THE PROPER PROTECTION BY LIENS, INDEMNITIES OR OTHERWISE OF THOSE WHO CEASE TO BE TRUSTEES

Personal liability of trustees

1 Because trusts are not legal entities that can sue or be sued it is the trustees who are personally liable for contractual, tortious or tax liabilities incurred by the trustees acting as trustees (except to the extent that a contracting party may relieve the trustees of personal liability if recourse to the trust fund is inadequate)[1] . Thus, if T_1 ceases to be trustee and T_2 becomes trustee, T_1 remains personally liable in respect of events occurring while it was trustee, T_2 only becoming liable for events occurring after taking over from T_1. Personal liability attaches to the person who was trustee rather than representative liability[2] attaching to whoever holds the office of trustee from time to time. While T_1 is trustee, T_1 can directly discharge properly incurred liabilities out of the trust fund or discharge the liability itself and reimburse itself out of the trust fund[3].

Problems for T_1 when replaced by T_2

2 In special circumstances T_1 may have personally discharged a trust liability but have been unable to reimburse itself e.g. because no trust cash was available and trust assets could not be sold for cash before the end of the tax year, by which time T_1 had to transfer the assets to T_2, or the trust assets could only have been sold at an inappropriate time when their value was low. More commonly T_1 may know of (a) a contingent, ascertained or ascertainable liability for which it will have to pay in due course or (b) may know of a possible, potential liability for which it may have to pay in due course.

3 It is also possible that a very nervous T_1 may be fearful of unanticipated, unknown possible liabilities against which it would like to guard itself *ex abundante cautela.*

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[1] See Trust Law Committee Consultation Paper, Creditors' Rights against Trustees and Trust Funds Tolley Publishing Ltd 1997

[2] Like that of executors whose liability is limited to the value of the deceased's estate where they plead *plene administravit*

[3] Trustee Act 1925 s.30(2), Settled Land Act 1925 s.100, *James* v *May* (1873) LR 6HL 328, *Carver* v *Duncan* [1985] AC 1082. It is noteworthy that the following bracketed words are omitted from the other words in s. 30(2) "A trustee [only so long as he continues to be trustee] may reimburse himself or pay or discharge out of the trust premises all expenses incurred in or about the execution of the trusts or powers"

Protective steps available to T_1

4 If T_1 is in control of matters because it is retiring and replacing itself with a new trustee then it will not retire until it considers its interests have been adequately protected, although T_2, of course, will not agree to become new trustee unless it considers that its interests have been adequately protected. It is possible, however, that T_1 may be somewhat constrained if it fears that it could be liable for a breach of trust if not replacing itself before expiry of a tax year.

5 If T_1 is trustee for beneficiaries between them of full capacity and absolutely entitled to the whole beneficial interest, then those beneficiaries can remove T_1 against its wishes, but section 19(3) (b) of the Trusts of Land and Appointment of Trustees Act 1996 entitles T_1 to remain in office until "reasonable arrangements" have been made for its protection.

6 It may be that the settlor or a protector exercises an express power to remove T_1 in which case it seems that T_1 could refuse to transfer assets to T_2 until T_1's interests were adequately or reasonably protected from an objective viewpoint.

7 It follows that there is bargaining leeway between T_1 and T_2. Where T_1's retirement is within its control it will not retire in favour of T_2 until T_1's interests are considered by T_1 to be adequately protected. Where T_1 is removed then the court may need to be called in to decide what objectively is adequate or reasonable protection.

8 Protective steps that T_1 may seek to take are:

(1) retaining sufficient trust assets to cover (a) a sum actually paid by T_1 but which for special reasons could not be reimbursed out of the trust fund before T_2 replaced T_1, (b) contingent, ascertained or ascertainable liabilities of T_1, (c) possible potential liabilities of which T_1 knows and which it may have to pay (d) unanticipated, unknown possible liabilities of T_1;

or passing the trust assets to T_2 but

(2) relying on the trustee's equitable non-possessory lien;
(3) taking an express covenant of indemnity from T_2;
(4) taking a legal or equitable charge over specific trust assets.

The foreign factor if T_2 is foreign

9 Where T_1 has an express power to appoint a foreign trustee, it can do this without the need to seek court approval. A disgruntled beneficiary can only have the court invalidate such a foreign appointment if discharging the very difficult burden of satisfying the court that the appointment was so inappropriate that no reasonable trustee would have made it[4]. It has been suggested[5] that T_1 should seek from the foreign T_2 a personal covenant of indemnity against any losses suffered if the appointment is subsequently invalidated by the court. We strongly consider that if T_1 believes that there may be a need for such a covenant it should not proceed with the appointment. In any event, T_2 should not agree to such a covenant imposing personal liability on T_2 to indemnify T_1 against T_1's breach of trust, no recourse to the trust fund being available to T_2 or T_1 in respect of any breach of trust.

10 However, in the context of a foreign trustee owning foreign trust assets or even English assets which could be sold and replaced with foreign assets, covenants of indemnity take on special significance. After all, T_1's trustee's lien may well be ineffective abroad, while any retention by T_1 of trust assets in England could well limit or even undermine the advantages of exporting the trust abroad.

Retention of assets

11 "A bird in the hand is worth two in the bush" underlies the attraction to T_1 of retaining trust assets, especially to cover sums already spent by T_1 and to cover outstanding, ascertained or ascertainable liabilities of T_1 that enable a reasonably accurate figure to be placed on the amount of such liabilities. It seems clear that no right of retention should be available for unanticipated, unknown possible liabilities because no justification can be put forward for retention of assets worth any particular amount. However, where T_1 knows of a potential possible liability (e.g. to a disputed tax or tortious claim) it seems justifiable for T_1 to retain assets of a value approximating to the claim[6] (until the claim becomes statute-barred) unless T_1 or the court considers that T_1's interests are adequately protected by reliance on the trustee's lien, perhaps coupled with an express indemnity covenant with T_2 because no lien-based claim of T_1 against T_2 can succeed if T_2 no longer has any assets. The right to retention rests on the trustee's equitable lien so the nature and extent of this lien require investigation.

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[4] *Richard* v *Mackay* reported only in (1997) 11 Trust Law Int. 22 and [1990] 1 OTPR 1, followed in *Re Beatty's W.T. (No. 2)*, reported only in (1997) 11 Trust L. I. 77
[5] The Use of Offshore Jurisdictions (ed. Harris) para B22
[6] *X* v *A* 1999 New Law Digest 6 August

The trustee's lien

12 It is very well-established that T_1 is entitled to indemnify itself out of the trust assets it owns for liabilities properly incurred as trustee, so long as T_1 is not indebted to the trust e.g. in respect of some unrelated breach of trust[7]. Thus, an account needs to be taken to ascertain the precise amount due to T_1, and, to the extent that insufficient trust money is available to satisfy T_1's claim, T_1 has an equitable lien entitling it to ask the court to authorise the sale of sufficient trust assets to pay the specific amount in question. T_1, of course, is entitled to this amount in priority to the beneficiaries[8].

13 T_1's lien therefore entitles T_1 to retain trust assets of sufficient value to cover its lien. Of course, this lien is of an inchoate nature until accounts have been taken and the precise amount due to T_1 has been ascertained, so some might argue that no equitable proprietary right should arise until ascertainment of such precise amount. However, it seems fairly clear[9] that the equitable proprietary right arises at the time that T_1 incurs the liability in question even though the amount of the liability for which the equitable lien provides security does not crystallise until the exact amount of the liability to the creditor is ascertained and accounts have been taken to fix the precise amount due to T_1 in case T_1 owes to the trust fund any off-setting liability. The position is analogous to that where a freeholder grants a mortgage to a creditor to cover liability for sums to be awarded by an arbitrator relating to the freeholder's past breach of contract with the creditor, and the arbitrator awards a provisional sum before crystallising the final sum due to the creditor. The mortgage is effective from the date of the grant and will not create a series of differing priorities depending upon the dates of the arbitrator's awards[10].

14 As Kennedy J makes clear in *Jennings* v *Mather*[11] a trustee has "a right and interest in the [trust goods] because he has a right to an indemnity in the nature of a lien over those

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[7] See footnote 1 above
[8] *Re Griffith* [1904] 1 Ch 807, *Octavo Investments Proprietary Ltd* v *Knight* (1979) 144 CLR 360 (Australian H.C.), *Chief Commissioner of Stamp Duties* v *Buckle* (1998) 72 ALJR 242 (Australian H.C.)
[9] In *Commissioner of Stamp Duties* v *ISPT* (1999) 2 ITELR 1, 18 (1998) 45 NSWLR 650 (CA) Mason P at p 653 stated, " A trustee's right of indemnity arises at the time when a liability is incurred, and it is at this stage that the lien over trust assets arises: *Custom Credit Corporation Ltd* v *Ravi Nominees Pty Ltd* (1992) 8 W.A.R. 42, 52-53"
[10] Cp. *State Bank of India* v *Sood* [1997] Ch 276 (equitable co-ownership interests overreached from date of grant of mortgage by joint freeholder-trustees even though money not advanced for some years)
[11] [1905] 1 KB 108
[12] 29th ed p 456

goods… a lien has always been held to be sufficient title as against the world to hold the goods until that lien is satisfied or is proved not to exist."

15 It is clear that T_1 can retain sufficient trust assets to cover actual or contingent liabilities and also possible, potential liabilities that it can identify. However, T_1, may choose not to exercise such right of retention if satisfied that its interests may be adequately protected even if it transfers the trust assets to T_2. The key question is whether T_1's lien is then lost because it is merely a possessory lien (like the common law artificer's lien of a garage owner for repairs to a car) or whether it survives like the normal equitable lien or charge.

16 Snell's *Equity*[12] states that the trustee's equitable lien "confers a charge upon property until certain claims are satisfied and differs from an equitable charge only in that it arises by operation of equity from the relationship between the parties rather than by act of theirs. It exists independently of possession , but will not avail against a purchaser for value of a legal estate without notice of it". This view is supported by Lewin on *Trusts*[13], an article by Robert Ham QC[14] and the two leading Australian textbooks, Jacobs on *Trusts*[15] and Ford & Lee, *Principles of the Law of Trusts*[16].

17 It has also been held in *Blenkinsopp* v *Foster*[17] that the fact that the trustee had paid the trust assets into court, pursuant to a court order, was no bar to reliance on the lien for conferring priority over other claimants, while in *Jennings* v *Mather*[18] the trustee's lien was held a right and interest in the trust goods which survived the goods passing into the hands of a creditor. One can therefore discount the unfortunate comment of Walton J in *Stephenson* v *Barclays Bank*[19] that "any lien of the trustees is a possessory lien only and is lost as soon as the property is handed over".

18 This becomes very clear when Australian appellate authorities are considered. In *Octavo Investments Pty Ltd* v *Knight*[20] the High Court of Australia stated, "There are two classes of persons having a beneficial interest in the trust: first, the *cestuis que trust* … and

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[13] Sweet & Maxwell (2000) para 14.50
[14] (1996) 10 Trust L.I. 45
[15] 6th ed para 2104
[16] 3rd ed para 14020: "a successor trustee takes the trust assets subject to any unsatisfied lien of a former trustee"
[17] (1838) 8 LJ Ex Eq 8
[18] [1901] 1 KB 108. Note also that in *Re Pauling's S.T* (No2) [1963] Ch 576 Wilberforce J held that parting with the trust fund is not sufficient to take away the trustee's right to impound a beneficiary 's interest.
[19] [1975] 1 All ER 625, 638
[20] (1979) 144 CLR 360

second, the trustee in respect of his right to be indemnified out of the trust assets … The latter interest will be preferred to the former, so that the *cestuis que trust* are not entitled to call for a distribution of the trust assets which are subject to a charge in favour of the trustee until the charge has been satisfied." As stated by McPherson JA in *Kemtron Industries Pty Ltd* v *Commissioner of Stamp Duties*[21] , "*Octavo* authoritatively establishes that a trustee acquires in the assets of a trust a beneficial interest commensurate with his right of indemnity. It follows that the property conveyed by the assignment of the share of a beneficiary cannot include that interest but only what remains". Stamp duty is only exigible in respect of the value of what remains, as also held by the High Court of Australia in *Chief Commissioner of Stamp Duties* v *Buckle*[22] following the approach of McPherson JA, and citing *Dimos* v *Dikeakos Nominees Ltd*[23].

19 In this Federal Court of Australia decision Jenkinson J stated[24], "A trustee's right of indemnity out of trust property survives the trustee's loss of office," while Hearey J stated[25], "The right of indemnity did not cease upon retirement … There is no reason why the fact of retirement from trusteeship should result in the abandonment of property, that is to say the interest commensurate with the right of indemnity to which the trustee is beneficially entitled. Although the right of indemnity undoubtedly confers a right to retain possession of the trust property, it is also a property right equivalent to (and ranking ahead of) the interests of the beneficiaries." The third judge concurred with Jenkinson and Hearey JJ.

20 Because T_1's lien is a proprietary right in the nature of an equitable charge it follows that such right confers an independent right of recourse to the trust assets owned by T_2, so that it is not dependent upon subrogation to T_2's right of indemnity against the trust assets[26]. It also follows that the rights of trust creditors of T_1 are derivative rights only to the extent dependent upon T_1's right of indemnity, not being further dependent upon T_2's right of indemnity. This makes very good sense. Why should T_1 or creditors claiming through him be prejudiced by subsequent breaches of trust or other indebtedness of T_2?

21 Because T_1's lien is a proprietary right in the nature of an equitable charge attaching to all the trust assets transferred to T_2 it will *prima facie* continue to attach to assets

[21] [1984] 1 Qd R 576, 590
[22] (1998) 72 ALJR 242
[23] (1997) 149 ALR 113 (also, (1996) 68 FCR 39)
[24] Ibid, at 114. This was held to be the case in *Rothmore Farms Pty Ltd* v *Belgravia Pty Ltd* (1999) 2 ITELR 159
[25] Ibid, at 117
[26] Generally, on derivative rights of subrogation, see TLC Consultation Paper, Creditors' Rights against Trustees and Trust Funds (Tolley 1997) para 2.18-2. 29

transferred by T_2 to beneficiaries[27], the latter not qualifying as *bona fide* purchasers of a legal interest for value without notice. In practice, one would expect T_1 to satisfy his lien out of assets remaining in the ownership of T_2 but, in theory, T_1 could instead (e.g. if he disliked a beneficiary, B) proceed to enforce his lien against trust assets distributed to B.

22 Consider the following scenario. T_1 seeks to recover £50,000 paid out after transferring all trust assets to T_2, who now holds assets worth £200,000 having made a distribution of £100,000 each to A, B and C who invested rather than dissipated the money. One would expect T_1 to recover the £50,000 out of T_2's £200,000 but what if T_1 claimed to recover it from B? If T_1's lien affects the whole £500,000 B should be able to claim a contribution[28] from T_2, A and C whose liabilities he will be discharging, so that T_2 contributes £20,000 and A, B and C £10,000 each. Does this mean that if T_2 discharges the whole £50,000 liability T_2 can recover £10,000 from each of A, B and C? Logically this follows, and it certainly makes sense if T_2 held the trust fund for A, B, C, D and E equally, contingent on attaining 25 years of age, and A, B and C had attained 25 but D and E had not yet done so. If T_2 held on discretionary trusts, then one would expect T_2 to exercise his discretionary powers in such a way as to obviate seeking any contribution from A, B or C, unless in T_2's discretion equal benefits should be conferred on the discretionary beneficiaries A, B, C, D and E.

23 T_1's lien becomes unenforceable if the assets it affects cease to be traceable as where A and C dissipate their £100,000. However, if, as above, B were forced to pay the £50,000 could he not seek to make A and C personally liable to make a contribution to him for discharging their liability? It would seem not, because A and C only had a proprietary liability which has ceased and had no personal liability to T_1 (unless it can be successfully argued that they received property subject to T_1's equitable interest and dishonestly dealt with it to the prejudice of T_1[29] or unjustly enriched themselves at T_1's expense, not having T_1's consent to their dissipation of the property) so that the question of a change of position defence anyhow, does not arise. Thus, B could only seek contribution from T_2. In the normal case it would seem that the court should exercise its discretion[30] so that T_1's lien should first be satisfied out of trust assets owned by T_2, with any balance remaining to be satisfied proportionally out of trust assets transferred to beneficiaries.

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[27] Generally, on the pervasiveness of the equitable charge over traced assets, see *El Ajou* v *Dollar Land Holdings plc* [1993] 3 All E R 717, 735-736

[28] Civil Liability (Contribution) Act 1978, Re *Mainwaring's S.T.* [1937] Ch 96

[29] *Royal Brunei Airlines* v *Tan* [1995] 2 AC 378

[30] See discretionary order of liability in *Eaves* v *Hickson* (1861) 30 Beav. 136, and primary liability of personal representatives before distributees from them in *Ministry of Health* v *Simpson* [1951] AC 251

24 The logical ramifications for beneficiaries that flow from T_1 having an equitable lien are compelling unless the court can pragmatically treat the lien as a special one that is limited to trust assets held by successor trustees, automatically ceasing when trustees transfer trust assets out of the trust absolutely to beneficiaries (or to trustees of another trust), unless the trustees expressly preserve their lien, whether or not coupled with an express personal covenant for their indemnification. Requiring such a lien and covenant would not be a fraud on the trustee's powers because the trustee is simply protecting a legitimate interest of the trustee and thereby preventing unjust enrichment of the beneficiaries at the trustee's expense.

25 One could consider the trustee's right to an indemnity as the price paid by the beneficiary for the trustee's services[31], so that the beneficiary should be entitled to believe he has paid the full price if the trustee transfers trust property to him absolutely without any reservation of rights in the trustee's favour: in such circumstances the beneficiary is entitled to believe that the trustee has intended the beneficiary to have the full unencumbered interest in the distributed property. Significantly, the already cited dictum of Walton J that "any lien of the trustees is … lost as soon as the property is handed over" was uttered in the context of beneficiaries becoming absolutely entitled against the trustees to trust property, while Lord Roskill in *Roome* v *Edwards* said[32] "Persons, whether professional men or not, who accept appointment as trustees … are clearly at risk … and have only themselves to blame if they accept the obligations of trustees without ensuring that they are sufficiently and effectively protected whether by their beneficiaries or otherwise for fiscal or other liabilities which may fall on them personally as a result of the obligations which they had felt able to assume."

26 Where new trustees are appointed, the trust fund remains intact, continuing to be subject to subsisting equitable interests therein of the old trustees and of the beneficiaries and available for satisfying trust liabilities. However, where assets are distributed absolutely to beneficiaries, trustees will intend the natural consequences of their actions so that the beneficiaries as absolute beneficial owners take the assets freed altogether from any interests of the trustees or of other beneficiaries under the trust as *Lewin on Trusts* (2000) points out at para 14.50. Thus, *Lewin* goes on to state (at para 26.22) "When the trustee makes a distribution we consider that the trustee's proprietary right of indemnity ceases to exist, unless expressly preserved."

[31] See Lindley L J in *Re Beddoe* [1897] 1 Ch 547, 558
[32] [1981] 1 All E R 736, 744

27 However, further consideration needs to be given to the extent to which a distribution to a beneficiary by T_2 can affect T_1's equitable lien as opposed to T_2's equitable lien. If T_1 appoints T_2 as his successor, then T_2 takes the trust fund subject to the equitable lien of T_1, and to the equitable interests of the beneficiaries. If T_2 then makes a discretionary distribution of assets to B as absolute beneficial owner expressly or impliedly freed and discharged from then trusts previously affecting the assets, the question arises whether T_2 has power not only to overreach or override the equitable interests of the other beneficiaries and of T_2 but also the equitable interest of T_1. The answer depends upon whether the court construes the discretionary power as broad enough to encompass the overreaching or overriding not just of beneficiaries' equitable interests but also the equitable interests of existing and previous trustees so that the interests of such trustees are inherently defeasible upon exercise of such discretionary power. On the basis of Australian cases[33] treating the trustee's right of indemnity not as an "encumbrance" but as a proprietary right equivalent to (but ranking ahead of) the equitable interests of the beneficiaries, the English court may well construe discretionary powers as presumptively enabling the overreaching or overriding of trustees' equitable interests as well as beneficiaries' equitable interests. Unfortunately, there is no such scope open to the court for permitting ouster of previous trustee's equitable interests where B becomes absolutely entitled as of right under the terms of the settlement e.g. on death of a prior life tenant or upon satisfying a contingency.

28 Otherwise, in the common case where only the original trustee, T, is involved, the judge can hold that because T holds assets on trust first for T as to an equitable interest commensurate with T's right of indemnity and then for various beneficiaries, it follows that if T distributes assets to B (whether pursuant to a power of appointment or upon an event making B absolutely entitled) T should be taken to intend B to receive those assets free from the equitable interests of T and any other beneficiaries. Because T is transferring legal title to assets in respect of which T has an equitable interest and power to transfer assets free from other beneficiaries' equitable interests, it seems from the reasoning in *Vandervell* v *IRC*[34] that an effective transfer of the legal title carries with it the equitable interest without the need for any separate document disposing of the equitable interest. As Lord Upjohn said[35], "if there had to be assignments in express terms of both legal and equitable interests, that would make the section [53(1)(c) L.P.A. 1925] more productive of injustice than the supposed evils it was intended to prevent." or, as Lord Donovan pithily said[36], "If owning the entire estate, legal

[33] *Chief Commissioner of Stamp Duties* v *Buckle* (1998) 72 ALJR 242, *Dimos* v *Dikeakos Nominees* (1997) 114 ALR 113
[34] [1967] 2 AC 291
[36] *Ibid* at 312
[36] *Ibid* at 317

and beneficial, in a piece of property, and desiring to transfer that estate to another, I do so by means of a disposition which *ex facie* deals only with the legal estate, it would be ridiculous to argue that s. 53(1)(c) had not been complied with, and that therefore the legal estate alone has passed."

29 Even if it were the case that s. 53(1)(c) applied a judge could well find either that written communications from T to B should be construed as amounting to an implicit assignment of T's interest in favour of B or that T's conduct led B to assume that B was absolute beneficial owner of unencumbered assets received from T, so that B's detrimental reliance thereon precluded enforcement of T's lien (although this latter approach, unfortunately, benefits spendthrifts and penalises thrifty investors).

30 The question whether a trustee's lien binds beneficiaries to whom trust property had been distributed has not arisen for decision except at first instance in the Australian Federal Court in *Rothmore Farms Pty Ltd* v *Belgravia Pty Ltd*[37]. Here, Rothmore was T_1 and was owned by a farmer and her three sons, all of them except one son, Andrew, personally guaranteeing loans taken on by T_1 for the benefit of the family farming business. With intent to put the trust assets beyond the reach of its creditors T_1 (*via* its family directors) transferred the trust assets to Belgravia, T_2. Mansfield J held that T_1 had a lien which survived the transfer, but if it had not, then the transfer would have been void against the liquidator of T_1. Belgravia's directors were the wife of one son and that wife's uncle, both part of the farming family. Belgravia then distributed all the trust assets absolutely to Andrew, his mother and brothers having been made bankrupt.

31 T_1 made the general submission that its "equitable interest remains enforceable against all but a purchaser for value without notice of that interest" (para 26). Mansfield J stated (paras 116 and 117) "Counsel for Andrew Cooper did not put any submissions that the equitable interest did not survive the second transaction [the distribution of the trust assets to Andrew], apart from the contentions, which I have rejected earlier, that there was no ongoing debt to the Banks and that no right of indemnity existed or equitable interest arose because of the wrongful conduct of Rothmore Farms as trustee. There is, in my judgement, no reason in equity why Andrew Cooper's title to the Trust assets as a result of the second transaction was not subject to the equitable interest of Rothmore Farms in those assets." Thus, the second transaction did not prejudice Rothmore, but if it had the judge would have held it to have been a voidable transaction to defraud creditors.

[37] See footnote 24 above

32 There was then a third transaction when Andrew purportedly sold the trust assets (worth about 600,000 dollars the judge found) to Mr Turner for some opals worth between 2,000 and 8,000 dollars, as the judge found, but represented as worth 700,000 dollars in the sale agreement. Mr Turner was a friend of the family and an adviser to them who knew of their financial predicament, so the judge held "that the equitable charge or lien of Rothmore Farms in the Trust assets was not lost by reason of the third transaction" (para 172) which he held anyhow was a sham and not a *bona fide* transaction at all (para 171).

33 It will be seen that this is an exceptional set of fraudulent circumstances where counsel did not put forward any reasons for a trustee's lien not surviving a distribution of the trust assets to beneficiaries let alone the reasons discussed in paragraphs 25 to 28 above. In normal circumstances, we believe it likely that an English court will hold that the trustee's lien does not survive a distribution (unless expressly preserved) for such reasons.

Covenants of indemnity

34 As part of "a belt and braces" exercise and to guard against unenforceability of the trustee's lien if all the trust assets are dissipated by beneficiaries after distribution by T_2 of all the assets to them, it is common for T_1 to require a covenant from T_2 to indemnify T_1. However, if T_2 becomes insolvent T_1's rights against the trust fund are derived (by subrogation) from T_2's rights, so that if T_2 cannot claim against the trust fund due to indebtedness thereto (e.g. arising from breaches of trust) then T_1 cannot so claim[38].

35 It may be that the trust instrument confers power on T_2 to give an indemnity covenant but, otherwise, it seems very likely that the court would uphold reliance on section 15 of the Trustee Act 1925. This empowers trustees to "settle any….claim or thing whatever relating…to the trust…and…enter into, give, execute and do….such agreements….and other things as…seem expedient, without being liable for any loss occasioned by any act or thing so done… in good faith." Indeed, does the express covenant not simply give effect to rights which T_1, in any event, has under the general law?

36 It seems proper for any indemnity covenant to cover not just actual and contingent liabilities but also specified possible liabilities. However, T_1 often requires a blanket covenant covering any liabilities that T_1 is forced to discharge, so including any unknown,

[38] See footnote 1 above

unanticipated liability that may emerge to everyone's surprise. Because T_1 has to discharge such surprising liability it is right and proper, so as to prevent unjust enrichment of the beneficiaries at T_1's expense, for T_2's covenant to extend (like T_2's liability under T_1's lien) to such surprising liability. Where T_1 is so protected it follows that (except perhaps where someone replaces T_1 with a man of straw) he cannot insist on physical retention of trust assets to cover any unknown, unanticipated liability that might possibly arise, especially when it is impossible to estimate the amount of any cover that could be required.

37 It may well be that T_1 will want to protect himself as fully as possible by having T_2 covenant not to distribute trust assets so as to leave the trust fund with a value of less than £x, being the maximum estimated amount of T_1's liabilities. However, it seems that that could be regarded as an unjustifiable and invalid fetter[39] on T_2's future functions as trustee. It will thus be better for T_1 to have T_2 personally covenant to indemnify T_1 up to an amount of £x in the hope that it will then be unlikely that T_2 will distribute assets so as to leave less than £x of trust assets in T_2's hands unless T_2 is covered by personal indemnities from the beneficial recipients of such assets. The position is similar to that where T_1 may seek to have T_2 agree to limit the personal liability of T_2 on the indemnity covenant to the aggregate value of the trust assets owned by T_2 when T_1 makes its claim and the assets distributed by T_2 to beneficiaries or transferred by T_2 to a replacement trustee, T_3. The onus is then on T_2 to protect itself by obtaining for itself indemnity covenants with the beneficiaries and with T_3.

38 T_2 will therefore prefer to limit its liability to T_1 to the trust assets it owns when T_1 makes its claim, so long as T_2 carried out its covenant with T_1 that on making a distribution to a beneficiary it would ensure that such distributee entered into a direct indemnity covenant with T_1 to discharge any liability of T_1 not discharged by T_2 (or a replacement trustee) out of trust assets: T_2 will also covenant that on transferring trust assets to T_3 it will ensure that T_3 enters into a direct indemnity covenant with T_1 to a corresponding effect to that of T_2.

39 Which of the two methods is chosen depends on the bargaining power of T_1 and T_2: how strong is T_1's need to retire if it controls its retirement; how much does T_2 want the trust business; how large is T_1's estimated liability? Indeed, T_1 could be requested to warrant that any liability will not exceed £x, and T_1 might, in some circumstances, be prepared to risk this where it considers there can hardly be any other liability than the £x liability.

Taking security over the trust property

[39] *Re Gibson's S. T.* [1981] Ch 179

40 T_1 may seek from T_2 a legal or equitable charge over specific trust assets as security for actual, contingent, or possible claims against T_1. In our view T_2 should not properly agree to this since T_1 is adequately protected (except perhaps where someone replaces T_1 with a man of straw) by T_1's lien, supplemented by an indemnity covenant along the lines considered above. Any such fixed charge increases the cost of the exercise and limits T_2's freedom of action as trustee. However, if s.15 of the Trustee Act 1925 were invoked to justify T_2's action T_2 will be protected from a breach of trust action if T_2 "acted in good faith", so protecting T_2.

Distributions to absolutely entitled beneficiaries

41 The above points dealing with transfers by T_1 of trust assets to T_2 as replacement trustee are (apart from s.15 Trustee Act 1925) equally applicable where T_1 transfers assets to B, whether as absolutely entitled remainderman on the life tenant's death or as absolutely entitled under the discretionary exercise of a power of appointment or of a power of advancement. However, T_1 may refuse to exercise such a power unless it considers that its interests have been adequately protected.

42 The key issue is whether the courts might pragmatically deny the persistence of the trustee's equitable lien so as to distinguish between the position on the one hand of successor replacement trustees bound by the lien and on the other hand of beneficiaries (or of trustees of other trusts) to whom assets had been transferred out of the trust presumptively free from the lien. It seems likely that the courts will be so bold as explained at paras 25-28.

43 In the case of T briefly holding trust property on a bare trust for B before transferring it to B as absolutely entitled thereto, can T subsequently claim a personal indemnity for any subsequent liability of T by invoking the *Hardoon* v *Belilios*[40] principle? In our Consultation Paper on Creditors' Rights[41] we considered that too wide a view was often taken of that principle. We do not believe that a trustee of a discretionary trust can obtain the benefit of a personal indemnity against all beneficiaries of a trust or objects of a power of appointment by the simple device of appointing itself briefly a bare trustee for a beneficiary or object before distributing the property to the beneficiary or object. However, the New South Wales Court of Appeal in a reserved judgment in *Balkin* v *Peck*[42] held that where property is held on trust for B for life, remainder equally to C, D and E, and the English trustees have to pay

[40] [1901] AC 118
[41] See footnote 1, paras 2.13-2.17
[42] (1998/1999) ITELR 717, (1997) 43 NSWLR 706

overlooked inheritance tax on the death of the English resident B, then the trustees have a *Hardoon* v *Belilios* right of personal indemnity against C, D and E resident in Australia to whom the trustees had transferred the trust assets. We believe the English courts are likely to follow this and infer such a personal covenant in favour of the trustee, so justifying the practice for a trustee to take an express personal covenant of indemnity to protect its legitimate interests.

Conclusions

44 It makes sense for T_1 to have an equitable non-possessory lien against trust assets owned by successor trustees to enable T_1 to be reimbursed in respect of all liabilities properly incurred by T_1 when acting as trustee, so as to prevent the beneficiaries being unjustly enriched at T_1's expense.

45 On outright distribution of assets out of the trust to persons as absolute beneficial owners (or to trustees for particular persons) it seems very likely (as discussed in paras 25-28) that the distributing trustee then loses his equitable lien unless he expressly preserves his lien. However, the contrary is arguable, so to put the position beyond doubt, on making a distribution a trustee should always spell out whether he is releasing or preserving an equitable lien. This should turn the attention of a successor trustee to the position of a predecessor trustee's lien and whether he can or should override or overreach such lien.

46 Where trustees preserve liens against distributees, logically when T_1 transfers trust assets to beneficiaries (A, B and C) or to T_2, the lien must affect the traceable assets owned by A, B and C and by T_2 and by beneficiaries (X, Y and Z) who receive assets from T_2. However, it seems that the Court has an equitable discretion to require T_1's lien to be satisfied first out of assets owned by T_2 (unless there are special circumstances where the settlor's intention is regarded as requiring equal distributions to all beneficiaries after taking account of all liabilities) and then out of traceable assets owned by beneficiaries who had received assets. This may well encourage A, B, C, X, Y and Z to spend the trust assets in such fashion (e.g. on payment of debts or purchase of consumables) that there are no traceable assets to which T_1's lien can attach, unless those beneficiaries have entered into personal covenants of indemnity so that they may be encouraged to retain the assets as investments to cover such potential liability (with possible bankruptcy potential). It would seem that the court will make those of the beneficiaries A, B, C, X, Y and Z still owning traceable assets liable for the amount outstanding, (after exercising T_1's lien against the trust assets owned by T_2), in the proportions that the values of the traceable assets remaining in each beneficiary's hands bear

to each other, unless (as seems preferable) the court considers it more equitable (in order to prevent unjust enrichment) to make those beneficiaries who have traceable assets liable in the proportions that the values of the distributions received by them bear to each other. We consider either result for an extremely rare case to be more satisfactory than the alternative of making X, Y and Z liable as a class before A, B and C or of making the latest recipient of trust assets liable to the full extent of T_1's lien before proceeding to the second latest and so on (as in the case of claims of French heirs to have their forced heirship amounts made up from lifetime donees of their parent in the order of absorbing recent gifts before older gifts). However, it does seem unfair that thrifty beneficiaries who retain and invest what they receive are penalised *via* enforcement of the lien, while spendthrift beneficiaries who have spent what they receive escape liability unless they can be made liable to make a contribution because all the beneficiaries entered into personal covenants of indemnity with the trustee. We thus recommend statutory reforms in paras 49 and 50.

47 Whether or not T_1 has an equitable non-possessory lien, T_1, for proper protection, needs to be able to rely on personal covenants of indemnity. The lien is useless if T_2 or a beneficiary no longer has traceable trust assets because dissipated or taken to a civil law country. Moreover, the covenant needs to confer blanket protection because T_1 is entitled to be indemnified if some surprising unanticipated, liability forces T_1 to pay out money that would otherwise lead to the beneficiaries being unjustly enriched at T_1's expense. Even with the benefit of a personal covenant T_1 runs the risk that the covenantee may become insolvent or may have died some time ago and his estate distributed free from any claim of T_1. We thus consider that T_1 is entitled to negotiate personal indemnity covenants with beneficiaries to whom T_1 distributes trust assets and with T_2 to whom T_1 transfers all the trust assets but we believe that the statutory reforms proposed below should make negotiation of such covenants unnecessary (except if a foreign jurisdiction or special elements are involved). Such reforms should also make unnecessary (except if a foreign jurisdiction or special elements are involved) the time and cost of negotiating complex personal indemnity covenants in each case of T_1 being replaced by T_2.

48 We recommend that T_1 should automatically continue to have an equitable non-possessory lien on transferring the trust assets to T_2 which will continue automatically to bind the trust assets on passing to new trustees of the original trusts, T_3, T_4 etc.

49 However, upon a trustee unimpeachably transferring assets absolutely to a beneficiary or to a new trustee absolutely entitled against the old trustee (whether on trust for an incapacitated beneficiary or on trust for a beneficiary and the beneficiary's family) who gives

a valid receipt for the distributed trust assets free from the trusts of the original settlement, statute should prohibit any equitable lien arising in favour of the transferring trustee, who is irrebuttably taken to intend to transfer full unencumbered ownership to the transferee, whether as beneficiary or as trustee for beneficiaries.

50 Statute should then provide that, to the extent that a trustee cannot obtain reimbursement for properly incurred liabilities *via* payment out of the trust fund in the ownership of a successor trustee or trustees pursuant to the trustee's lien, such trustee shall have a direct statutory right to be indemnified personally by any person ("the distributee") to whom such trustee or a successor trustee has made an outright distribution of trust assets, whether the distributee has taken the property beneficially or as trustee, so long as the distributee received a notice in statutory form informing him of such potential liability. A distributee (whether a beneficial owner or a trustee) may only escape liability in respect of such distribution to the extent that he made a gift of all or part of such distribution to a donee who received from the distributee a notice in statutory form informing him that he faced a potential statutory liability for the amount for which he would have been liable if the donated assets had been distributed directly to him by the trustee who had made the distribution to the distributee. A donee of such donated property may similarly escape liability if giving a similar statutory notice to the person to whom he makes a gift of all or part of such donated property. In the case of a beneficiary with an interest in possession (e.g. a life interest), it shall suffice for the protection of the trustee making income payments that the statutory notice was served on the beneficiary in respect of an earlier income payment received by the beneficiary as a person of full capacity.

51 To promote fairness amongst the beneficiaries and donees from them in sharing the burden of reimbursing a trustee, who cannot obtain reimbursement against successor trustees *via* the trustee's lien, any beneficiary or donee against whom the trustee proceeds can seek contribution from the other beneficiaries and donees so that, if all are solvent, the burden is borne proportionately to the value of the assets received by them.

QUESTIONS FOR CONSULTATION

In this difficult complex area, we believe we have analysed and investigated matters further than has hitherto been done but are conscious that we cannot state the law with conclusive accuracy so that unsatisfactory uncertainty taints the position of trustees.

1. Do you agree that the Paper sets out the law as accurately as it is currently possible to do?

   - ☐ Yes
   - ☐ No, because

2. Do you agree that the trustee's lien should continue to bind trust assets held by successor trustees of the original trust?

   - ☐ Yes
   - ☐ No, because

3. Do you agree that it is unsatisfactory if a trustee's lien continues to bind assets distributed out of the trust assets absolutely to beneficiaries (or to trustees of other trusts for beneficiaries) whether distributed by such trustee or a successor trustee?

   - ☐ Yes
   - ☐ No, because

4. To remedy such unsatisfactory position, do you agree that statute should provide that the trustee's lien automatically ceases in respect of property distributed out of the trust assets absolutely (or to trustees of other trusts for beneficiaries) whether distributed by the trustee or a successor trustee, so long as the trustee can take steps to protect itself (to the extent the lien against trust assets owned by successor trustees does not provide

protection) *via* personal covenants of indemnity or a scheme for the imposition of personal liability upon distributees served with a statutory form of notice?

- ☐ Yes
- ☐ No, because

5. To avoid the need for drafting complex chains of indemnity covenants for particular trusts, do you agree that statute should provide that, to the extent T cannot obtain reimbursement by enforcing his lien against successor trustees, T should have a direct statutory right to be indemnified personally (up to the value of the distributed assets at the date of distribution) by any distributee to whom T or a successor trustee had made an outright distribution of assets out of the trust fund (whether the distributee takes the assets beneficially or as trustee of another trust), so long as the distributee at or before the time of distribution had been served with a standard form statutory notice informing him of T's statutory personal right of indemnity (and of how he can escape from such liability if gifting the property on to someone else)?

   - ☐ Yes
   - ☐ No, because

6. The statute should also provide that such distributee will escape such liability to the extent that he made a gift of all or part of such distribution to a donee (whether taking beneficially or as trustee) upon whom he served a standard form statutory notice informing the donee that the donee is to be personally liable in place of the distributee in respect of the gifted assets valued at the date of the gift unless the donee makes a further gift of such traceable assets and serves the standard statutory notice on the new donee (taking beneficially or as trustee). Do you agree?

   - ☐ Yes
   - ☐ No, because

7. Where income payments (as opposed to capital payments) are made to a beneficiary with an interest in possession by a trustee, do you agree that to save a multiplicity of notices, the trustee will have the full protection of the statutory scheme once he has served one statutory notice in connection with an earlier payment of income to that beneficiary if then of full capacity?

    - ☐ Yes
    - ☐ No, because

8. Where income is paid by a trustee pursuant to a discretionary trust or to a power of appointment to a beneficiary or an object of a power, do you agree that a statutory notice needs to be served in respect of each payment, as in the case of all capital payments, so as to prevent prejudice to the position of such distributees?

    - ☐ Yes
    - ☐ No, because

9. Do you agree that any person served with a statutory notice should, if proceeded against by the trustee, be able to obtain contribution from all other persons similarly so served, so that if all are solvent the burden will be borne by them proportionately to the value of the assets when distributed to them?

    - ☐ Yes
    - ☐ No, because

10. If you can see any way in which this statutory scheme could be improved, please explain as follows:

Responses must be returned to Peter Niven, Administrative Secretary – TLC, School of Law, King's College London, Strand, London WC2R 2LS (fax: 020 7848 2788) by 28 April 2000.

APPENDIX A

MEMBERS OF WORKING PARTY ON PROPER PROTECTION OF TRUSTEES

Chair	**Professor David Hayton, King's College London**
Members	**John Dilger, Macfarlanes, Solicitors, London**
	Charles Gordon, Foster, Savage & Gordon, Solicitors, Farnborough
	Judith Ingham, Withers, Solicitors, London
	Victoria Love, Linklaters & Paynes, Solicitors, London
	Professor Paul Matthews, Withers, Solicitors, London and KCL
	Paul Saunders, Barclays Bank, Northwich, Cheshire
	Simon Taube, Barrister, Lincoln's Inn, London