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TRUSTEE'S INDEMNITIES ON DISTRIBUTION – MORE THAN REASONABLE SECURITY?

by Advocate David Dorgan

INTRODUCTION

When a trustee resigns, retires or is removed from office it is under a statutory obligation by Article 34 of the Trusts (Jersey) Law 1984 (as amended) (the **Trusts Law**) to surrender the trust property and upon doing so is released from liability to any beneficiary, trustee or person interested under the trust except for liability arising from any breach of trust to which it was a party or in respect of actions to recover trust property in its possession or its proceeds. But what is the position where a trustee parts with part of the trust fund but remains a trustee of the remainder?

PERSONAL LIABILITY OF TRUSTEES

Because trusts do not have separate legal personality a trustee remains personally liable for third party contractual, tortious or taxation liabilities incurred or arising from its office as trustee. Whilst in office a trustee has possession or control of the trust property and can therefore directly discharge properly incurred liabilities from it, but after leaving office the trustee no longer possesses or controls the trust property yet remains personally liable. The greatest fear of a retired trustee is of being assessed for an unforeseen tax liability arising from its trusteeship and then finding that it is not possible to have that liability discharged out of the trust fund.

Due to the onerous nature of trusteeship, professional trustees expect not only to be remunerated but also protected in respect of any personal liability whilst in office and thereafter. These concerns were only partly

dealt with by Article 34(2) of the Trusts Law under which "… A trustee who resigns, retires or is removed may require to be provided with reasonable security for liabilities whether existing, future, contingent or otherwise before surrendering trust property". However Article 34(2) is silent upon whether a trustee, who distributes or transfers trust property to beneficiaries or other trustees but remains as trustee of the remainder, can require to be provided with reasonable security for third party liabilities.

Under English case law Lord Roskill in *Roome v Edwards* [1981] said "Persons, whether professional men or not, who accept appointment as trustees ... are clearly at risk ... and have only themselves to blame if they accept the obligations of trustees without ensuring that they are sufficiently and effectively protected whether by their beneficiaries or otherwise for fiscal or other liabilities which fall on them personally...".

Trustees have to protect themselves in respect of third party liabilities arising from their trusteeship and cannot expect any assistance or sympathy from the court if they do not do so. Consequently the practice has developed of including a contractual indemnity within an instrument of appointment and retirement of trustees under which a retiring trustee preserves its right to claim against the trust property to discharge liabilities arising from its trusteeship notwithstanding transferring possession and control of it to its successor as otherwise it would have to meet them personally.

WHAT IS "REASONABLE SECURITY?"

As the term reasonable security was left undefined by both statute and subsequent judicial interpretation, a retiring trustee invariably insists on the maximum protection permitted by the Trusts Law, namely for all liabilities except for breach of trust to which it was party and in respect of actions against it to recover trust property or the proceeds of it. Almost without exception the indemnity required is for the full value of the trust fund and unlimited in time, which is claimed to be "reasonable security" on the basis that a retiring trustee should be in no worse position in respect of protection against personal liability for third party liabilities arising from its trusteeship than if it had remained as trustee.

However the practice has gone a stage further by seeking to attach that right to trust property after distribution to beneficiaries and it is this which causes the greatest problems - and often the greatest expense - on a change of trusteeship. This was initially achieved by the retiring trustee insisting on a provision in the instrument of appointment of retirement under which the new trustee undertook that it would not make any distribution to a beneficiary unless it first procured from that beneficiary an indemnity limited to the value of the distribution.

Some qualification has developed to enable distributions to be made up to a certain amount or a certain percentage of the trust fund without any indemnity being required from the beneficiary because beneficiaries were not always willing to give indemnities and/or because the cost of putting the indemnity in place was disproportionate to the amount being distributed.

There then developed a school of thought that an incoming trustee should not fetter its discretion by agreeing on its appointment to make its ability to distribute to beneficiaries conditional upon them giving indemnities. Consequently the practice developed of providing in the instrument of retirement and appointment that the trustee did not have to procure an indemnity from the beneficiary as a condition of being able to make the distribution, but that if the trustee did not do so then it remained liable to the extent of the distribution. In the latter case the distributing trustee was placing itself in a potentially dangerous position because it was maintaining an indemnity to its predecessor to the extent of the value of assets which it no longer had possession or control of.

At first the requirement was for the indemnity to be given to the trustee making the distribution, but this resulted in chains of indemnities through successive trustees and the need to take them into account on every change of trusteeship, so the practice developed of requiring the indemnity to be given direct to the original or

retired trustee, thus circumventing the distributing trustee and thereby avoiding creating a chain of indemnities. However, in practice, the problem was that a former trustee, to whom the beneficiary of a proposed distribution is willing to provide an indemnity, refused to accept or be party to it without legal advice, refused to seek that advice unless it is indemnified for the cost of it, and neither the distributing trustee or the beneficiary of the proposed distribution was willing to do so because they consider it unnecessary.

GOING BEYOND REASONABLE SECURITY?

The principal reason why the indemnities commonly go far beyond what may actual amount to "reasonable security" is because there is invariably no risk assessment made by the retiring or distributing trustee of what third party liabilities there may be in terms of nature, amount or time. It may well be the case that it has no risk of third party liability at all, but the trustee nevertheless insists on an unlimited indemnity because it has not worked out that there is no risk. Even where there is some potential liability, the absence of any limit or qualification to the extent of the indemnity will in most cases very probably lead to a trustee receiving a degree of security which is much more than anyone might consider "reasonable" - for example, security over a trust fund of £10 million for an indefinite period when the worst case on a full risk assessment is that there will be a tax liability of no more than £50,000 and which will become prescribed after six years.

The fundamental principle of a trust is that it is set up for the benefit of the beneficiaries and thus it is contemplated from the outset that the trust fund will be paid out to the beneficiaries. The vast majority of powers to pay or appoint income or capital to beneficiaries do not contain any provision which expressly entitles trustees to make distributions conditional upon the beneficiary providing an indemnity for the amount of the distribution, and the indemnity is for the benefit of the trustee, not the beneficiary. On that basis it could be argued that trustees should not be entitled to require a beneficiary to provide an indemnity.

However the courts have accepted that as a matter of principle it is in the best interests of beneficiaries to have trusts properly managed by those who have the requisite skill and knowledge to do so and have applied that principle to vary trusts to enable trustees to be paid to secure their services. As stated above, due to the onerous nature of trusteeship, professional trustees expect not only to be remunerated but also protected in respect of any personal liability whilst in office and thereafter. It can therefore also be argued that if a party is not adequately protected against personal liability for third party claims arising from its trusteeship it will not take on the trusteeship in the first place, and thus that by virtue of the principle which applies for remuneration, it is in the best interests of beneficiaries for trustees to be protected.

SOLUTION TO CONTRACTUAL CHAIN INDEMNITIES?

It is not surprising to learn that these indemnities, even with *de minimis* provisions, are subject to continuing criticism by trustees and beneficiaries alike. From a successor trustee's perspective it is easy for a busy trust administrator to overlook the existence of a covenant given on that trustee's appointment, resulting in neglect of the trustee's obligation to procure a direct indemnity from the recipient of a distribution. In such cases the administration of any distribution may become very complicated, costly and time-consuming, particularly if there are regular capital payments which are not within any *de minimis* provisions that may exist.

From a beneficiary's perspective, it may seem unreasonable that a benefit is made subject to exposure to potential personal liability, contrary to the beneficiary's understanding of the purpose of the trust because he or she did not expect any condition or restriction on their freedom to apply the benefit as they see fit. For both trustee and beneficiaries the process of negotiating indemnities leads to higher costs of administration which depletes the trust property intended for other purposes and also often causes unnecessary delays to distributions and to the transfer of effective management of the trust to new trustees. So is there a solution to this problem?

EQUITABLE LIEN AND VICARIOUS BENEFIT

Amendment No. 5 to the Trusts Law was anticipated to introduce two possible options to improve the situation:

(i) to create an *equitable lien* which attaches to the trust property for the benefit of the trustee for the time being and all former trustees; and

(ii) to permit a former trustee to *vicariously benefit* from a contractual indemnity that it is not a party to (i.e. removing the need for a former trustee to be party to a subsequent transaction in order to benefit from any indemnity given by a beneficiary on a distribution of trust property); and

The *equitable lien* was not introduced into law and, because Jersey law does not possess the developed principle and judicial authority to support it, the introduction of an *equitable lien* has remained absent from Jersey law until 2015 (see our article on this matter - A Jersey Trustee's Equitable Right to the Trust Property Lien).

It has been confirmed under English Law (and also in Australian High Court and Federal Court decisions) that a trustee's *equitable lien* confers a charge upon the trust property until claims are satisfied and that it exists independently of possession and control of it. This means that it will take priority over the interests of the beneficiaries and survive the trustee's loss of office and dispossession of trust property, but will not avail against a bona fide purchaser for value without notice. Practically speaking, this means that if a third party liability arises against it a former trustee's *equitable lien* will not only attach to or charge all property comprised in the trust fund from time to time but will also continue to attach to trust property after distribution to a beneficiary.

From a trustee's point of view an equitable lien might well be worthless if either:

a) the present trustee, or the beneficiary to whom trust property has been distributed, no longer has any traceable trust property because it has been dissipated; or

b) the trust property is in or has been moved to a jurisdiction which does not recognise equity or trusts; or

c) because title to trust property has been passed to a bona fide purchaser for value without notice.

As the *equitable lien* has those risks for a trustee, and also does not solve the problem of a beneficiary wishing to receive a distribution unconditionally and unencumbered, it can be argued that it will not provide "reasonable security" and that the current industry standard of a contractual chain of indemnities should be maintained.

However, *vicarious benefit* was introduced into law and, in some ways, is preferable to an *equitable lien*: it maintains a contractual relationship of some description, which is potentially more protection for a trustee and, therefore, more likely to be acceptable as "reasonable security". Furthermore, because contract law is recognised in civil law countries, and because the beneficiary remains contractually liable, the *vicarious benefit* avoids the issue of a bona fide purchaser for value without notice. However it still does not achieve a position whereby the trustee is protected and the beneficiary of a distribution receives trust property unconditionally, so again it is only a partial solution to the problem.

CONCLUSION

The options introduced into law do not resolve the issue of limitation of time or amount (which needs to be agreed at the start of a chain indemnity) and, therefore, may result in a trustee being in a better position than if it had remained as trustee. This lack of limitation may also result in conditions being imposed on beneficiaries on distributions to them which are in fact unnecessary, a situation which cannot be in the best

interests of the beneficiaries and which is, therefore, likely to be offensive to the "reasonable" part of "reasonable security".

Another option is for trustees to rely solely upon their professional indemnity insurance, but in doing so the potential insurance exposure, particularly without any other recourse of protection, is likely to make insurance premiums astronomically high or simply unavailable.

Whilst the introduction of vicarious benefit and an equitable lien has or will improve the situation, I do not believe we will see the end of contractual indemnities any time soon. Neither option fully resolves the position where a beneficiary receives trust property unconditionally and fully protects the trustee, albeit there might be circumstances where these options will do so. Consequently, there seems to be no immediately obvious solution to the problem at hand.

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