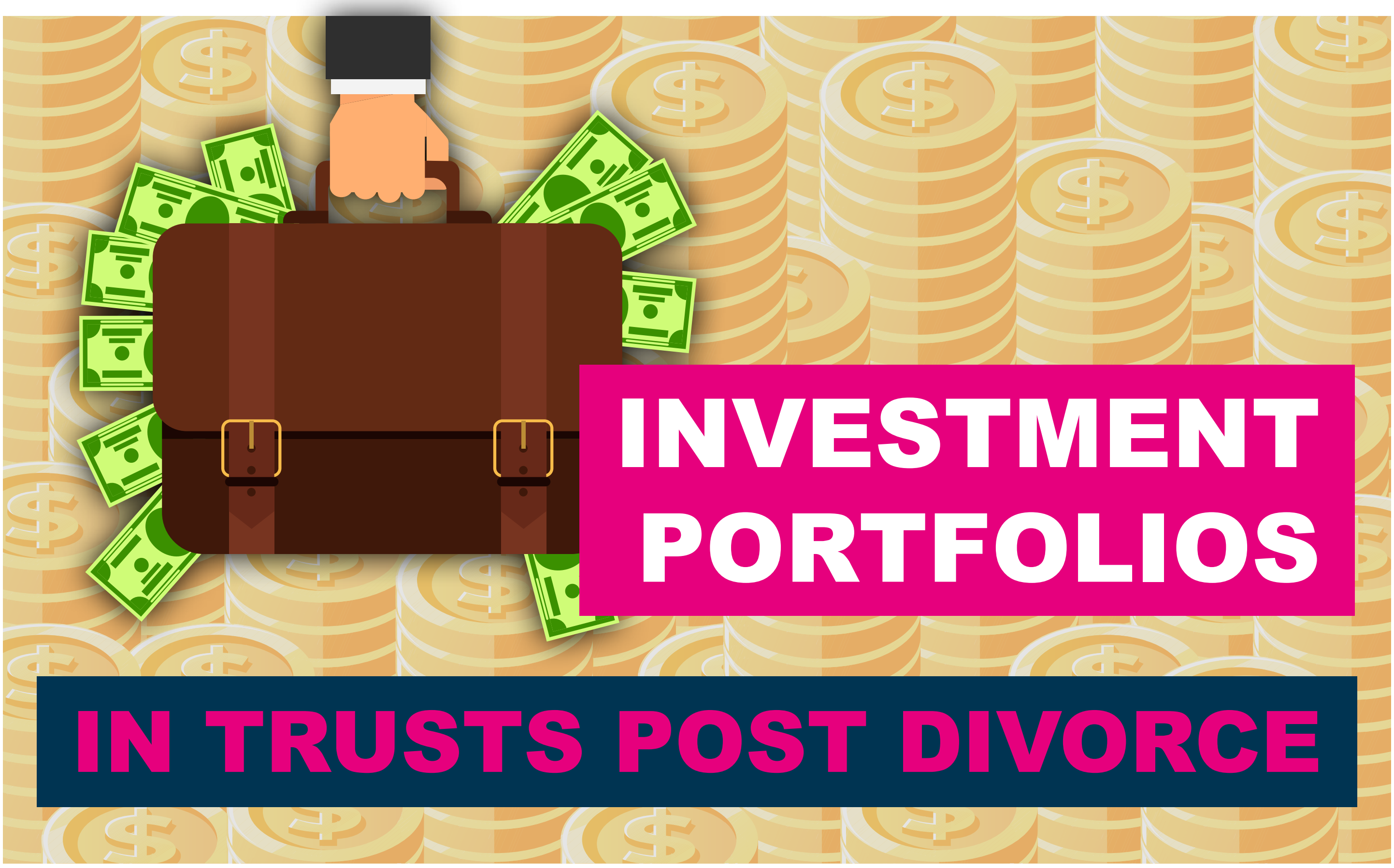

INVESTMENT PORTFOLIOS IN TRUSTS POST DIVORCE

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From lawyers advising on asset protection trusts to jurisdictions imposing firewalls against foreign judgements, there is still a school of thought that assets in trust might be ring fenced in the event of a divorce settlement.

This may sometimes hold true, but more often than not the parties will agree that assets held in a trust should form part of the calculations of family wealth. And even if a judgement is not made against the trust assets per se, the trustees may be requested to make changes to the way in which they manage trust assets in order to allow a beneficiary to meet their obligations under a divorce settlement. Where the trust assets comprise investment portfolios, this can lead to a variety of problems.

The most straightforward position for the trustee is where a payment away is requested. Typically this is where both divorcing spouses are beneficiaries of the trust, perhaps with one being added as a result of the divorce settlement, and the trustees are requested to pay away the investments to one of the beneficiaries. This does not differ from any other request for a distribution and the trustees will follow the same process. The investment question for the trustee is whether to transfer out the investments in specie or to liquidate the portfolio and pay away the proceeds. A number of factors might influence this decision.

The trustees might first seek advice on whether the tax impact on the trust and the beneficiary would be more or less onerous in either scenario. Assuming the tax position is neutral, there are then investment and practical concerns. A liquidation of the portfolio might crystalise losses where individual investments are sitting at valuations below their original purchase price. An instruction to liquidate the portfolio would override the managers own decisions on what to do about these investments. There is also a timing issue as some of the investments might not be liquid and could require notice periods or a delay until the next dealing day. This could upset the overall financial arrangements of the divorce and create additional costs and expenses.

A transfer in specie would not remove all of these issues but would put control of the process into the hands of the beneficiary which might be preferable.

A second scenario we have seen is where the trustees are asked to manage the assets to benefit one of the beneficiaries, typically the spouse on the receiving end of the settlement. How the trustees deal with this request may depend on the current arrangements for the portfolio. Assuming it is in a discretionary portfolio with an investment manager, the first thing for the trustees to do will be to conduct a new risk assessment and suitability review for the beneficiary to establish whether the existing policy will work for them and meet their requirements. If, for example, the portfolio is being managed for long term capital growth but the new beneficiary requires a regular income, then the mandate for the manager may need to change. It is also possible that the beneficiary will be unhappy with the incumbent manager, perhaps because of an association with the other spouse, and will ask the trustees to make a change. Such a request can pose problems of both principle and practicality for the trustee. If the existing manager has been doing a good job then the trustees might struggle to justify a change which will almost certainly result in additional fees and a negative impact on investment performance.

If the trustees are happy to accommodate the request for a change of manager, then they will be faced with the practical difficulties of finding a new manager and then organising the transfer between the managers. The decision for the trustees might be made easier if the existing manager would not be an ideal choice for the new set of objectives. A top performing manager for capital growth might not be the number one choice for a portfolio designed to produce income. If this is not the case, and the trustees would be happy to stay with the existing manager, then it might be sensible to persuade the beneficiary of the benefits of leaving the manager in place, at least until their track record under the new mandate can be established.

The final scenario to consider is where the trustees are asked to separate the portfolio into two, with one pot notionally or explicitly designated for each spouse. This is the most complex situation for the trustees and brings together the problems of the previous two scenarios and adds a few more for good luck.

Questions around in-specie versus liquidation, suitability and choice of manager will all need to be answered. The added difficulty is that the same answer might not work for each spouse.

If the trustees are lucky, both spouses will be happy to continue with the existing manager following the existing mandate. This would allow the manager to simply divide each holding and segregate into two accounts. There may be practical problems relating to minimum holdings or other conditions specific to individual investments but with the same manager in place these might be easier to overcome. It may even be that the manager can continue with a single portfolio with the notional

split happening at trust level. Sadly, post a divorce this level of harmony and cooperation is rare so it is more likely that the trustees will be asked to make greater changes. The same manager might stay in place but with different investment objectives for each new portfolio. Or one or other spouse might ask the trustees to find a new manager. As discussed previously, the issue is getting from one arrangement to the other at the least cost in fees and damage to investment performance.

The investment issues identified in this article can all occur outside of a divorce situation but the added personal issues which a divorce brings can make the decisions seem more difficult and the pressures on the trustees can be more intense.

The key for the trustees is to ensure that they do not lose focus on the investment portfolios while sorting out the requested arrangements.

All of the regular disciplines around performance monitoring must be maintained. It is ultimately not in the interests of either spouse, or the trustee, to see the portfolio diminish in value as a direct result of a badly handled transition.