Feature

Authors Clare Stanley and Thomas Lowe QC

Is liability of trustees for losses in share portfolios illusory?

KEY POINTS

- Trustees have well-established duties to safeguard trust property and to manage shareholdings in the same way a prudent investor should do so.
- It is common for such duties to be limited by the wishes of a settlor by means of so-called "anti-Bartlett clauses" and similar devices.
- However, the law is now wholly uncertain as to whether there can ever be meaningful liability for breach of the duty to safeguard a corporate shareholding – for instance where the corporate suffers trading losses, gets into financial difficulties or goes into liquidation.

INTRODUCTION

As a matter of general law, trustees have to protect and safeguard trust property. At the risk of stating the obvious, the assets of many trusts include shares (held directly or indirectly) in underlying trading companies. Sometimes the underlying trading company is a private company, sometimes it is a public company, sometimes its shares are wholly owned by the trust structure, and sometimes they are not. Sometimes a trustee, or a trust company director, is involved in the management, and/or on the board, of the underlying trading company. Sometimes they are not, but just observe from the sidelines.

What is the exposure of trustees when such companies suffer trading losses, or get into financial difficulties, or worse still go into liquidation? What is the scope of their duty to prevent such losses? Will they be liable to both the trading company and to the beneficiaries if they are negligent? Will they be able to rely on their anti-Bartlett clause? What should they do if the company goes into liquidation? Will they be pursued by the liquidator?

In reality, Trustees may operate from a variety of common law jurisdictions, only seldom from the UK, and the corporate vehicles in which their investments are held could themselves be more or less anywhere. For the purposes of simplification, this feature proceeds on the assumption that the underlying trading companies are all incorporated in England and Wales, and that the statutory corporate and insolvency regime is governed by English law. Most common law jurisdictions enjoy similar (but by no means identical) legislation.

TRUSTEE'S DUTY OF CARE TO PROTECT VALUE OF SHAREHOLDING AS TRUST ASSET

One of the signal duties of the trustee is to take proper care of the trust assets (see s 4 of the Trustee Act 2000). The standard of care required of the trustee when exercising powers of investment is to exercise such skill and diligence as an ordinary prudent man of business would exercise in managing his own affairs (see *Speight v Gaunt* (1883) 9 App Cas 1). He must act cautiously (see *Learoyd v Whitely* (1887) 12 App Cas 727 (HL) *per* Lord Watson at p 733). The duty of care, both statutory and non-statutory, can be restricted by the terms of the trust instrument to limit the duties of the trustees and to exclude liability for all forms of misconduct save actual personal fraud (see *Spread Trustee Co Ltd v Hutcheson* [2012] 1 All ER 251).

If the assets of the trust include a minority shareholding in an active listed trading company the beneficiaries are entitled to expect the trustee to monitor the performance of that company, and to consider from time-to-time whether or not the shares should be retained or sold, and the trustee has a correlative duty to do so. When the trustees own a majority or controlling shareholding, the law imposes much greater burdens on them. They need to monitor the management of the company carefully, to keep themselves informed about the company's affairs and be ready to act on the information provided. They have a duty to protect the value of the shares from foreseeable losses.

The modern interventionist duty of a trustee with a substantial shareholding was first considered by Cross J in *Re Lucking's Will Trusts* [1968] 1 WLR 866 which was followed by Brightman in *Bartlett v Barclays Bank Trust Co Ltd* [1980] 1 Ch 515 where bank trustees with a 99% shareholding were held liable for failing to prevent the company from entering into a speculative property development project. The bank contented itself with reviewing annual accounts and reports and did not seek or obtain a greater flow of information. Brightman J held that a corporate trustee owed duties as follows (at p 532):

> "The prudent man of business will act in such manner as is necessary to safeguard his investment. He will do this in two ways. If facts come to his knowledge which tell him that the company's affairs are not being conducted as they should be, or which put him on inquiry, he will take appropriate action… What the prudent man of business will not do is to content himself with the receipt of such information on the affairs of the company as a shareholder ordinarily receives at annual general meetings. Since he has the power to do so, he

Biog box
Clare Stanley is a practising barrister at Wilberforce Chambers, Lincoln's Inn, London. She specialises in large scale multijurisdictional commercial litigation, mostly involving trusts and complex underlying structures.
Email: cstanley@wilberforce.co.uk

will go further and see that he has sufficient information to enable him to make a responsible decision from time to time either to let matters proceed as they are proceeding, or to intervene if he is dissatisfied."

A trustee should monitor the management so as to make it reasonably probable that the trustee will receive an adequate flow of information in time to enable him to use the controlling interest should this be necessary for the protection of the trust asset, namely the shareholding.

A duty to safeguard investments includes a duty to require the company to pursue wrongdoers such as directors for breach of fiduciary duty and to take reasonable steps to ensure that the company maximises its chances of receiving compensation where possible. Beneficiaries cannot be expected to take up the cudgels as ordinarily they have no standing to pursue wrongs to the trust let alone wrongs done to companies in whose shares they have a beneficial interest.

"ANTI-BARTLETT" CLAUSES

Businessmen who settle majority stakes generally do not want interventionist trustees. Trustees rarely have the skills appropriate to monitor business decisions and are not remunerated on that basis. Insurance may not be available at reasonable rates. The settlor may want the trustee to keep the family business even if a prudent man of business would rather sell. If the settlor is involved in the business he would not thank the trustee for intermeddling. Modern trust instruments commonly contain provisions negativing any duty by the trustee to enquire into or interfere in the conduct of a company or to supervise its directors – so-called "*anti*-Bartlett" clauses. The trustee commits no breach of trust if he does not enquire, monitor or supervise.

There are three important (perhaps obvious) points to note about the limitations of "*anti*-Bartlett" clauses:

- They are likely to be of no assistance to a trustee who does in fact involve himself in the business, for example if the trustee himself becomes a director or an employee or a director of the trustee becomes involved in the management of the business. The "*anti*-Bartlett" clause excludes the duty to get involved, but if the trustee goes ahead and gets involved nonetheless he will have assumed a duty of care to the beneficiaries.
- They affect the extent of the trustee's duty to the beneficiaries, but they have no bearing on the duty owed to the company owed by the director. Thus, they cannot be used to defeat a claim by the company against the director who acts negligently or in breach of fiduciary duty to the company.
- If the trustee has actual knowledge of facts which call for enquiry, he will not be entitled to rely on the clause to avoid further investigation.

Partly in recognition of these limitations the BVI's the Virgin Islands Special Trusts Act 2003 creates a special regime for trusts of BVI company shares in which the Bartlett duty is effectively eliminated. The trust instrument can direct trustees to retain the shares indefinitely or only to dispose of them with the consent of directors and to prohibit them from intervening in the management of the company. In practice, such trusts are set up with the BVI company as an intermediate holding company. Since *Armitage v Nurse* [1998] Ch 241 established that a duty of care was not a core duty of a trustee, such legislation does not cut down the basic concept of a trust.

REFLECTIVE LOSS

As the law currently stands there is considerable uncertainty as to whether beneficiaries are prevented from recovering for breach of the Bartlett duty by the principle against recovery of "reflective loss". Beneficiaries run a serious risk of any claim for breach of the Bartlett duty being stymied by this principle. The rule against reflective loss was developed from the decision of *Prudential Assurance v Newman Industries* and first upheld in the House of Lords in *Johnson v Gore-Wood* [2002] 2 AC 1 (HL). It has since been applied in a number of cases in England at Court of Appeal level and by the Court of Final Appeal in Hong Kong (see *Waddington Ltd v Chan Chun Hoo Thomas* [2008] HKFCA 86 [2009] 2 BCLC 82).

The reflective loss principle holds that a shareholder cannot sue on his own cause of action for the loss of his investment in shares when the company also has a cause of action on those facts and the shareholder's claim is for the diminution in value of his interest. This is said to be a rule of public policy. It ensures that there is no double recovery against a defendant and that the creditors of a company are not prejudiced by such a claim. It is for the Company to sue. If it recovers the shareholder will be made whole again. Normally the shareholder's position remains the same even if the Company chooses for whatever reason not to enforce its claim.

Of course, the claim by beneficiaries against trustees in *Lucking* and *Bartlett* type cases is the paradigm claim for the diminution in the value of shares. There has been much debate (judicial and academic) as to whether reflective loss can be deployed by negligent trustees as a defence to beneficiary claims. In England the principle did not preclude recovery in *Walker v Stones* [2001] QB 902 although that case was decided prior to the publication of the House of Lords decision in *Gore Wood* and was treated as *obiter* in subsequent Court of Appeal decisions. In *Ellis v Property Leeds (UK) Limited* [2002] EWCA Civ 32 Peter Gibson LJ suggested *obiter* that the principle would operate as a defence against a trustee (para 22). In *Shaker v Al-Bedrawi* [2003] Ch 350 Peter Gibson

Biog box

Tom Lowe QC practises permanently from Wilberforce Chambers in the Cayman Islands. His main areas of expertise include commercial fraud, insolvency, trust litigation, professional negligence, financial services, banking as well as probate disputes. He has recently been acting in numerous hedge fund liquidations. Email: tlowe@wilberforce-cay.com

LJ qualified this by holding that, if a claim was brought by a beneficiary *qua* beneficiary against a trustee-director for an account of profits, the claim would only be barred if the company had a claim against the director in respect of that same profit. In *Gardner v Parker* [2004] 2 BCLC 554 Neuberger LJ reaffirmed the application of this principle. The editors of *Lewin on Trusts* appear to go further (see 18th ed (2008) para 39-39) – they consider it to be arguable that the reflective loss principle is engaged irrespective of whether or not the company has a claim against the trustee (ie whether or not he is a director). They take this view on the basis that it is arguable that the reflective loss principle operates even when the shareholder and company do not have a claim against the same party.

As applied in *Shaker* and *Gardner* the reflective loss principle only operates in favour of a trustee if that trustee is also a director and against whom the company has the same claim. There are limitations to the "reflective loss" principle even if expressed in this way. The mere fact that the trustee had been a director does not mean that the company would have had a claim against the director for negligence; directors are allowed to commit the company to risky ventures, provided they act in what they *bona fide* consider to be the company's best interests, taking all relevant considerations into account. In contrast, trustees must proceed cautiously.

The rationale for the distinction in *Shaker* and *Gardner* is nevertheless hard to follow or accommodate within the policy reasoning expressed by Lords Bingham and Millett in *Johnson v Gore Wood*. It is difficult to see why a director should be relieved of the consequences of his breach of quite separate duties as a trustee by the mere expedient of taking an appointment as a director. If anything, the position of the editors of *Lewin* is more logical, even if ultimately incorrect. Either the reflective loss principle is engaged because of the overlap of the trust claim and the corporate claim or it is not. If there is a corporate claim the beneficiary will be made whole if there is corporate recovery.

More recently in Jersey the court refused to summarily dismiss a Bartlett type claim against a trustee because the application of the principle to trustees seemed to be unclear (see *Freeman v Ansbacher* [2010] WTLR 569). A similar conclusion was reached by the Court of Appeal in Hong Kong in *Hotung v Ho Yuen Ki* [2010] HKCA 385. It is indeed curious that the "reflective loss" principle should bar a claim against a trustee. After all it is not contrary to public policy to insure against losses in investments in shares even if the company might have legal claims of its own. When someone like a trustee has a specific duty to safeguard against investment losses by virtue of the *Bartlett* duty it is startling that the beneficiary should have no claim as a result of the "reflective loss" principle.

The result of this is to create an anomaly, the ramifications of which have not been fully explored. Take the case of a settlement, which owns shares in a company of which only one of the trustees was a director. If that trustee conducted the affairs of the company in breach of his duty to the beneficiary under the settlement and in breach of his duty as director to the company, it could lead to a curious result, so far as his fellow trustees were concerned. He, as the person principally responsible for the damage to the value of the settlement, could avoid liability to the beneficiary by invoking the rule against reflective loss as a defence to the beneficiaries' claim. In contrast, his co-trustees, who were not directors and whose negligence was merely their failure to supervise him, would be liable in full to the beneficiaries; they have no reflective loss defence. They cannot claim contribution from him – that too would be met by a reflective loss defence. Their only recourse would be to promote action by the company against the negligent trustee/director. However, since they would be doing so in their own interests they would have to obtain fully informed consent from their beneficiaries.

CONCLUSIONS

Despite the relatively large number of recent cases, this area of the law is in a state of confusion because of the rule against reflective loss. Beneficiaries do not have a clear basis of recourse against a trustee for breach of the Bartlett duty.

It seems inevitable that the rule will have to be reconsidered by the Supreme Court in the near future. At present the position seems to be as follows:

- If the trust instrument contains an anti-Bartlett clause, trustees ought not to get involved in the underlying business. If they do get involved and/or become aware of risky ventures or potential dissipation of assets or approaching insolvency, they must act if they are to avoid a claim for breach of trust.
- The reflective loss rule is now entrenched as part of English law, and it will afford a defence to any director or third party who faces claims from a shareholder of a kind which reflects the company's loss. It is unclear whether *Re Lucking* types of claims against director/trustees can ever now be pursued.
- If trustees are directors, on English authority a reflective loss defence can be advanced to a Bartlett type claim by beneficiaries where the company has a similar claim against the trustee director.
- Trustees should not wait for the beneficiaries to take steps to sue a wrongdoing director. They should consider how best to assume control of the company, replace its directors if appropriate and cause the company to take proceedings against the recalcitrant director. ■