The Personal Tax Planning Review

TRUSTEE EXEMPTION CLAUSES

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The recent decision of the Court of Appeal in *Armitage v Nurse*[2] presents a timely opportunity to review the topic of trustee exemption clauses[3]. The topic falls naturally into the following divisions:

1. Questions of Construction: What is a particular form of words taken to mean.

2. Questions of Validity: To what extent exclusion clauses are valid.

3. Questions of Drafting: What clauses should a draftsman actually use in a settlement.

4. Questions of Legal Policy: What clauses should the law recognise as effective.

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2 [1997] 2 All ER 705.

3 A note on terminology. The terms "exemption clause", "exoneration clause", "exclusion clause", "exculpation clause" and "indemnity clause" are all used interchangeably. "Indemnity clause" is not strictly apposite as the clause prevents liability rather than providing an indemnity for an extant liability.

Construction of Exemption Clauses

Liability for "actual fraud"

The recent decision in *Armitage v Nurse* discussed the following clause:

> No Trustee shall be liable for any loss or damage which may happen to [the Trust Fund] or any part thereof or the income thereof at any time or from any cause whatsoever unless such loss or damage shall be caused by his own *actual fraud.*

It was held that the expression "actual fraud" means dishonesty.[4] "Dishonesty" connotes action by the trustee:

(1) knowing that it is contrary to the interests of the beneficiaries (in the discussion below, "Knowing Dishonesty"); or

(2) recklessly indifferent whether it is contrary to their interests or not (in the discussion below, "Reckless Indifference").

The clause "exempts the trustee from liability for loss or damage to the trust property no matter how indolent, imprudent, lacking in diligence, negligent or wilful he may have been, so long as he has not acted dishonestly".[5]

"Wilful Default"

Some exclusion clauses exclude liability for loss unless due to the "wilful default" of the trustee.[6] What does this mean?

The expression "wilful default" has two meanings. It sometimes means want of ordinary prudence (i.e. negligence); or any breach of fiduciary duty; for instance in the phrase "liable to account on the footing of wilful default". In the context of a trustee

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4 The word "actual" excluded the extended meaning of "fraud" ("constructive fraud" or "equitable fraud") with the vague definition (or non-definition) of "a breach of duty, falling short of deceit, to which equity attached its sanction".

5 This is consistent with the definition of "fraud" for the purposes of the tort of deceit (fraudulent misrepresentation). See *Derry v Peek* (1889) 14 App. Cas. 337; the head note reads:

> "In an action of deceit the Plaintiff must prove actual fraud. Fraud is proved when it is shown that a false representation has been made knowingly, or without belief in its truth, or recklessly, without caring whether it be true or false."

6 S.30(1) Trustee Act 1925 is the pattern for such clauses.

exemption clause, however, wilful default means fraud: Knowing Dishonesty or Reckless Indifference.[7]

"Conscious Wrongdoing"

Some exemption clauses exclude liability for loss unless due to "conscious wrongdoing" on the part of the trustee. What is the meaning of this expression? It is suggested that "conscious wrongdoing" is best construed to mean the same as "actual fraud", that is, both Knowing Dishonesty and Reckless Indifference[8].

In drafting it would be best now to use the form based on that approved in *Armitage v Nurse*; and not one of the other forms.

Exemption clause attached to specific power

A clause discussed in *Armitage v Nurse* provided:

> The Trustees may carry on the business of farming *and the Trustees shall be free from all responsibility and be fully indemnified out of the Trust Fund in respect of any loss arising in relation to the business.*

Millet LJ commented:

> In the absence of the clause, the trustees would have no power to carry on a farming business. If they did so, however prudently, they would commit a breach of trust. The concluding words of the clause confer upon the trustees a consequential exemption from liability for trading losses incurred in the carrying on of the farming business. It does not exonerate them from liability for imprudently investing in a farming business yielding poor returns or from failing to ensure that the business is properly managed.

On this construction the words in italics (which appear at the first sight to be an exclusion clause) are not an exclusion clause at all: they simply spell out the implications of the power to carry on the business of farming; the words must in fact

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7 *Armitage v Nurse* at p. 711 approving *Re Vickery* [1931] 1 Ch 572.

8 Millett L. in *Armitage v Nurse* at p. 712 referred to both Knowing Dishonesty and Reckless Indifference as "conscious and wilful misconduct". He also expressed the view that the prolix exclusion clause in Key & Elphinstone (15th edn 1953 vol 2 p. 695) had the same meaning as an exclusion clause referring to actual fraud. The Key & Elphinstone clause referred to "personal conscious bad faith of the trustee sought to be made liable".

be completely otiose. This should be regarded a case where the principle of construction, that exclusion clauses are to be narrowly construed where the context so permits, overrides the weaker principle of construction that words in a document should not be regarded as otiose.

It would be better drafting not to use this form of words.

"Beneficial Owner" clauses

In *Bartlett v Barclays Trust Co (No. 1)*, Brightman J considered the following clause:

> "The Trustee may act in relation to the Bartlett Trust Ltd or any other company and the shares securities and properties thereof in such way as it shall think best calculated to benefit the trust premises and *as if it was the absolute owner* of such shares, securities and property."

This was held merely to confer on the bank power trustee to engage in a transaction which might otherwise be outside the scope of its authority; it was not an exclusion clause protecting the bank against liability for breach of trust (e.g. a transaction that a prudent man of business would have eschewed).[9]

Validity of Exclusion Clauses

It is now settled, at all levels below the House of Lords, that one can exclude liability except for fraud, in the sense of Knowing Dishonesty and Reckless Indifference.

Plainly one cannot exclude liability for Knowing Dishonesty. That is inconsistent with any trust at all.

Can one accept liability for Knowing Dishonesty, but at least exclude liability for mere Reckless Indifference? Millett LJ said:

> "There is an irreducible core of obligations owed by the trustees to the beneficiaries and enforceable by them which is fundamental to the concept of a trust. If the beneficiaries have no rights enforceable against the trustees there are no trusts. But I do not accept that these core obligations include the duties of skill and care, prudence and diligence. The duty of the trustees to perform the trusts honestly and in good faith for the benefit of the beneficiaries is the minimum necessary to give substance to the trusts, but in my opinion it is

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9 [1980] Ch 515 at 536.

sufficient."

The natural reading of the passage is that Millett LJ thought one could not exclude liability for Reckless Indifference, and this is submitted to be a better view of the law.

A clause excluding liability for Reckless Indifference would be void, unless its invalidity could be severed so the clause could be taken as void so far as it purported to exclude liability for Reckless Indifference, but nevertheless valid so far as it excluded liability for mere negligence.

Should the draftsman insert an exclusion clause?

At the time a settlement is drafted no-one anticipates an action for breach of trust. Nevertheless, exemption for trustees' negligence is wrong in principle. It would directly contravene the wishes of the settlor, if he were asked; which he certainly never is. The blanket exemption clause has no place in a standard draft. It is sometimes said that trustees refuse to act where there is no exemption clause. This is not convincing: a trustee who took that view would lose business.

The most respected textbooks regard the trustee exemption clause with anxiety or unease. Prideaux states "the form should only be used in special circumstances". Hallett advises that the relieving clause should only be used for unpaid trustees. The Encyclopaedia of Forms & Precedents adopts the same approach: the proposed exemption clause does not apply to professional trustees and a note properly adds: "It is essential that the settlor is made fully aware of how the clause operates and agrees to its inclusion".[10] That note of caution has fallen on deaf ears: it is commonplace nowadays to find a wide trustee exemption clause.

Suppose there are non-professional, unpaid trustees. Certainly less can reasonably be expected of them. The law already recognises this; or, more positively, it may be said that more is expected of the professional trustee.[11] Moreover, in the usual case, where there are professional and family trustees, the professional (and his firm) will act for the trustees as a whole; so in the event of professional incompetence, the professional will carry the liability. The settlor may sometimes want to authorise lay trustees to be negligent. However, it should not be assumed that he will do so in the absence of express instructions, and a wide exclusion clause, even for the unpaid trustee, should

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10 Prideaux, *Forms and Precedents in Conveyancing* (25th Ed., 1959) Vol.3 p.158; Hallett, *Conveyancing Precedents* (Sweet & Maxwell, 1965) p.801, n.30; *Encyclopedia of Forms & Precedents* (5th ed), Vol. 40, p.512.

11 *Bartlett v Barclays Trust Co (No.1)* [1980] Ch 515.

not be a standard form.

There are two cases where a wide exclusion clause may properly be inserted by the draftsman.

1. Where the settlor (and spouse) are trustees. Here the settlor may indeed wish for a low standard of duty to rest on the trustees. It is suggested that an exemption clause in such a case should be limited to unpaid trustees.

2. Where the draftsman is acting for the trustees and is not acting for the settlor. The clause is in the interest of the draftsman's client. Where in such a case a broad exemption clause is used, the effect of the clause should be explained to the settlor. It would be good practice to record his agreement to it expressly in a side letter.

It is difficult to see how a draftsman can properly include such a clause when he is acting for the settlor and the draftsman (or his partner) will be a trustee. There is a conflict of interest here, and professional conduct implications for solicitors who draft wills or settlements if the same firm is to act as trustee.[12]

Narrow exemption clauses

Trustees enjoy a number of statutory indemnities. Most importantly, they are not liable if they have acted honestly and reasonably and ought fairly to be excused for any breach of trust.[13] Do they need any more than this? It is considered some slight tinkering is desirable to get the fairest balance between the needs of trustees and beneficiaries. Trustees should not be liable for:

(1) Claims by unknown illegitimate beneficiaries

(2) Acting in good faith on the advice of Counsel

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12 *The Professional Conduct of Solicitors* (the Law Society 7th ed, 1996) does not specifically address the question of exoneration clauses in trusts or wills. The inclusion of an exoneration clause would not appear to be a breach of the code of conduct. It is, however, relevant to note para. 12.09: "There is no objection as a matter of conduct to solicitors seeking to limit their liability provided that such limitation is not below the minimum level of cover required from time to time by the Solicitors Indemnity Rules. The cover currently required is £1m. Any limitation must be brought clearly to the attention of the client and be understood and accepted by him or her" This comment, however, relates more to an exclusion clause in direct contractual relationships between solicitor and client; the relationship between solicitor and potential settler is different."

13 Section 61 Trustee Act 1925. See also section 20(3) AJA 1982.

(3) Failing to supervise family companies

(4) Failing to supervise parents and guardians of beneficiaries.[14]

Legal Policy: should exclusion clauses be allowed?

In *Armitage v Nurse*, Millett LJ said:

> "The view is widely held that these clauses have gone too far, and that trustees who charge for their services and who, as professional men, would not dream of excluding liability for ordinary professional negligence, should not be able to rely on a trustee exception clause excluding liability for gross negligence."

The subject is under consideration by the Trust Law Committee. Such clauses are outlawed in England for directors (whose position is analogous to trustees) and in some investor protection legislation; and in some foreign jurisdictions, such as Jersey. Yet if settlors genuinely wish their trustees to have the benefit of an exclusion clause, it is hard to see why they should not be allowed to do so. Moreover, statutory reform can bring additional problems and complications to the law. For instance, if reform prohibited exclusion of liability for gross negligence, the Courts would have to identify what is or is not "gross" negligence. Moreover, reform could easily outlaw perfectly reasonable, targeted, exclusion clauses such as those mentioned above.

The problem with exclusion clauses, it is submitted, is not one of trust law but of trust draftsmanship. The solution is not law reform, but a drafting solution: to encourage more appropriate use of such clauses in trust drafting. A strengthening of the rules of professional conduct - or a better recognition of existing rules - would largely solve the problem.

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[14] For further discussion and draft clauses see *Drafting Trusts & Will Trusts* (James Kessler, Sweet & Maxwell, 3rd edition) 1997.