

TRUSTEE EXEMPTION CLAUSES

EXECUTIVE SUMMARY

The Law Commission Consultation Paper “Trustee Exemption Clauses” examines the current law and practice relating to trustee exemption clauses in England and Wales, considers the economic implications of regulation of such clauses, sets out the options for reform and makes provisional proposals on which the views of consultees are invited.

In this project we are concerned with the extent to which trustees can exclude or restrict their liability to the beneficiaries for breach of trust.

THE PROBLEM

Trust duties are obligations contained in the trust instrument or imposed by law, which must be carried out by the trustees. The trustees’ failure to carry out their duties is a breach of trust and the trust beneficiaries (subject to the existence of an exemption clause) may take action to recover any loss caused to the trust by the trustees’ failure.

The relatively unrestricted nature of trustees’ liability for breach of trust has resulted in the use of common form clauses in trust instruments which exclude or restrict that liability. The terms of such clauses in early trust instruments were fairly narrow and they were strictly construed against trustees. However the changed nature of the trust assets, the use of the trust for purposes never before envisaged, the extended powers given to trustees and the fear of increasingly litigious beneficiaries has led to the inclusion of ever wider exemption clauses in trust instruments.

A typical trustee exemption clause may read as follows:

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

It is now relatively common to find express provisions in modern trust instruments inserted to protect trustees from their liabilities in respect of acts or omissions that would normally be regarded as breaches of trust. As the powers of trustees have increased as a result both of express provisions in trust instruments and by legislation, so has the breadth of trustee exemption clauses. When coupled with the less restrictive approach recently adopted by the courts to the construction of exemption clauses, it can be strongly argued that the protection offered to beneficiaries, one of the prime concerns of trust law, is weaker than in the past.

THE CURRENT LAW

The current law recognises that there is an irreducible core of obligations from which trustees cannot escape. However, as that core comprises little more than a duty to act honestly and in good faith it does not impact seriously on a settlor's freedom to exclude trustees' liability by express terms in the trust instrument.

In 1998 in *Armitage v Nurse* the Court of Appeal dispelled all doubts as to the validity of trustee exemption clauses which exclude liability for ordinary or even gross negligence. The court held that a clause (similar to that set out above) could exclude 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". It is now settled law in England and Wales that trustee exemption clauses can validly exempt trustees from liability for breaches of trust except fraud.

In each case the court must construe the words of the exemption clause in light of the conduct complained of and decide whether liability has been excluded by the terms of the clause. In carrying out this exercise the clause must be construed fairly according to the natural meaning of the words used. Although there are restrictions on exemption clauses or duty modifying clauses in other areas of the law, there are currently no statutory provisions which are directed at all kinds of trustee exemption clauses.

THE ECONOMIC IMPLICATIONS OF REGULATING TRUSTEE EXEMPTION CLAUSES

The economic impact of any legal regulation of trustee exemption clauses is an important consideration in deciding whether reform should be recommended. Obtaining accurate information about trust practice is a difficult exercise, as trusts are not publicly recorded or registered. In an attempt to understand as fully as possible the current significance of trustee exemption clauses, we commissioned independent socio-economic research on the subject.

The research revealed that trustee exemption clauses are now widely used in trust instruments and that professional trustees in particular have come to rely upon them as affording a means of protection from liability for breach of trust. This trend is not by any means universally approved- even among professional trustees themselves, many of whom take the view that those who charge for their services should be properly accountable to the beneficiaries of the trust.

However many professional trustees consider trustee exemption clauses to be a necessary component in modern trust practice. They would argue that any regulation would lead to a greater reluctance to act and possibly to the transfer of trusts to jurisdictions which do not restrict reliance on trustee exemption clauses. We are not presently convinced that there is a significant risk of the latter. The most convenient jurisdictions, namely Jersey and Guernsey, have already imposed legislative controls on trustee exemption clauses, and it does not appear that this is an issue which is usually determinative of choice of jurisdiction for a settlor or for that matter a trustee.

Where a trust contains a trustee exemption clause, liability insurance premiums are likely to be lower. In so far as exclusion of liability is regulated, the trustee's degree of risk will increase, and the concomitant rise in premiums will be carried through to the settlor in the fees being charged by the trustee. There may also be higher operational costs which could be fairly attributed to regulation.

PROVISIONAL PROPOSALS

The Law Commission does not believe that an absolute prohibition on all trustee exemption clauses is justifiable at present. One of the advantages of the trust is its flexibility and its adaptability to different factual circumstances and to different kinds of relationship. To deny settlors all power to modify or to restrict the extent of the obligations and liabilities of the trustee would have a very significant impact on the nature of the trust relationship. The trust would inevitably become more inflexible. We are particularly concerned that excessive regulation of trustee exemption clauses may deter lay trustees from assuming the responsibility of trusteeship in the first place.

At the same time, the Law Commission does believe that there is a very strong case for some regulation of trustee exemption clauses. Their increased use in recent years has without doubt reduced the protection afforded to beneficiaries in the event of breach of trust. While there is a need to maintain a balance between the respective interests of settlor, trustee and beneficiary, we believe that the current law is too deferential to trustees, in particular professional trustees who hold themselves out as having special knowledge skills and experience, charge for the services they provide and insure themselves against the risk of liability for breach of trust.

We therefore propose to draw a distinction between the professional trustee and the lay trustee. "Professional" trustees would comprise trust corporations and any other trustees acting in a professional capacity. All others would be "lay" trustees.

As a matter of good practice, the draftsman of a trust should always bring the presence of a trustee exemption clause to the attention of the settlor, explain clearly its implications and discuss the alternatives which may be available for the protection of those who may be acting as trustees.

We make several provisional proposals which would require legislation:

- All trustees should be given power to make payments out of the trust fund to purchase indemnity insurance to cover their liability for breach of trust.
- Professional trustees should not be able to rely on clauses which exclude their liability for breach of trust arising from negligence.
- In so far as professional trustees may not exclude liability for breach of trust they should not be permitted to claim indemnity from the trust fund.

- In determining whether professional trustees have been negligent, the court should have power to disapply duty exclusion clauses or extended powers clauses where reliance on such clauses would be inconsistent with the overall purposes of the trust and it would be unreasonable in the circumstances for the trustee to be exempted from liability.
- Any regulation of trustee exemption clauses should be made applicable not only to trusts governed by English law but also to persons carrying on a trust business in England and Wales.
- Any legislation should apply to any breaches of trust which occur on or after the date when it comes into force but it should not apply to breaches of trust which precede that date.

The Law Commission also invites views of consultees on other possible options for reform of the law, for example:

- Whether a trustee should be able to rely on a trustee exemption clause to exclude or restrict his or her liability for breach of trust only where the clause satisfies the test of reasonableness.
- Whether professional trustees should not be able to rely upon a trustee exemption clause where it is not reasonable to do so by reference to all the circumstances including the nature and extent of the breach of trust itself.

We also invite comments from consultees on the economic implications of any regulation of trustee exemption clauses, including the regulatory impact of our provisional proposals.

All views expressed in the Consultation Paper are provisional only, and we look forward to hearing the views of those who have an interest in the subject. The consultation period ends on 30 April 2003. The postal and electronic addresses to which comments should be sent are shown on the inside front cover of this Consultation Paper.