risk which is inherent in bringing any claim to court is particularly intense when one is faced with the possibility that in doing so, one may have already forfeited an interest in a substantial trust fund. Such claimants will need, more than ever, to obtain robust advice in support of the merits of their claim before issuing it and that advice will need to be kept under constant review through every twist and turn in the litigation. In short, the claimant in the AN case will need to wait for some time longer to find out whether she has had her "one strike" and is "out".

[This article is based upon a presentation given by Shân Warnock-Smith QC and Morven McMillan at the Association of Contentious Trusts and Probate Practitioners at their lunchtime seminar in London on 11 June 2007 and subsequently appeared in the ACTAPS newsletter and in Private Client Business, issue 1 of 2008.]