

TRUST LAW COMMITTEE

Conflicts of Interest

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1. I was brought up to believe that the first duty of a good trustee was to commit judicious breaches of trust. This is not a policy that I would advocate for those learning about trust law now. I have tried to analyse why this should be so, and what are the consequences in the field of conflicts of interest and try and draw out whether these are inherent problems from real legal difficulties or whether they are a transitional problem arising from changes in custom and practice.
2. I have tried to draw from what I know of the history of Lawrence Graham's experience in administering trusts for large families stretching back to our founding in 1729. In particular, there are a number of families for whom we have acted since before 1800.
3. I am not sure if there is any information generally to prove it but I suspect that the preponderance of trusts in 1900 (certainly by value) would have been Settled Land Act settlements, with trusts for sale being used for personalty and for trusts for widows and younger children. I regret the passing of the strict settlement, for it does seem to me that giving the power of sale of land to a tenant for life who was occupying it or managing it reflected the reality of the decision making process, with trustees having more limited powers of guardianship of the trust assets. It is also interesting that the trustees of those settlements were generally members of the family, or friends, and the concept of a professional becoming a trustee (in Lawrence Graham's practice at least) only became more common in the 1930s and afterwards.
4. In a modern context, a trust which can be created by a settlor who, reserves to himself the right to sell the trust assets and direct their reinvestment, has a wider power of appointment over the assets (sometimes) as well as managing them, and has a life interest, might be confused with a sham trust.
5. Trust documents in earlier times tended to be of much shorter length and the powers in particular were relatively short in drafting. It seems to me that there were really three influences that were important in changing the nature of the drafting process to much longer and more comprehensive documents:-
 - (a) the estate duty driven attraction of discretionary trusts (from the mid-1950s onwards - see *Re Gestetners Settled Trusts* 1954) and
 - (b) the offshore trust explosion from the late 1960s onwards and
 - (c) the development of photocopiers and word processors - you are much more economical if you have to draft in longhand!

It is interesting to note the speed of the development in the drafting of discretionary trusts as the concept, and its advantages, caught on. Early examples in the late 1950s included limited classes of beneficiaries (and the ability to add beneficiaries was only realised later), discretions limited to selection of the beneficiary to benefit and not how he/she would benefit, and no powers for trustees to delegate their discretions. By the late 1960s, many of these points had been picked up in such works as Hallett's Conveyancing Precedents which became the most dog-eared book in the office!

The three influences mentioned above multiplied the drafting of trust documents as '**products**' of the tax mitigation industry. Otherwise, and perhaps making yet another generalisation, the attraction of traditional trusts in the estate duty regime was built round creating surviving spouse trusts in Wills to avoid tax on the death of the surviving spouse.

6. With the creation of the trust '**product**', trustees became, much more commonly and influentially professionals, either solicitors and accountants, and also professional trust corporations. The introduction in the drafts of wide indemnity protection for trustees has, of course, created its own issues but those issues are a response to the conflict of interest that a trustee has with his own interests compared with those of the beneficiaries or possibly even the settlor. On the other hand, the exercise of a discretion by a professional adviser acting as a trustee is a change in relationship which, fairly, causes some discomfort that can be eased by indemnities. After all, the adviser is there to give **advice**, and a trustee, especially one exercising discretions, is making **decisions**.
7. The other major social change in conflicts of interest is the change in regulatory intrusion into professional ethics standards. Insider dealing was attacked and the influence of well informed general practitioners as advisers in relation to trust investments was substituted by reliance on professional investors. Of course the whole investment profession turned upside-down as well. Attack can also come from unexpected quarters. A trustee of a pension fund is exposed to attack not just from beneficiaries but also from the Pensions Regulator and the Charity Commission continues to extend the intrusion of its regulatory powers.
8. In short, what we have is Rolls Royces of an earlier generation being asked to cope with road conditions of the turn of the Millennium! As we all know, the 1920 Rolls Royce copes well but does not have many of the attachments now considered to be indispensable.

Practical problems

9. In the context of the above introduction, what are the conflicts that have arisen in practice that I have come across? Obviously this is merely a reflection of my individual practice coupled with the experience of the rest of the department, as well as dealing with conflicts of interest from other practitioners.

10. **The fundamental conflict as a trustee.** I now think that if a person is prepared to accept the office of trusteeship without having the initial response of refusal, he/she is probably not an appropriate person to be a trustee! For reasons which we need not explore, because they are well enough known, the trustees must accept in taking office that they are exposed to the risk of attack in respect of the exercise of their powers and duties and this attack could expose their personal assets. Accordingly, a trustee will want indemnities as a condition of taking on the trusteeship but, as we know, such indemnities will be interpreted against the person seeking their protection. This may be appropriate if the person claiming the benefits of the indemnity, as frequently happens, is also the draftsman of the deed and the adviser to the parties, but if the trustee is brought in as a family friend, then that presumption can be less fair.

However, it does bring into highlight the fact that there can be conflict. I was asked to advise in connection with a case where a solicitor was a trustee of a settlement with a surveyor. Both acted in respect of the family's affairs. The surveyor instructed his co-trustee's property department and the transaction went wrong, with right and wrong on both sides. At the end of the matter, there was a major dispute about fees with the result that both trustees were, apart from being in conflict with each other, also in conflict with their beneficiaries in respect of how much was properly payable. The way that was chosen to deal with this problem was to refer the matter to mediation. Is the lesson to be learnt here that traditional trust law concepts were of course that a trustee was not remunerated, so that, as soon as an introduction of a professional takes place for a payment of fees, then the conditions for a conflict can arise? However, the problem that seems to be arising is that it is now starting to be suggested that there is a conflict **because** a professional is appointed. That is the old fallacy that 'all cows are animals, therefore all animals are cows'. It merely leads to the fact that a conflict **can** arise in some circumstances. As we know, in the large majority of cases, these provisions for paying trustees work perfectly adequately.

Even more basically, you cannot get away from the fact that all trustees have a conflict which is that, in a simple life interest trust, the balance has to be struck between the interests of the life tenant and the remainderman, while in the discretionary trust at the other end of the scale, trustees have to make judgements about the competing priorities of the beneficial class. For all the theory of conflict, the judgement must be that you only take on a trusteeship if you are comfortable with that reality and the over-whelming preponderance of trusts, even though where there are contentious elements, do not founder because of that conflict and more positively work well.

11. Another practical problem relates to undiversified assets in trust. In one family case of a large settled estate, the family chose to put the valuable works of art into one strict settlement, the other landed estates, of which there were a number of distinct geographical divisions, were settled in other strict settlements, and a final fund to benefit the next generation, consisting of,

largely, another section of the main part of the estate plus a fund of investments, was settled on trust for sale. The position is, of course, ameliorated in practice by the fact that the art is held in a strict settlement and the current life tenant has the power of sale but, if the life tenant died and his infant son succeeded, would the trustees, as the succeeding statutory owners, be faced with an obligation to diversify the assets within the trust? They represent a very large value of non-income producing, and indeed expense making, assets, with horrible practical insurance problems! There was no direction in the original trust which could afford the trustees any protection from considering the diversification issue and the trust (dated 1929) has only the traditional powers and provisions that were expected at that time.

12. Indeed, the problem of diversification of assets is an example of the problems that are found in those families who have several family trusts, some of which may have been created in different generations, and some of which may have been the result of a continuing estate planning policy. Some of those trusts are intended to keep a general control over family assets while benefiting different branches of the family, for example. Some may be a reaction to individual circumstance, and some may have been created with specific dynastic objectives in mind. It must be generally good advice that, if at all possible, there should at least be some diversification of the trust to ensure that, particularly where the principal assets are illiquid, there is some money to give the trustees flexibility to pay tax, pay costs and finance advice and emergencies.
13. It is of course well-known that the traditional conflict rules constrain trustees who are common, from dealing with themselves unless the trust instrument contains a specific power to authorise it. However, it would be a great surprise in one of those families if there were different trustees for every family trust and, indeed, it is strongly arguable that there may be very powerful reasons why a family would want common trustees for all of the trusts, if those trustees are to have a full picture of all of the family's assets the competing interests of the beneficiaries, and of their financial and other needs.
14. Indeed, it is interesting to look at the terms of section 31 of the Trustee Act 1925 in its original form and not subject to the almost invariable amendment that is applied to it in modern Wills and trust deeds. That provision required the trustee to inform himself as to whether there were other funds which overlap and required the trustee to adopt an objective test as to what was reasonable, and, in cases where there were other available funds, only to contribute to a proportionate amount. The argument for common trustees in a particular family is strong.
15. However, we are then faced with the decision of the Court of Appeal in *Walker -v- Stones*. Readers will be familiar with the facts of the case but the critical issue was that the solicitor trustee took the risk of sacrificing the assets of one of the family trusts by charging them to a financial institution in the hope that, by so doing, it would release pressure on the rest of the family assets in the wider sense. The Court of Appeal held that the solicitor trustee should only have looked at the affairs of the individual trust of which he was, in that case, the trustee but went

further than that. They held that to have looked beyond the trust was so removed from what a reasonable solicitor trustee should have done that it vitiated his ability to claim on his firm's indemnity insurance policy. This does seem to be an extreme, and impractical view and many hoped that the case would be reviewed by the House of Lords but it would seem that the parties must have settled.

16. It becomes highly unsatisfactory, if *Walker -v- Stones* is good law for family trustees. Suppose that Trust A is invested in a particular landed estate whose value becomes blighted by the construction of a large prison on one side and an airbase on the other. Trust B contains another area of land on the other side of town which, largely because of the employment introduced in the area by the prison and the airbase, becomes right for development. The trustees of Trust A are at risk of attack from the beneficiaries for having failed to diversify out of land while what may be the same beneficiaries will enjoy the benefits of the profits generated from Trust B. Surely that cannot be a realistic statement of the law.
17. What is the trustee to do if faced with problems of this nature? Certainly, the trustee should discuss the issues within the family and there may be serious impracticabilities in diversification of the assets in the trusts, even if it were desirable to do so. A common reason for this will be the imposition of Capital Gains and, now that the rate applicable to trustees has risen in all cases to 40%, the tax exposure cannot be ignored. Even in the case of quoted investments, one often finds that a particular holding has been so successful that it has been retained. An investment adviser will often counsel against selling on the grounds that, after the tax liability, any replacement asset has got to perform outstandingly well (and what investment manager is going to guarantee that!) to make up for the diminution of the assets from the tax that has to be paid. Some trustees and advisers have an antipathy to paying tax but on so many occasions, the reluctance to sell assets and pay the tax has led to failure to realise a gain which on a market adjustment or a decline in favour of a company whittles away to nothing! It cannot be wrong to realise a gain as [Nathan?] Rothschild once observed.
18. The other thought where the trustee is in this sort of conflict position is to ask the senior family members, understanding the issues involved, to indemnify the trustees for continuing to hold the assets against any possible claim from other beneficiaries (presumably minors) for failure to diversify. It is true that this may itself cause her the problems because, in *Walker -v- Stones*, indemnities were given but were not given with independent advice. Does it really make sense to involve that independence of advice and all the costs that go with it? It depends of course on the degree of concern that the trustees have.
19. It also raises the point that trustees should not be shy about taking Counsel's advice. The Chancery Bar sees problems from the whole breadth of the profession and the trust industry and its ability to offer pragmatic and helpful advice has soothed the brow of many a worried trustee. It

also satisfies that fundamental duty of a trustee under the Trustee Act 2000 of taking advice especially in areas in which the trustee does not have a particular competence.

20. Another area where groups of trustees can come into conflict arises in the common case where what was once a large discretionary trust has been appointed amongst a number of smaller funds to benefit different branches of the family. As we know, following the case of *Roome -v- Edwards*, for tax purposes, these will be treated as one fund for Capital Gains Tax purposes. However, in Fund A, investments, which the entirely independent set of trustees held, generate large losses. In Fund B, the separate trustees made large gains. For Capital Gains Tax purposes, because the fund is treated as one, those losses can be set against those gains. However, what happens when Fund A subsequently recovers and makes gains on disposals when it finds that it cannot use the losses because they have already been used?
21. On a smaller scale, but nevertheless sometimes it can be as important, how does one deal with the apportionment of the annual CGT allowance for the trust if Fund A can use it and Fund B cannot? Where the funds are run by trustees who can cooperate together, no doubt some practical solution can be achieved, although not without a cost of exchanging information and cooperating on detail, and that goes with a fee cost. There is no guarantee that, even where families are on cordial terms, exposure to exchange of financial confidential information is welcome. It is suggested that one possible approach is for the settlor in the drafting of the trust to acknowledge the reality that this circumstance might arise and to provide a specific power for trustees of any sub-trusts to require information from other sub-trusts if it is for the purpose of doing equity because funds, but with a condition that this information could be kept confidential from individual beneficiaries of the fund. This might lead to the matter being sorted out at adviser level.
22. There are a number of other solutions, none of which is universally satisfactory but which might be appropriate. Can the advisers in respect of funds A and B in the example above, agree that a log is kept so that fairness can be achieved by allocating the use of the exemption in a different way in a subsequent year to compensate a trust which has lost out. Can the trust which has been '**saved**' its tax make some form of compensation payment to the other fund? Should there be a de minimis level at which it really is not worth worrying about the problem, despite the fact that there could be a theoretical disadvantage. Much will depend on the relationships between the funds, their beneficiaries, and their advisers as to whether any of these solutions is workable.
23. Similar problems arise with trusts of other special assets, very particularly private company shares. I became involved with the case of a trust drafted in the 1980s which was a discretionary charitable trust. The settlor settled a fund of investments and a significant share in the family company which subsequently was listed on the stock exchange. This charity had a holding of just over 7% of the company's shares and the trust deed gave the trustees a specific **power** to retain the family company shares. There was also a letter of wishes that the shares should be

retained within the charity because, not surprisingly, the settlor considered that they would rise in value and provide a good income but also because he was wanting to show that the trust which was stated to benefit charitable causes in the geographical area where the company operated, was contributing positively itself to that community.

That 7% shareholding when added to the remainder of the shareholdings in the family comprised in discretionary trusts and personal holdings and with another holder of shares with whom the settlor had signed an agreement to operate their shareholding together, held 51% of the listed shares in the company. The company did not do well and from a high of a price of about £2 per share, the shares dropped to about 10% of that value. The settlor was still on the board of the company, not surprisingly, and gave reasons to the trustees of the charity why it made sense, in his view, to retain the holding.

At the same time, the other fund was managed by institutional investment managers and a note was attached to their report specifically confirming that they were not advising on the shares of the company.

Enter the Charity Commission who attacked the trustees on the basis that they had not taken independent advice about the holding. It was not that the trustees had not been worried about the holding, but that they had not taken independent advice, and had probably gone to the person who knew more about the company than anyone else. If they had taken independent advice, would the trustees have had to follow it - they would certainly have had to consider it. The problem was resolved in the end because the family and the trustees sold out of the holding but it is an example of the conflict for trustees in this case.

24. Very often, it is, as we know, the family company shares that a settlor will wish to protect by the use of a trust. We also know that many institutional trustees will not accept trust investments now when they do consist of private company shares but this probably says more about trustees' attitudes to risk and reward than it does about the approach to the selfless traditional nature of trusteeship! However, to build in sufficient safe-guards for trustees in these cases, it becomes necessary to consider duties to retain as opposed to powers to retain, and then mechanisms to enable the trustees to unlock, if their fiduciary judgement leads to the conclusion that there should indeed be a disposal, or at least the consideration of a disposal. Sometimes, one of the attractive ways of dealing with the problem is by the introduction of a purpose trust but, of course, one cannot set up a purpose trust in the UK. Would it be desirable if we were to introduce purpose trusts as a tool that has served other jurisdictions well, and does allow for the maintenance of certain classes of assets which could usefully be protected in an undiversified form. This works on the assumption that because of the provisions of the Trustee Act 2000, that duty of diversification has been emphasised as being one of the core duties of a trustee.

Some conflicts arise in ways which would not have been foreseen when the trust was created and it reminds us that trustees have to adapt to the influences that affect the trust's existence and its exposures. An example may be where a trust was set up to preserve and protect property. Suddenly, the property becomes zoned for major development. The beneficiaries may wish to preserve the property for environmental reasons. Trustees are, however, in the interests of the beneficiaries faced with failing to realise the true potential of the property and this can be an invidious position for a trustee to take. (Sometimes, it comes up when beneficiaries request trustees to instruct the investment managers to take ethical decisions in restricting the classes of asset that trustees buy. In practice in that case, it is difficult to say that, with a wide range of investment products available, a trust portfolio has been damaged to any significant effect.)

25. In another area, should trustees, particularly in the climate of today where tax avoidance is under such emotional attack, be active in looking to reduce the tax bill in respect of a trust. Could trustees be criticised for failing to mitigate tax, particularly if the cost of doing so was modest and the potential amount of tax was large. Trustees must make their own judgement, but again, taking Counsel's opinion, may be the safeguard that trustees need in deciding what is right for them to do.
26. I cannot finish, without making one or two comments. It has been said that a trust is fundamentally inflammatory (Robert Hunter of Allen & Overy) and as a trust litigator, one can see why he says it. At one level, the existence of a trust denies beneficiaries (certainly those who expected to have it) power to dispose of the assets which are the subject of the trust and at another level, it identifies the fact that the settlor did not trust the beneficiaries and that is at an emotional level. It would perhaps be fair to say that discretionary trusts are particularly damaging because they deny the beneficiaries the certainty of fixed interests and uncertainty is unsatisfactory. It is particularly unsatisfactory, if it is exercised by trustees (particularly corporate trustees if I may say so) who have viewed the trust as a product service and less as a matter of personal fiduciary interest and involvement. The fundamental problem is that conflicts arise much more when there is a sold product.
27. On the other hand, the answer to Robert Hunter, I suggest, is that those families who have lived with trusts for many generations have an understanding of their place in the families affairs. Those who are new to it (and particularly this applies to settlors and families from other jurisdictions) tend not to have that sense. What is it that made the difference? It is that the trust was understood became the beneficiaries understood. If you understand, you are not threatened and understanding comes from communication and consultation. If I were to highlight what I feel has been the principal failure in the management of trusts, it is the failure of the trustees or their advisers to embrace the reality of their duty to inform the beneficiary, either simply of their rights, and indeed duties, but also to explain the advantages and the reasons. Some settlors were sold the advantage of the trust as being a way of maintaining control. That overstated the position

and undermined their effectiveness in the longer term. Trustees cannot be 'settlors men'. Their primary duty is to be 'beneficiaries men'. 'Know Your Client' in trust affairs is not ticking boxes. It is embracing the primary responsibility of a trustee.

28. A particular difficulty in explaining to beneficiaries arises where there are international factors involved. We know, from experience, that different cultures around the world find the concepts of trust more or less difficult to appreciate. A society which still favours sons as opposed to daughters, and that still applies in many parts of the world, will find difficulty when a daughter moves to a western culture such as Britain or the United States, where that culture is not now accepted. Equally, the cultures that apply on continental Europe of forced heirship (as opposed to the freedom of disposition with restraints) favoured in the common law countries, creates an entirely different expectation as to how trustees should, or indeed will act in certain circumstances. Where the trustee is a product of one or other culture, the inbuilt prejudices affecting his or her decision-making may lead to serious misunderstanding which can lead to litigation. Trustees are the ones who are responsible for understanding those cultural influences and appreciating what the expectations of any beneficiary will be, and then trying to carry the beneficiaries with them. As the world shrinks, the problem has become much more evident, and will do so even more.
29. Given that, certainly in a world where we still have a rule against perpetuities, and trusts can come to an end and do so more quickly than probably they used to, and given the powers to go to Court for directions, it is my view that the problems that have arisen and which are sometimes fearsomely difficult to deal with, are not systemic but are a reflection on the fundamental change in attitudes to trusts which have arisen over the last 40 years, by stealth. In the proper hands, and where used with the professional enthusiasm and care, the trust has an important and valuable place in society and the reality that there can be conflicts should not be taken out of that context.