Trustee exoneration and indemnity clauses – back on the agenda

Being a trustee is a risky business. Trustees have to make difficult decisions and may make mistakes. Given the size of many occupational pension schemes, those mistakes could prove expensive. Sometimes pension scheme members lose out, and they look for someone to blame. How do trustees cope? They should take particular care before acting (eg by implementing a risk management strategy and taking appropriate professional advice) - but no strategy is 100% risk-free and even professional advisers may make mistakes. And they may wish to take out trustee indemnity insurance – but this may be expensive or provide limited cover. What about trustee indemnity and exoneration clauses? Don't they afford all the protection trustees need? Simon Tyler considers these issues.

Executive summary

• Indemnity clauses are only worth having as long as the person or the fund providing the indemnity can afford to pay. Exoneration clauses offer better protection for trustees, but they are of no benefit to scheme members.

• Indemnity and exoneration clauses do not offer protection for trustees guilty of fraud or dishonesty. Exoneration clauses do not offer protection in relation to trustees' investment decisions. Trustees should take appropriate steps in appointing an investment manager to ensure they will not be liable for the manager's defaults.

• Companies often agree to indemnify pension scheme trustees against any personal liability. The law governing the granting of those indemnities to directors of corporate trustees is changing. Trustee directors may wish to review their liability and the protections available in the light of the new legislation.

• The Law Commission's report on trustee exemption clauses was published in July 2006. The Law Commission made a couple of proposals, but they do not affect pension scheme trustees.

Exoneration and indemnity clauses

Trustees are obliged to comply with the trust deed and rules, relevant legislation and trust principles. Trustees may be held liable for a breach of any of those obligations. Exoneration clauses in the trust deed simply negate that liability. They state that, despite any breach, trustees cannot be held liable. Some exoneration clauses may be conditional, for example they may be stated to apply only where trustees act on professional advice. Claims against trustees by persons other than members or employers are rare but, if they are brought, the exoneration clause offers no protection since third parties are not bound by the trust deed.

Indemnity clauses do not affect trustees' liability as such. Instead, they provide that a person (usually a scheme employer) will indemnify the trustees against any claim that trustees would otherwise be required to meet out of their own assets. Alternatively, the indemnity clause may allow trustees to recoup any claim out of scheme assets. An indemnity clause is of no value if the scheme or the employer has insufficient assets to meet the claim against the trustees. If the indemnifier does not pay out for any reason, the trustees may find themselves in serious difficulties and may need to take legal action to recover the money. Scheme members would prefer trustees to have the benefit of an indemnity rather than an exoneration clause. An exoneration clause may prove a defence to an otherwise legitimate claim by a member, whereas an indemnity may provide funds that would not otherwise be available to meet a member's claim.

An exoneration clause does not prevent the Regulator from imposing a fine. Trustees cannot rely on an indemnity clause to seek to recoup fines from the Regulator out of scheme assets, although employers can lawfully indemnify trustees where a fine is imposed.
Statutory exoneration

A court has power under the Trustee Act 1925 to relieve a trustee in whole or part of personal liability, if it finds that the trustee has acted honestly and reasonably and ought fairly to be excused for the breach of trust. The problem is that this statutory exoneration does not apply automatically. It is only effective if a particular court decides, in its discretion, to apply it.

Validity of indemnity and exoneration clauses

In the case of *Armitage v Nurse*, the Court of Appeal held that an exoneration clause could cover liability for all breaches of trust except fraud. Here “fraud” means intending to act contrary to the interests of beneficiaries or being recklessly indifferent to their interests. Consequently, an exoneration clause may cover liability for negligence, provided it is worded so that it does not offer protection in cases of dishonesty, bad faith, recklessness or fraud. If trustees were to act on the basis that they need not worry about whether or not something was permitted by the trust deed, they risk being unable to rely on their exoneration clause. The burden of proof is on trustees to show that an exoneration clause applies and is sufficiently widely worded to cover their actions.

The case of *Seifert v the Pensions Ombudsman* established that former trustees may rely on exoneration clauses. The Pensions Ombudsman confirmed in a determination in 2002 that trustees may continue to rely on a pension scheme’s exoneration clause even after a scheme has wound up - even if the effect of that exoneration clause is to deprive a member of an entitlement otherwise due to him.

The Pensions Act 1995 has restricted the applicability of exoneration clauses in one important area. It prohibits clauses limiting the liability of trustees of occupational pension schemes in respect of claims for negligent investment. However, where trustees take certain appropriate steps in appointing an investment manager, they will not be liable for the manager’s defaults. Trustees may well wish to check that those steps have been taken.

Indemnity clauses have been subject to less scrutiny by the courts than exoneration clauses. However, they too are likely to be ineffective if the trustees knew (or were reckless as to whether they knew) what they were doing was a breach of trust.

Corporate trustees

A person bringing a claim against directors of a corporate trustee for alleged breach of trust would have to lift the “corporate veil” if he wished to hold the directors personally liable. He might want to do this if the scheme and the company had no available assets. Whether the directors could successfully hide behind the veil is a grey area. In the case of *HR v JAPT*, the court held, among other things, that the veil did protect the director unless he dishonestly assisted in the breach of trust (for example by deliberating concealing relevant facts). It is therefore far less likely that the director of a trustee company would be held personally liable than an individual trustee. This does not, however, mean that trustee directors can escape all personal liability and would prefer also to have the benefit of an indemnity or exoneration clause. Unfortunately, the granting of an indemnity to a trustee director is not straightforward.

The Companies Act 1985 contained a general prohibition on companies indemnifying their own directors. This was extended from 6 April 2005: a company cannot now provide an indemnity either to its own directors or to directors of any associated company (such as a subsidiary), subject to certain exceptions (such as indemnities granted before 29 October 2005).

In response to concern about the impact of this legislation on pension scheme trustees, the Companies Bill 2006 is expected to permit "qualifying pension scheme indemnity clauses". If enacted in the form proposed, the new legislation will allow companies to indemnify trustee directors of an associated company in connection with that company’s activities as trustee of an occupational pension scheme. In other words, parent companies will be able to indemnify directors of a corporate pension trustee that is one of their subsidiaries. However, the indemnity will only qualify if it does not apply to the payment of criminal fines, regulatory penalties or any liability incurred by the director in defending criminal proceedings in which he is convicted.

The Companies Bill 2006 is expected to receive Royal Assent in November 2006, with implementation expected in 2007. Pension scheme trustee directors may wish to review their exposure to liability and the forms of protection available in the light of that new legislation.

Exoneration clauses and legal reform

A fractious scheme member might ask “Why should trustees be let off the hook? What’s in it for me? Shouldn’t they be held responsible if they get it wrong?” The Court of Appeal
considered this line of questioning in 1925. Lord Justice Sargant concluded: “The truth is that [trustee exoneration clauses] may, and I think often do, operate to protect rather than harm beneficiaries, because they prevent honest and responsible persons from being frightened away from accepting an office which might otherwise involve them in various unmerited and unexpected losses notwithstanding perfect honesty on their part.” In other words, exoneration clauses are not bad news – even for a fractious scheme member who can be assumed not to want their schemes run by dishonest or irresponsible trustees.

Yet many have continued to hold our fractious scheme member’s dim view of exoneration clauses. In January 2003, the Law Commission published proposals for legal reform that he would have welcomed:

• Professional trustees should be prevented from relying on exoneration clauses in respect of liability arising from negligence – a proposal first made in the Goode Report in September 1993.

• All trustees should have power to use trust assets to buy insurance to cover their liability for breach of trust.

However, in July 2006, the Law Commission published its final report, showing a distinct swing from our fractious scheme member to Sargant LJ:

• Exoneration clauses control risk and keep costs down. This encourages a sufficient number of trustees to accept appointments. Trustee indemnity insurance is not capable of replacing the role played by exoneration clauses.

• Restricting reliance on exemption clauses might have adverse unintended consequences and would restrict the autonomy of those establishing a trust.

The Law Commission ended up making just one recommendation: the Government should promote a rule of practice as widely as possible across the trust industry, without issuing any new legislation. The rule of practice should state that any paid trustee introducing an exoneration clause in a trust would need to take reasonable steps to ensure that the settlor (ie the person setting up the trust) is aware of the clause.

Employers establishing pension schemes are usually legally advised and will therefore be made aware of any exoneration clause in any event. The Law Commission therefore recommended that the new rule of practice should not apply to trustees of pension schemes.

Back on the agenda

The Law Commission has finally preferred the 1925 views of Sargant LJ on exoneration clauses to those of our fractious scheme member. The Companies Bill intends to ensure that indemnities of a particular form can be given by companies to directors of corporate trustees – a reversion to a position not dissimilar from that before 6 April 2005. Why are exoneration and indemnity clauses back in vogue? Perhaps it’s because, despite the Government’s forlorn attempts to simplify pensions legislation, being a pension scheme trustee has never been such a complex and risky business. More than ever, trustees are checking exoneration and indemnity clauses before accepting an appointment. Without such protection, pension schemes would be run only by those caring little for their own, and possibly scheme members’, liability.

Simon Tyler