First Know the Law of the Land

Had the trust beneficiaries and SEC been more aware of Jersey law, all their interests might have been better served in a recent case

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Understanding the trust laws of different jurisdictions can give counsel a critical advantage in litigation. Case in point: *Securities and Exchange Commission v. Franco*,[1] in which none of the parties seem to have understood an important aspect of the trust law of the Isle of Jersey, and as a result neither the interests of the trust beneficiaries nor the U.S. Securities and Exchange Commission were well-served.

In October of 1998, Ileana Ballesteros created a trust for the benefit of herself and her husband, Jorge, during their lifetimes and, after her death, for Jorge's benefit alone. She also executed a letter giving her husband authority to issue investment instructions to the trustee and permitting him to veto any distribution instructions she might give the trustee. On the same day, Jorge's mother executed a similar trust and letter of wishes, except that the mother's directives would control in the event that there was a conflict between the investment instructions she and Jorge gave to the trustee.

The trust was sued, but on the Isle of Jersey, there is no separate "trust entity."

Neither Jorge's wife nor his mother ever tried to exercise their authority to make investment decisions. The trusts made investments through corporations that they controlled and Jorge made all investment decisions for the trusts and corporations. The trustees and nominee officers of the underlying corporations were at Bankers Trust AG of Zurich. But the trusts and corporations were administered through BT Trustees (Jersey Ltd.).

The problem began on June 5, 1999, when Jorge's brother, Jose, a director of Nalco Chemical Company, a publicly traded company, was informed of a tender offer for the purchase of Nalco stock by a

subsidiary of Suez Lyonnaise des Eaux, S.A. Jose also was aware of a blackout period then in effect that prohibited Nalco directors from trading their stock in the company. Nonetheless, Jose communicated the non-public information relating to the tender offer to Jorge, who directed the Ballesteros trusts and underlying companies to purchase 216,300 shares of Nalco stock worth about $5.7 million. Once the tender offer became public, the Ballesteros trusts and companies sold their shares for a profit of about $3.2 million.

The SEC filed a claim of securities fraud in the U.S. District Court for the Southern District of New York, and in contesting the defendants' motion to dismiss, asserted a novel argument. The regulators claimed the trusts had treated Jorge as the trust settlor, rather than a mere investment advisor, and that Jorge exercised "domination and control" over the trusts.[2] Under this theory, the SEC sought to equate Jorge's knowledge with the trusts' and so claim that the trusts themselves had violated their fiduciary duty under the Securities Exchange Act to abstain from trading stock on the basis of material nonpublic information.

The trust defendants, in support of their motion to dismiss, pointed out that they already had disgorged the illegal profits and argued that there was "simply no basis for holding trust entities liable under the securities laws for violations that were perpetrated by any individual merely associated with those entities"[3] and, therefore, the injunctive relief and civil penalties sought by the SEC should be denied.

U.S. District Judge John G. Koeltl noted in his March 28, 2003, decision that none of the parties were able to find a precedent that squarely addressed the question of whether, under U.S. federal securities laws, the knowledge of an individual who is not a trustee (Jorge) can be imputed to a trust entity. In denying the defendants' motion to dismiss, the court therefore concluded that there was "no persuasive reason to explain why trusts are to be treated differently from corporations, estates, or other entities that have been held liable under [the securities laws] based on the activities of individuals who dominate or control those entities."[4]

What none of the parties seemed to take into consideration, though, is that Jersey law apparently governed the Ballesteros trusts.[5] Under Jersey law there is no "trust entity" to which Jorge's knowledge could be imputed.[6] Rather, recourse should have been sought from the trustee in the trustee's individual capacity.

Had the trust defendants and beneficiaries advanced this argument, they might have made short work of the SEC's claim. Because there is no separate legal trust entity in Jersey, the trusts were improperly named as parties to the suit. The SEC should have been forced to sue the trustee in its individual capacity. If the regulators were successful and collected from the trustee on the judgment, the trustee would have no claim for reimbursement from the trust fund, as it was the trustee's breach of duty that led to the liability. In this manner, the beneficiaries could have protected their interests in the trusts.[7] Instead, counsel for the trust beneficiaries permitted the case to move forward without questioning its underlying premise—a premise that would have been correct from the perspective of U.S. trust law, but not Jersey law.

The SEC also would have been better-advised to name as a defendant the trustee in its individual capacity. It is more likely that trust funds would be insufficient to pay applicable penalties than it would be for the corporate trustee, as a financial institution with billions of dollars in assets, to be short of funds. Also, if the SEC were successful, it's doubtful a Jersey court could enforce the judgment against the trusts, even if it were inclined to do so. This is because any order of a U.S. district court would be against the trusts as separate legal entities—entities that do not exist for this purpose under Jersey law—rather than against the trustee, which was not a party to the proceeding.

Finally, and perhaps most importantly, the SEC's public policy concerns would be better served by a successful claim against the trustee than the trust fund. Winning against the corporate trustee would have sent a strong message to all offshore corporate trustees that they have an economic incentive

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to institute policies to help ensure that investments are not made based upon nonpublic information. As it stands, offshore corporate trustees have no such incentive. ∎

Endnotes

1. 253 F. Supp. 2d 720; 2003 U.S. Dist. LEXIS 4902 (Mar. 28, 2003).
2. *Ibid* at p. 12.
3. *Ibid* at p. 22.
4. *Ibid* at p. 25. At press time, the case on the merits had yet to go to trial.
5. Even if this assumption is incorrect, the points raised would be equally true under the laws of most jurisdictions that may govern the trusts, such as England, or the Caribbean islands or Bermuda, whose law is based on English law.
6. The single exception to this rule is found in Article 28 of the Trusts (Jersey) Law, which provides that if a trustee informs another party to any matter affecting a trust that he is acting as trustee, a claim by such other party in relation to that matter shall extend only to the trust property. Otherwise, all acts or omissions of a trustee give rise to personal liability subject to a right of indemnity in respect of such liabilities properly incurred as trustee. Here, insofar as the persons who sold the stock to the trusts or purchased the stock from the trusts have a claim (which does not seem to be the case), they may be afforded the benefit of this statute and be permitted to collect from the trust fund if it was clear that the trustee was acting in its capacity as trustee. But unless the trusts filed with the SEC upon the purchase or sale of the stock in which the trustee indicated that it was acting in its capacity as trustee, the SEC would not be able to reach the trust assets. It is unlikely that the trusts so informed the SEC of their purchase and sale.
7. As it stands, if the SEC is successful in collecting from the trust funds, the beneficiaries may be able to recoup their losses from the trustee. But it would be far better from the beneficiaries' perspective for the trustee to be individually accountable for any liability in the first instance.

Collectors' Spotlight

This clockwatch designed as an amphora, 11.7 mm by 62 mm, with 18 carat gold, pearls and enamel is attributed to Jaquet Droz circa 1790. It sold at auction in October 2003 by Antiquorum for $170,610.