

Abstract

This article explores two aspects of the interplay between the trustee's right to an indemnity for liabilities incurred towards third parties ('external liabilities') and an adverse claim for breach of trust, as raised in the recent Privy Council case of *Investec Trust (Guernsey) Ltd v Glenalla Properties Ltd*. The first is whether a full indemnity should be granted for external liabilities reasonably assumed, even if they were unreasonably maintained, as the Board held. This article argues that such a conclusion ignores the fact that an award of indemnification reflects the extent to which the trustee is forgiven her stewardship duty. There is therefore a strong case on authority and principle that the entitlement to indemnification should be determined after taking all events, whenever they occur, into account. The second issue is whether the right to indemnity should effectively be enhanced by the existence in the trust deed of an exemption clause for negligence. There is scope for saying, contrary to the apparent view of the Board, that such a clause is (or should be) entirely irrelevant to indemnification, though this is a more nuanced point, which requires further consideration by the courts. For the reasons given in the article, the outcomes on both of these points reflect the current judicial direction of travel in regard to quantifying a trustee's liability for breach of trust.

Key Words: trusts, trustees, indemnities, liabilities, breach of trust, exemption clauses

Word Count: 12,167 (including footnotes, excluding abstract, etc)

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Trustees' Indemnities – Is Timing Everything?

Sinéad Agnew & Kathryn Purkis

Introduction

As a matter of general law and statute, a trustee is entitled to be indemnified in respect of costs, expenses and liabilities which have been incurred in the performance of her office. This entitlement extends to liabilities incurred by the trustee to third parties ('external liabilities'). The general right to indemnification is governed by rules internal to the trust relationship, regulating the position as between the trustee and her beneficiaries. However, difficult analytical questions arise as to how precisely these internal rules work where the subject-matter of the indemnification is an external liability, and as to how they interact with other rules relating to the internal regulation of the trust, such as the rules on exoneration clauses.

This article explores two specific questions arising in relation to a trustee's right to be indemnified out of trust assets against external liabilities. First, should events after the creation of an external liability, such as the trustee's unreasonable failure to reduce or eliminate the liability, ultimately affect her right to indemnification in respect of it? Secondly, should the presence of an exoneration clause in the trust instrument operate to enhance a trustee's entitlement to indemnification, by permitting her to escape personal liability for breach of trust, where the breach involves using trust money to pay an external liability that in the absence of the clause it would not be permissible for her to pay?

The answers to these questions are important, as they reflect wider debates in trusts law about the correct approach to quantifying loss to a trust fund in varying circumstances,¹ and the tension between proprietary and obligational conceptions of the trust. They also bear directly on a trustee's statutory right to indemnification under s.31 of the Trustee Act 2000 ('s.31'), which provides that a trustee is entitled to reimbursement, or may pay out of the trust funds, 'expenses properly incurred by him when acting on behalf of the trust.'

Both questions (amongst others) recently arose before the Privy Council in *Investec Trust (Guernsey) Ltd v Glenalla Properties Ltd*². The majority (whose judgment was given by Lord Hodge) answered the first question shortly and in the negative. In their view, only the trustee's conduct in *creating* the liability is relevant when assessing her right to indemnification in respect of it. Lord Mance dissented on this point. The second question was not fully considered by the court, but Lord Hodge's judgment suggests that the terms of an exemption clause are relevant to the scope of a trustee's right to indemnification.

In our view, neither question has been satisfactorily answered. As *Investec* is a Privy Council decision relating to Jersey law, it is of persuasive authority only in English law, and

¹ E.g., *Target Holdings Ltd v Redferns* [1996] AC 421 (HL); *AIB Group (UK) Plc v Mark Redler & Co Solicitors* [2014] UKSC 58; [2015] AC 1503.

² *Investec Trust (Guernsey) Ltd v Glenalla Properties Ltd* [2018] UKPC 7; noted, K. Purkis, *Trusts and Trustees*, vol 132, 31 July 2018.

these issues merit further consideration by the higher courts of England and Wales.³ We consider that the arguments on each question are more complex and difficult than admitted in the majority judgment. As a matter of authority and principle, there are good reasons for answering the first question positively (as Lord Mance did). The second question is more difficult. It raises important questions of principle and policy, which require resolution at the highest level.

The decision in *Investec v Glenalla*

Investec was the former trustee of a Jersey trust, the Tchenguiz Discretionary Trust ('the TDT'). The TDT trust deed exempted the trustee from liability for any loss to the trust fund unless arising by reason of its own fraud, wilful misconduct or gross negligence. The trust assets included various BVI companies, holding various investments, including public equity investments and contracts for difference. The movement of money between companies within the trust structure was accounted for as loans to or from the trustee as shareholder. As a result of the financial crisis, by 2007 the companies were facing increased margin calls on the investments, so Investec and three subsidiaries borrowed from the Icelandic bank, Kaupthing to support them. The position then gradually worsened, which meant that the trust structure had to be refinanced.

Investec, the companies and Kaupthing agreed on a new corporate structure within the trust, whereby a new trust-owned company, Oscatello, would take the shares in the BVI companies. Kaupthing would take security for existing and further lending over the shares in Oscatello, with the intent that this was to be Kaupthing's only recourse in the event of default. The practice of inter-company lending meant that at this time, Investec owed loans to two of the companies which were transferred into the structure (Glenalla and Thorson), but it omitted to divest itself of the burden of these loans by transferring or novating them to Oscatello. From the proceeds of the refinancing, Oscatello also repaid a third loan which Investec had owed to Kaupthing. Kaupthing subsequently became insolvent, and was effectively nationalised. It exercised its security rights over the companies within the Oscatello structure, and Oscatello, Glenalla and Thorson were placed in liquidation. The joint liquidators then demanded repayment of the Glenalla and Thorson loans and sought restitution in respect of the liability that Oscatello had repaid.

Investec claimed that it was entitled to be indemnified out of the TDT assets in respect of the loan liabilities, relying on Article 26(2) of the Trusts (Jersey) Law 1984 ('Article 26(2)'), which entitles a trustee to reimburse itself or pay out of the trust 'all expenses and liabilities reasonably incurred in connection with the trust.' By then, a new trustee was in office, who counterclaimed for damages for breach of trust, and denied that the liabilities had been reasonably incurred. Although in the Privy Council the new trustee had ceased to dispute the propriety of Investec's conduct in *entering into* the BVI loans, it argued that Investec's

³ As Lord Mance acknowledged: *ibid* [194].

subsequent failure to novate the Glenalla and Thorson loan liabilities into the Oscanello structure was both grossly negligent and sufficiently unreasonable to deprive it of its right to indemnification under Article 26(2).

The current trustee's arguments failed and Investec's claim for indemnification was upheld by the Privy Council. As indicated above, Lord Hodge (for the majority) considered that the court could only have regard to a trustee's conduct in *creating* the liability in assessing whether it was reasonable to indemnify for it. As it had been conceded that the liability had been reasonably created, Investec was entitled to its indemnity. Further, the claim for damages for grossly negligent breach of trust was dismissed at least in part because no sufficient evidence had been adduced that Investec could have acted differently so as to avoid the loss.

Had the current trustee's argument on timing succeeded, there were indications that the Investec's conduct in failing to get rid of the liabilities on restructuring could have been seen as unreasonable,⁴ which would have deprived it of the indemnity. Then, as Lord Hodge described it⁵, the court would have had to consider whether the exemption clause in the TDT "would have been applicable to nullify ...[the] effect [of the lost indemnity]". Given the majority's decision on the first question, it was unnecessary for it to consider this issue, although Lord Hodge seemed to regard the presence or absence of an exemption clause as a relevant factor in assessing such reasonableness.⁶

Lord Mance dissented from the majority on the indemnification issue. In his view, the whole point of a provision such as Article 26 was to operate when the trustee claimed reimbursement of liabilities actually incurred, and therefore "the requirement that the expenses or liability be "reasonably incurred" looks back over the whole period up to that moment."⁷ The presence or absence of an exemption clause could make no difference to this conclusion.

A trustee's right to an indemnity originated at common law, so we begin by considering the parameters of a trustee's right to indemnification under the general law.

A trustee's right to indemnification under the general law and statute

In England and Wales a trustee is personally liable in her dealings with third parties⁸ but (subject to the terms of the trust) she is entitled to be indemnified out of the trust fund against all costs, expenses and liabilities incurred by her in relation to the execution of the trust.⁹ This entitlement extends to liabilities actually incurred by the trustee in the

⁴ *Investec v Glenalla* (nError! Bookmark not defined.) [106].

⁵ *Ibid* [116].

⁶ *Ibid* [113].

⁷ *ibid* [233].

⁸ Though she may by contract stipulate that the third party's recourse is confined to the available trust assets or their worth: *Watling v Lewis* [1911] 1 Ch 414, 422.

⁹ *Worrall v Harford* 8 Ves. 8; 32 ER 250; see also T. Lewin, *A Practical Treatise on the Law and Practice of Trusts and Trustees* (A. Maxwell & Co., London, 1837) 450, citing *How v Godfrey* Rep. t. Finch 361.

performance of her office,¹⁰ e.g., where the trust involves the carrying on of a business,¹¹ or the trustee enters into contractual arrangements with third parties in relation to, or for, the trust;¹² and it encompasses contingent and future liabilities.¹³ It also extends to a liability to pay damages to a third party in tort, incurred by the trustee in the performance of her duties.¹⁴

The indemnity has been recently described as “an entrenched incident of trusteeship”.¹⁵ It may take the form of reimbursement for payments already made, but usually when the trustee is in office it is used to pay the liability directly from trust assets, thereby exonerating her personal estate from the burden of the liability.¹⁶ The indemnity has commonly been described as a giving rise to a charge or lien over the trust fund,¹⁷ providing the trustee with an equitable interest¹⁸ in the trust property which survives loss of office,¹⁹ and priority over any claims of the beneficiaries.²⁰ However, it does not operate as an all-mones charge arising on the occasion of first indebtedness where those liabilities have not yet manifested, nor does it give the trustee priority in insolvency as against trust creditors or against successor trustees.²¹ Moreover, where a trustee asserts a right of exoneration, she may only avail of it to discharge the relevant liability. This means that if the trustee herself becomes bankrupt, her trustee in bankruptcy may not avail of the indemnity to distribute the relevant trust assets amongst her general (non-trust) creditors.²²

The right to an indemnity has strict parameters: a trustee’s claim is limited to her ‘proper costs and expenses’²³ which are ‘incident to the execution of the trust’,²⁴ and for external liabilities which the trustee has ‘properly paid’ (or would have to pay),²⁵ or which

¹⁰ *Re Grimthorpe* [1958] Ch. 615 (C.A.), 623 (Danckwerts L.J.).

¹¹ *Re Johnson* (1880) 15 Ch. D. 548; *Jennings v Mather* [1902] 1 K.B. 1 (C.A.), 6-7 (Stirling L.J.).

¹² E.g. *Angullia v Estate and Trust Agencies* [1938] A.C. 624 (H.L.).

¹³ *In Re Blundell* [1889] LR 40 Ch D 370, 376-377.

¹⁴ *Benett v Wyndham* (1862) 4 De G. F. & J. 259; 45 ER 1183; *Re Raybould* [1900] 1 Ch. 199.

¹⁵ *Rawlinson & Hunter Trustees SA v Chiddicks, Re Z II Trusts* [2018] JRC 119.

¹⁶ Thus, it is called the right of exoneration. See also N. Le Poidevin, L. Tucker & J. Brightwell (eds), *Lewin on Trusts* (19th ed.), (Sweet & Maxwell 2015) [21-043]; *Jennings v Mather* (n11).

¹⁷ *Re Exhall Coal Co. Ltd* (1886) 35 Beav. 449, 452-3; 55 E.R. 970, 971 (Lord Romilly M.R.); *Re Pumfrey* (1882) 22 Ch.D. 255, 262 (Kay J.); *Stott v Milne* (1884) 25 Ch. 710, 715 (Earl of Selbourne L.C.).

¹⁸ *Jennings v Mather* (n11) 6 (Stirling L.J.), 9 (Matthew L.J.).

¹⁹ *Lewin on Trusts* (19th ed) (n16) [17-034]-[17-036].

²⁰ *Dodds v Tuke* (1884) 25 Ch.D. 617, 619 (Bacon V.C.)

²¹ *Re Z II Trusts* (n 15) respectively at [146], [122] and [140].

²² *Re Richardson* [1911] 2 KB (CA) 705, 711, 712; A. Ollikainen-Read, ‘Creditors’ Claims Against Trustees and Trust Funds’ (2018) 24 *Trusts & Trustees* 177, 183 and (on the difficulties associated with the lien analysis) 191-2. The point seems to be less well established in Australian law, but there is support for it: see, e.g., *Re Suco Gold Pty Ltd (in liq)* (1983) 33 SASR 99 (SC), 105; A. Silink, ‘Trustee Exoneration from Trust Assets – Out on a Limb? The Tension Between Creditor Expectations and the “Clear Accounts” Rule’ (2018) 12 *Journal of Equity* 58, 79-80.

²³ *X v A* [2000] 1 All ER 490 (Ch.D), 493 (Arden L.J.).

²⁴ *Turner v Hancock* (1880) 20 Ch. D. 303 (C.A.), 305 (Jessel M.R.).

²⁵ *Re Exhall Coal Co Ltd* (n17), 452-3 (Lord Romilly M.R.).

have been 'properly incurred'.²⁶ In *Re Beddoe*,²⁷ where the court had to consider whether a trustee was entitled to retain out of the trust estate its costs of proceedings relating to the administration of the trust, Lindley LJ held that 'the words "properly incurred" in the ordinary form of costs order made by the court were equivalent to "not improperly incurred"'.²⁸ In Bowen LJ's view, the word 'properly' meant 'reasonably as well as honestly incurred'.²⁹

When is a trustee to be deprived of her indemnity on the ground that the costs, expenses or liabilities in respect of which she claims it are improper or improperly incurred? The older cases indicate that a 'violation or culpable neglect' of duty,³⁰ or misconduct³¹ is necessary to deprive a trustee of her indemnity, such that innocent breaches of trust would not have that effect. However, the rule seems to have tightened as against the trustees, certainly in relation to litigation costs. Now, a trustee who unsuccessfully defends hostile proceedings for breach of trust will not, unless she has some other reason to prevail on the court's discretion, be entitled to recover her costs,³² and questionable conduct may also defeat a trustee's ability to recover her costs of non-hostile proceedings relating to the administration of the trust.³³ It seems likely that the high threshold of "misconduct" was set at a time when the office of trusteeship was often performed voluntarily by laypeople, and that the term should in most cases now be understood to include unreasonable conduct falling short of dishonesty.³⁴ That conclusion is certainly consonant with what follows.

As regards external liabilities, no indemnity is available in respect of an unauthorised transaction, i.e., one that falls outside the powers of the trustee (and to which the beneficiaries have not assented).³⁵ However, the courts may be prepared to make an exception and indemnify a trustee acting without authority who acts in good faith and ultimately benefits the estate in some way.³⁶ Furthermore, no indemnity is available if the external liability arises from a negligent breach of trust, either where the indemnity sought is

²⁶ *Dowse v Gorton* [1891] A.C. 190 (H.L.), 199 (Lord Herschell); *Jennings v Mather* (n11) 6-7 (Stirling L.J.). See also *Re Grimthorpe* [1958] Ch. 615, 623-4 (Danckwerts J.); *Re Suco Gold Pty Ltd (in Liq)* (n22), 104-105 (King C.J.).

²⁷ *Re Beddoe* [1893] 1 Ch. 547 (C.A.), 558 (Lindley L.J.), 562 (Bowen L.J.).

²⁸ *ibid*, 558.

²⁹ *Ibid*, 562; *Lewin on Trusts* (19th ed) (n16) [27-112]; *Abdullah v Abdullah* [2013] EWHC 4281 (Ch.), [23].

³⁰ *Turner v Hancock* (n24) 305 (Jessel M.R.)

³¹ *Re Chennell* (1878) 8 Ch. 492, 502 (Jessel M.R.); see also *Cotterell v Stratton* (1872) 8 Ch. 295, 302 (Earl Selbourne L.C.).

³² *Armitage v Nurse* [1998] Ch. 241, 262 (Millett L.J.); *Lewin on Trusts* (19th ed) (n16) [27-174], n606.

³³ *Lewin on Trusts* (19th ed) (n16), [27-113].

³⁴ See the discussion in *In re Silver Valley Mines* (1882) 21 ChD 381 at 386-7; *Lewin on Trusts* (19th ed) (n16) [27-112].

³⁵ *Leedham v Chawner* (1858) 4 K & J 458; 70 ER 191.

³⁶ *Vyse v Foster* (1872-1873) L.R. 8 Ch. App. 309, 336-337 (James L.J.); see also *Conway v Fenton* (1888) 11 Ch.D. 512; *Fitzwood Pty Ltd v Unique Goal Pty Ltd* [2002] FCAFC 285, [138]; (2002) 188 ALR 566.

contractual³⁷ or for a tortious liability.³⁸ *A fortiori*, a fraudulent breach of trust would almost certainly deprive a trustee of her indemnity.³⁹

Importantly, the quantum of the indemnity to which a trustee is entitled depends on the state of the account between the trustee and the beneficiaries. A trustee who is in default in her dealings with the trust is not entitled to indemnification in respect of any costs, expenses or liabilities (even if reasonably and properly incurred) until she has made good her default.⁴⁰ The key question is whether the accounts balance when the account is taken. For example, in *Hulbert v Avens*⁴¹ a trustee's breach in failing to pay capital gains tax at the appropriate time resulted in interest and penalties being payable to HMRC. The beneficiaries sought to argue that the breach precluded the trustee from paying its own fees out of the trust fund. By the time of the hearing of the action, the trust was in surplus as the trust fund had earned interest since the breach, and the trustee had made good the remaining shortfall from its own pocket. It was held that the mere fact of the breach did not disentitle the trustee from claiming its fees, as the accounts balanced.

Where a creditor has a claim against the trustee in respect of an external liability, her first recourse would be to sue the trustee personally, although she also has an alternative right⁴² to subrogate to the trustee's lien.⁴³ Such a right enables the creditor to ensure that those who take the benefit of a transaction with her (the beneficiaries) also take the burden.⁴⁴ In accordance with the general principles on subrogation,⁴⁵ the existence and extent of the creditor's claim cannot exceed the trustee's own rights. If the trustee's right to an indemnity is curtailed, e.g., because the trustee acts in breach of trust by taking more out of the trust assets than is necessary to pay the debts, and pockets the difference,⁴⁶ or if the right is lost entirely because the transaction was unauthorized,⁴⁷ so too is the creditor's right. Similarly, the creditor will only be entitled to an indemnity if a defaulting trustee first makes good her default.⁴⁸ This rule is thought to operate harshly in cases of exoneration, as unsecured trust creditors will only be paid if and when the trustee has balanced the account with the beneficiaries.⁴⁹

³⁷ *Collinson v Lister* (1856) 20 Beav 356; 52 ER 629; see also *Ecclesiastical Commissioners v Pinney* [1902] 2 Ch 736.

³⁸ *Re Raybould* (n14), 201 (Byrne J), applying *Benett v Wyndham* (n14) 263; 1185 (Knight Bruce L.J.). The position in Australian law appears to be similar: *Gatsios Holdings v Nick Kritharas Holdings* [2002] NSWCA 29 [14], [42], [47], interpreted in *Nolan v Collie* [2003] VSCA 39; (2003) 7 VR 287, [57].

³⁹ *Gatsios Holdings* (n38); *Nolan v Collie* (n38) [53]-[57].

⁴⁰ *Re Johnson* (n11); *Smith v Dale* (1881) 18 Ch.D. 516, 518 (Jessel M.R.).

⁴¹ *Hulbert v Avens* [2003] EWHC 76.

⁴² *Re Raybould* (n14), 201-202 (Byrne J.).

⁴³ *Ex p Garland* (1804) 10 Ves. Jr. 110, 120; 32 E.R. 786; *Re Pumfrey* (n17), 259 (Kay J.); *Lewin on Trusts* (19th ed)(n16) [21-048].

⁴⁴ *Re Johnson* (n11), 552 (Jessel M.R.).

⁴⁵ *Cheltenham & Gloucester plc v Appleyard* [2004] EWCA Civ 291, [43].

⁴⁶ *Re Johnson* (n11), 552.

⁴⁷ *Ecclesiastical Commissioners v Pinney* (n37).

⁴⁸ *Re Johnson* (n11).

⁴⁹ See, e.g., *Silink* (n22) 84-5; *Ollikainen-Read* (n22) 188-190.

In the absence of any indication that the indemnity provisions in s.31 and Article 26(2) are designed to supersede or amend the general law, they should be treated as statutory overlays, which are designed to give effect to the trustee's right to indemnification under the general law,⁵⁰ and should therefore be interpreted in light of it.

Section 31 permits indemnification in respect of 'expenses properly incurred', while Article 26(2) refers to 'expenses and liabilities reasonably incurred'. The Jersey Court of Appeal has suggested that the words 'reasonably incurred' are not necessarily synonymous with 'properly incurred', as the former may afford less latitude to a trustee than the latter.⁵¹ However, given the implicit requirement in English law that the trustee's conduct in incurring a liability must be reasonable (i.e., not negligent⁵²), the conduct which will preclude a trustee from recovering in respect of a liability in both jurisdictions would seem to be very similar, if not identical. Therefore, the arguments which follow are relevant to a trustee's right to indemnification under both English and Jersey law.

The first question - timing

The first question is whether, in deciding if a trustee is entitled to indemnification in respect of an external liability, the court may have regard only to her conduct in *creating* the liability, or also her subsequent conduct in failing to divest herself of the liability when she ought reasonably to have done so. In the view of the majority in *Investec*, if the liability was properly *created*, that is the end of the matter: the trustee's subsequent conduct cannot negate a finding that it was reasonably (or properly) incurred. In our view, the matter is not as straightforward as the majority implies. When the trustee claims a right to an indemnity in respect of costs, expenses or liabilities incurred in the execution of the trust, it is self-evident that she is asserting a right to claim and retain trust property as against the beneficiaries. It follows that although a trustee may come to court at any time to enforce her right of indemnity,⁵³ the question of whether she is *entitled* to it relates to the state of the account between the trustee and the beneficiaries. Thus, the timing issue should be considered in light of the common law principles whereby a trustee is held to account.

Trust accounting principles and the right to an indemnity

There are two types of trust account. An account in common form 'enforces the trustee's primary duty to hold the trust property for the beneficiaries, paying out sums only as he is authorised to do under the terms of the trust.'⁵⁴ For the purposes of such an account, the trustee must charge herself with any property received in her capacity as trustee (and its fruits

⁵⁰ *Gatsios Holdings* (n38), [9]; *In re The Esteem Settlement* [2002] JLR 53, [83]-[87], where the Royal Court of Jersey confirmed that the Jersey statute is not a codification.

⁵¹ *Alhamrani v JP Morgan Trust Company Ltd* [2007] JLR 527, [27] (Vos JA).

⁵² Text to n28 above.

⁵³ *Re Pumfrey* (n17), 262.

⁵⁴ *Lewin on Trusts* (19th ed)(n16), [39-005]; *Partington v Reynolds* (1858) 4 Drew 253, 255; 62 ER 98; *Re Stevens* (1898) 1 Ch 162 (CA), 176 (Vaughan Williams LJ).

or traceable proceeds).⁵⁵ Discharges are credited to the trustee, and may be offset against receipts. The trustee is entitled to three different types of discharge only,⁵⁶ including a discharge for proper administrative outlays or 'just allowances',⁵⁷ i.e., those payments necessitated by the carrying out of her powers and duties.⁵⁸ She will be charged with any sum she takes as an allowance without being entitled to do so.⁵⁹

A beneficiary may falsify the account and challenge an item of discharge.⁶⁰ If the payment 'could not be vouched as having properly been made under the trust', it would be disallowed, and the trustee 'would be treated as still having in his hands the balance found to be due from him.'⁶¹ The trustee is then required to perform her primary stewardship duty⁶² and 'pay such a sum as will make [the accounts] balance',⁶³ either by replacing the trust assets or, if she cannot, by making good the deficit in money's worth.⁶⁴ The trustee's stewardship duty continues to the date on which the account is taken, and her liability is strict.⁶⁵ If she has made an unauthorised⁶⁶ or imprudent⁶⁷ outlay, she must reconstitute the fund by restoring the value of the trust asset, such value to be 'determined at the date when the account is taken and with the full benefit of hindsight.'⁶⁸ The proper analogy is with a claim for debt rather than a claim for damages to compensate for loss caused by a breach of duty,⁶⁹ and thus questions of loss and causation do not arise.⁷⁰ The trustee's obligation to preserve the trust fund is paramount.

These days, claims in this form are not very common. Beneficiaries now tend to plead a claim for a specific breach of trust without also seeking a full account.⁷¹ Furthermore, the decisions of the House of Lords in *Target Holdings Ltd v Redfern*⁷² ('*Target*') and the Supreme Court in *AIB Group Plc v Redler*⁷³ ('*AIB*') have moved the law along by providing that, in the

⁵⁵ J. McGhee Q.C. (ed), *Snell's Equity* (33rd ed) (Sweet & Maxwell, London, 2015) [20-019].

⁵⁶ *Ibid* [20-020].

⁵⁷ *Ibid*.

⁵⁸ *ibid*; *Worrall v Harford* (n9) 8.

⁵⁹ P. Turner, 'Want of Causation as a Defence' in P.S. Davies, S. Douglas & J. Goudkamp (eds.), *Defences in Equity* (Hart Publishing, Oxford 2018) 155, 160. See also C. Mitchell, 'Stewardship of Property and Liability to Account' [2014] Conv. 215, 216.

⁶⁰ Turner (n59) 160.

⁶¹ *Re Windsor Steam Coal Co Ltd* [1929] 1 Ch. 151, 166-167 (Lawrence LJ).

⁶² Mitchell (n59), 216.

⁶³ *Head v Gould* [1898] 2 Ch 250, 266.

⁶⁴ Mitchell (n59), 222, citing *Hall v Libertarian Investments Ltd* [2013] HKFCA 94, [169] (Lord Millett NPJ). See also J. Edelman & S. Elliott, 'Money Remedies Against Trustees' (2004) 18 Tru. L. Int. 116, 116-118.

⁶⁵ P. Millett, 'Equity's Place in the Law of Commerce'. (1998) 114 LQR 214, 225.

⁶⁶ *Knott v Cottee* (1852) 16 Beav 77, 70-80; 51 ER 705.

⁶⁷ M. Conaglen, 'Equitable Compensation for Breach of Trust: Off *Target*' (2016) 40 Melb. U.L.Rev. 125, 142, citing *Re Salmon; Priest v Uppleby* (1889) 42 Ch. D. 351.

⁶⁸ *Libertarian Investments* (n64), [168] (Lord Millett NPJ).

⁶⁹ *Bacon v Clark* (1837) 2 My & CR 294, 298-299; 40 ER 938; Mitchell (n59), 216; Edelman & Elliott (n64), 116-118; J. Edelman, 'An English Misturning with Equitable Compensation' in S. Degeling & J. Varuhas (eds), *Equitable Compensation and Disgorgement of Profit* (Hart Publishing, Oxford, 2017) 91.

⁷⁰ Mitchell (n59) 216; Turner (n59) 160; Conaglen (n67) 127.

⁷¹ Conaglen (n67) 148.

⁷² *Target* (n1).

⁷³ *AIB* (n1).

context of bare commercial trusts or where a trust has come to an end, the extent of the beneficiary's remedy *will* depend on the extent to which the trustee's breach caused the loss to the trust fund.⁷⁴ Indeed, the Jersey Court of Appeal has recently had regard to these decisions in refusing a beneficiary of an extant family trust the remedy of reconstitution. The court considered its discretion to be affected in part by the extreme remoteness of the claimant's interest in the sub-fund for which reconstitution was sought, given that such an order would principally benefit a non-participating beneficiary the merits of whose overall position were unclear.⁷⁵ Thus, a trustee who has no discharge in respect of a payment must restore the money but the amount she must restore may be reduced if she can show that part of the loss was not caused by her conduct.⁷⁶ These decisions have been criticised on the basis that they are inconsistent with the idea that the beneficiary is entitled to require the trustee to *perform* her primary stewardship duty to look after the trust assets and only to disburse them in accordance with the terms of the trust.⁷⁷ Moreover, the orthodox accounting principles have not been abolished, and *Target* and *AIB* do not affect, e.g., the types of payment for which a trustee is entitled to a discharge.

The second type of account is an account on the footing of wilful default. This requires the trustee 'to account, not only for what he has received, but also for what he might, without his wilful neglect or default, have received, although he has not received it.'⁷⁸ For example, if a trustee behaves negligently in the making of investments and breaches her administrative duties, the beneficiary may surcharge the account and the trustee must compensate the trust for any losses caused by her breach.⁷⁹ Here, questions of causation and loss are very obviously relevant. Thus, an account on the footing of wilful default looks to determine 'what might have been done if the trustee had acted properly', rather than 'the appropriateness of what the trustee has *actually* done with the trust property', which is the concern of an account in common form.⁸⁰

A trustee's right to indemnification relates to what she has done, or is about to do, with the trust property, i.e., by using it to pay an expense or external liability directly or to reimburse herself in respect of the same. There is a complete correlation between indemnifiable outlays, and those for which she would be entitled to a discharge in the taking of an account in common form. Thus, to describe an external liability as 'properly' incurred is shorthand for saying that the trustee is entitled to a discharge in respect of it, and may

⁷⁴ Turner (n59) 182.

⁷⁵ *BNP Paribas v Crociani* [2018] JCA 136A, [14] – [50].

⁷⁶ *ibid* 171-2.

⁷⁷ Mitchell (n59); Conaglen (n67) 165-166; Edelman (n69); P. Davies, 'Compensatory Remedies for Breach of Trust' in R. Nolan, K. Low & T. Wu, *Trusts and Modern Wealth Management* (Cambridge University Press, 2018). However, others suggest that the decisions can be rationalised in accordance with orthodox accounting principles: Millett (n65); J. Penner, 'Falsifying the Trust and Compensatory Equitable Compensation' in S. Degeling & J. Varuhas (eds), *Equitable Compensation and Disgorgement of Profit* (Hart Publishing, Oxford, 2017) 143; L. Ho, 'Causation in the Restoration of a Misapplied Trust Fund', *ibid*, 159.

⁷⁸ *Partington v Reynolds* (1858) 4 Drew 253, 256, 257; 62 ER 98.

⁷⁹ See, e.g., Edelman & Elliott (n64).

⁸⁰ Conaglen (n67), 139-40, emphasis added.

offset it against the receipts for which she must account to the beneficiaries. Thus conceived, the right to an indemnity in respect of an item of expenditure gives the trustee an exemption from her general stewardship duty in respect of that sum. If the cost, expense or external liability was not properly incurred, it is not indemnifiable, the trustee is not entitled to a discharge in respect of it, and the beneficiary may enforce the trustee's stewardship duty.

It follows that if a trustee pays an unreasonably or improperly incurred external liability directly out of trust assets or reimburses herself in respect of it, the beneficiary may falsify that item in the accounts, and obtain an order that the trustee restore the fund. For example, in *Bonham v Blake Laphorn Linell*,⁸¹ the issue was whether a trustee should bear the costs of trust proceedings personally or was entitled to pay them out of the trust fund. On the facts, Kitchin J found that the costs had been properly and reasonably incurred and therefore the trustee was entitled to pay them out of the trust fund. However, he also accepted as the premise of one of the beneficiaries' counter-arguments, that if the costs had *not* been properly and reasonably incurred, they would have been treated on an account in the same way as an unauthorised payment, such that the beneficiaries could falsify the account.⁸² Yet it is the case that, because an order that the trustee restore the fund requires her to make substitutive performance of her primary stewardship duty, an improperly discharged external liability *need not* be pleaded as a breach of trust. It 'can simply be raised as an objection to the account, and the resulting personal liability is not a species of damages'.⁸³

Although there is no direct authority which states that the same analysis applies to a trustee's failure to divest herself of a pre-existing external liability in a timely fashion, there is authority which offers support for this view. The first relevant case is *Angullia v Estate and Trust Agencies (1927) Ltd*.⁸⁴ An executor mortgaged property belonging to the testator's estate to raise \$17,000 to pay off a debt owed to a builder, whom the testator had retained to build six shops on land which had been settled for his benefit and that of his son. Subsequently, the court held that the testator's will had been improperly executed and he had died intestate. Initially, there was a dispute between the testator's son (as beneficiary of the settlement) and the administrators of the testator's estate as to whether the cost of the shops should be borne by the settled property or the estate. At first instance, it was held that it should be borne by the settled property, so the court ordered an account in common form of the personal property received by the executor. The testator's son successfully appealed this finding, thus throwing the liability onto the estate. In making the account, the executor sought to credit himself (i.e., to obtain indemnity) for the \$17,000 plus interest. The administrators of the estate successfully challenged this before the Registrar on the basis that the executor should have refused to pay the builder, who would then have had to sue for damages for breach of contract. In the Court of Appeal the executor argued that the items

⁸¹ *Bonham v Blake Laphorn Linell* [2006] EWHC 2513 (Ch).

⁸² *Ibid*, [173]-[175] and [180].

⁸³ *Snell's Equity* (n55) [20-021].

⁸⁴ [1938] A.C. 624 (H.L.). This case was cited in *Investec*, but not referred to in the judgment.

in the account relating to the building of the shops could only be disallowed on the basis that he had committed a breach of trust, and as one had not been pleaded, he could not be charged with one in the taking of the account in common form. The Court of Appeal rejected this contention.

The executor appealed to the Privy Council on the basis that his duty did not extend to an unlawful act, such as breaching a contract, and he won. In the absence of any evidence that a good compromise was possible, the payments by the executor were proper and they were allowed against the estate. Importantly, however, the Privy Council also confirmed the Court of Appeal's finding that there was no need to plead a breach of trust. Lord Romer accepted that in the taking of an account in common form of the personal estate received by the executor, he could not be charged with damages for breach of trust. However, he held that it 'it was incumbent on him to justify his payments, and if he could not do so, they would be disallowed.'⁸⁵ In support of this conclusion Lord Romer cited earlier authority to the effect that executors could be charged with a devastavit arising on the taking of an account in common form; they 'stand charged with their receipts; and if they seek to discharge themselves by unlawful payments, their discharge is disallowed.'⁸⁶

The substance of the argument in *Angullia* was that the executor's duty required her to do more to get rid of a pre-existing (properly created) external liability at a lower cost, and that her failure to do this meant that the liability should be borne personally by her, rather than the estate.⁸⁷ The Privy Council's decision in that case establishes that such a complaint may in principle be addressed in an account in common form, rather than having to be dealt with separately as a breach of trust. It goes to the question whether the payment of the external liability is proper, and therefore one in respect of which the executor is entitled to a discharge. Therefore, the case offers some support for the view that the question whether a trustee has failed unreasonably to mitigate or eliminate an external liability is relevant to whether she is entitled to a discharge in respect of that liability in an account in common form. If not, it is an unauthorised outlay in respect of which she will not be entitled to indemnification.

Further authority suggests that, consistently with the idea that an account in common form is concerned to ensure the ongoing performance of a trustee's stewardship duty, when the court is considering a trustee's right to indemnification, it does not stop the clock at the date on which the external liability was initially created. Rather, it looks at the position at the date on which the account is taken or when the challenge to the trustee's right to an indemnity is heard.

This may be seen, first, in *Re Exhall Coal Co Ltd*,⁸⁸ where the trustee and promoter of a mining company had been compelled to pay rent due from an insolvent company to the

⁸⁵ Ibid, 637.

⁸⁶ Ibid, citing *Re Stevens* [1898] 1 Ch. 162, 17.

⁸⁷ The fact that the case involved an executor and an estate does not detract from its relevance in relation to trusts. See, for example, the parity of treatment afforded by the definition of "trust" in section 68(17) of the Trustee Act 1925.

⁸⁸ *Re Exhall Coal Co Ltd* (n17).

lessor of the mine into court, as the price of an injunction to restrain an action by the lessor to recover the rent. In winding up proceedings, he claimed the sum of £1,016 belonging to the company (the proceeds of sale of fixtures, plant and machinery) to indemnify him against the lessor's claim. The debenture holders insisted that the sum be divided between them, but the Court of Appeal found for the trustee. Lord Romilly clearly regarded the question of the trustee's right to indemnification as depending on the circumstances pertaining when the trustee was called to account:⁸⁹

'He was the trustee of the mine, including the fixtures, the plant and machinery; he is the owner of this property at law, and *when called upon to account in equity, he is entitled to deduct, out of the trust property in him, all that is necessary for the purpose of repaying him the sums he has properly paid, and of indemnifying him against such sums as he is liable to pay in the discharge of his trust*; and, in my opinion, this liability to repay and to indemnify him is the first charge on the property ... [He was entitled to] deduct all that he had properly paid for the preservation of that property.'

The same approach is discernible in *Stott v Milne*.⁹⁰ The trustees' solicitors held rents earned on properties in the trust, but had had to commence two sets of proceedings against third parties to vindicate the trust's rights in the properties held. Their costs of doing so had exceeded the rents. There was an issue as to whether the costs could be offset from that income or be taken out of capital, which is immaterial. The important point is that the court can be seen appraising the reasonableness of the incurring of the litigation costs with the full benefit of hindsight. There is no trace in the report that the trustees might not have had authorisation to take proceedings to preserve trust property;⁹¹ indeed it was likely to have been their duty to do so. It was expressly held at first instance that because the proceedings had been commenced on Counsel's advice, that was sufficient to establish that it was proper for the trustee to take the costs out of the trust estate. On appeal, Lord Selborne LC held that the reason given in the first instance order should be varied, as the result did not follow simply because the proceedings had been commenced under counsel's advice. The mere fact that the trustees had acted bona fide and reasonably in bringing the actions was insufficient alone to justify the indemnity. Rather, the question was assessed more broadly, in terms of the actual benefit to the trust estate, which was assessed as at the time of the taking of the account. His Lordship concluded that:⁹²

'That the result of the first action was beneficial to the estate is clear. Whether the estate was benefited by the second action is disputed, but I am disposed to think that it was. Looking at the whole circumstances, at the manifest bona fides of the trustees,

⁸⁹ *ibid* 452-3, emphasis added.

⁹⁰ *Stott v Milne* (n17).

⁹¹ The basis on which *Stott* was distinguished by Lord Hodge: see text to (n96) below.

⁹² *Ibid* at 714.

and at the opinion of the Vice-Chancellor that costs ought to be allowed ... [they should be paid out of the trust corpus.]’

Finally, in *Conway v Fenton*⁹³ Kekewich J. was faced with trusts that did not empower the trustees to make the capital expenditure that was necessary for the preservation of the trust estate. Nevertheless, he held that the court had the power under its supervisory jurisdiction to approve the expenditure, and ordered it, thereby effectively accepting that it was proper for the trustees to incur it. He added that:⁹⁴

‘[I]f the trustees were to make the repairs at their own risk, and the trustees were called on to account, if they could prove to the satisfaction of the court that what had been done had really preserved the property – no doubt a difficult thing to do afterwards – the Court would certainly have jurisdiction in an infant’s suit to say that it was for the benefit of the infants that the property should be taken as improved, and that the trustees would not be made liable.’

Although *Conway* was a case to do with the incurring of an unauthorised external liability, it clearly supports the view that when the courts come to determine a trustee’s right to an indemnity, they are prepared to consider the position pertaining at the date of the hearing, rather than regarding themselves as constrained to consider *only* the creation of the liability.

It follows that the ultimate enquiry into whether an external liability has been ‘properly’ or ‘reasonably’ incurred, such that it is indemnifiable, is not referable only to the moment when the liability was first created but falls to be assessed with the benefit of hindsight at the date of the hearing. The court can consider the question in wide terms, as to whether it is proper and appropriate in all the circumstances for her to be released from her stewardship duties in respect of it, and granted a discharge for it in the accounts. This allows it to take into account unreasonable conduct in failing to reduce or eliminate the liability after its creation.

Difficulties with the majority’s reasoning in Investec

When giving the majority judgment in *Investec*, Lord Hodge⁹⁵ did not refer to trust accounting principles or to *Angullia* at all. He discussed *Re Exhall Coal Co Ltd*, *Stott v Milne* and *Conway v Fenton* but held that they were all distinguishable on the basis that they were about ‘liabilities which might, viewed strictly when incurred, have been unauthorised’ but which were recoverable under the trustee’s indemnity ‘because of the benefit which they brought

⁹³ *Conway v Fenton* (1888) 11 Ch.D. 512.

⁹⁴ *Ibid*, 518.

⁹⁵ *Investec v Glenalla* (n2) [110].

to the trust fund'.⁹⁶ As regards *Stott v Milne*, this is clearly incorrect. Moreover, his Lordship failed to appreciate the significance and persuasive value of *Re Exhall Coal Co Ltd*, *Conway v Fenton* and *Angullia* in relation to the timing issue. For these reasons, and in light of our analysis above, we suggest that Lord Mance's conclusion in *Investec* is to be preferred. In his view, the statutory provisions are designed to operate, 'and only matter at the time *when reimbursement is claimed* in respect of expenses or liabilities actually incurred', which mean that 'the requirement that the expenses or liability be "reasonably incurred" looks back over the whole period up to that moment.'⁹⁷

Lord Hodge's other reasons for rejecting the more expansive approach to timing are also problematic. His second reason was that loan liabilities of the size incurred by *Investec* were not the typical sort of liability for which the provision was designed, i.e., trustees' remuneration and expenses.⁹⁸ However this ignores the fact that, as explained above, Article 26(2) is taken to include external liabilities within its remit, and it and s.31 are merely statutory overlays which are meant to give effect to the general law. Neither the statutory provisions nor the general law cut down the trustee's right to indemnification by reference to the size of the liability.

Lord Hodge's third reason was that unreasonably leaving an external liability in place would constitute a breach of trust, but the measure of loss would rarely equate to the full extent of such liability, given that the ability to discharge an external liability early would usually come at a cost. Thus, it would rarely be right to say that the entire external liability was not reasonably incurred because it could have been got rid of sooner.⁹⁹ However, this reason assumes what it seeks to prove, i.e., that a failure to reduce or eliminate an external liability has nothing to do with the question whether it was properly or reasonably incurred. It also suggests that in principle the courts could never find that only part of an external liability had been unreasonably incurred, which cannot be right.¹⁰⁰ For example, say that a trustee properly and reasonably borrows money under a loan contract. The contract gives her a contractual option which, if exercised, will reduce to 1/10th the value of the amount to be repaid. The trustee negligently fails to exercise the option, and the lender calls in the full amount of the debt. Logic and justice suggest that the trustee should only ever be entitled to reimbursement of 1/10th of the debt out of the trust assets, and that the rest should be treated as an unauthorised outlay for which she is not entitled to a valid discharge. Therefore, 9/10^{ths} of the debt can be said to have been improperly and unreasonably incurred.

Lord Hodge's discussion of loss also appears to contain an implicit appeal to the principles that govern a common law damages assessment in a way that echoes the approach of the courts in *Target* and *AIB*, but *Investec* is distinguishable from those cases: unlike in

⁹⁶ *ibid* [110].

⁹⁷ *Investec v Glenalla* (n2) [233].

⁹⁸ *Ibid*, [111].

⁹⁹ *Ibid* [112].

¹⁰⁰ See *ibid* [235] (Lord Mance). This is axiomatic in the test of just allowances being those "reasonably" incurred. See also *Foster v Spencer* [1996] 2 All ER 672, where trustees were partially successful in a claim for remuneration.

Target and *AIB*, the beneficiaries of the TDT were not seeking to be put in a better position on the facts than if the trust had been fully performed. Furthermore, the TDT was not a bare trust arising in a commercial context; it was a family trust, albeit that its trust-owned companies were investment vehicles with a robust attitude to risk. If the *Target* approach is to be extended to express trusts with and because of these features, this should be explicitly considered. Furthermore, whilst Lord Hodge's approach would seem to acknowledge that the question of whether an external liability has been properly created is a question of stewardship - if an external liability has been properly *created*, that is sufficient to entitle the trustee to a discharge in respect of it –, where a beneficiary wishes to complain about the improper *continuation* of such a liability, the trustee's duties of administration are required to be engaged. She would have to require the trustee to account on the footing of wilful default, or sue for compensation for loss in order to recover the money which the trustee would have saved if she had succeeded in getting rid of the liability sooner. If it is right that the trustee's entitlement to indemnification equates to the extent that she is forgiven her stewardship duty, this split treatment is difficult to justify conceptually and is susceptible to the same criticisms as *Target* and *AIB*.

Fourth, Lord Hodge held that if the trust instrument contained an exoneration clause, regard should be had to it in the interests of ensuring fairness to trustees or creditors.¹⁰¹ We discuss the impact of exoneration clauses on a trustee's right to indemnification in more detail below, but in our view the presence or absence of an exoneration clause of itself should not be determinative of the timing issue. If it is right that a trustee's failure to reduce or eliminate an external liability never goes to the question of the trustee's *right* to an indemnity, such conduct will only ever fall to be considered as a subsequent breach of trust, which in principle may be covered by an exoneration clause. To suggest its presence has implications for a trustee's right to indemnification too without explaining how or why is, with respect, confusing.

Finally, Lord Hodge found that to interpret the word 'incurred' in Article 26(2) as including the unreasonable failure to discharge a liability would be a recipe for uncertainty, and would undermine the purpose of the statutory provision, which was to allow a trustee to pay expenses and external liabilities out of the trust fund, or reimburse herself in respect of them, without having first to go to the court and get directions.¹⁰² At first blush, the statutory nature of the provision suggests that the words 'reasonably incurred' should be interpreted strictly, i.e., as meaning 'reasonably created'. But this is to ignore the point that the statute was never a codification; the general indemnification principles still lie behind Article 26, and they support the wider interpretation of Article 26(2) as argued for by the new trustee in *Investec*. Furthermore, the scope of a trustee's indemnity is itself a question of principle and should not be driven by questions of administrative convenience to trustees (or creditors).

As Lord Mance remarked, it is difficult to identify any principled rationale 'for a distinction between a claim for reimbursement in respect of an expense or liability

¹⁰¹ *Investec v Glenalla* (n 2) [113].

¹⁰² *Ibid* [114].

unreasonably incurred because it should never have been incurred in the first place and an expense or liability unreasonably incurred because the person claiming reimbursement has allowed it to continue and failed to mitigate it.’¹⁰³ This argument has even more force when it is borne in mind that a trustee’s liability to *pay* is not necessarily (and perhaps not even usually) incurred at the point when the trustee enters the transaction creating the ‘liability’, e.g., a loan contract. It will often be later, at the date when payment is required, e.g., when a loan is demanded. That (and not the date of the loan contract) is the moment when the trustee is obliged to satisfy a claim, and looks for indemnification from the trust fund.

In response, it might be argued that it matters little if a trustee’s right to indemnification in respect of an external liability hinges only on her conduct in relation to its creation, given that any subsequent unreasonable failure to discharge it will inevitably constitute a breach of trust. However, we contend that it does matter, for three reasons. It is important for the coherence of the law in general that legal questions are resolved consistently with principle. Furthermore, the resolution of the timing issue feeds into bigger debates about the trust. The position we have argued for above is consistent with a view of the trust that emphasises the importance of upholding the trustee’s ongoing stewardship duty. By contrast, Lord Hodge’s approach is more consistent with the prevailing judicial tendency (exemplified by the decisions in *Target* and *AIB*) to focus on compensating the beneficiaries for only that loss which was caused by the trustee’s breach.

Finally, the majority’s approach facilitates a disjunction between the threshold for indemnification on the one hand and exemption clauses on the other, which may often be difficult to justify. If a trustee enters into a loan transaction on Monday, she will be entitled to her indemnity unless her conduct in creating the external liability was unreasonable. However, if on Tuesday, she behaves unreasonably by negligently failing to mitigate or eliminate the external liability, her right to an indemnity remains undisturbed. The beneficiaries must sue her for breach of trust and, if there is an appropriately worded exemption clause in the trust instrument, they will not succeed unless they can prove that her conduct in allowing the liability to continue was grossly negligent (under Jersey law¹⁰⁴) or fraudulent (under English law¹⁰⁵). This is illogical. As Lord Mance explained, ‘[T]here is no logic or likelihood in the parties’ intending to preclude reimbursement of an expense or liability which was from the outset unreasonably incurred but to preclude reimbursement of an expense or liability which was unreasonably continued only if this was due to gross negligence. The two situations are conceptually parallel, and the same test should apply to each.’¹⁰⁶

¹⁰³ *Ibid* [234].

¹⁰⁴ Article 30(10) of the Trusts (Jersey) Law 1984.

¹⁰⁵ *Armitage v Nurse* (n32), 252 (Millett L.J.).

¹⁰⁶ *Investec v Glenalla* (n2) [235].

The second question – the relevance of exoneration clauses

The second question is whether, as a matter of principle, the presence of an exoneration clause in the trust instrument should operate to enhance a trustee's entitlement to indemnification, by permitting her to escape personal liability for a breach of trust comprising the use of trust money to pay an improperly or unreasonably incurred external liability. In our view, the correct answer to this question requires careful consideration of how the principles governing exoneration clauses and the principles governing indemnification of trustees should interact. Ultimately, the answer is likely to be informed by the weight the courts give to the importance of enforcing a trustee's stewardship duty.

An exoneration clause may cut down the scope of, or exclude, a trustee's duty ('an exclusion clause'), and the extent to which it does so is a matter of construction. Alternatively, it may say nothing to narrow or relax the scope of the duties to which the trustee is subject, but it may exempt the trustee from liability for loss arising from any breach of duty ('an exemption clause'). Lawyers have long regarded with suspicion the proposition that it is conceptually possible for a trust to exclude a trustee's stewardship duty entirely, save for a possible temporary ouster of accountability.¹⁰⁷

The issue is particularly acute in trusts containing exemption clauses in the usual form. This is because, as previously explained, the standards by reference to which: (i) a trustee's entitlement to indemnification; and (ii) her entitlement to an exemption from liability for loss caused by breach of trust will likely be different. A trustee could incur and pay an external liability of £1,000 out of the trust assets in breach of her duty of care. According to the indemnification rules, the consequence would be that the external liability was not properly or reasonably incurred, such that it would constitute an outlay for which she would not be entitled to a discharge and which she would have to bear personally. However, if the trustee were expressly exempted from liability for any loss caused to the trust fund by her breach of trust and that exemption were assumed to be engaged, then unless the beneficiaries could prove that the trustee's conduct was (in Jersey or Guernsey) grossly negligent or worse, or (in England) fraudulent, she could thereby escape personal liability for any loss caused by that unauthorised disposal. To this extent, exemption clauses have the potential to contradict and undermine the purpose of the common law and statutory indemnity provisions; but should they?

Authority

An application of orthodox trust accounting principles suggests that the presence of an exemption clause does not, and should not permit a trustee to escape personal liability in respect of external liabilities improperly or unreasonably incurred. If the payment of such a liability is an outlay for which the trustee is not entitled to a valid discharge, the beneficiaries

¹⁰⁷ D. Hayton, 'The Irreducible Core Content of Trusteeship' in A. Oakley (ed.), *Trends in Contemporary Trust Law* (Clarendon, Oxford 1996) 47, 57, citing *Hayim v Citibank* [1987] AC 730.

would be entitled to falsify the account in respect of any such payment. Then, without requiring the beneficiary to plead or prove loss caused by a breach of trust, the court could simply enforce the trustee's primary stewardship duty by requiring her to refund the money, or pay an equivalent sum from her own pocket by way of substitutive performance. The presence of an exemption clause in the trust instrument would be neither here nor there, as it would not eliminate the trustee's stewardship duty, but merely exempt her from liability for any loss arising from the breach. If the trustee performs her stewardship duty specifically or substitutively, there is no loss and therefore nothing to engage the exemption clause.

Support for this argument may be found in *Re Windsor Steam Coal Co Ltd*,¹⁰⁸ in which the Court of Appeal had to consider the impact of the statutory exemption from liability conferred on trustees by s.30(1) of the Trustee Act 1925 in respect of an unauthorised disbursement of trust money. S.30(1) provided that a trustee would be 'answerable and accountable only for his own acts, receipts, neglects, or defaults' and not for those of anyone else 'nor for any other loss, unless the same happens through his own wilful default.' Without first seeking the directions of the court, a liquidator paid £15,000 out of company assets to settle a debt which was not in fact due. He claimed that the effect of s.30 was to exempt him from liability to refund the money as he had not been guilty of wilful default. The Court of Appeal held that the liquidator had acted unreasonably (albeit honestly) in paying the debt,¹⁰⁹ and he was not entitled to exemption from liability to refund the money under s.30.

The key passage in Lawrence LJ's judgment suggests that in the view of the Court of Appeal¹¹⁰ the statutory exemption did not affect the trustee's liability to account in respect of the trust property. A trustee was 'always liable for the due application of trust funds received by him, and is accountable for all his own receipts: under the ordinary account he can only discharge himself by showing that he has paid the trust fund to the right person.'¹¹¹ Lawrence LJ held¹¹² that on the taking of an account in common form:

'Every payment which could not be vouched as having properly been made under the trust would be disallowed, and [the trustee] would be treated as still having in his hands the balance found to be due from him. There would be no loss and there would be no question of wilful default. In my judgment the words of the section relied on are directed to an entirely different set of circumstances.'

Thus, the court recognised a difference in principle (even if the result will often be the same) between: (a) allowing a trustee an indemnity against trust assets; and (b) giving a trustee an immunity from suit for compensation for loss arising from a breach of duty. In

¹⁰⁸ *Re Windsor Steam Coal Co Ltd* (n61).

¹⁰⁹ *Ibid*, 165 (Lawrence LJ).

¹¹⁰ *ibid* 161 (where Lord Hanworth MR endorsed the point, referencing the argument reported at p.156 and his interjection) and 169-7 (Russell LJ concurring).

¹¹¹ *Ibid* 166.

¹¹² *Ibid*, 166-167 (Lawrence LJ).

doing so, it set its face against allowing exemption clauses to enable trustees to obtain indemnification through the back door.

However, the recent case of *Bonham v Blake Laphorn Linell*¹¹³ suggests that the courts may now incline towards a different approach. The question was whether one of two former trustees was entitled to an indemnity in respect of litigation costs relating to proceedings in which the former trustees had sought orders compelling the beneficiaries to transfer to them certain shares in Bonhams. On advice, these proceedings had been discontinued and settled. One of the beneficiaries alleged that the litigation was brought for an improper purpose and that the claims had no real prospect of success, so that the proceedings should have been discontinued earlier and the costs had not been properly incurred. Kitchin J rejected this argument and held that the trustees' costs should be borne by the trust fund. For this reason, there was no need to consider the former trustee's alternative argument that if the costs had not been properly incurred (so as to disentitle him from indemnification), he could nevertheless rely on clause 17 of the trust instrument which exempted the trustees from liability for loss caused by anything 'except wilful and individual fraud or wrongdoing on the part of the Trustee'. Nevertheless, Kitchin J. decided to set out his (*obiter*) conclusions on the issue, on the basis that the matter had been argued before him.

The beneficiary argued that if the costs had not been properly incurred, the former trustee would have been acting in breach of trust by using trust monies to discharge an external liability which should have been borne personally. This would constitute an unauthorised disposal of trust money, the trust account would be liable to falsification, and the funds paid away would be treated as never having been paid out. The former trustee would have to account on the basis that the monies were retained by the trust (and make good the deficit personally). Therefore, there would have been no loss to the trust fund, and clause 17 would not be engaged. The argument followed the same essential approach as that in *Re Windsor Steam Coal Co Ltd*, though the case was not cited.

However, Kitchin J. rejected the argument. He held that an unauthorised application of trust funds to pay an improperly incurred external liability would have engaged the exemption clause, so that ultimately the trustee would not have been personally liable for the loss caused by the breach.¹¹⁴ First, he held that the unauthorised application of trust funds was a breach which left 'a deficiency within the trust', which meant that 'funds need to be restored. To my mind the trust has in these circumstances clearly sustained a loss.'¹¹⁵ He held that the drawing of the account was 'the formal process by means of which the extent of the liability to reconstitute the trust fund is identified', following which the trustee was obligated to restore the deficiency.¹¹⁶

¹¹³ *Bonham v Blake Laphorn Linell* [2006] EWHC 2513.

¹¹⁴ *Ibid* [178].

¹¹⁵ *Ibid* [179].

¹¹⁶ *Ibid* [180].

Kitchin J. held further that the interpretation of the clause for which the claimants argued would mean that the trustees would be 'exposed to liability for breach of trust for any unauthorised expenditure, however innocent the breach may have been.'¹¹⁷ In his view, this would create an illogical result, as the trustees would be protected in respect of authorised but negligently undertaken conduct, but they would not be protected 'in respect of conduct which they negligently failed to appreciate was unauthorised'.¹¹⁸ He saw no justification for this distinction. Finally, he cited *Armitage v Nurse* to the effect that it was possible to exempt trustees from liability for breach of trust for all types of conduct short of dishonesty.¹¹⁹

There are several reasons why Kitchin J's judgment may not be the last word on the matter. First, the fact that *Re Windsor Steam Coal Co Ltd*, a Court of Appeal decision, was not cited before him, strictly speaking renders his *obiter* comments on this point also *per incuriam*. Second, he did not examine whether there is a relevant distinction between an unauthorised disposal of trust assets, which constitutes a breach of the trustee's stewardship duty, and a negligent breach of the trustee's duty of care in relation to the administration of the trust, e.g., in the form of a negligent investment decision. Lawrence LJ's judgment in the *Windsor Steamship* case suggests that this *is* a relevant distinction that may justify a conclusion that exemption clauses cannot help a trustee to obtain indirectly indemnification for an improperly incurred liability.

Third, in our view *Armitage* does not necessarily provide direct, unequivocal support for Kitchin J's conclusions, as the question of the interplay between exemption clauses and indemnification was not in issue in that case. Jacob J. and the Court of Appeal were solely concerned with a preliminary issue as to the permissible scope of an exemption clause in a settlement which exempted the trustees from liability for all loss save for that caused by fraud, and specifically whether 'fraud' extended to deliberate breaches of trust falling short of dishonesty.¹²⁰ This was the only point which the Court of Appeal had to decide. Millett LJ held that fraud required proof of dishonesty, so that even if the alleged breaches of trust had been committed, the exemption clause would save the trustees from liability absent a dishonest intention on their part.¹²¹

In *Armitage* the beneficiary had argued that a trustee's core duties included *inter alia* a duty of skill and care and a duty to account for their stewardship of the trust assets. Millett LJ accepted the submission that 'there is an irreducible core of obligations owed by the trustees to the beneficiaries which is fundamental to the concept of the trust. If the beneficiaries have no rights enforceable against the trustees there are no trusts.' However, he rejected the further submission that this included duties of skill and care.¹²² He went on to say that the irreducible core of the trust required the trustees to perform the trusts

¹¹⁷ Ibid [182].

¹¹⁸ Ibid.

¹¹⁹ Ibid [184].

¹²⁰ *Armitage v Nurse* [1995] N.P.C. 10; [1995] Lexis Citation 1730, Jacob J., Chancery Division, 17 July 1995; *Armitage v Nurse* (n32) 250.

¹²¹ *Armitage v Nurse* (n32), 250.

¹²² Ibid 253-4.

honestly and in good faith for the benefit of the beneficiaries. This was ‘the minimum necessary to give substance to the trusts, but in my opinion it is sufficient.’¹²³ Because the exemption clause did not purport to relieve the trustee from liability for this core duty, it was valid. Two points arise from this analysis. First, although the tenor of his Lordship’s remarks suggest that he did not regard a trustee’s stewardship duty as forming part of the irreducible core of trust obligations, he did not expressly address this question. More recently, in his judicial and extra-judicial writings, he has emphasised the importance of the courts’ ability to order specific or substitutive performance of a trustee’s stewardship duty.¹²⁴ Secondly, as Mitchell explains,¹²⁵ Millett LJ’s analysis in *Armitage* conflates questions relating to the existence of a duty with questions relating to liability for breach: the question whether a trust exists because a trustee holds property subject to the irreducible core duties is a different question from the extent to which a trustee ought to be liable for any loss flowing from a breach of duty. For these additional reasons, in our view *Armitage* does not constitute clear authority for the proposition that a trustee may invariably rely on an exemption clause to obtain (indirect) indemnification in respect of improperly or unreasonably incurred liabilities.¹²⁶

Nevertheless, Kitchin J’s view in *Blake Laphorn* that an exemption clause *can* apply to relieve a trustee from personal liability in respect of an improperly incurred external liability is consistent with the post-*Target* and *AIB* approach to unauthorised outlays. If a trustee is not entitled to a discharge in respect of an external liability of £1,000, the trustee’s use of trust money to pay that £1,000 or to reimburse herself in respect of it constitutes a breach of trust, which causes the trust to be £1,000 worse off. In plain English that *is* a loss, and, on the *Target* and *AIB* analysis,¹²⁷ it is artificial to say otherwise. The trustee simply makes good such loss by putting the money back or paying an equivalent sum out of her own pocket.¹²⁸ On this view, a trustee’s breach of her stewardship duty by paying an improperly or unreasonably incurred cost, expense or external liability *would* engage an exemption clause.

Principle

Whether one thinks exemption clauses *should* apply to relieve the trustee from liability for such losses depends on one’s view as to the nature of trusts. As Penner explains,¹²⁹ on one view, the trustee’s duties are not imposed by the settlor but by operation of law on the trustee, when she takes title to the trust property, and thus it is central to the idea of a trust. The trustee’s ‘personal obligations to the beneficiaries flow from the fact that he takes title

¹²³ Ibid.

¹²⁴ E.g., *Libertarian Investments* (n64); Millett, ‘Equity’s Place in the Law of Commerce’ (n65).

¹²⁵ C. Mitchell, ‘Good Faith, Self-Denial and Mandatory Trustee Duties’ (2018) 32 *Tru. L.I.* 92, 100.

¹²⁶ See, e.g., *Lewin on Trusts* (19th ed) (n16), [39-142], where the authors cite *Blake Laphorn* (and not *Armitage*) for this proposition.

¹²⁷ Cf Lord Toulson’s reference to “fairy tales” in *AIB* (n1) [69].

¹²⁸ Subject only to the post- *Target* and *AIB* qualification that she may reduce the quantum of her liability by demonstrating that any part of the loss was not caused by her breach: Turner (n59).

¹²⁹ J. Penner, ‘Exemptions’ in P. Birks & A. Pretto, *Breach of Trust* (Hart Publishing, Oxford & Oregon 2002) 241.

to the property which is beneficially theirs.’¹³⁰ Penner points out that the logical consequence is that it is not possible to exempt trustees from liability for loss caused by their stewardship duty, as this is a strict duty imposed by law, which is central to the idea of the trust. It would follow that exemption clauses should have no impact on a trustee’s right to indemnification. However, as Penner also explains, there has been a recent shift towards a more contractarian analysis of the trust.¹³¹ On this view, there is no obvious reason to deny settlors and trustees ‘complete freedom or latitude in relieving trustees of personal liability for breach of trust’ as proprietary claims to the trust assets or their traceable substitutes in the trustee’s hands are always possible, and bad faith transactions can be reversed.¹³² Consequently, an exemption clause may relieve the trustee from personal liability for loss caused by an improperly or unreasonably incurred external liability.

If the contractarian view continues to dominate, difficulties will arise from the disjunction between the standard of reasonableness applicable to a trustee’s right to indemnification and that which applies to exemption clauses, whereby a trustee may be held harmless for negligent, and in England even grossly negligent losses. This could, in theory, be resolved by aligning the conduct for which a trustee may be exempted from liability with that for which she may be disentitled from her right to an indemnity. It is beyond the scope of this article to expand on the point, but it is notable that after extensive consultation the Law Commission could not find a satisfactory balance to strike in the regulation of exclusion clauses, even whilst recognizing support in principle for doing so.¹³³

Conclusion

The questions relating to a trustee’s right to indemnification discussed in this article go to the heart of debates about the trust, and the way in which they are answered tells us something about the importance we attach to upholding and enforcing a trustee’s stewardship duty. In our view, the need to uphold that duty suggests that there are good reasons for allowing the courts to have regard to events after the creation of an external liability in deciding whether it has been properly or reasonably incurred. It also requires the courts to consider carefully whether attempts by trustees to use exemption clauses to obtain indemnification for external liabilities through the back door should be permitted, given that different standards apply in each context. Finally, it is notable that in *Investec* Lord Hodge’s judgment intimates some concern for the position of creditors, who rely on the right of subrogation for recourse against the trust assets. However, in our view, if the derivative right of unsecured creditors to have

¹³⁰ *ibid* 263.

¹³¹ *Ibid* 354.

¹³² *Ibid* 260. See, e.g., P. Sales, ‘Exemption Clauses in Trusts’ in P. Davies, S. Douglas & J. Goudkamp (eds), *Defences in Equity* (Hart Publishing, Oxford 2018) 121, 131-2.

¹³³ Law Comm No 301: Trustee Exemption Clauses, 2006. Support for the view that a paid trustee should not enjoy exemption from the consequences of negligent conduct may be found in, e.g., the conclusions of the Trust Law Committee: *Consultation Paper: Trustee Exemption Clauses* (June 1999) and the leading drafting textbooks, such as Kessler, *Drafting Trusts and Will Trusts*, 6.40; *Encyclopaedia of Forms and Precedents*, vol 40, [67].

recourse to the trust assets is to be regarded as inadequate,¹³⁴ that is a separate question of policy and a matter for statutory reform.¹³⁵

¹³⁴ There may be good reasons for saying that this is so: e.g., Harlan F. Stone, 'A Theory of Liability of Trust Estates for the Contracts and Torts of the Trustee' (1922) 22 Colum L Rev 527; H. Ford, 'Trading Trusts and Creditors' Rights' (1981) 13 Melbourne University Law Review 1; R. Sackville AO QC, 'The Trustee's Right of Indemnity and the Creditor's Right of Subrogation: The Hardening of Equity' (2013) 7 Journal of Equity 34; M. Scott Donald, 'The "Proper" Approach to a Trustee's Right to Indemnity out of Trust Assets' (2014) 8 Journal of Equity 283; Silink (n22) 89-90. Cf Ollikainen-Read (n22) 187-191, who suggests the problems may not be as acute as others think.

¹³⁵ Sackville (n134) shares this view; cf Scott Donald (n134) who suggests that the reasonableness precondition for indemnification should be dropped.