MENTAL CAPACITY ISSUES - WHAT TRUSTEES NEED TO KNOW

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Mental capacity is a complex issue and often difficult for trustees to navigate – most of us are not qualified to assess an individual's mental health and raising concerns in respect of an individual's mental health is a delicate and emotive matter.

But the risks of not spotting when a settlor or power-holder (e.g. a settlor who has reserved powers under the terms of the trust, or a protector) does not have capacity are significant – the trust may be invalid, the individual's appointment as the power-holder may automatically terminate, any exercise of their powers may be open to challenge and the trustee's own actions (or inactions) may be criticised.

What does 'mental capacity' mean?

Generally speaking, having mental capacity means being able to make one's own decisions, which requires a level of understanding of the information on which a decision is based. Mental capacity may be affected by a number of factors such as mental or physical illness, age or drugs and alcohol abuse.

The applicable legal test to determine mental capacity varies between different jurisdictions and may also differ depending on whether an individual is setting up a trust or exercising a power under the terms of a trust.

Under English law, the common law test set out in Banks v Goodfellow is applied when a trust is set up – in order to set up a trust, the settlor must understand:

(i) the nature of their act and its effects;

(ii) the extent of the property of which they are disposing; and

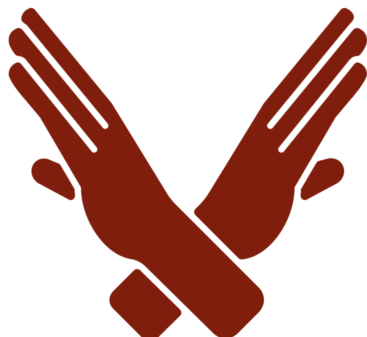
(iii) the claims to which they may give effect.

However, when assessing the capacity of a power-holder after the trust has been created, the test under the Mental Capacity Act 2005 (the MCA) is usually applied. Under section 2 of the MCA, “a person lacks capacity in relation to a matter if at the material time he is unable to make a decision for himself in relation to the matter because of an impairment of, or a disturbance in the functioning of, the mind or brain”. A similar capacity test applies under Guernsey and Jersey law[1].

Other jurisdictions have applied the Banks v Goodfellow test to the question of whether an individual had the mental capacity to exercise certain powers. For example, the Court in the Cayman Islands applied this test last year in Re Poulton Trust[2] where the settlor exercised his powers to remove his children as beneficiaries and to terminate the trust in his own favour. In that case, the settlor was terminally ill, and the children had concerns about whether he was capable of making such important decisions at a time when he was dependent on prescription medications and suffering from chemotherapy side-effects.

Impact of mental capacity issues on trusts

Trust creation



In most jurisdictions, if a settlor is found not to have had capacity when creating the trust, the trust will not be valid. For example, under Guernsey law, a Guernsey trust is invalid and unenforceable to the extent that the Royal Court of Guernsey declares that the settlor was, at the time of the creation of the trust, incapable of creating the trust .

The consequences of the trust not being valid are likely to be significant. If the trust is not valid, it is as though it never existed. The property is likely to revert to the settlor – under Guernsey law the property would be held by the trustees on bare trust for the settlor (or, if they are dead, their personal representatives), unless the Royal Court orders otherwise.

This is likely to impact any succession, estate and tax planning behind setting up the trust – for example, the settlor and their advisers, believing a particular asset had been put into a trust, may not have made any specific provision for that asset in the settlor’s will so the asset may pass under intestacy rules if the settlor dies.

Validity of acts of power-holders

Where a power-holder exercises a power (e.g. to remove a beneficiary) at a time when they lack mental-capacity, there is a risk that the exercise of their power (the removal) could be set aside.

This is one of the issues the Cayman Court had to consider in Re Poulton Trust ¬ - whether the removal of the beneficiaries and the termination of the trust should be set aside. In that case those actions were not set aside on the basis of mental capacity as the Court found that, despite the settlor’s ill health and temporary cognitive impairments, his mental capacity was sufficient to take the steps he did (i.e. he understood what he was doing).

Termination of appointment

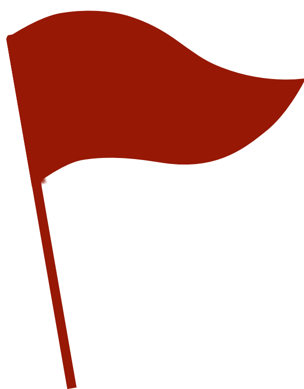
Trust instruments often provide for the appointment of a power-holder to terminate when they become incapacitated and for their powers to pass to a successor if they lose capacity. Such a provision often requires an assessment by a medical professional to determine that the individual has lost capacity.

However, issues can arise when the trustee or another interested party has concerns that a power-holder has lost capacity, or may be likely to lose capacity – that person’s appointment will not necessarily have terminated yet under the terms of the trust (because the formal assessment triggers the termination).

In those circumstances, the trustee could attempt to expedite the assessment process required by the terms of the trust. Alternatively, it may be possible under the terms of the trust to remove the power-holder from their position. Or there may be applicable statutory provisions which dictate what the trustees should do – for example, under Guernsey law, where the trustee of a non-charitable purpose trust has reason to believe that the enforcer is incapable of acting, the trustee must apply to the Royal Court for the removal of the enforcer and the appointment of a replacement[3].

1 Section 4 of the Capacity (Bailiwick of Guernsey) Law, 2020 (as amended) and section 4 of the Capacity and Self-Determination (Jersey) Law, 2016 respectively.
2 In the matter of the Poulton Trust FSD 121 of 2016.
3 Section 12(9) of the Guernsey Trusts Law.

Red flags

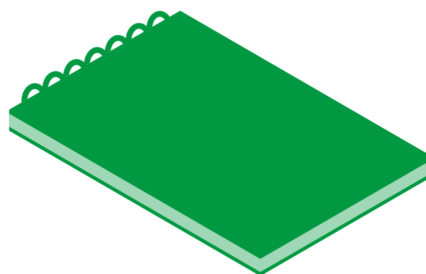


But how would a trustee know when an individual may be lacking mental capacity to make certain decisions? We are not medical professionals and will not always have face-to-face contact with the individual at the point a decision is being made, particularly when dealing with international clients , or where we usually deal with their other professional advisers or family office representatives.

There are a few red flags to watch out for, and one or more of these red flags can be seen in most cases involving mental capacity issues:

- **A settlor has a sudden change of heart and makes a decision, or attempts to take an action, that is at odds with the trustee's understanding of their wishes, as set out in their letter of wishes or as otherwise conveyed to the trustee or family members.**
- **The trustee becomes aware that a power-holder has an illness which it suspects could affect their mental capacity, e.g. Alzheimer's, or for which the power-holder is taking strong medication that could affect their capacity, e.g. strong painkillers.**
- **The trustee does not have any direct contact with the settlor or power-holder, and there are concerns that another individual is attempting to make their decisions for them (this could also be a red flag for undue duress).**
- **The settlor or power-holder is elderly or otherwise vulnerable, particularly where beneficiaries may be unhappy with their actions (e.g. because they are being removed).**

What can a trustee do if they suspect mental capacity issues?



Trustees are under a duty to act in the interests of the beneficiaries which will include ensuring powers are properly exercised (so that the trust is properly administered) and avoiding the financial and emotional consequences of litigation that could result if a settlor or power-holder's mental health is challenged.

Trustees should therefore remain alive to potential red flags and take proactive steps to reduce the risks including:

- Keeping detailed file notes of meetings with the settlor and their professional advisers, including a note of the trustee's own observations.
- Maintaining some direct contact with the settlor or power-holder, e.g. periodic in-person meetings, or telephone or video calls.
- Obtaining medical reports where appropriate.

Finally, given the complexities and the significant consequences of not managing mental capacity issues properly, trustees should always take appropriate legal advice as soon as they have any concerns about a settlor or power-holder's mental capacity.