Feature

KEY POINTS

- A trustee of a trust based personal pension scheme ought to be liable in respect of secret profits made by the beneficiary's investment adviser or manager **if** the trustee knows, or suspects and fails to ascertain, that a secret commission is to be paid.
- However, clauses in the Trust Deed are likely to exonerate the trustee from such liability except in cases of fraud (or at least gross negligence in jurisdictions such as Jersey) on the part of the trustee.
- If a trustee acts dishonestly (knowing that the investment he is making is not in the best interests of the beneficiary of the trust, at least without the secret commission payable to the investment manager upon such investment being made having first been disclosed to the beneficiary) he may be liable not only in breach of trust but also as a dishonest assister of the investment manager's breach of fiduciary duty.

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Whose liability is it anyway? Commissions and conflicts

This article explains how trustees of personal pension trusts may be exposed to liability in respect of investments made by beneficiary-appointed investment managers, who receive commissions which they do not disclose to the beneficiary.

The fiscal advantages of personal trust based pensions have made them recipients of very substantial investment funds. Those funds are often invested on the advice of financial advisers or at the direction of investment managers, whose duties include selecting the best investments to fit the particular circumstances of each case. Often however, that duty is compromised by a conflicting personal interest in the payment of commissions by the investment houses to which the funds are introduced: for example, a manager selects an investment in the High Oxygen Unit Trust. There is a 10 per cent entry fee into this Unit Trust, which is creamed off the top of the funds as soon as they are received, so the £1m pension contribution is immediately reduced to £900,000. The High Oxygen Unit Trust then pays 5 per cent (half of the entry fee) to the manager who introduced the funds, as a commission.

If this commission has been disclosed by the manager, and the investment has therefore been made with full knowledge of his personal interest in receiving £50,000 from the High Oxygen Unit Trust, that is one thing. All too often, however, the payment of the commission by the investment house to the manager is not disclosed and the funds are invested in ignorance of his personal interest in the investment.

Where investments are made into funds of funds, the commission to the manager may well be buried deeper in the structure: for example, the High Oxygen Unit Trust may only charge a 3 per cent entry fee and pay the manager a small commission (which the manager discloses – it is only a smallish amount), but the High Oxygen Unit Trust automatically invests 50 per cent of its funds in the Deep Water Fund and 50 per cent in the Clear Blue Sky Fund. Both charge an entry fee of 10 per cent of funds invested and both pay half of that entry fee to the managers who introduce funds to the High Oxygen Unit Trust (because, through that Unit Trust, they are introducing the funds to them). Those commissions are not disclosed and the funds are therefore invested in ignorance of the manager's personal interest in the underlying investments.

What, then, are the trustees' duties in these circumstances? And can they be made liable for the manager's non-disclosure?

THE STRUCTURE

The investment function of a trust-based personal pension scheme will generally be delegated to the beneficiary or an investment manager appointed by him (although there may be limitations on the nature of the investments which can be held in a personal pension scheme and if there are (as there are in the UK), the trustee will only make permitted investments so as to preserve the status of the scheme). Accordingly while the trustee, as the legal owner of the funds, has to execute all investment transactions made with the pension funds, the decisions as to the investment of the trust funds are not made by the trustee but by the beneficiary (often on the advice of an investment advisor retained by the beneficiary) or by an investment manager appointed by the beneficiary.

In providing those financial services to the beneficiary, the adviser or manager owes duties to his client, the beneficiary, including duties to take reasonable care in the selection of investments for the scheme and not to allow a personal interest conflict with that duty. He must not therefore allow a personal interest in earning commissions to conflict with his duty to select the best investments for his client. If such a conflict arises, he must at the very least disclose the conflict to his client and seek his client's consent to the proposed transaction, so that the client can assess the investment decisions being taken with his eyes fully open to the conflicting personal interest which lies in the breast of his manager. If the manager does not take this course, he is likely to find himself laid open to a claim by the beneficiary for breach of duty (quite apart from the regulatory ramifications which there may be in jurisdictions, such as the UK, where the provision of financial services is regulated).

THE TRUSTEE

But what about the trustee in such circumstances? Can the trustee stand on the sidelines and look on in silence, with impunity? Or is he duty bound to tell his beneficiary what is going on (and if he doesn't know what is going on to find out)?

It seems to us that the answer to these questions will depend on the extent of the trustee's knowledge. In many cases, perhaps the majority, the trustee will be so far removed from the investment of the trust funds that he will have no idea that there is anything untoward going on. He executes the

transactions which he is instructed to execute by the manager, believing that the manager is performing his function satisfactorily and having no grounds to suspect otherwise. In those circumstances we think that it is difficult to see how the trustee can be said to be responsible for the manager's failure to disclose.

However, let us say that the trustee knows that the manager is receiving commissions from the investment houses to which he is introducing the client's funds: is the trustee liable to the beneficiary of his trust if, as trustee and legal owner of the funds, he executes the transactions he is asked to execute by the manager, knowing that the manager is receiving commissions as a result of the investment made?

We think that knowledge of the payment of commissions without more is unlikely to be enough to fix the trustee with any responsibility in respect of the manager's non-disclosure of commissions in respect of the investments he is directing the trustee to make. The trustee may well feel entitled to assume that the manager has performed his function properly, and that he has therefore disclosed his personal interest in the investment to the client: the trustee has, after all, delegated the investment management function, and therefore all responsibility for the investment management function, to the beneficiary-appointed manager.

But what if the trustee not only knows that the manager is being paid commissions but he also knows, or suspects, that the manager has not disclosed those commissions to the beneficiary?

BREACH OF TRUST

If, at the direction of the beneficiary's investment manager, the trustee buys a particular investment which he knows will result in a substantial commission being paid to the manager, which he knows has not been disclosed to the beneficiary, it seems to us that in executing the transaction (which being the legal owner he must do in order for the transaction to be undertaken at all) without informing the beneficiary of the manager's personal interest in the investment being made, the trustee is not acting in the interests of the beneficiary of the trust and is therefore acting in breach of one of his core duties (to act in the best interests of the beneficiaries of the trust). In other words, we don't see why the trustee should not be duty bound in such circumstances to blow the whistle on the non-disclosing manager so that the beneficiary can either give an informed consent to the proposed investment or withdraw the manager's direction to buy it.

In a case in which the trustee suspects, but does not positively know of, the non-disclosure of a substantial commission payment to the manager, whether the trustee can be condemned as being in breach of trust for making the directed investment without first telling the beneficiary of the manager's conflict, or of his suspicions of the manager's conflict, is likely to be heavily fact dependent. For example, if a trustee knows that the manager will be paid a commission, has good grounds for suspecting that the manager has not told the beneficiary of the commission payment and makes the deliberate decision not to ask the manager whether he has disclosed the commission payment to the beneficiary (for fear that his suspicions will be confirmed not assuaged), it seems to us that the trustee is not acting in the best interests of his beneficiary if he simply makes the investment directed without first either making the enquiries of the manager or informing the beneficiary of his suspicions. If, on the other hand, the trustee does ask the manager whether he has told the beneficiary of his personal interest in the commission payable, and is given a dishonest answer ('yes, I have'), it seems to us that it would be difficult to argue that the trustee was in breach of trust in making the investment directed in those circumstances unless it can also be shown that the trustee knew that his question had been answered dishonestly ie the trustee knew that, contrary to what the investment manager had said, the commission had not been disclosed to the beneficiary.

> "What if the trustee ... also knows, or suspects, that the manager has not disclosed commissions to the beneficiary?"

EXONERATION CLAUSES

Even in those cases where the trustee knew, or suspected and deliberately did not find out, that the adviser or manager had not disclosed his commission payment to his client, such that there is a *prima facie* case in breach of trust against the trustee, the shield of the exoneration clause is likely immediately to be raised by the trustee. Exoneration clauses are likely to be included in the Trust Deed, to be expansive in their terms and to operate so as to absolve the trustee from liability for any breach of trust other than a breach based on his own actual fraud (liability for which cannot lawfully be excluded). Such clauses are effective in law (*Armitage v Nurse* [1998] Ch 241) and mean that in order to mount a sustainable claim in breach of trust against the trustee, the breach of trust has to be alleged and shown to be fraudulent (unless the trust is based in a jurisdiction in which liability for gross negligence also cannot be excluded (such as Jersey), in which case the breach of trust would have to be shown to be grossly negligent).

FRAUD

A claim against a trustee for breach of trust based on his own actual fraud (as would be necessary for such a claim to strike above the shield of an expansive exoneration clause) essentially depends upon the beneficiary being able to establish that the trustee has acted dishonestly: he must establish that the trustee has deliberately acted in a way:

- which he did not honestly believe was in the interest of the beneficiaries;
- recklessly indifferent as to whether it was contrary to the interests of the beneficiaries or not; or

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- whether his belief that the deliberate breach was not contrary to the interests of the beneficiaries was 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 beneficiary (*Armitage v Nurse* supra, Millett LJ, *Fattal v Walbrook* [2010] EWHC 2767 (Ch), Lewison J).

If a trustee positively knows both that a commission payment is payable and that it has not been disclosed to the beneficiary, but he goes ahead and makes the investment as directed, without first informing the beneficiary of the commission payment, it seems to us arguable that:

- he commits a deliberate breach of trust in investing the funds without telling the beneficiary about what he knows; and
- he could not have thought it in the interests of the beneficiary that the investment was made without the beneficiary being told of the manager's conflicting personal interest

such that he could be accused of a fraudulent breach of trust.

DISHONEST ASSISTANCE

An alternative claim against the trustee in such circumstances might be a claim for dishonestly assisting the manager's breach of fiduciary duty.

The law of dishonest assistance now basically requires the following basic conditions to be established:

- a fiduciary relationship and a breach of a fiduciary duty which has caused a loss;
- the assistance of that breach;
- a dishonest state of mind.

It now seems that liability for dishonest assistance in a breach of fiduciary duty, as a form of accessorial liability, can in principle apply to any breach of fiduciary duty, whether or not such a breach of fiduciary duty involves the misapplication of property belonging to the claimant (*JD Wetherspoon PLC v van de Berg & Co Ltd* [2009] EWHC 639 (Ch) per Peter Smith J at [518]). Any breaches of fiduciary duty by an investment manager may therefore, in principle, give rise to claims against trustees as dishonest assistants of the breach.

Whether a trustee has assisted a breach of fiduciary duty by an investment manager is a question of fact: the assistance must be of more than minimal importance in the breach of fiduciary duty, though it is not necessary to show that the assistance itself inevitably caused loss (*Baden v Société Générale* [1993] 1 WLR 509 at 574 to 575). The trustee's execution of the investment manager's instructions by the purchase of the selected (and tainted) investment would in our view be sufficient assistance if all the other elements of the wrong are present.

> "Any breaches of fiduciary duty by an investment manager may in principle be dishonestly assisted by trustees."

Although there is some academic controversy about the means by which the law reached its present state with regard to the test for dishonest assistance, the test which appears to be accepted as the authoritative test is the objective test set out by Lord Hoffmann in *Barlow Clowes International Ltd v Eurotrust International Ltd* [2006] 1 WLR 1476 (para 10):

> '... liability for dishonest assistance requires a dishonest state of mind on the part of the person who assists in a breach of trust. Such a state of mind may consist in knowledge that the transaction is one in which he cannot honestly participate (for example, a misappropriation of other people's money), or it may consist in suspicion combined with a conscious decision not to make inquiries which might result in knowledge: see *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd* [2003] 1 AC 469. Although a dishonest state of mind is a subjective mental state, the standard by which the law determines whether it is dishonest is objective. If by ordinary standards a defendant's mental state would be characterised as dishonest, it is irrelevant that the defendant judges by different standards.'

Thus broadly the same question as arises in relation to fraudulent breach of trust arises in relation to a potential claim for dishonest assistance. The question resolves itself into this: would executing the instructions of an investment manager – in which the manager has a personal interest – which, the trustee knows, has not been disclosed to the beneficiary, without informing the beneficiary of the manager's interest be characterised as dishonest by ordinary standards?

CONCLUSION

Attaching liability to a trustee of a trust based personal pension scheme in respect of secret profits made by the beneficiary's investment adviser or manager ought to be possible *if* the trustee knows, or suspects and fails to ascertain, that a secret commission is to be paid. However, clauses in the Trust Deed are likely to exonerate the trustee from liability for such liability except in cases of fraud (or at least gross negligence in jurisdictions such as Jersey) on the part of the trustee. In such cases dishonesty (or gross negligence) will have to be pleaded and proved for a claim against the trustee to be sustained. If a trustee actually knows that secret profits are being made by the investment manager, it may be that a judge takes the view that the trustee does act dishonestly (in the sense of knowing that he is not acting in the best interests of his beneficiary) if he goes ahead and executes the transaction which gives rise to that secret profit without informing the beneficiary of the secret profit. In such a case, the trustee may be liable not only in breach of trust but also as a dishonest assister of the investment manager's breach of fiduciary duty. However, if the trustee does not know of the secret commission, or is told (albeit wrongly) that one is not being paid, a case in dishonesty (or gross negligence) against him seems forlorn. ■