

# United States Trust Law and the Hague Convention on Trusts<sup>1</sup>

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Practitioners who develop estate plans for individuals and families with international holdings quickly learn, often to their chagrin, that many countries in the world, including some of the wealthiest and most economically important, do not have the institution of the trust and do not understand trusts. The purpose of the Hague Convention on the Law Applicable to Trusts and on Their Recognition is to gain the consent of countries that do not have trusts to recognize trusts validly established in countries that have trusts and to permit these trusts to function on an international basis with all the legal rights and privileges of trusts. The United States was a vital participant in the international conference that led to the drafting and approval of the Convention by the Hague Conference on Private International Law and is a signatory to the Convention.

Unfortunately, the United States has not ratified the Convention, which means that the United States is not yet officially a party to the Convention. While most of the major common law jurisdictions have become parties, only the Netherlands and Italy, among the civil law countries that do not ordinarily recognize trusts, have ratified the Convention. In the opinion of many, the failure of the United States to ratify the Convention has become a major disincentive to other important civil law countries that do not ordinarily recognize trusts, such as France, Germany, Japan, and Switzerland to become parties to the Convention.

In 1998, at the behest of the office of the Assistant Legal Advisor to the Secretary of State for Private International Law, the Committee on International Estate Planning of the Trusts and Estates Section of the New York State Bar Association, with the approval of the Executive Committee of the Trusts and Estates Section, became actively involved in efforts to promote U.S. ratification of the Convention. In canvassing support from the other major estate planning organizations in the United States, certain questions were raised about the effect the Convention would have on U.S. law concerning transfers of property to trusts, existing U.S. conflicts-of-law rules related to trusts, and the jurisdiction of U.S. courts over trusts. This article addresses each of these issues. The article concludes that (1) the Convention would not cause foreign law to apply to transfers of U.S. real property to trusts, (2) application of the Convention's choice-of-law rules will have no effect on domestic trusts and should not, as a practical matter, significantly change

the way U.S. courts currently apply choice-of-law rules to foreign trusts, and (3) the Convention will not enlarge the jurisdiction of U.S. federal courts over domestic and foreign trusts.

## 1. The Convention Will Not Cause Foreign Law to Apply to the Disposition of U.S. Real Property

The purpose of the Convention is to enable trusts to operate as legal persons in jurisdictions where they previously have not been accorded legal status and to eliminate the possibility that a trustee of a valid trust could be considered to be acting in the trustee's individual capacity. For a trust to operate as a legal person means, among other matters, recognition of the capacity of the trustee to hold real property validly transferred to the trust in the name of the trust, without danger that the property would be considered property of the trustee in the trustee's individual capacity. Every jurisdiction within the United States (including Louisiana) recognizes the institution of the trust and the right of trusts to own real property without having the property rights of the trustee *qua* trustee confused with the property rights of the person acting as trustee. The Convention simply confirms this fundamental principle of trust law and provides a mechanism whereby this salutary principle may be recognized in countries where this principle, up to now, has not been generally recognized.

Article 8 requires state parties to apply the governing law of the trust only in matters affecting the internal order of the trust, such as the appointment, removal and resignation of a trustee, the rights and duties of trustees among themselves, the rights of trustees to delegate their authority, the power of trustees to dispose of and acquire assets, the power of investment, restrictions on the duration of a trust, the liability of the trustees to the beneficiaries, the distribution of trust assets and the duty to account. Article 11 lays down the primary rule of the Convention that a trust eligible for recognition under the provisions of the Convention is to be treated as a trust, and therefore, "at a minimum, that the trust property constitutes a separate fund, that the trustee may sue and be sued in his capacity as trustee, and that he may appear or act in this capacity before a notary or any person acting in an official capacity." This means (1) that personal creditors of the trustees have no recourse against trust assets, (2) that the trust assets shall not form part of a trustee's estate in insolvency

or bankruptcy, (3) that the trust assets will not form part of the matrimonial property of a trustee or a trustee's spouse nor part of the trustee's estate at death, and (4) that trust assets may be recovered when the trustee, in breach of trust, has mingled trust assets with the trustee's personal assets.

The key idea to note here is that while the Convention requires the trust's governing law to apply to the internal order of the trust, it does not authorize a trust to own real property in any other way than that allowed by local law. Articles 4 and 15 make it clear that the Convention does not purport to impose any rule of application or choice-of-law with regard to the manner in which property is transferred to or from the trust nor with regard to issues affecting the relationships of the trust to others persons "outside" the trust. Article 4 provides that the Convention does not apply to issues regarding "the validity of wills or other acts by which assets are transferred to the trustee." In the Explanatory Report that is included in the *travaux préparatoires* of the Convention, Proceedings of the Fifteenth Session of the Hague Conference on Private International Law, Vol. II, 370, 381, Professor Alfred Overbeck states,

A transfer of assets to the trustee is a *sine qua non* condition for the creation of a trust. But the law designated by the Convention applies only to the establishment of the trust itself, and not to the validity of the act by which the transfer of assets is carried out. This act is entirely governed by the law to which the conflicts rules of the forum submit it.<sup>2</sup>

Consistent with this view, Article 15 sets forth key areas of law that continue to be governed by the law designated by the forum, including the protection of minors, marital rights, succession rights, the protection of creditors in bankruptcy—and most importantly for our purposes here—"the transfer of title to property and security interests in property." As Professor Overbeck explains, when "the law applicable to a trust recognized as such will encroach on the area of another law designated by the forum's conflict rules," under Article 15, "it is then that other law which will prevail . . . as concerns the mandatory rules of that other law,"<sup>3</sup> it being the intent of Article 15 "to preserve above all the forum's substantive law in cases where its conflicts rules designated its own law."<sup>4</sup>

According to Article 12, "[w]here the trustee desires to register assets, movable or immovable, or documents of title to them, he shall be entitled, *in so far as this is not prohibited by or inconsistent with the law of the State where registration is sought*, to do so in his

capacity as trustee or in such other way that the existence of the trust is disclosed." (emphasis added). Presumably, if registration were a prerequisite to owning property at all, the forum would make some form of registration available in order to abide by Article 11. But beyond that, the forum state is afforded unlimited authority to require a trust to conform to the same rules regarding ownership of real property that any other person or entity authorized to own real property in the forum state would have to follow.<sup>5</sup>

## 2. Analysis of Effect of the Convention on U.S. Choice-of-law Rules Regarding Trusts

The Convention does not apply to interstate conflicts of law issues regarding domestic trust and should not, as a practical matter, significantly change the way U.S. courts currently apply choice-of-law rules to foreign trusts.

### (a) Impact on Domestic Trusts

The Convention is not intended to deal with conflicts of law issues concerning domestic trusts. Article 24 provides that a state with different territorial units with their own rules of law regarding trusts is not bound to apply the Convention "to conflicts solely between the laws of such units." In other words, choice-of-law issues about domestic trusts that have connections with different states of the United States are not governed by the Convention, and therefore neither are trusts that have connections with only one state.

### (b) General Approach of the Convention

It is helpful to differentiate between a "one-step" approach to the creation of trusts and a "two-step" approach. In the one-step approach, a trust is constituted by a donation of property to a trustee, often though not necessarily effected by a declaration or deed of trust.<sup>6</sup> The instrument and the transfer are integrally connected so that if the transfer is invalid the deed has to be a nullity. In the two-step approach, the trust instrument and the transfer of property are viewed separately. The trust is essentially established by the trust agreement (with what is often a token transfer of property to conform to the common law requirement that property be transferred to the trustee). The transfers of the assets intended for the trust are effected by separate deeds or instruments of conveyance. The two-step approach has been incorporated in New York's recent inter-vivos trust legislation, which requires that a trust agreement be validly executed in conformity with the statutory requirements for a valid agreement and that property be transferred to the trust by separate deed or instrument, rather than by the trust agreement.<sup>7</sup>

The Convention essentially embraces a two-step approach. It clearly distinguishes between the trust instrument and the transfer of property to the trust.<sup>8</sup> Article 3 states that the Convention “applies only to trusts created voluntarily and evidenced in writing.” Article 4 of the Convention expressly excludes from the Convention’s purview “the validity of wills or other acts by which assets are transferred to the trustee.” The result is that the Convention focuses on the obligations and rights established by the written evidence of the trust, but not the property laws that govern transfers to the trust. Under Article 15, the latter are left to the law indicated by the situs of the property.

This distinction is important because it puts in proper context an otherwise apparent inconsistency between the Convention and the Restatement Second on Conflict of Laws regarding “trusts of land.” According to Restatement Second § 277(1), the construction of a trust of land is to be governed by the law chosen by the settlor. *See* Restatement (Second) of Conflict of Laws: Construction of Trust Instrument § 277(1) (1969). To that extent, the Restatement is clearly consistent with the Convention. However, Restatement Second § 278 makes the law indicated by the situs (which need not but is often likely to be the law of the situs) the governing law regarding the validity of a trust of land, whereas the Convention looks first to the law chosen by the settlor.<sup>9</sup> This apparent inconsistency is removed once one appreciates that validity for the Restatement means the validity of the transfer of land to the trust, which, under the Convention is also governed by the law indicated by the situs.<sup>10</sup>

### (c) Choice-of-law Rules for Foreign Trusts

Article 6 of the Convention provides that a trust shall be governed by the law chosen by the settlor, unless the law so chosen does not provide for trusts. Article 7 establishes as the default choice the law with which the trust is “most closely connected.” Relevant considerations are the place of the trust’s administration, the situs of the trust’s assets, the place of residence or business of the trustee, and “the objects of the trust and the places where they are to be fulfilled.” Article 9 provides that a severable aspect of the trust, particularly matters of administration, may be governed by a different law. These principles are consistent with the choice-of-law rules commonly applied by American courts. It is probably safe to say that most wills do not contain a choice-of-law provision. Testamentary trusts under such wills are in most instances governed by the law of the decedent’s domicile, which is most likely to be the place of the trust’s administration, the situs of the trust’s assets, and the place of residence of the trustee, if not always the

location where the beneficiaries, as “objects of the trust,” may live.

Most courts will honor the choice-of-law contained in an inter vivos trust agreement as long as there is some connection between the trust and the country whose law is so designated.<sup>11</sup> Article 6 does not expressly require that the law chosen by the settlor have a substantial connection to the trust, but it does require that the law chosen by the settlor provide for trusts or the category of trust involved. Moreover, article 13 expressly excludes recognition in the case where the “significant elements” of a trust, *other than* the choice of applicable law, the place of administration and of the habitual residence of the trustee, are more closely connected to states that do not have the institution of the trust. As a practical matter, it is much more likely than not that a settlor’s choice of law will be based on some connection between the trust, the trust grantor, the trust beneficiaries, or some related factor, and the country whose law is designated.

Besides, articles 16 and 18 of the Convention give a court broad latitude to curb an effort to import a rule that would offend the forum’s concepts of fundamental justice, good order, or public policy. Article 16 authorizes a court to apply the “law of the forum which must be applied even to international situations,” i.e., “laws of immediate application” or “mandatory rules” designed to foster public health, vital economic interests, the protection of weaker parties, and so forth.<sup>12</sup> Article 16 also permits a court to apply similar rules of another country if a case before it has a substantial connection with another country. And, under Article 18, the provisions of the Convention may be disregarded “when their application would be manifestly incompatible with public policy.”

As noted above, under Article 15, “the transfer of title to property and security interests in property” and other important areas of law regarding the rights of third parties (including creditors’ rights, marital and succession rights, and the rights of owners) are to be governed by the choice-of-law rules of the forum insofar as these cannot be varied by voluntary act. This means, for example, that a forum that applies the rule against perpetuities to all transfers of real property would not be required to recognize a transfer of real property to a trust that, under its governing law, could last longer than the applicable perpetuities period.<sup>13</sup> It also means that a forum would not have to apply the law of a country unduly hostile to creditors’ claims just because the law of that country happens to be the governing law of the trust.

Section 279 of the Restatement Second on Conflict of Laws provides that the administration of a trust of

an interest in land is determined by the law that would be applied by the courts of the situs of the land.<sup>14</sup> “Administration” includes matters relating to the “carrying out of the trust” such as the duties and powers of trustees and their right to compensation, but not issues of construction such as the identity of the beneficiaries and the nature of their interests.<sup>15</sup> Under the Convention, it is possible for a grantor to select a governing law other than the law of the situs. But the apparent difference between the rule reflected in the Restatement and the rule of the Convention dissolves into virtual insignificance on closer inspection. According to the Restatement § 279, Comment a, “if the testator or settlor provides that the local law of some other state shall be applied to govern the administration of the trust . . . the courts of the situs would apply the designated law as to issues which can be controlled by the terms of the trust.” Again, Articles 16 and 18 of the Convention give a court broad latitude to prevent the application of a rule that would offend the forum’s concepts of fundamental justice, good order or public policy and to apply its “mandatory rules” designed to foster vital economic interests such as the appropriate use and regulation of land.<sup>16</sup>

### **3. Analysis of Effect of the Convention on the Jurisdiction of U.S. Federal Courts Over Trusts**

Federal courts have, under 28 U.S.C. § 1331, jurisdiction over matters arising under treaties of the United States with other countries. However, U.S. ratification of the Convention should not permit litigants to attempt to remove jurisdiction over such matters as trust construction, beneficiary rights, and accounting issues from the state courts to the federal courts. As discussed above, the Convention does not govern the choice-of-law rules applied to inter-state conflicts issues. Thus, the Convention cannot be used as a basis for conferring jurisdiction on a federal court in a disputed matter involving a domestic trust because the Convention does not apply to such trusts.

A foreign trustee may invoke the Convention when there is an issue involving the recognition of the trust’s right to operate within the United States as a trust. However, this does not enlarge the jurisdiction that the federal courts currently have over certain foreign trusts. Under 28 U.S.C. § 1332(a)(2), the federal courts have jurisdiction over disputes between citizens of the United States and the citizens or subjects of a foreign state. Foreign trustees are “citizens” of foreign countries and therefore the federal courts already have jurisdiction over disputes involving foreign trusts as long as the diversity between the foreign and United States parties is not broken by having a foreign party on both sides of the claim or controversy.

In a case where complete diversity does not obtain between a foreign trust and the United States parties, the foreign trust would be required to avail itself of a state court. The mere invocation of the Convention will confer neither federal question jurisdiction under 28 U.S.C. § 1331 nor supplemental jurisdiction under 28 U.S.C. § 1367 on the federal courts. It is a fundamental axiom of federal question jurisdiction based on treaties that “[a]n action arises under a treaty only when the treaty expressly or by implication provides for a private right of action.”<sup>17</sup> The Convention does not provide any remedies or causes of action, and therefore confers no independent basis for federal jurisdiction.

Even if there were a private right of action to enforce the Convention’s choice-of-law rules, which there is not, any effort to invoke on that basis the supplemental jurisdiction of the federal courts with respect to any legal remedy under the substantive law of trusts would be likewise unavailing. To confer jurisdiction on a federal district court with original jurisdiction with respect to a supplemental claim, it is necessary under 28 U.S.C. § 1367(a) for the claim “to be so related to claims in the action within such original jurisdiction that they form part of the same case or controversy under Article III of the United States Constitution.” While the issues of choice of law and recognition under the Convention may be significant preliminary issues in any claim or controversy, they are analytically distinct from any particular claim or controversy and thus would not appear to have the requisite relationship to such claim or controversy that § 1367(a) requires. Indeed, by themselves, they would not state a claim. Moreover, under 28 U.S.C. § 1367(b), a district court has discretion to decline supplemental jurisdiction whenever the supplemental claim “substantially predominates over the claim or claims over which the district court has original jurisdiction.” While the threshold issues of applicable law and recognition are clearly critical, it is hard to imagine any claim that would not predominate over the preliminary issues regarding the trust’s applicable law and right to recognition because it is the claim and not the threshold issues that would be the gravamen of the lawsuit.

Finally, because the Convention does not attempt to preempt issues regarding the validity of wills creating trusts,<sup>18</sup> the Convention would not affect state jurisdiction over ancillary probate and administration proceedings related to estates of non-United States decedents and would therefore not weaken the general principle that federal courts should avoid interfering in probate matters.<sup>19</sup>

