CHANCERY BAR

FORGIVENESS BEFORE THE EVENT

Trustee exoneration clauses and articles of association protecting directors

A. Exoneration clauses in trust deeds

Trust deeds can by their terms protect a trustee or ease its task in different ways.

First, they can limit the duties of the trustee – for example they can provide that a trustee does not have a duty that the general law would ascribe to it. One such example might be a provision to the effect that a trustee holding as part of the trust property a substantial proportion of the share capital of a private company should not have to concern itself with the director's management of the company beyond specified steps. That will ease the task of the trustee – and do so by limiting his duty rather than by exonerating him from a breach of duty.

Secondly a trust deed may extend the power of a trustee beyond what the general law might provide. The commonest example is an extension to a trustee's investment powers. So investing in high risk assets will be expressly authorised by the trust deed – not be a breach of duty for which retrospective exoneration is needed.

Thirdly, and this is the topic I am going to address, a trust deed can provide that even though a trustee breaches his duty, he will not be liable. There is a fundamental distinction

between cases of this type and cases where the duties of the trustee have been limited or the trustee's powers extended. In those two cases, there will be no breach. In the situation that I am going to be addressing there has been a breach. There however is no liability because the trust deed says there is no liability.

We are dealing therefore with a trust deed with a clause in it like this one:

"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 . . . ."

That is in fact the clause found in the case I am about to address: Armitage v Nurse [1998] Ch 241. You can see that it happily envisages a breach of trust but, other than where caused by actual fraud, it declares that the trustee shall not be liable for such a non-fraudulent breach.

Confusingly this type of clause can be found referred to in the literature as an exclusion clause, an exoneration clause, an indemnity clause or a special indemnity clause. I shall try to use the term "exoneration clause".

Let's look first then at the English CoA case of Armitage v Nurse. As noted on the slide, this case has been followed here in at least two cases that I am aware of.

Armitage v Nurse is not without criticism, not least in relation to its reliance on Millet LJ's view of Scots law which apparently is not entirely concurred in by Scots lawyers. As we shall

see however it has recently been accepted as authoritative as a matter of English law by the Privy Council in Spread Trustee v Hutcheson - another case I am going to come on to.

In Armitage v Nurse Millett LJ examined whether there were irreducible aspects of trusteeship such that there was a limit to what protections a trust deed could give a trustee -while still maintaining the fundamental features of a trust. If a trust deed said that a beneficiary could not complain about his trustee's negligence or carelessness, it might be thought that it was not much of a trust.

Millett also considered in Armitage what, in the context of a trust deed and an exoneration clause, the term "fraud" or "actual fraud" meant.

His view, which has now been approved by the PC in Spread is that there **are** irreducible core obligations owed by trustees to beneficiaries but they are limited:

"The duty 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 is sufficient"

LJ Millett therefore had no time for a public policy argument that a trust deed should not be allowed to exclude liability for a breach where the breach did not amount to a breach of that fundamental duty. A trustee to be a trustee had to act "honestly and in good faith for the benefit of the beneficiaries". If he did that and lived up to that standard, however carelessly, he was still a trustee and if the settler decided that his trustee should not be

liable so long as he lived up to that standard, the courts should uphold that. In short there was no problem with a trust deed excluding liability for negligence.

LJ Millett drew the line very clearly at dishonesty. A settlor could not set up a trust which allowed the trustee to be dishonest without repercussion, but he could set up a trust which allowed the trustee to make mistakes and be incompetent without repercussion.

So much for public policy – but that left the question that will always arise, what in fact does the exoneration clause in question in any particular case actually mean.

In Armitage v Nurse all liability was excluded except for "actual fraud"– pretty clear you would think. But it took the CoA to sort it out. The problem of course is that in the trust context, phrases like "wilful default" and "equitable fraud" abound and give rise to lots of opportunity for argument about what precisely the word "fraud" is referring to.

"wilful default" sounds to many ears like "fraud", yet in the context of an account the phrase "an account on a wilful default basis" can extend to a profit which an accounting party should with due care and diligence have made for the trust. No dishonesty at all there.

"equitable fraud" again looks like fraud – but in fact is a phrase used to refer to a misuse of a trust power. No need for dishonesty

You have moreover to be careful even about apparently clear phrases such as deliberate breach of trust. Notoriously a trustee may be justified in committing a deliberate breach of trust. Certainly if it is committed with the intent to benefit beneficiaries, there is probably nothing dishonest about it. The illustration is of course the old story about LJ Lindley commenting that his old pupil master's view was that a trustee's main duty was precisely to commit "judicious" breaches of trust.

It is worth bearing in mind that much of what Millett has to say in this context in Armitage v Nurse regarding the meaning of the phrase "actual fraud" is strictly merely his views in the construction of the settlement in front of him. As a matter of construction "actual fraud" is a phrase to be construed in the context of each settlement in which it is used. Obviously however Millett LJ's approach may be persuasive. It also might now be considered part of a trust draftsman's technical dictionary.

Millett was clear that in the context of an exoneration clause in a trust deed, "actual fraud" meant dishonesty. Wilful default or equitable fraud, unless dishonest, would not be enough.

Later cases in England appear to have come to some conclusion regarding what, in the case at least of a professional trustee, will amount to dishonesty. This was Lewison J's conclusion in Fattal v Walbrook Trustees [2010] EWHC 2767:

"what is required to show dishonesty in the case of a professional trustee is:

i) A deliberate breach of trust;

ii) Committed by a professional trustee:

a) Who knows that the deliberate breach is contrary to the interests of the beneficiaries; or

b) Who is recklessly indifferent whether the deliberate breach is contrary to their interests or not; or

c) Whose belief that the deliberate breach is not contrary to the interests of the beneficiaries is so unreasonable that, by any objective standard, no reasonable professional trustee could have thought that what he did or agreed to do was for the benefit of the beneficiaries."

A last point on Armitage v Nurse: note that Millett concluded his judgment in Armitage by referring to the controversy over whether trustees, in particular professional trustees, should be able to have their liability, including their liability for negligence extensively excluded by the settlor. His view was that if the freedom of the settlor and trustee to agree on the terms of the trust, including on trustee exoneration clauses, was to be restricted beyond the outlawing of exoneration for dishonesty, that would have to be done by statute.

In England that has not been done generally - although certain statutes do regulate specific types of trust: for pension trustees and for trustees of unit trusts statute has outlawed clauses excluding liability for breach of a duty of skill and care: see Pensions Act 1995 s.33 and FSMA s. 253.

As we shall see in other jurisdictions, statute has stepped in more generally.

Brings me on to Spread v Hutcheson [2012] 2 AC 194.

Millett in Armitage v Nurse grappled with the meaning of the term fraud and its various uses in the context of trustee exoneration clauses. In Spread v Hutcheson, the PC grappled with the meaning of the term negligence, specifically "gross negligence" in the same context.

As we are probably all aware English law, while it does sometimes use the term "gross negligence" generally is uncomfortable with it. The classic description was that it was no more than negligence with a vituperative epithet.

It is important to bear in mind the status of Spread. It is a decision of the PC on appeal from the Guernsey Court of Appeal. In the PC it was a majority decision 3:2 on Guernsey law and its ratio also depends upon its analysis of both English and Scottish law. While clearly an important decision and certainly persuasive outside Guernsey, it cannot be ruled out that a PC hearing an appeal from another jurisdiction or the Supreme Court on an English case might not follow it.

The question for the PC concerned the effect of a Guernsey statute. In short a 1989 statute had codified for the first time the Guernsey law relating to trusts and had included a provision to the effect that a trust deed could not relieve liability for breach of trust arising from fraud or wilful misconduct. That had then been amended in 1991 by the addition of the words "or gross negligence".

The settlements in question had an exoneration clause in the following form:

"In the execution of the trusts and powers hereof no trustee shall be liable for any loss to the trust fund arising in consequence of the failure depreciation or loss of any investments made in good faith or by reason of any mistake or omission made in good faith or of any other matter or thing except wilful and individual fraud and wrongdoing on the part of the trustee who is sought to be made liable"

All parties and courts in Spread accepted that Guernsey law prohibited exoneration of trustees for actual fraud and dishonesty. At 1st instance and in a Guernsey CoA, which it may be noted consisted of 3 English lawyers, it was however decided that pre-1989 Guernsey customary law had also prohibited the exclusion of liability for gross negligence. In the Guernsey CoA this conclusion was grounded on a finding (i) that English law on whether you could exclude liability for gross negligence was unclear, (ii) Scottish law clearly said that you could not exclude liability for gross negligence, and (iii) Guernsey customary law would have followed Scottish law as a similar mix of civil and common law.

A first question was what was meant by gross negligence in the authorities and in the Guernsey statute as amended. In the context of a trustee exoneration clause the majority were happy to conclude that gross negligence was not a species of "fraud or wilful misconduct". They drew the line like Millett in Armitage between negligence and dishonesty. As far as the original form of the 1989 Guernsey Law was concerned, by prohibiting exclusion of liability for "fraud or wilful misconduct", implicitly exclusion of liability for gross negligence was not prohibited.

Spread was strictly a narrow decision on the effect of a Guernsey statute, and one which has since been changed. A fair amount of its argument was also addressed to the question of retrospectivity. Its significance lies much in its approval of LJ Millett's approach in Armitage v Nurse.

I have mentioned that other jurisdictions do not necessarily follow the English common law position as enunciated by LJ Millett in Armitage v Nurse. As mentioned, so far as I am aware, the courts in Cayman have followed Armitage v Nurse and I have seen nothing in the Trusts Law to affect that. With the warning that what I say here about non-English jurisdictions should not be relied upon at all – I am only an English lawyer, my understanding is that Guernsey prohibits exclusion of liability for gross negligence, Jersey also does so; the Turks & Caicos Islands go further and prohibit exclusion of liability for ordinary negligence; Scotland apparently prohibits exclusion of liability for gross negligence on the basis that gross negligence is equivalent to fraud. The message is – ask a local lawyer.

Appelby. I mentioned at the outset that exoneration clauses were just one of three methods of easing the position of trustees. A case in the BVI has highlighted a further approach. This is the case of Appelby Corporate Services v Citco Trustees BVIHC (Com) 156 of 2011. In this case the trust deed allowed the trustee an indemnity on retirement in the form:

"The Trustee may resign as trustee hereof on providing 60 days notice to the Protector ... and at the end of such period the Protector .... shall exercise its power of appointment to appoint a new trustee and the outgoing trustee shall be discharged from its trust and shall be indemnified in respect of any fiscal imposition or other liability of any nature payable in respect of the Trust Fund or otherwise in connection with this Trust except its own wilful fraud or wrongdoing"

It was argued on a strike out application that a claim for breach of trust by a new trustee must fail because if the old trustee was liable for breach of trust, it was entitled to an

indemnity out of the trust fund to that extent and the claim would fail for circuity. Ingenious.

Even more ingenious was the trustee's answer to the point that the alleged defalcations had so diminished the trust fund that there was not enough in the trust fund to meet the trust fund's liability to the trustee on the indemnity. The trustee answered that to the extent that it was ordered to pay compensation to the trust fund, it under its indemnity would have a first charge on that reconstituted trust fund. So circuity was maintained.

Unfortunately we do not know whether the argument would ultimately have succeeded because it was a strike out application and the court refused a strike out on the grounds that it was arguable that the trustee's indemnity did not as a matter of proper construction extend to breaches of trust at all. It was therefore arguable that the circuity argument did not arise and therefore the matter should proceed to trial.

That failure of the Appleby strike out because of an issue of construction which had to go to trial is a timely reminder that we are on every occasion going to be facing a preliminary question of construction – what does the clause in question mean? On a proper construction, does the clause in question exonerate the trustee from liability for the breach in question?

For this purpose it is worth remembering that the principle applies that a exoneration clause is an exclusion clause and should be construed restrictively – you need clear and unambiguous words. However as ever that principle should never be taken too far. see LJ

Millett again in Bogg v Raper (1998-99) 1 ITELR 267. Referring to a settlement in a case where at issue was an exclusion of liability for negligence, he observed:

"The document is the unilateral work of the testator or settlor through whom the beneficiaries claim. There is no inherent improbability that he should intend to absolve his executors or trustees from liability from the consequences of their negligence. They accept office on the terms of a document for which they are not responsible, and are entitled to have the document fairly construed according to the natural meaning of the words used"

B. Articles of Association & Directors

We have been considering the position of exoneration clauses in trust deeds. What about the often analogous position of company directors?

Here the position in England has since 1929 been regulated by statute. In England s.232 Companies Act 2006 now applies in general outlawing provisions in articles or contracts exonerating directors from liability for breach of duty.

232 Provisions protecting directors from liability

(1) Any provision that purports to exempt a director of a company (to any extent) from any liability that would otherwise attach to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company is void.

(2) Any provision by which a company directly or indirectly provides an indemnity (to any extent) for a director of the company, or of an associated company, against any liability attaching to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company of which he is a director is void, except as permitted by–

(a) section 233(provision of insurance),

(b) section 234(qualifying third party indemnity provision), or

(c) section 235(qualifying pension scheme indemnity provision).

(3) This section applies to any provision, whether contained in a company's articles or in any contract with the company or otherwise.

(4) Nothing in this section prevents a company's articles from making such provision as has previously been lawful for dealing with conflicts of interest.

As you can see, statute provides exceptions. Not time to look at now in detail but in short, it can be lawful for a company to pay for insurance, it can also be lawful for a company to indemnify a director for liabilities to third parties or for liability as a pension scheme trustee

That however is the statutory position. Prior to 1929 it was customary and effective in England for articles to exempt directors for liability save in the case of wilful default or dishonesty. My understanding is that in some jurisdictions this remains the case. Certainly there is a Jersey Privy Council case as late as 1986 which suggests that as late as then Jersey statute had not intervened. My understanding however is that Guernsey law is now aligned with English law.

I have perused the Cayman Companies Ordinance and as far as I can see it too refrains from intervening. That conclusion is reinforced by the two Cayman cases: In the matter of Bristol Fund Ltd [2008] CILR 317 and Renova Resources Private Equity Ltd v Gilbertson [2009] CILR

268 in which articles excluding liability other than on a wilful default basis were construed. Correctly I think both those cases considered that regardless of the absence of statutory intervention in the Cayman Islands, an attempt in articles to exclude liability for dishonesty or actual fraud would not be allowed.

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May 2014