

TRUSTEE EXEMPTION CLAUSES REPORT

Launch event: 19 July 2006

Stuart Bridge, Law Commissioner

- 1.1 The issue of trustee exemption clauses was brought to public attention by the decision of the Court of Appeal in *Armitage v Nurse* in 1997. In that case, a claim was made by a beneficiary of a trust that the trustees had so seriously mismanaged the trust fund (which contained largely farm-land) that she had suffered financial loss. The claim was however doomed to fail. The trust instrument contained a trustee exemption clause which absolved the trustees from liability for any loss or damage from any cause whatsoever unless such loss or damage was caused by the trustee's own actual fraud.
- 1.2 Lord Justice Millett (as he then was) acknowledged that the question whether professional trustees (in particular) should be entitled to rely upon trustee exemption clauses raised important issues of policy. At the time, the Trust Law Committee had started to consider these issues. Lord Millett, while expressing concern about such clauses, believed that it should be a matter for Parliament alone, which could act with the benefit of wide consultation with interested bodies, as to whether they should be denied effect.
- 1.3 The subject of trustee exemption clauses was referred to the Law Commission in 2001 by the Lord Chancellor's predecessor. We published a consultation paper in 2003. This took the bull by the horns and made a number of provisional proposals for legislation. In particular, we proposed that a professional trustee should no longer be able to rely on any provision in a trust instrument excluding liability for breach of trust where that breach of trust arose from negligence.
- 1.4 We realised at the time that such a proposal was not sufficiently comprehensive in itself. If it was thought necessary to regulate by legislation trustee exemption clauses (that is, clauses which purport to exclude the trustees from liability for breach of trust), then as an anti-avoidance measure it would also be necessary to regulate those clauses which did not exclude or restrict liability as such, but which sought, by modifying the duties to which trustees were subject, to prevent liability arising in the first place: what we refer to in the Report as "duty modification clauses".
- 1.5 Unfortunately, such clauses defy easy definition. We found it quite impossible to formulate satisfactory terminology which would separate out the acceptable from the unacceptable, the good from the bad, the wheat from the chaff. The CP therefore proposed an ad hoc (case by case) approach, conferring power on the court to strike down duty modification clauses where to rely on them would be inconsistent with the overall purposes of the trust and where it would be unreasonable in the circumstances for the trustee to be exempted from liability.
- 1.6 We carried out a spirited and pro-active consultation process, taking the issue to those who are involved in the administration of trusts and asking their views of the proposals we had made.

- 1.7 The consultation process showed the level of interest in, and controversy surrounding, this subject. It is impossible to summarise the responses we received (there were 116 in all) but there were certain underlying themes which came through.
- 1.8 It was generally felt that “something should be done”. There was however no discernible consensus on what that something should be. It was noticeable that many consultees accepted the need for, and importance of, reform, but only insofar as it did not extend to them (either on the basis that they were not the kind of trustee that regulation should be dealing with, or on the basis that regulation should not apply to their kind of trust.)
- 1.9 It became clear that a number of obstacles stood in the way of statutory intervention of the sort we had provisionally proposed in the Consultation Paper.
- 1.10 First, there were very real concerns about the potential adverse consequences of legislative regulation. Among the dangers of “over-regulation” put forward by consultees we can list:
- (1) The administration of trusts would become more bureaucratic, and probably more expensive, as indemnity insurance premiums would be likely to increase;
 - (2) Trustees would become more defensive in their policies, being disinclined to act expeditiously without first obtaining legal advice;
 - (3) The management of trust property would become correspondingly less flexible;
 - (4) There would be an increase in trust litigation by disappointed beneficiaries;
 - (5) There would be no clear alternative protection to trustee exemption clauses available to trustees. Ex post facto judicial relief was uncertain in its scope, and it was apparent that trustee indemnity insurance was not capable of filling the role;
 - (6) Some trustees would even become reluctant to act at all.
- 1.11 Secondly, serious reservations were expressed about the treatment of duty modification clauses we had proposed, on the grounds that it would give rise to uncertainty as to whether trustees could safely rely upon the apparent terms of the trust. That is in our view a legitimate concern. Although we have tried, we have not been able to overcome the technical difficulties presented by duty modification clauses. We have therefore been unable to frame legislative regulation satisfactorily so that it would effectively prevent the successful use of avoidance mechanisms and at the same time not create a system with even greater potential adverse impact.
- 1.12 Thirdly and finally, we remain aware that any statutory prohibition of reliance on trustee exemption clauses would restrict the autonomy of settlors to determine the terms on which they settle assets on trust. This would limit the flexibility of the trust, and thereby detract from one of its greatest attributes.

- 1.13 To summarise, we have taken the view that any statutory regulation of trustee exemption clauses would be ill-advised, and that it would risk significant adverse consequences. These would impact as much on beneficiaries (who are the ones who stand to gain from the pro-active management of the trust fund by capable trustees, and from the current flexibility inherent in the trust) as on trustees. In short, we believe that the cure could be worse than the disease.
- 1.14 As a consequence, we are not now recommending any statutory regulation, and we are not proceeding further with our provisional proposals. But that is not to say that nothing should be done. On the contrary, we are firmly of the view that we should deal with one particular problem.
- 1.15 During the course of the consultation process it was pointed out to us that many settlors appear to be unaware of the existence (or the effect) of trustee exemption clauses. This is an unacceptable state of affairs. Without the knowledge and consent of the settlor, how can it be said that the clause is a true manifestation of the settlor's autonomy? We believe that trustees should be required to ensure that, before the trust is executed, the settlor is made aware of any trustee exemption clauses contained within the instrument.
- 1.16 The most effective means of achieving this objective is not however by means of legislation. A broad statutory prohibition on reliance on trustee exemption clauses where the trustee cannot prove "settlor awareness" would not only be fiendishly difficult to draft in view of the problems we have already identified, it would give rise to delay and cost when the trust is being established, and it would inevitably lead to uncertainty as to the validity of any such clauses thereafter.
- 1.17 The approach we prefer, and we have decided to adopt, is to regulate by means of securing the acceptance of changes in practice by those who take responsibility for the promulgation of good practice and conduct on the part of trustees. We believe that this approach represents the most appropriate and effective way of influencing and informing trustees so as to ensure the proper disclosure of exemption clauses to the settlor.
- 1.18 During the last six months or so, the Law Commission has therefore been discussing with the regulatory and professional bodies the formulation and dissemination of an appropriate rule of practice. Regulated persons would be required to adhere to good practice as so defined. Breach of such a rule would not in itself incur liability in damages, but it would render the trustee open to disciplinary sanctions by the relevant governing body.
- 1.19 The rule we have settled upon, and which forms the basis of the rule to be adopted by regulatory and professional bodies, is to the effect that:

Any paid trustee who causes a settlor to include a clause in a trust instrument which has the effect of excluding or limiting liability for negligence must before the creation of the trust take such steps as are reasonable to ensure that the settlor is aware of the meaning and effect of the clause.

- 1.20 The rule should also apply to those who draft trusts. We give detailed guidance in the Report on the application of the rule. I should however mention that there are several specific circumstances where (for a range of reasons) we do not consider that the rule should apply. These include pension trusts, charitable trusts (save in relation to the original settlor or founder), where the trustee is already subject to statutory regulation in respect of trustee exemption clauses, and (in general) where the settlor is acting in the course of business.
- 1.21 We are recommending that Government should promote the application of this rule of practice as widely as possible across the trust industry. We are encouraging relevant regulatory and professional bodies to adopt a version of the rule appropriate to the particular circumstances of their membership, and to enforce such regulation in accordance with their existing codes of conduct.
- 1.22 The Society of Trust and Estates Practitioners is the first organisation to have finalised such a rule, and to have formally decided to adopt it. (Mr Gothard will explain further in a moment). We are very grateful to STEP for its assistance throughout the currency of this project.
- 1.23 But the Law Society, representing all practising solicitors, and the Institute of Chartered Accountants, are also well on the way to developing regulation within their own specific disciplinary contexts. We look forward to them finalising and implementing this regulation. We are deeply appreciative of the assistance and support which has been given to us by the Wills and Equity Committee of the Law Society, which has not only been ready to put its accumulation of practical expertise at our disposal, but which has also, by the efforts of its officers, ensured that appropriate action is taken. We are also very grateful for the support of the ICAEW, and we are pleased that, following our prompting, they have appreciated the nature of the problems posed by trustee exemption clauses and have also taken action accordingly.
- 1.24 We believe that this is a sensible and proportionate response to the problem we are seeking to address. We anticipate that the successful adoption of this rule of practice across the trust industry will significantly ameliorate the problems associated with trustee exemption clauses. This approach allows paid trustees to make legitimate use of trustee exemption clauses provided they take reasonable steps to bring them to the attention of the settlor. And where trustee exemption clauses are relied upon, it will be on the basis that they represent the proper and fully informed expression of the terms on which settlors are willing to dispose of their property. That is surely how it should be.

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