The Offshore Tax Planning Review

SCOTTISH TRUSTEES, INVESTMENT MANAGEMENT AND THE USE OF NOMINEES OR CUSTODIANS

Simon Mackintosh[1]

The purpose of this article is to highlight some difficult areas for those concerned in the administration offshore of older Scottish trusts.

A modern well-drafted trust deed will give the trustees power to delegate investment management functions to properly qualified individuals, firms or corporations on a discretionary basis; and to hold investments through nominees or custodians. Such clauses were, however, comparatively rare in Scottish trusts until recently and the powers of delegation conferred on trustees by general Scots law are very limited. Many older Scottish trusts have been exported and are now administered offshore. What is the legal position of the offshore trustees of such trusts, in respect of delegation of investment management functions and the use of nominees, where Scots law continues to govern the powers of the trustees and the administration of the trust?

Trustees may find almost irresistible commercial pressures to use nominee companies: for example, the introduction of rolling settlement and eventually CREST; lower dealing costs where brokers' or managers' in-house nominees are used; and if the trustees are dealing in the London Stock Exchange and are outside the immediate surroundings of the UK, or if there is more than one trustee, it may be practically impossible to operate under the five day rolling settlement regime without using nominees.

On the investment management side, trustees may not wish to be involved in instructing every single investment management transaction; the Financial Services Act 1986, if relevant to them, may require them to be authorised before becoming

[1] Simon A Mackintosh, Partner, W S & J Burness, Solicitors, 16 Hope Street, Charlotte Square, Edinburgh EH2 4DD Tel: (0131) 226 2561 Fax: (0131) 225 4575; and at Suite 9, The Maze, Bertholet Street, St Peter Port, Guernsey GY1 1JT Tel: (01481) 710867 Fax: (01481) 710578.

intimately involved in individual investment decisions; it may also be impractical to get instructions from a number of trustees in different jurisdictions within a time scale which is acceptable to the investment adviser. It also has to be accepted that long time delays in instructing transactions proposed by an investment adviser may lead to to lost opportunities and losses to the Trust Funds.

The trustees may therefore be tempted to use nominees or to delegate investment powers, as a purely practical matter and indeed in the best interests of the Trust Funds, even if this is in excess of their powers. The trustees may thereby be committing a breach of trust; what then is their position if their chosen Fund Manager makes poor investments; or, worse, becomes insolvent, together with his nominee company, and it is then discovered that the use of the nominee has in some way led to a loss to the Trust Funds?

We start from the assumption that the trust deed does not give the trustees power to delegate investment management on a discretionary basis nor to use nominees or custodians. What does the general law of Scotland say about their position? Two much loved Latin maxims apply: *delectus personae* and *delegatus non potest delegare*. These provide the basic rule that trustees must perform their duties personally and may not delegate their responsibilities. Everything else must be looked at against the background assumption that, unless otherwise authorised to do so, the trustees have been chosen personally to carry out the trustee function; and they should exercise their discretions and powers personally and not delegate them. Writing in 1932, Mackenzie Stuart stated:

> "A trustee is not entitled to delegate the execution of the trust. He must retain control of the administration and management, and not surrender that control to an agent. Nor is he entitled to delegate the control to his co-trustees. He must exercise his due share.
>
> But this does not mean that he must do everything himself. Although he may not delegate his duties as trustee, he is not bound to transact in person such business connected with or arising out of the trust as reasonably prudent business men would transact with the aid of servants or experts." [Mackenzie Stuart, *The Law of Trusts*, 1932].

A similar passage can be found in Walker's *Principles of Scottish Private Law* at page 1816 and Wilson and Duncan's *Trusts, Trustees and Executors* (1975 Edition, page 306).

Mackenzie Stuart states that while a trustee is not entitled to employ others to do what he ought to do himself, he is **bound** to take advice and employ assistance wherever a reasonably prudent business man would do so in the management of his own affairs. Examples are given of the appointment of solicitors, buying and selling investments through stockbrokers, having trust accounts prepared by

accountants, employing auctioneers, rent collectors, estate managers etc. A trustee does not delegate his duties when he takes such assistance and accepts and uses its results.

The whole tenor of the passage quoted from is that of the trustee taking properly qualified advice. "Advice given by experts must not be accepted blindly. It must be scrutinised to see whether the expert is dealing with what has been properly remitted to him or whether he is assuming functions of decision in matters such as policy which cannot be delegated by the trustees" (page 165). That this is the type of approach which would still be followed by the Courts in Scotland is supported by comments in the case of *Martin v City of Edinburgh District Council* (1988 SLT 329) which concerned the investment policy of Edinburgh District Council and instructions not to invest in South Africa. In that case, Lord Murray accepted that the trustee was entitled to give guidance on investment policy and emphasised that it was abdication of the trustee's duties "merely to rubber stamp the professional advice of financial advisers".

Some appointment of agents is allowed: the Trusts (Scotland) Act 1921 recognised that it was perfectly acceptable for trustees to instruct agents to carry out certain functions for them. Section 4 of that Act includes a series of powers which are conferred upon trustees where not at variance with the terms or purposes of the Trust. One of these powers is "(f) to appoint factors and law agents and to pay them suitable remuneration". I do not think that you can stretch the word "factor" to cover discretionary investment managers. There is no other express power to appoint agents, but the types of appointment which are normal have developed over the years, in my view as a result of the application of the "reasonably prudent business man in the management of his own affairs" test. There is, however, no statutory power in Scotland for trustees to delegate to attorneys even for a limited time.

It is my personal view that it is by no means certain that a reasonably prudent business man **would** employ investment managers on a discretionary basis. He might do so but he might also wish to retain control over the individual investment decisions, and I do not think that discretionary management has become so commonplace that one can say it is the norm for business people in managing their own affairs; it is in any event quite different from employing agents, so I am not sure that an argument based on everyday practice would have much chance of success.

I therefore suggest that if trustees who do not have express power to do so, delegate discretionary investment management powers, they are at risk of having committed a breach of trust. They are, after all, letting others exercise decision making powers which the trust deed reserves to them.

If I can turn now to the use of nominees, there are considerable practical and commercial pressures to use nominees. They sit uneasily with the general Scots

law relating to the duties of trustees. Mackenzie Stuart again, at page 200, states "it is the duty of a trustee to take possession of the [Trust] Estate, and to have it transferred into the name of the trustees to the extent that no individual trustee or third party can use it for other than Trust purposes. If he allows the Trust Estate to remain in the hands of a third party, or of the law agent, without reducing it into the possession of the Trust, he incurs the risk of personal liability if it should be lost. Belief in the integrity of the party holding the property of the Trust is no excuse."

Wilson & Duncan (page 248) states that the trustee has a duty to complete title to the various assets comprised in the trust estate so far as within his power to do so.

Readers will notice that the authorities are for the most part old. It is also relevant to note that Mackenzie Stuart goes at some length into the duty of trustees not to let their law agents (solicitors) have control of the Trust Funds for administrative purposes other than for particular transactions. It is fair to say that with the introduction of strict solicitors' accounts rules, the Guarantee Fund, high levels of professional indemnity cover and the like, trustees who place funds with solicitors (and other professional advisers) are well protected against loss. It is also fair to say that the practice of trust administration has developed considerably and it is now commonplace and the norm for trustees to entrust solicitors, other professional advisers or banks with the day to day administration of trust investments and cash.

In this context it would be a mistake to go back to the older authorities and treat them blindly as authority for the proposition that trustees may not hold investments through nominees. This is a very different issue from the delegation of actual investment decision taking functions. Practice has developed in other areas of administration and why should it not develop in this area? The Stock Exchange has drastically reduced the timescale within which bargains have to be settled. It can be argued that the trustees are only entering into an appropriate administrative arrangement, not merely for their own convenience, but of necessity for the proper settlement of Stock Exchange transactions. (It may also be necessary for trustees to hold non-UK investments through foreign bank custodian arrangements if they are to invest abroad at all; and if the proper investment decision is to invest direct in foreign equities then the trustees may in practice have no choice but to use a foreign nominee company.) I do not think that it is stretching a point too far to say that an ordinary prudent business man in the management of his own affairs would now use a properly qualified nominee (particularly if there was a joint holding of investments, or a foreign investment portfolio). I suggest, therefore, that the use of a nominee (or custodian) should not now, in the context of developed trust administration practice, be seen as a breach of trust. The trustees should, of course, exercise proper care in the selection and supervision of the nominee.

I am encouraged in this argument by the discussion in Wilson & Duncan at p. 235 where the use of nominees to hold stock exchange investments is discussed without any suggestion of breach of trust; but it seems that the authors envisaged this as part of the role of a custodian trustee, still to be developed in Scotland.

I am not convinced that the use in good faith of nominees, who still hold the assets to the order of the trustees, should be considered in the same light as a transfer for no consideration where no enquiry was made as to whether the transfer was for purposes connected with those for which the assets were held: the situation in *Bishopsgate Investment Management Limited v Maxwell* (No 2) [1994] 1 All ER 261, where a strict view was taken as to liability for a transfer in breach of a fiduciary duty.

It has to be accepted, though, that this line of argument may well not find favour with a Scottish Court considering a breach of trust case. It would take a substantial change of approach by the Scottish Courts to sanction the use of nominees where this is not authorised by the trust deed.

If it is shown that, in any particular circumstances, either delegation of investment management functions on a discretionary basis, or the use of nominees, are breaches of trust, what is the exposure of the trustee? The beneficiaries would have a right of action against the trustees for breach of trust. The nature of the breach or the degree of fault do not affect the measure of damages once the breach has been established. [See, e.g., *Menzies on Trustees*, 2nd edition, 1913, para 1071; Wilson & Duncan pp.382-387]. The liability on the trustee is to make good to the Trust Fund the loss which he has caused. The onus is on the trustee to show, if this is the case, that loss suffered by the trust estate is not attributable to his default. If there are two separate transactions in breach of trust, one producing a gain and the other a loss, the trustee cannot set the gain on the one transaction against the loss on the other in coming up with the measure of loss to the Trust Fund. The profit is part of the Trust Fund, while the loss is a personal liability. This puts the trustee in an unenviable position.

If there is unauthorised delegation of discretionary investment management functions and some investments come good and others lose money, then the trustee is at risk of having to make up to the Trust Fund the losses on the unauthorised investments; while the Trust Fund keeps the profits on the other investments.

What if the trustee uses a nominee and as a result of this the Fund Manager is able to indulge in, say, stock lending which is in excess of the trustee's powers or outside the terms of the investment management agreement? The use of nominees in itself has made the loss possible, which would not otherwise be possible. If the nominee company is unable to recover the stock lent, e.g., because of the borrower has become insolvent, then the trustee appears to have personal liability to the Trust Fund if his action constituted a breach of trust.

Clearly these issues are of considerable concern to trustees at present, partly because of the commercial pressures to use nominees and discretionary investment managers. On the other hand there is the concern that, where Barings went, others may follow without a full rescue operation; and the recent English cases of *Target Holdings Limited v Redferns* [1994] All ER 337 and *Bishopsgate v Maxwell* (mentioned above) indicate that there is still a strict view in England, which would on past experience be followed by the Courts in Scotland, as to liability of those in a fiduciary position where there has been a breach of trust.

What can a trustee do? It is unlikely that any immunity clause in a trust deed will confer immunity on trustees for breach of trust. The trustee may apply to the Court of Session under section 32 of the Trusts (Scotland) Act 1921. This provides that "if it appears to the Court that a trustee is or may be personally liable for any breach of trust..... but has acted honestly and reasonably, and ought fairly to be excused for the breach of trust, then the Court may relieve the trustee, either wholly or partly, from personal liability for the same." This may be of some comfort to the trustee if the loss has already happened but it is unlikely to be of comfort to a trustee contemplating an action which he may be advised is in breach of trust. It seems to me to be honest and reasonable for trustees to use nominees in the present day investment climate; and if the trustee enquires carefully into the establishment and procedures of the nominee, supervises the nominee properly, and is satisfied that it is protected by suitable insurance cover, the trustee may hope for relief under section 32.

Further, under section 31 of the 1921 Act, where a trustee has committed a breach of trust at the instigation or request or with the consent in writing of the beneficiary, the court is entitled to make an order applying the beneficiary's interest in the trust estate by way of indemnity to the trustee. Again this may be of some comfort in some circumstances but it is still short of the clear cut protection which a trustee would normally seek. There is no right of personal action by the trustee against the beneficiary and there is no obligation on the Court to protect the trustee: it merely has discretion to do so.

An indemnity from the beneficiaries may be of some comfort although it is not at all clear that an indemnity from a beneficiary to a trustee in respect of a breach of trust is enforceable by the trustee.

It may be preferable to apply to the Court of Session under section 1 of the Trusts (Scotland) Act 1961 for the extension of the trustee's investment and related powers. That section enables the Court to grant approval of an arrangement varying or revoking all or any of the trust purposes "or enlarging the powers of the trustees of managing or administering the estate". This may be the preferred route for many trustees; initially, under the 1961 Act procedure, the Court was reluctant to sanction extensions beyond the stated and statutory powers, but as shown in the case of *Henderson, Petitioner*, 1981 SLT (Notes) 40, the Court will

now sanction the extension of investment powers beyond those stipulated in the trust deed and the Trustee Investments Act 1961 if appropriate.

As far as nominees are concerned, the trustee might feel more comfortable and less exposed to the risk of personal costs with the use of a nominee controlled by the trust administrators (solicitors, accountants, etc) rather than by the investment managers.

Finally, there is always the hope that the law will be changed, and although representations have been made on this subject, it may be some time before the next Law Reform (Miscellaneous Provisions) (Scotland) Act has space into which appropriate trust administration clauses can be inserted.

In an article of this length it is only possible to scratch at the surface of some difficult legal and practical issues. If nothing else, those involved with the administration offshore of Scottish trusts should consider again in the light of recent developments exactly what their investment management and nominee arrangements are.