

Choosing Among the Beneficiaries of Discretionary Trusts

John Mowbray Q.C.

Address: 12, New Square, Lincoln's Inn, London, WC2A 3SW.

Tel. : 020 7419 1212

Fax : 020 7419 1313

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Trustees need to have regard to a variety of factors when benefiting discretionary beneficiaries.

Trust deeds of offshore trusts usually contain discretionary trusts or powers for the trustees, protectors or others, to appoint or informally distribute capital or income among the beneficiaries. This article considers the constraints that may apply to the way in which beneficiaries are chosen to benefit under such discretionary trusts and powers.

Illusory shares

Let us begin with a piece of history which is more relevant today than might at first be thought. Before there was any legislation on the topic, by the law of England a power of appointment among a class of objects could not be exercised so as to cut any of them out altogether unless this was authorised by the wording of the trust instrument. For instance, a trust to transfer funds unto and amongst such child or children of a marriage "or unto and amongst the issue of such child or children, in case such child or children should be then dead" as the husband should appoint did not authorise an appointment to some of the issue of a child exclusively, whereas a trust for "such child or children of the said intended marriage, and if more than one in such shares", as the husband and wife should appoint allowed some of the children to be excluded. Moreover, there was an ill-defined equitable jurisdiction to set aside an appointment made under a non-exclusive power if the share appointed to any of its objects was not of a substantial size. In 1830, however, statute provided that no appointment was to be invalid on the ground merely that an unsubstantial, illusory or nominal share only of the property was appointed to any object of the power, and in 1874 this was extended to cases where an object of the power was altogether excluded. As was said, "The Act of 1830 enabled an appointor to cut off any object of the power with a shilling: the Act of 1874 enables him to cut off the shilling also."

The importance of this piece of history at the present day is that offshore jurisdictions in which settlements with discretionary trusts and powers are often set up do not always have corresponding legislation. For instance, though the lack of this is being remedied in the Bahamas by a new Trustee Act, there has been no such legislation there up to now.

Likewise there is none on the Cayman Islands statute book, nor is there any in Jersey.

The lesson for anyone drafting discretionary trusts or powers for an offshore trust is obvious. Always use a form of words which clearly authorises the donee of the power to exclude objects of the trust or power if thought fit. It has traditionally been recognised that this can be authorised by giving the power to appoint, or to distribute informally, not simply to the objects, but to ". . . such one or more exclusively of the other or others of . . ." the objects as may be thought fit. Wording of that kind is in common use, and can be recommended for use, today. It will enable the donee of the power to exclude any of the class of objects if thought fit, whether or not the governing law of the trust includes provisions like the English legislation. A further precaution sometimes taken is to reproduce the English legislation in the trust deed.

Is there a duty of impartiality?

Discretionary trusts and powers of appointment must like all other powers, be exercised in good faith for the purpose for which they are conferred, and not for any collateral purpose. They differ, however, from administrative powers in that there is no duty to exercise them impartially as between beneficiaries with different interests. Since the powers that we are considering involve selection among the beneficiaries, their exercise necessarily involves preferring one beneficiary to another, so references to a duty of impartiality are inapposite. This was clarified in the judgment of Scott V.-C. in a recent case, *Edge v. Pensions Ombudsman*. This was an appeal from a decision of the Ombudsman striking down an amendment to the rules of a pension plan made by the trustees using surplus funds to increase the benefits and reduce the contributions of working members but giving nothing to the retired pensioners of the plan. The Ombudsman had cited *Megarry V.-C.* in the famous case of *Cowan v. Scargill*, referring to ". . . the duty of trustees to exercise their powers in the best interests of the trust, holding the scales impartially between different classes of beneficiaries". He had gone on to rule that the decision of the pension plan trustees to exclude the pensioner beneficiaries from the benefit of the amendment breached the trustees' duty of impartiality, because it was the result of undue partiality towards the interests of the preferred beneficiaries. Scott V.-C. said of the quotation from *Cowan v. Scargill*:

"Sir Robert Megarry was dealing with an issue regarding the exercise by pension fund trustees of an investment power. He was not dealing with the exercise of a discretionary power to choose which beneficiaries, or which classes of beneficiaries, should be the recipients of trust benefits. In relation to a discretionary power of that character it is, in my opinion, meaningless to speak of a duty on the trustees to act impartially. Trustees, when exercising a discretionary power to choose, must of course not take into account irrelevant, irrational or improper factors. But, provided they avoid doing so, they are entitled to choose and to prefer some beneficiaries over others."

Regarding the Ombudsman's notion that the trustees must not act with undue partiality,

Scott V.-C. asked:

"What is 'undue partiality'? The trustees are entitled to be partial. They are entitled to exclude some beneficiaries from particular benefits and to prefer others. If what is meant by 'undue partiality' is that the trustees have taken into account irrelevant or improper or irrational factors, their exercise of discretion may well be flawed. But it is not flawed simply because someone else, whether or not a judge, regards the partiality as 'undue'. It is the trustees' discretion that is to be exercised. Except in a case in which the discretion has been surrendered to the court, it is not for a judge to exercise the discretion. The judge may disagree with the manner in which trustees have exercised their discretion but, unless they can be seen to have taken into account irrelevant, improper or irrational factors, or unless their decision can be said to be one that no reasonable body of trustees properly directing themselves could have reached, the judge cannot interfere. In particular he cannot interfere simply on the ground that partiality shown to the preferred beneficiaries was in his opinion undue."

Surveying the field

In exercising a discretionary trust or power, its donee has to weigh the needs and deserts of the different objects one against another in the light of the wishes of the settlor or testator so far as these are known and are relevant to the circumstances at the time. Usually, the donee of the discretion will be able to identify the objects of the power and consider their respective needs and deserts and the probable wishes of the settlor or testator, and exercise the power, or refrain from exercising it, accordingly. Sometimes, though, the class of possible objects is very wide, and it may be so wide that it is not possible to survey the whole field and identify all the possible objects. For instance, this obviously cannot be done with the power commonly seen in offshore trust deeds for trustees or protectors to add to the class of beneficiaries anyone in the world other than themselves and perhaps the settlor and his wife, or with what is sometimes called an "intermediate" or "hybrid" power of appointment among a similar class. The width of the class does not make the power invalid, at any rate if there is a letter of wishes or some other way of deciding what the settlor's or testator's wishes might have been, even if the power is given to trustees or others in a fiduciary position. The donees of such a power have to exercise it in a responsible manner according to its purpose. They have to make such a survey of the range of objects or possible beneficiaries as will enable them to carry out their fiduciary duty. They must find out the permissible area of selection and then consider responsibly, in individual cases, whether a contemplated beneficiary is within the power and whether, in relation to other possible claimants, a particular appointment or distribution is appropriate. But it is not necessary for them to compile a complete list of every object, nor is the power invalid if they are unable to do so. As Sir Charles Harman J. said in a famous phrase, they need not "worry their heads to survey the world from China to Peru, when there are perfectly good objects of the class in England."

Trustees must not, however, simply proceed to exercise the power in favour of such of

the objects as happen to be at hand or claim their attention. They must first consider what persons or classes of persons are objects of the power within the definition in the settlement or will. Though they need not attempt to compile a complete list of objects, or even to make an accurate assessment of the number of them, they have to assess the width of the field of choice to see whether a selection is to be made merely from a dozen or, instead, from thousands or millions. Only when the donees of the power have applied their minds to "the size of the problem" should they then consider in individual cases whether, in relation to other possible claimants, a particular distribution or appointment is appropriate.

They should not prefer the undeserving to the deserving, but they are not required to make any exact calculation whether, as between deserving objects, A is more deserving than B.

An express power to disregard those not benefited?

In connection with powers to add as beneficiaries anyone (or almost anyone) in the world; the question is sometimes raised as to how, or even whether, such a power can be exercised, seeing that the result is to dilute the interests of the existing beneficiaries. As we have seen, such powers are valid, trustees are free to favour the added beneficiary over the existing beneficiaries in exercising them, and need not attempt to identify all those who might possibly be added. Trustees need not be concerned about exercising the power so long as they follow the procedure in the previous paragraph.

Perhaps with a view to answering such concerns, or to easing the trustees' task when they have a very wide field of potential beneficiaries to consider, trust deeds sometimes include a provision to the effect that the trustees can exercise their powers in favour of any particular beneficiary in entire disregard of the interests of any others. In view of the above, such a provision hardly seems to be needed to enable the trustees to exercise their power sensibly. It may be doubted whether settlors generally would wish trustees to exercise such a power in favour of a beneficiary without first assessing the width of the field and considering the possible claims of such of those standing within it as can be identified, as described in the previous paragraph.

When the donee is an object of the power

In recent years serious doubts have been thrown on the ability of donees who are themselves objects of their discretionary powers to exercise such powers in their own favour, or at all. Fortunately, however, it is thought that these doubts have now been dispelled.

It was in *Re William Makin & Son Ltd* that Vinelott J. first raised the doubts. The case concerned a pension plan of which the employer company was the sole trustee. The company was in insolvent liquidation and the question arose whether its liquidator could exercise a power given to the trustee of the plan to use surplus assets to augment

members' benefits, seeing that any of the surplus not so used was to be paid to the employers. It was argued that the company retained the power to augment the benefits, in spite of the liquidation and the intervening rights of its unsecured creditors claiming through the liquidator. As the company had been the sole trustee from the first, it was argued that it must have been intended by all concerned that the company should be able to exercise the power in its own liquidation, notwithstanding that its creditors were interested in whatever surplus was not used, and in spite of the usual principle described by Vinelott J. as:

" [T]he principle that a trustee cannot act if he finds himself in a position where he has conflicting duties or where his duty conflicts with his own interest."

The learned Judge said of this argument:

"I do not find it necessary to consider the doubtful and difficult question whether the application of this principle can in fact be excluded by an express provision in the trust instrument . . .":

and went on to hold that the power of augmentation was fiduciary and could not be exercised by the liquidator because of the head-on conflict between the duty owed by him as liquidator to the unsecured creditors of the company and the duty that, as representing the company, he owed as sole trustee of the scheme to the members of the plan as objects of the power.

Since the power could not be exercised by the liquidator, some other method had to be found of exercising it. The learned Judge would have preferred to appoint new trustees who could prepare a scheme of distribution and who would either surrender their discretion to the court or, alternatively and preferably, seek a declaration by the court that the scheme was one which they could properly carry into effect. However, all the parties were anxious to avoid the delay that might result from appointing new trustees and the Judge came to the conclusion that the court could assume the duty of directing how the surplus should be applied. He therefore directed two defendants, former directors who had been appointed to represent different classes of beneficiaries in the proceedings, to bring in a scheme for the distribution of the surplus assets. Perhaps because he had at the front of his mind the conflict of interest of the liquidator, the Judge added that these representative defendants ". . . must, of course, accept that they themselves will have to be excluded from any benefit under the scheme".

This received unfavourable comment from the editors of the Occupational Pensions Law Reports and also from those of the Pensions Law Reports, who expressed the view that it was outrageous that representative members who put themselves forward to help should by doing so forfeit their benefits. In *British Coal Corporation v. British Coal Staff Superannuation Scheme Trustees Ltd* Vinelott J. said:

"My answer to that observation is that I find the idea that a person who has a

power to distribute a fund amongst a class which includes himself should be able to apply the fund or any part of it for his own benefit equally outrageous. This does not rest on any technical rule of trust law; common sense dictates that no man should be asked to exercise a discretion as to the application of a fund amongst a class of which he is a member. He cannot be expected fairly to weigh his own merits against the merits of others.

Later, in *Re Drexel Burnham Lambert U.K. Pension Plan* Lindsay J. was asked in the winding up of another pension fund to approve an arrangement for the disposal of the fund proposed by its trustees notwithstanding that they were themselves personally interested in it as members of the fund. He approved the arrangement in spite of the fact that it was proposed by trustees in a conflict of interest. He pointed out that in the *William Makin* case Vinelott J. had been concerned with avoiding a future conflict rather than with the effectiveness of trustees' actions taken in a pre-existing conflict, and added:

"I do not attempt to rule on the subject, identified by Vinelott J. as difficult, of whether the general rule can be overcome by express provision in the trust deed, although I note that in *Bray v. Ford*, Lord Herschell, on a closely related point, included the words 'unless otherwise expressly provided'."

He recommended that the point should be covered by legislation, as regards the trustees of pension funds, and this was done.

Not surprisingly in view of the reservations expressed by both Vinelott J. and Lindsay J. and the response of the Legislature, the profession was thrown into doubt as to whether trustees could exercise their trust powers when they were personally interested, even if expressly authorised to do so. These doubts can now, however, be seen to be without foundation. Four important authorities appear not to have been cited to Vinelott J. in the *William Makin* case. If they had been cited to him, it is thought that he would not have raised the doubts, nor would he have referred to the general rule in the terms that he did.

Bray v. Ford

The earliest of these authorities was *Bray v. Ford*, where Lord Herschell said:

"It is an inflexible rule of a Court of Equity that a person in a fiduciary position ... is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict."
(Emphases added)

The *Space Investments* case

Another important authority not cited to Vinelott J. was *Space Investments Ltd v. Canadian Imperial Bank of Commerce Trust Co. (Bahamas) Ltd* where Lord Templeman, delivering the advice of the Privy Council in a Bahamian Appeal, said:

"Equity thus protects beneficiaries against breaches of trust, but equity does not protect beneficiaries against the consequences of the exercise in good faith of powers conferred by the trust instrument.

Although as a general rule, a trustee is not allowed to derive a benefit from the trust property, that general rule may be altered by the express terms of the trust instrument. One illustration is an express provision in a settlement which permits a trustee to charge and deduct from trust money remuneration for the services of the trustee. A settlement may also confer on a trustee power to make use of trust money in other ways."

In that case, the Privy Council held that a trustee was able to deposit trust money with itself as a banker under an express power, so as to become the outright owner of the money. The description in the judgment of the remedy against a bank that wrongly takes trust money has been criticised, but the exception to the general rule that allows a bank trustee to deposit trust money with itself if authorised by the trust instrument has not.

Re Penrose

The third important authority not cited to Vinelott J. in the William Makin case was Re Penrose where Luxmoore J. held that the donee of a special power of appointment (not, admittedly, a trustee) could appoint to himself if, on the correct interpretation of the clause, he was one of the objects of the power: it was simply a matter of interpretation.

Sargeant v. National Provincial Bank plc

Finally, Vinelott J. did not have the advantage of being referred to the decision of the Court of Appeal in Sargeant v. National Westminster Bank. A testator had appointed his three children to be his executors and had left his estate to them equally. His estate included three farms which he had let to the three children. They farmed them in partnership. One of them, Charles, died. The other two acquired his share in the partnership and proposed that the farms should be sold subject to the tenancy. The administrator of Charles's estate objected. He contended that the two surviving executors were in a position in which duty and interest conflicted and that they were not entitled to sell the farms so long as the tenancy subsisted. He contended that Charles's estate was entitled to a one-third share of the vacant possession value of the farms. The Court of Appeal held that the executors were entitled, notwithstanding the conflict between interest and duty, to sell the farms subject to the tenancy.

Nourse L.J. explained why. He pointed out that the executors were both tenants and beneficiaries in the estate and said that since Charles's death:

"It cannot be doubted that the trustees have ... been in a position where their interests as tenants may conflict with their duties as trustees to the estate of Charles. But the conclusive objection to the application of the absolute rule on

which [counsel for Charles's administrator] relies is that it is not they who have put themselves in that position. They have been put there mainly by the testator's grant of the tenancies and by the provisions of his Will and partly by contractual arrangements to which Charles himself was a party and of which his representatives cannot complain."

Bingham L.J. (now C.J.) and Sir George Waller agreed.

If those four authorities had been cited to Vinelott J., it is suggested that he would not have doubted that trustees could be authorised to exercise their powers in a conflict of interest. Nor would he have stated the general rule as applying when a trustee "finds" himself in such a conflict, rather than forbidding a trustee to "put" himself into a position of conflict.

Two more recent decisions

Two even more recent decisions are, it is thought, decisive of these points. The first is a decision of Smellie J. in chambers in the Grand Court of the Cayman Islands that was noted in *The Chase Journal* 2, and is expected to be reported with the approval of the Judge in redacted form in the Cayman Island Law Reports. It will be recalled that this case concerned the management committee of a Cayman trust. Under the trust deed, a mother took most of the income, then on her death it was to go among her husband and daughters, and on the death of the last of them the trust fund was to go to the daughters' children. The grantor retained a power to amend the trust deed with the unanimous written consent of a management committee set up under a separate clause to supervise changes of investment. The committee was composed of the mother, her husband and one of her daughters. The grantor amended the trust deed with the committee's consent so as to give the mother half the trust fund outright, she previously having had no interest except in income. Two grandsons sought a declaration that the amendment was invalid, on the ground that the power of the management committee to consent or withhold consent to amendments was a fiduciary power and that the mother had therefore been unable to consent to this amendment in her own favour, being caught in a conflict of interest and duty.

The court held that, though the power of the management committee to supervise the investments was a qualified fiduciary power, its power to consent or withhold consent to amendments was not a fiduciary one. The court went on to hold, as an alternative and "safer" ground of the decision, that even if the power to consent or refuse consent was fiduciary, since the mother had from the start been both a member of the management committee and a beneficiary, it was the terms of the trust deed that had brought her into the position of conflict; she had not placed herself in that position, and therefore she was not prevented from exercising the power in her own favour by the rule that fiduciaries must not place themselves in positions in which their interests may conflict with their duties. On this aspect of the case the judgment relied on *Sargeant v. National Westminster Bank plc* and *Re Penrose* above.

The other very recent decision is *Edge v. The Pensions Ombudsman*. An account has already been given of this case as it related to the question whether the trustees of the pension plan in question had broken a duty of impartiality in amending the rules of the plan to apply surplus funds to benefit members still in service but not retired members. The Ombudsman in that case had not only determined that the trustees had committed a breach of trust by failing to act impartially in making the amendments, as described above, but also that such of the trustees as were themselves members would be accountable for any benefits that they might receive under the amendments, because they had acted in a conflict of interest and duty. On the appeal, Scott V.-C. said:

"The Pension Scheme Rules required there to be Member Trustees who were current employees of an Employer participating in the Scheme. The trustees as a body, including these Member Trustees, have a variety of discretionary powers entrusted to them by the Rules. The power to fix the level of Members' contributions is one such power. The logic of the Pensions Ombudsman's premise would be that if the Members' contribution rate were reduced, the Member Trustees would have to continue paying contributions at the higher rate. Otherwise they would be benefiting from a conflict of interest and duty and would have to account to the trust for the benefit. Another discretionary power is the power to amend the Rules. The Rules expressly contemplate that an amendment may materially affect "any benefit ... of ... Members", i.e. may increase, reduce, add to or remove any such benefit. This is the discretion which Member Trustees, as part of the body of Managing Trustees, may from time to time have to exercise. The notion that, when the discretionary power of amendment is exercised so as to increase an existing benefit or add a new benefit, the Member Trustees must be excluded from benefit is, in my opinion, quite simply ridiculous. The Rules could not be taken to have intended so absurd a result. So why should equity intervene? Rules of equity were devised in order to produce fair and sensible results."

After a quotation of some length from Sargeant's case, including the passage from the judgment of Nourse L.J. quoted above, the Vice-Chancellor continued:

"The passage from Nourse L.J.'s judgment that I have cited is, in my judgment, conclusive of the conflict of interest point in the present case. The Member Trustees are placed by the Rules themselves in the position of conflict between interest and duty to which the pensions Ombudsman referred. The Rules require the body of trustees to include employee members. The Rules contemplate that, as trustees, the employee members will from time to time have to exercise discretions in which their duty and interest may conflict. In these circumstances there is, in my judgment, no rule of equity that requires them to account for benefits that an entirely proper exercise of discretionary powers may produce for them."

After referring to the *Drexel Burnham Lambert* case, the Vice-Chancellor added

"In my judgment ... the question whether the case falls within the Sargeant v. National Westminster Bank exception cannot depend on whether the trustees in question have been proactive in seeking appointment or, in the style of the Speaker of the House of Commons, have been dragged protesting into office. If the constitution of a Pension Scheme requires there to be employee member trustees and vests in those trustees, with or without colleagues who are not employees, discretionary powers the proper exercise of which may confer, or augment, pension benefits on employees, the Sargeant v. National Westminster Bank exception, in my judgment, applies. The employee member trustees will not be accountable for those benefits."

Conclusion

From the authorities cited above it seems clear that trustees who have discretionary powers to distribute trust capital or income among a class of objects of the power which includes themselves are automatically authorised to distribute to themselves, and that they are not accountable to the other beneficiaries for what they receive, and similar considerations apply to protectors or the like whose powers are so phrased as to be exercisable in their own favour. Occasionally, a trust deed contains a specific provision allowing trustees or protectors or the like to exercise powers notwithstanding that they are personally interested. This may be a useful precaution, but it could go too far unless it is confined to the kind of powers that we have been considering. For instance, it might allow the trustees to buy and sell trust property from and to themselves, which may not be what the settlor would have wished. Such a provision is not needed for the kind of powers that we have been considering.