Feature

KEY POINTS

- A major obstacle for beneficiaries recovering compensation against trustees as a result of poorly performing and/or overly expensive offshore portfolio bonds is the severe restriction imposed by wide, and currently enforceable, exclusion clauses.
- The authors consider that the trustee protection derived from such clauses goes too far in the modern world of trusts and trustees, and that the court should readdress the balance by limiting the effect of these clauses, making it easier for beneficiaries to require trustees to reconstitute the trust fund where trustees' conduct has led to avoidable loss.
- Jersey and Guernsey have narrowed the scope of permissible exclusion clauses by legislation. The authors consider that the court can and should use its supervisory jurisdiction to refuse to give effect to exclusion clauses in appropriate circumstances.

Authors Elspeth Talbot Rice QC and Timothy Sherwin

Time for change: trustees' liability for negligent investment in offshore portfolio bonds

Offshore portfolio bonds are a popular type of investment because of the potential tax savings they offer. Trustees may be tempted to invest in them. If they do, and the investment portfolio which lies behind the bond bombs, is there anything the beneficiaries of the trust can do about it?

WHAT IS AN OFFSHORE PORTFOLIO BOND?

Offshore portfolio bonds are typically life insurance policies which pay out on the insured event (usually the death of the insured life). The premia for the life insurance policy are invested by an investment manager, and it is the contents of the investment portfolio which is paid out on the insured event. Financial advisors market these financial products to investors, including trustees, to win the investment business of investing the insurance premia and managing the investment portfolio thereby established after the offshore portfolio bond is purchased. Essentially, therefore, what the investor invests in is the portfolio of investments chosen and managed by the investment advisor; but, because that investment portfolio is wrapped in an insurance wrapper, the asset the investor holds is an insurance policy, not a portfolio of investments. The investor is not therefore taxed on the income and capital gains in the investment portfolio. The growth of the investment portfolio is thus received (by the insurer) tax free (if the insurer is based in a jurisdiction with a favourable tax regime).

Further, since the investment portfolio is held by the insurer, not by the investor, a layer of privacy is added to the investment. Thus, offshore portfolio bonds provide a tax efficient and private means of investing, which trustees might find attractive. Trustees who invest in offshore portfolio bonds will generally insure the life of one or more of the beneficiaries of the trust and pay the policy premia from the trust fund. The insurance policy is thus a trust asset, and when it pays out, the investment portfolio is paid out to the trustees.

WHAT COULD POSSIBLY GO WRONG?

Unfortunately, some (not all) offshore portfolio bonds have been, and are, marketed and sold by high-charging commission-based salesmen who sell risky investments to unsuspecting investors.

Beneficiaries of trusts whose trustees invest in bad offshore portfolio bonds may therefore be faced with an excruciatingly poorly performing investment which is subject to eye wateringly high charges. Can they complain about the loss to their trust fund by this activity?

The culprit who ought to be called to account for the loss caused by the poor investment is the investment manager whose investment activity, and charging, has caused the loss. However, there are two problems. First, beneficiaries of the trust do not have an obvious cause of action directly against that investment manager. Second, the manager is likely to be offshore, and may not be worthwhile suing from a commercial perspective.

Can beneficiaries make complaint against their trustees for investing money into this poor investment?

CLAIMS AGAINST THE TRUSTEES

The answer is that the beneficiaries *can* make complaint, but that they face obstacles to such complaints ever resulting in compensation being paid to the trust fund.

In most trust deeds and in most common trust jurisdictions (including England) trustees are given a wide enough power to invest to enable them to invest in offshore portfolio bonds (whether the power derives from the trust deed or from statute). There are three potential lines of attack likely to be open to beneficiaries: they may be able to complain about the trustees':

- decision to invest in an offshore portfolio bond as an investment class;
- choice of a particular offshore portfolio bond and, therefore, choice of investment advisor; and/or
- failure to monitor or supervise the investments in the offshore portfolio bond wrapper.

Trustees' investment powers derive either from the express terms of the trust instrument, or, in England, from the general power contained in s 3 of the Trustee Act 2000. The power is a fiduciary power, to be exercised with a single eye to the benefit of the beneficiaries (*Lord Vestey's Executors v IRC* [1949] 1 All ER 1108). The trustees must employ reasonable care and skill (*Learoyd v Whiteley* (1887) LR 12 App Cas 727; and s 1 of the Trustee Act 2000). To meet their fiduciary duties, the trustees must seek to further the purposes of their trust by seeking to obtain the maximum return from investment consistent with commercial prudence, taking into account well established investment criteria (*Harries v The Church Commissioners for England* [1992] 1 WLR 1241, 1246). To meet their duties of reasonable care and skill the trustees must "take such care as an ordinary prudent man would if he were minded to make an investment for the benefit of people for whom he felt morally bound to provide" (*Re Whiteley* (1886) 33 ChD 347, 355).

Unless the trustees are themselves competent to make well informed investment decisions, they should take investment advice from an appropriately qualified investment advisor before making investment decisions for the trust assets (s 5 Trustee Act 2000).

If English trustees delegate the management of trust funds to an investment manager, they must provide a policy statement to the investment manager and put in place a written agreement which includes an acceptance by the investment manager that he will abide by the policy or any revised version of it (ss 11 and 15 of the Trustee Act 2000). The trustees must also scrutinise the manager and the policy statement on an ongoing basis (s 22 of the Trustee Act 2000). Whether these provisions are engaged in the case of an offshore portfolio bond will depend upon whether it is the trustees or the insurer who has engaged the investment manager to manage the investment portfolio lying under the insurance policy.

An offshore portfolio bond

Before deciding to invest in an offshore portfolio bond at all, the trustees should consider whether investing in the proposed investment portfolio which is to be wrapped in the insurance policy is suitable for the trust at all, given the trust's size, the proportion of the trust fund proposed to be invested in the offshore portfolio bond, and the size, nature and risk profile of the other investments held by the trust. If investments of the kind offered by the offshore portfolio bond being considered are appropriate for the trust, it is unlikely that the trustees' decision to buy such investments in an offshore portfolio bond can realistically be challenged given the tax benefits which an offshore portfolio bond offers. If, however, the trust fund already has a significant exposure to investments of the kind represented by the proposed offshore portfolio bond, such that investment in the bond will unbalance the trust investments (because, for example, the trust's remaining funds ought to be kept in cash or invested in gilts or real property) the beneficiaries might have a legitimate complaint against the trustee.

The particular offshore portfolio bond

A more likely complaint on the part of the beneficiaries will be as to the trustees' decision to invest in a particular offshore portfolio bond. Since (as we have explained above) investment in an offshore portfolio bond is really a decision to invest in the investment portfolio offered by the investment manager, trustees should look with some care at both the composition of the proposed investments to be made within the bond, and at the proposed investment manager before investing.

If the composition of the proposed investment portfolio within the bond is high risk, because, for example, it is to be invested in speculative equities, the bond is unlikely to be suitable for the trust fund. Even if the composition of the proposed investment portfolio is more conservative, it may still be an unsuitable investment for the trust if the trust already has similar investments, and investing in more will unbalance the trust's investment portfolio as a whole. A failure to consider the suitability of the proposed offshore portfolio bond for the trust exposes the trustees to a claim for breach of fiduciary duty in the selection of the particular investment.

The trustees should also investigate the investment manager to whom the investment of the insurance premia is to be entrusted, looking at his track record and historical results to ensure that the funds will be managed by someone who has proved himself to be well qualified to manage investments of the type proposed. A failure to conduct proper due diligence on the investment manager also exposes the trustees to a claim for breach of fiduciary duty in the selection of the investment.

Furthermore, the trustees should apprise themselves of the charges associated with the offshore portfolio bond they are considering purchasing for the trust. This may be easier said than done because there is often a lack of transparency in relation to the costs and charges of some offshore portfolio bonds, and there are various layers of costs and charges which may need to be peeled back before a full picture of the costs is appreciated. However, if the trustees fail to do this, it seems to us that they expose themselves to criticism if the charging structure for the offshore portfolio bond means that an excessive level of charges makes its net performance poor when compared with similar investment products.

Monitoring the investment

Even if the trustees' choice of a particular offshore portfolio bond cannot be criticised by the beneficiaries of a trust, they may be able to criticise the trustees' monitoring and supervision of it. Acting as prudent men of business, the trustees should keep an eye on the performance of the investment portfolio bond they have purchased for the trust (gross and net of costs and charges) on a regular and ongoing basis, checking its performance against other similar investments. They should then not be slow to take action if its investments are under-performing on a consistent basis against comparable investments, unless there are justifiable reasons why the bond has poorly performed and there are good grounds to believe that its performance fortunes will soon be reversed.

However, complaining about trustees' decisions in respect of a poor choice of offshore portfolio bond will only result in compensation to the trust if it can be shown that:

- The trustees were negligent in their choice of offshore portfolio bond: ie they failed in their duties when deciding to invest (some of which duties and possible failures are adumbrated above);
- That negligence has been the cause of loss to the trust. The court recognises that there are risks inherent in investment, and will apply hindsight and a common sense view to ascertain whether, and

if so what, loss has been caused by any breach: "it will not be sufficient to establish liability unless any breach of duty resulted in investment choices which were imprudent and then only to the extent of the difference between the position to which the choices gave rise and the position which would be likely to have resulted from prudent investment choices" (*Daniel v Tee* [2016] 4 WLR 115 at §§155-156); and

- Any liability of the trustees is not released by an exclusion clause in the trust deed.

The last of these points often presents a serious barrier to a successful claim against trustees, and we therefore turn to consider it in a little detail.

TRUSTEE EXCLUSION CLAUSES

Most modern trust deeds contain a clause which provides that the trustees are not liable for any loss caused to the trust fund unless it is caused by their own fraud or wilful default, which clause essentially absolves trustees from any liability to compensate the trust fund for loss unless it can be shown that the loss has been caused by their fraudulent or knowing breach of trust: the Court of Appeal has recently held that the words "wilful and individual fraud or wrongdoing" contained in a fairly standard form of exclusion clause in favour of a trustee of a will trust, meant that the trustee was not liable for loss caused by his conduct to the trust unless he was "deliberately or consciously acting in a way he knew to be wrong" (*Barnsley v Noble* [2017] Ch 191).

Where the trust deed contains such a clause, therefore, the trustees will not be liable for investing the trust funds in an offshore portfolio bond which proves to be disastrous unless the beneficiaries can establish that, in making the investment, the trustees were either:

- deliberately or consciously investing in an investment which they knew they should not be investing in; or
- were reckless as to the investment they were making; or
- made the investment relying on the protection of the exclusion clause: as Millett LJ said in *Armitage v Nurse* [1998] Ch 241 (at 246): "a trustee who relied on the presence of a trustee exemption clause to justify what he proposed to do would thereby lose its protection: he would be acting recklessly in the proper sense of the term".

It seems to us that the absolution of trustees for negligence provided by these clauses is a hard pill for beneficiaries to have to swallow. This is particularly the case where the trustees are professional trustees who charge the trust handsomely for their administration of it, and probably also produced the trust deed in which the wide exclusion clause is contained, probably amongst a number of other detailed trust terms, nestled towards the end of the deed. The settlor may not therefore have known that the clause was even there, let alone what its import was, when he settled the funds on the trust.

The Royal Court of Jersey found this to be an unpalatable state of affairs in *West Lazard Bros & Co (Jersey) Ltd* [1993] JLR 165, in which case Commissioner Hamon said:

> "Mr West [the settlor] cannot be bound by the terms of a 'standard form trust' or 'shelf trust' of which he had no knowledge … it is the fault of Lazard [the trustee] that it took down a shelf trust without attempting to give Mr West an explanation of the terms of it and (as trustee) to ensure that it conformed with his wishes. What if Lazard had taken Mr West through its standard trust and explained (as it was, in our view, bound to do) the full import of cl.9(f) [the exoneration clause]? … We do not hesitate to find that Lazard Trust failed in its duty in this regard".

Whilst this appears to have been an *obiter* comment, and is largely unsupported by analysis or reasoning, it derives some (limited) support from the decision of the Court of Appeal of Saskatchewan in *Baskerville v Thurgood* (1992) 100 Sask R 214, which found that a "no-representation" clause in an agreement between a fiduciary and principal was unenforceable since "[a] person in a fiduciary relationship who makes untrue representations as to matters which should be within his knowledge cannot enforce against the person to whom he owes a fiduciary duty a contract induced by such untrue representations" (at §43).

Jersey and Guernsey have dealt with the unpalatability of professional trustees absolving themselves from liability for grossly negligent conduct in the administration of trusts by legislating against it: in both jurisdictions the legislation provides that no term of the trust shall relieve, release or exonerate a trustee from liability for breach of trust arising from the trustee's own fraud, wilful misconduct or gross negligence.

The position is not the same in England. Whilst it is not possible in England for a trustee to exclude liability for his dishonesty or fraud, it is possible for him to exclude liability for gross negligence.

An attempt was made in *Armitage v Nurse* [1998] Ch 241 to argue that such clauses should be declared void as being repugnant to the trust. It failed. Millett LJ held that a trustee exclusion clause 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" (at 251). At the same time, though, he recognised that (at 256):

> "it must be acknowledged that the view is widely held that these clauses have gone too far, and that trustees who charge for their services and who, as professional men, would not dream of excluding liability for ordinary professional negligence, should not be able to rely on a trustee exemption clause excluding liability for gross negligence. Jersey introduced a law in 1989 which denies effect to a trustee exemption clause which purports to absolve a trustee from liability for his own 'fraud, wilful misconduct or gross negligence'. The subject is presently under consideration in this country by the Trust Law Committee under the chairmanship of Sir John Vinelott. If clauses such as Clause 15 of the Settlement are to be denied effect, then in my opinion this should be done by Parliament which will have the advantage of wide consultation with interested bodies and the advice of the Trust Law Committee."

Biog box
Elspeth Talbot Rice QC and Timothy Sherwin are barristers practising from XXIV Old Buildings, Lincoln's Inn.
Email: elspeth.talbotrice@xxiv.co.uk and timothy.sherwin@xxiv.co.uk

Lord Clarke expressed a similar sentiment in In *Spread Trustee Co Ltd v Hutcheson* [2012] 2 AC 194 (at §62):

> "If, as is common ground, the essential obligation is to act as a prudent trustee would act, namely with reasonable care and skill, it can be said with force that the core obligation of a person acting *en bon père de famille* includes a duty to act with reasonable care and skill and thus without negligence. In these circumstances there might be much to be said for saying, as a matter of policy, that it is not permissible to exclude liability for any breach of that duty."

However, Lord Clarke also took the view that only Parliament could legislate to change the position that ordinary negligence *can* be excluded by the trust instrument.

Unfortunately for beneficiaries of English trusts, nothing has yet been done by Parliament in England to deny effect to exclusion clauses absolving trustees of liabilities for anything other than their own dishonesty or fraud.

However, we wonder whether the court can refuse to allow a trustee to rely on the protection of an exclusion clause in an appropriate case under its general supervisory jurisdiction, notwithstanding the absence of legislation in England and the views expressed by Millet LJ and Lord Clarke that, if anything is to be done about this, it should be done by Parliament. The court's inherent supervisory jurisdiction over trusts and trustees is one in which:

> "Equity will not only modify and regulate the Execution of Trusts *but also direct, limit and controul the Acts of the Parties, Trustees, Guardians, &c.…*" (*Uvedale v Ettrick* (1682) 2 Ch Cas 130, 22 ER 880, 881 (our emphasis); see also *Schmidt v Rosewood Trust Ltd* [2003] AC 709 at §51).

The court therefore has a general jurisdiction to control the trustees. We see no reason why the court cannot use this jurisdiction, in appropriate circumstances, to refuse to allow a trustee to rely on a wide exclusion clause, particularly where it cannot be shown that the clause was brought to the attention of and specifically agreed to by the settlor at the time the trust was settled. It does not seem to us to be very different from the court controlling trustees' right to reimburse themselves out of the trust fund in respect of costs and expenses incurred by them in the administration of the trust: the court limits that right of reimbursement to only those costs and expenses which were properly and reasonably incurred.

Beneficiaries (who were not settlors) have a stronger argument in this regard, by analogy with *dicta* in the opinion of the Privy Council in *Crociani v Crociani* [2015] WTLR 975. The Privy Council's decision concerned the enforceability of an exclusive jurisdiction clause in a trust instrument. The Board held that the clause in question was not, on its true construction, an exclusive jurisdiction clause. However, Lord Neuberger went on to consider whether an exclusive jurisdiction clause in a trust instrument *could* bind beneficiaries, and held (at §35) that:

> "it should be less difficult for a beneficiary to resist the enforcement of an exclusive jurisdiction clause than for a contracting party to resist the enforcement of such a clause in a contract".

The Board drew attention to fact that:

> "a beneficiary, who wishes to take advantage of a trust, can be expected to accept that she is bound by the terms of the trust, but it is not a commitment of the same order as a contracting party being bound by the terms of a commercial contract".

The Board pointed to the court's supervisory function in respect of trusts as one which was "primarily to protect the interests of beneficiaries", and concluded that:

> "the weight to be given to the existence of the clause is less (or the strength of the arguments needed to outweigh the effect of the clause is less) than when one contracting party is seeking to enforce a contractual exclusive jurisdiction clause against another contracting party" (at §§36-37).

In our view it is now time for the court to take control of exclusion clauses in the exercise of its supervisory function, particularly where:

- the clause is included in a trust deed produced by or on behalf of the trustees;
- the trustees are professionals remunerated for their services; and
- either there is no evidence to show that the clause had been drawn specifically to the settlor's attention and that he specifically agreed it, or the trustees are seeking to enforce the clause against beneficiaries.

This argument has not, to our knowledge, been run or developed to date, but in our view it should be. We think that it is wrong in principle to prevent innocent beneficiaries from recovering compensation for their trust from well remunerated, and insured, fiduciaries who are in breach of their duties.

CONCLUSION

A major obstacle for beneficiaries recovering compensation against trustees as a result of poorly performing and/or overly expensive offshore portfolio bonds is the severe restriction imposed by wide, and currently enforceable, exclusion clauses. We consider that the trustee protection derived from such clauses goes too far in the modern world of trusts and trustees, and that the court should readdress the balance by limiting the effect of these clauses, making it easier for beneficiaries to require trustees to reconstitute the trust fund where trustees' conduct has led to avoidable loss. ■

Further Reading:

- How do recent Hong Kong trust law changes affect bond trustees? A comparative analysis with Singapore and English law (2014) 6 JIBFL 393.
- Trustee liability for poor investment performance (2009) 10 JIBFL 599.
- LexisPSL: Restructuring and insolvency: is liability of trustees for losses in share portfolios illusory?