Title

Has the non-commercial trust relationship for the most part managed to avoid the cross hairs of the Financial Crimes Enforcement Network (FinCEN)?

Summary

FinCEN issued (05/11/2016) final rules under the Bank Secrecy Act "to clarify and strengthen customer due diligence requirements" for: Banks; brokers or dealers in securities; mutual funds; and futures commission merchants and introducing brokers in commodities. The rules contain explicit customer due diligence requirements and include a new requirement "to identify and verify the identity of beneficial owners of legal entity customers," subject to certain exclusions and exemptions. One such identification exemption is a beneficial interest under a trust other than a "statutory trust created by a filing with a Secretary of State or similar office." Why? The rationale may be found in the Rule's preliminary section-by-section analysis: "…[B]cause, unlike the legal entities that are subject to the final rule, a trust is a contractual arrangement between the person who provides the funds or other assets and specifies the terms (i.e., the grantor or settlor) and the person with control over the assets (i.e., the trustee), for the benefit of those named in the trust deed (i.e., the beneficiaries)." While I have no quarrel whatsoever with the exemption, I find the expression of its rationale to be, shall we say, wanting, both grammatically and substantively. As to the latter, see *Loring and Rounds: A Trustee's Handbook* §9.9.1 [pages 1525-1529 of the 2016 Edition] (trusts are not contracts), which section is reproduced in its entirety below.

Text

§9.9.1 *Contracts Generally; Life Insurance and Third-Party Beneficiary Contracts in Particular* [from *Loring and Rounds: A Trustee's Handbook* (2016)]

> *To appreciate why trusts are used in various contexts it is necessary to appreciate the nature and strengths of the trust concept. This concept straddles the law of property and the law of personal obligations and allows circumvention of the English privity of contract doctrine that prevents third parties from enforcing a contract for their benefit made by others.*[1]
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> *The debtor is not a steward for the creditor.*[2]

A contract is not a trust. The trust relationship is *sui generis*.[3] It is not some sub-category of the contractual relationship, although the occasional judge or academic will confuse the two.[4] A trust

[1]David Hayton, *The Uses of Trusts in the Commercial Context*, in Trusts in Prime Jurisdictions 431 (Alon Kaplan ed., 2000).

[2]Bogert §17.

[3]*Cf*. Charles E. Rounds, Jr. & István Illés, *Is a Hungarian Trust a Clone of the Anglo-American Trust, or Just a Type of Contract?: Parsing the Asset-Management Provisions of the New Hungarian Civil Code*, 6 Geo. Mason J. Int'l Com. L. 153 (2015).

[4]*See* Bogert §17 n.2.

beneficiary possesses an equitable property interest in the subject property incident to a declaration or conveyance that need not involve the exchange of consideration.[5] "Contracts are still dependent on consideration for their enforceability. This is a marked distinction between a trust and a contract."[6] A contract requires the mutual assent of the parties. A trust, on the other hand, can come into existence without the knowledge, let alone the consent, of either the designated trustee or the beneficiary.[7]

It is said that the interest of a creditor is a chose in action while the interest of a trust beneficiary amounts to equitable ownership of the subject property.[8] Contractual rights, however, may be the subject of a trust.[9] So may equitable interests in other trusts.[10]

The property of a trust is not commingled with the trustee's personal assets and thus is insulated from the reach of the trustee's personal creditors and spouse.[11] Absent special facts, an unsecured contract creditor has no equitable property interest in the personal assets of the debtor.[12] In other words there is no segregation of a portion or all of the debtor's personal assets for the purpose of securing the creditor's contractual rights.[13] "A debtor ordinarily may freely dispose of all property interests. A debtor has no positive duty to use property for the benefit of the creditors. Rather, debtors have a negative duty not to employ their assets in ways that might be detrimental to the creditors."[14] It is said that the debtor owns his own property absolutely.[15] There is no divided ownership.[16] That having been said, a debtor's personal assets may be reached by the debtor's unsecured contract creditors in satisfaction of the debtor's contractual obligations to them.[17] That a debtor owes certain duties to creditors that may be enforceable in equity, however, does not somehow transform the contract into a trust, or make those duties fiduciary in nature.[18] The only duty that comes to mind is to not fraudulently convey.[19]

Third-party beneficiary contracts are not trusts. At one time, only the promisor and the promisee of a third-party beneficiary contract had standing to seek its enforcement.[20] By the middle of the twentieth century, however, it had become settled law that a third-party beneficiary of the contract would have the

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[5]*See generally* §5.3.1 of this handbook (nature and extent of beneficiary's property interest).

[6]Bogert §17.

[7]*See generally* §3.4.2 of this handbook (a trust shall not fail for want of a trustee).

[8]"Because a beneficiary has equitable ownership in the ordinary case, the beneficiary receives the net income of the trust property rather than any fixed rate of income or return on the value of that property. The creditor, however, is not the owner of the money or other property which he has transferred to the debtor, and has no rights to the actual income which it produces in the absence of special contract." Bogert §17.

[9]*See generally* §2.1.1 of this handbook (entrusted contractual rights generally) and §2.2.2 of this handbook (entrusted third-party beneficiary contractual rights).

[10]*See generally* §2.1.1 of this handbook (entrusted equitable property rights generally).

[11]*See generally* §8.3.1 of this handbook (the trustee's personal creditors and the trustee's spouse). "Because a trustee's duties apply to specific assets in which a beneficiary has an equitable interest, a trustee may be excused from all liability if the trust res is lost through no fault of the trustee. This is because none of the trustee's other assets are affected by trust duties." Bogert §17.

[12]Bogert §17.

[13]"The loss or destruction of any particular property of a debtor, on the other hand, even though wholly without the debtor's fault, will not discharge a debt." Bogert §17.

[14]Bogert §17.

[15]Bogert §17.

[16]Bogert §17.

[17]Bogert §17.

[18]Bogert §17.

[19]Bogert §17.

[20]Bogert §17.

requisite standing as well.[21] English law is now in accord. In England, The Contracts (Rights of Third Parties) Act 1999 "provides that a contract may confer the right to enforce a term of the contract on a person who is not a party to it."[22] In the United States today, the third-party contract beneficiary can sue the promisor at law, or sue the promisor and promisee in equity.[23]

Back when it was questionable whether a third-party contract beneficiary would have standing to seek the contract's enforcement in a court of law, there was always the trust argument, which was that the promisee was contracting as a trustee for the benefit of the third party.[24] "If the contract…[was]…not performed, the trustee…[could]…take proceedings in his own name to enforce it for the benefit of the third party and, if he refuse…[d]…to do so, the third party…[could]…sue, joining the trustee as a defendant."[25] Essentially the promisee held the chose in action in trust for the benefit of the third party.[26] *The fact that the promisee was a trustee, however, did not somehow transmogrify the third-party beneficiary contract itself into a trust*.[27] Had the core arrangement been a trust, there would have been no question that the beneficiary would have had standing to seek its enforcement, even if the beneficiary had not been a party to the trust's creation.[28]

In the case of an equitable breach-of-trust action by a trust beneficiary against the trustee, laches principles may well govern when the applicable statute of limitations began to run against the beneficiary, a topic we take up in Section 7.1.3 of this handbook. Had it instead been a legal breach-of-contract action brought by a third-party contract beneficiary against the promisor, laches principles likely would not have governed.[29]

A life insurance policy is a third-party beneficiary contract, not a trust.[30] The insurance company does not segregate the policy premium as a trustee would;[31] rather the premium is commingled with the general assets of an insurance company and in exchange the insurance customer receives the company's promise to pay a certain amount, at a certain time, subject to the happening of certain events.[32]

On the other hand, an interest in a variable life or annuity product may be an interest in a fund that is segregated from the general assets of the insurance company and thus insulated from the reach of the

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[21]Bogert §17.

[22]Snell's Equity ¶19-21.

[23]Bogert §17. "The right of a third party contract beneficiary to sue in equity, joining the promisor and promisee, may seem to support the view that the beneficiary is in fact a beneficiary of a trust. More likely, however, chancery takes jurisdiction in this contract case, not because any trust is involved, but because more than two parties are interested in the same transaction, and hence equity is capable of administering full justice where law could not." Bogert §17.

[24]Bogert §17.

[25]Snell's Equity ¶19-21. *See also* §5.4.1.8 of this handbook (beneficiary's standing to proceed in stead of trustee against those with whom the trustee has contracted).

[26]Bogert §17.

[27]Bogert §17.

[28]*See generally* §7.1 of this handbook (trust beneficiary's standing to seek the trust's enforcement).

[29]Bogert §17.

[30]*See generally* 1 Scott on Trusts §14; Bogert §17. *See also* Uhlman v. New York Life Ins. Co., 109 N.Y. 421, 17 N.E. 363 (1888). *Cf.* Schoneberger v. Oelze, 208 Ariz. 591, 96 P.3d 1078 (2004) (confirming that a trust is not a contract).

[31]*See generally* 1A Scott on Trusts §87.1 (Life Insurance Companies Not Trustees); Bogert Trusts and Trustees §17(contract and trust). A trust is not to be confused with insurance company reserves, which are sums of money an insurer is required to set aside to insure the solvency of the company. *See* Arrow Trucking Co. v. Continental Ins. Co., 465 So. 2d 691, 696 (La. 1985).

[32]1 Scott & Ascher §2.3.10.

insurance company's general creditors in the event of insolvency.[33] Because such an interest is more in the nature of a trust participation than "insurance," the fund itself may be subject to registration as an investment company under the Investment Company Act of 1940.[34]

What about the situation where the insured under a standard life insurance contract dies and the proceeds are to be paid out over time in increments to the designated beneficiary? Is the insurance company a trustee of the proceeds? Unless the proceeds are to be segregated from the general assets of the insurance company, the answer is probably no.[35] The beneficiary is merely a creditor of the insurance company.[36]

Every third-party beneficiary contract does not necessarily involve insurance. If the owner of an item of property, for example, transfers it to *X* in consideration of *X*'s promise to pay a third party a certain sum out of *X*'s general assets, then we have a third-party beneficiary contract.[37] The arrangement is not a trust, in part because (1) *X* is not obliged to segregate the property from his own property and (2) *X* may use the property for his own purposes.[38]

Whether one's rights are categorized as equitable under a trust or legal under a third party beneficiary contract can have practical consequences.[39] A contractual claim, for example, may be barred by a statute of limitations not applicable to beneficiary claims in equity against trustees.[40] A trustee's insolvency generally will not affect the equitable interests of the trust beneficiaries, the assets of the trust being segregated from the personal assets of the trustee.[41] In the event of the insolvency of an insurance company, however, its policy holders and third party beneficiaries would generally have to stand in line

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[33]*See* Stephen E. Roth, *Separate Account/General Account Products: Insulation Issues and Developments in Conference on Life Insurance Company Products: Current Securities, Tax, ERISA, and State Regulatory Issues 1992*, at 105, 107–112 (ALI-ABA Course of Study No. C783, 1992); Rohm & Haas Co. v. Continental Assurance Co., 58 Ill. App. 3d 378, 374 N.E.2d 727 (1978) (holding assets held in "properly maintained and administered" separate accounts not chargeable with general liabilities of insolvent insurance company); *Variable Annuity Separate Accounts*, in Investment Company Regulation and Compliance 1993, at 277, 279 (ALI-ABA Course of Study No. C850, 1993) (noting that most "registered separate accounts [as that term is defined in Section 2(a)(37) of the 1940 Act] are formed as unit investment trusts"). For a general discussion of separate accounts, *see* Thomas J. Finnegan, Jr. and Joseph P. Garner, *The Separate Account as an Investment Company: The Structural Problems of the Ectoplasmic Theory*, 3 Conn. L. Rev. 107 (1970).

[34]*See* Stephen E. Roth, *Separate Account/General Account Products: Insulation Issues and Developments in Conference on Life Insurance Company Products: Current Securities, Tax, ERISA, and State Regulatory Issues 1992*, at 105, 107–112 (ALI-ABA Course of Study No. C783, 1992); Rohm & Haas Co. v. Continental Assurance Co., 58 Ill. App. 3d 378, 374 N.E.2d 727 (1978) (holding assets held in "properly maintained and administered" separate accounts not chargeable with general liabilities of insolvent insurance company); *Variable Annuity Separate Accounts*, in Investment Company Regulation and Compliance 1993, at 277, 279 (ALI-ABA Course of Study No. C850, 1993) (noting that most "registered separate accounts [as that term is defined in Section 2(a)(37) of the 1940 Act] are formed as unit investment trusts"). For a general discussion of separate accounts, *see* Thomas J. Finnegan, Jr. and Joseph P. Garner, *The Separate Account as an Investment Company: The Structural Problems of the Ectoplasmic Theory*, 3 Conn. L. Rev. 107 (1970).

[35]1 Scott & Ascher §10.11.1.

[36]1 Scott & Ascher §2.3.8.1.

[37]1 Scott on Trusts §14.1; 1 Scott & Ascher §2.3.10.1.

[38]2 Scott & Ascher §12.13.1; Bogert §17.

[39]*See generally* Bogert §17.

[40]*See generally* §7.2.10 of this handbook (laches and statutes of limitation); Bogert §17.

[41]*See generally* §7.4 of this handbook (trustee's discharge in bankruptcy).

with the company's other general creditors.[42]

A contract in and of itself is not a fiduciary relationship,[43] nor is a fiduciary relationship with its "generous, zeal-requiring, benefit-conferring aspects" a contract.[44] A trustee is a fiduciary with a duty of full disclosure.[45] Promisors under third-party beneficiary contracts, *e.g.*, insurance companies, generally have no such fiduciary obligations.[46]

[42]1 Scott & Ascher §2.3.10.3.

[43]Schoneberger v. Oelze, 208 Ariz. 591,596, 96 P.3d 1078, 1082 (2004) ("…[A] fiduciary relationship exists between a trustee and a trust beneficiary while no such relationship generally exists between parties to a contract"). *See also* Bogert §17.

[44]*See* Scott Fitzgibbon, *Fiduciary Relationships Are Not Contracts*, 82 Marq. L. Rev. 303, 325 (1999).

[45]*See generally* §6.1.5.1 of this handbook (trustee's duty to provide information).

[46]1 Scott & Ascher §2.3.10.3; Bogert §17.