

“ Plain speaking legal advice ”

## Protective Trusts

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**Protective trusts (or spendthrift trusts, as they are sometimes known) are a hybrid category of trust, sharing the characteristics of a life interest trust and a discretionary trust.**

Traditionally, in centuries gone by, one of the reasons why trusts were established was to protect beneficiaries from their own extravagance. For instance, assume S was a wealthy individual. He may be reluctant to make an absolute gift of all of the “family wealth” to his son, A, who is known for his financial indiscretions. S’s reluctance stems from the fact that, if A were to become bankrupt, all his property (with few exceptions) automatically passes to his trustee in bankruptcy. The trustee in bankruptcy is then charged with the task of collecting all A’s property from all sources and sharing it equally (*pari passu*) between A’s creditors. However, instead of simply gifting the “family wealth” to A (during S’s lifetime or by Will), S could create a trust in favour of A for life. In these circumstances, as A only has a life interest, the capital (i.e. the family’s wealth) has been protected. All that can pass to the trustee in bankruptcy, in the event of A’s bankruptcy, is A’s share of the trust fund, namely, the income.

The next stage in the development of protection of family wealth was to try and protect the income, not just the capital of the trust in the event of a beneficiary’s bankruptcy. The solution was a protective trust.

A protective trust usually involves the creation of a life interest in favour of A, remainder to B. The interest is, however, determinable (and therefore comes to an early end) upon a certain event occurring: usually A’s bankruptcy or attempted alienation (such as sale, transfer, mortgage or gift). After determination of the life interest, the trust income is held on discretionary trusts for a class of persons which may include A, A’s spouse, his children and grandchildren. Upon A’s death the remainderman (or default trust) will take the capital.

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The protective trust developed in the nineteenth century as an express private trust for settlors (this is the legal expression to describe someone who create a Trust, he “settles” the property on the Trustees to hold of the Trusts that are contained in the Trust document), who were concerned to protect the interests of a spendthrift son or daughter, or protect those beneficiaries who were engaged in speculative or risky business. Family members in these categories were often given a protective life interest. Accordingly, in the event of the beneficiary becoming insolvent and being declared bankrupt, instead of the future income of the trust being “attached” by his trustee in bankruptcy (and being used to pay off creditors), the life interest determines, and is replaced by, new trusts. The new trusts were often expressed to be discretionary trusts, that is, the trustees were directed to pay the trust income to such members of A’s family as they, in their discretion, thought fit.

**Since 1925, a statutory form of protective trust has been recognised. There are two parts to these statutory provisions.**

- (a) The trust fund is held on behalf of the principal beneficiary for life “or until he...does or attempts to do or suffers any act or thing...by which...he would be deprived of his right to receive the income or any part of it”.
- (b) On the happening of such an event, the protective life interest ends, and until his death the income is “held upon trust...for the maintenance support or otherwise for the benefit of any one or more of the following persons: namely the principal beneficiary, his or her spouse if any, his or her children or more remote issue, if any...”

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There are two events which will cause A to forfeit his life interest

- His bankruptcy, or
- His attempted alienation of the life interest

Bankruptcy is self-explanatory. As soon as an order is made by a court, declaring that A has been made bankrupt, his life interest will determine and be replaced by a new discretionary trust in favour of A and his family.

Alienation is not an easy concept to understand. Why would A try to sell or mortgage his life interest if he knows full well that it will cause the interest to determine? In short, he will not; but he may involuntarily alienate his interest. This would occur if, for instance, a creditor obtains a court judgment against A for a sum of money, and then seeks to enforce payment of that judgment by “attaching” A’s interest under the trust.

Although protective trusts were popular in years gone by, settlors now seem to prefer the greater flexibility achieved by the creation of a discretionary trust. You will recall that the beneficiary of a discretionary trust does not obtain any beneficial interest in the trust property whatsoever. There is, therefore, nothing that a beneficiary’s trustee in bankruptcy or a judgement creditor can “attach”. All the beneficiary has is a mere hope that the trustees will exercise their discretion and make a distribution in his favour. Clearly the trustees will not do so when the beneficiary is an undischarged bankrupt or where the beneficiary has unpaid judgment creditors, (unless, of course, such distribution were to be made in order to discharge the bankrupt or to enable him to pay the judgment creditor).

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Finally, it should be noted that the creation of a trust, whereby the settlor settles property upon himself on a protective life interest, determinable upon his own bankruptcy etc., is void.

Such a trust is contrary to public policy, as it would help the settlor cheat his lawful creditors and frustrate the operation of his bankruptcy. A protective trust is lawful only if the settlor creates the trust in favour of another.

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