



**Law
Commission**
Reforming the law

Trustee Exemption Clauses Executive Summary

19 July 2006

TRUSTEE EXEMPTION CLAUSES

EXECUTIVE SUMMARY

BACKGROUND

- 1.1 The Law Commission's project on trustee exemption clauses arose out of the passage through Parliament of the Trustee Bill in 2000. During debates in the House of Lords, concerns were expressed that the proposed measure did nothing to control the use of trustee exemption clauses.¹
- 1.2 The Lord Chancellor responded to these concerns by undertaking to refer the matter to the Law Commission for detailed examination.

THE CONSULTATION PROCESS

- 1.3 The Law Commission published a consultation paper on trustee exemption clauses in January 2003.² The paper argued that the law governing trustee exemption clauses was in need of reform and made wide-ranging proposals for legislative intervention. The central provisional proposals were as follows:
 - (1) A professional trustee should not be able to rely on any provision in a trust instrument excluding liability for breach of trust arising from negligence. Clauses purporting to exclude such liability should be of no effect and in so far as a professional trustee were prevented from excluding liability for breach of trust, the trustee should not be permitted to claim indemnity from the trust fund.
 - (2) Reliance on duty modification or extended powers clauses should not be prohibited. In determining whether professional trustees had been negligent, the court should, however, be able to disapply such clauses where to rely on them 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.
 - (3) 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.
- 1.4 We received a total of 116 written consultation responses from a wide variety of sources, including trust companies, banks, accountants, judges, legal practitioners, academics, charities and industry groups. We also discussed our provisional proposals with trust experts at a number of conferences and seminars across the country.

¹ A trustee exemption clause is a clause in a trust instrument which excludes or restricts a trustee's liability for breach of trust, either by expressly excluding liability or by modifying the trustee's powers and duties. The term is used interchangeably with "trustee exoneration clause" and "trustee exculpation clause".

² Trustee Exemption Clauses (2003) Law Com Consultation Paper No 171 ("the CP").

- 1.5 A particularly important feature of the consultation was the decision by the Financial Markets Law Committee to set up a working party in order to provide a formal written response to the CP and more generally to explain the operation of trusts in financial markets.³
- 1.6 Consultees varied enormously in their reaction to the CP and expressed a broad range of views on the issues raised. It was impossible to distil a consensus view on many aspects of this difficult topic as, although there was instinctive support for reform of some sort, this did not translate into unambiguous support for any particular regulatory scheme. The main thrust of responses to the CP may, however, be summarised as follows:
- (1) There was a general distaste for the wide and sometimes indiscriminate inclusion of trustee exemption clauses in trust instruments, especially where the settlor is unaware of their existence or meaning. Although there was in consequence support for a degree of regulation of trustee exemption clauses, this was balanced by concerns about its implications for settlor autonomy and the appropriate protection of trustees.
 - (2) The CP's proposed scheme of legislative regulation was more popular than the alternatives considered but rejected in the CP. However, there was serious concern about the CP's proposed treatment of duty modification clauses on the grounds that it would give rise to uncertainty as to whether trustees could rely on the apparent terms of the trust.
 - (3) The CP's proposed distinction between professional and lay trustees was considered difficult to apply and liable to cause unfairness (especially in relation to professionals acting pro bono).
 - (4) The practicability of the CP's proposal that all trustees should have power to purchase indemnity insurance using the funds held on trust was questioned on the grounds of cost and availability.
 - (5) There was widespread concern about the likely adverse impact of statutory regulation restricting reliance on trustee exemption clauses. Particular reference was made to the likelihood of increased indemnity insurance premiums and the possible unavailability of insurance; defensive trusteeship (in particular, a reluctance on the part of trustees to exercise discretionary powers expeditiously and without first taking legal advice); a decrease in the flexibility of the management of trust property; an increase in speculative litigation for breach of trust; and a possible reluctance to accept trusteeship.

RE-EXAMINATION OF POLICY

- 1.7 We accept that there are a number of obstacles to statutory intervention of the sort provisionally proposed in the CP.

³ The Financial Markets Law Committee's Report had a major impact on the timing of the project. The team agreed to delay the formulation of final policy recommendations until the working party had reported and in the meantime progressed its project on the classification and apportionment of trust capital and income to the consultation paper stage (see Capital and Income in Trusts: Classification and Apportionment (2004) Law Com Consultation Paper No 175).

- 1.8 It is clear that restricting the use of exemption clauses in the manner provisionally proposed by the CP would have a significant impact on the trusts system as a whole. Exemption clauses operate to control risk and to keep costs down, thereby encouraging a sufficient number of trustees to operate in the market. There is no clear alternative protection available to trustees. We accept in the light of consultation responses that trustee indemnity insurance is not capable of filling the role.
- 1.9 Although it is not possible to assess precisely what the impact of restricting trustees' reliance on exemption clauses would be, we have concluded that there is a significant risk that any such legislation could lead to adverse consequences more damaging than anticipated by the CP. Such impact would be likely to be felt most keenly by beneficiaries, the very group intended to benefit from reform.
- 1.10 We also 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, in turn, limit the flexibility of the trust and in doing so detract from one of its greatest attractions.
- 1.11 Finally, we have not overcome the technical difficulties presented by the use of duty modification provisions. Such clauses are often included in trust instruments for perfectly good and practical reasons not motivated by an intention to avoid liability for breach of trust. However, they are also capable of excluding liability and so undermining any regulation of trustee exemption clauses. We have been unable to frame legislative regulation in a way which would effectively distinguish between these two types of use, other than by creating a complicated system with even greater potential adverse impact.

AN ALTERNATIVE APPROACH

- 1.12 Consultation has shown that there is, among reputable trustees, a strongly-held belief that trustee exemption clauses should not be included in a trust without the full knowledge and consent of the settlor. We consider the current state of affairs in which many settlors appear to be unaware of the existence or the effect of trustee exemption clauses unacceptable. It undermines the argument that settlors may autonomously decide to grant their trustees the protection of exemption. It also challenges the view that exemption clauses operate in a properly functioning market; the asymmetry of information between the trustee and the settlor has the effect of conferring on the former the benefit of a protection not appreciated by the latter.
- 1.13 We are of the view that trustees should be required to ensure that the settlors are aware of any trustee exemption clauses in their trust deeds. We believe that many in the trust industry would support this view. An important consequential question is whether regulation to achieve this objective should be effected by legislation or by some other means.
- 1.14 We have considered the option, discussed in the CP, of introducing a statutory requirement that trustees must disclose to the settlor any exemption clause on which they wish to be able to rely. We have rejected this approach on the grounds that it would be likely to give rise to delay and additional cost when setting up a trust and to uncertainty as to the validity of the clause thereafter. It is also unclear how such a statutory requirement could adequately frame the regulation of duty modification clauses.

- 1.15 We have concluded that a practice-based approach, rather than legislation, is the better means to bring about reform of the conduct of trustees. The Report therefore recommends a rule of practice 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.⁴

- 1.16 We believe that a rule of practice approach represents the most appropriate and effective means of influencing and informing trustees so as to secure the proper disclosure of exemption clauses. It would not suffer the defects that we believe would undermine a statutory scheme. Regulated persons would be required to adhere to defined good practice. Breach of this rule would not give rise in itself to liability in damages but would render the trustee open to disciplinary measures by the relevant governing body. We consider this a proportionate response to the failure of the trustee to ensure adequate settlor awareness of the exemption provisions in the trust instrument.
- 1.17 We have spoken to a number of regulatory and professional bodies who would be prepared to introduce regulation of this sort into their own professional codes of conduct. The England and Wales region of STEP is the first organisation to finalise such a rule, a copy of which is appended to our Report. Other organisations, including the Law Society and the Institute of Chartered Accountants in England and Wales, are in the process of developing regulation appropriate to their disciplinary structures.
- 1.18 We recommend that Government should promote the application of the recommended rule of practice as widely as possible across the trust industry. We encourage 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.
- 1.19 We anticipate that the successful adoption of the rule across the trust industry will significantly ameliorate the problems associated with trustee exemption clauses. It will ensure that such provisions represent a proper and fully informed expression of the terms on which settlors are willing to dispose of their property on trust.

⁴ See Part 6 of the Report for a full discussion of the operation of such a rule and guidance about its precise application (including its application to the drafters of trusts). We explain that the rule should be of no application to pension trusts, that it should apply only in relation to the original settlors of charitable trusts (and not to subsequent donors) and that it should not apply where the trustee is subject to the statutory regulation of trustee exemption provisions or, generally, where the settlor acts in the course of business.