REFORM OF TRUST LAW

HONG KONG'S NEW TRUST LAW

BY WILLIAM AHERN

After more than seven years of lobbying by the Joint Committee on Trust Law Reform (JCTLR) and others, Hong Kong now has a new trust law by virtue of the significant amendments made to the existing *Trustee Ordinance* (Cap.29) and the *Perpetuities and Accumulations Ordinance* (Cap.257) via the *Trust Law (Amendment) Ordinance 2013* (the amending Ordinance).

The amending Ordinance came into effect on 1 December 2013 and put in place the following major reforms:

- **A new statutory duty of care.**
- **Provisions controlling the trustee's rights to restrict liability under so-called exoneration clauses and associated limits on the ability of trustees to be indemnified with respect to liability for breach of trust.**
- **Provisions concerning the statutory validation of certain investment functions when reserved to settlors and interestingly, a statutory relief from what might otherwise be a breach of trust where a trustee acts in accordance with directions given by a settlor with these reserved powers.**
- **The validation of certain transfers of movable property to Hong Kong law trusts where the trustees are resident and/or incorporated in Hong Kong (forced heirship rules).**
- **The abolition of the rule against perpetuities (RAP) and the rule against excessive accumulations (RAE) except with respect to charitable trusts.**
- **A court-free mechanism that allows beneficiaries who are both *sui juris* and have vested trust interests to remove trustees.**
- **Significantly improved default powers of trustees to delegate certain prescribed functions to (principally investment powers and functions) agents, nominees and custodians.**

I will deal with the listed amendments in turn but before doing so, point out that the existing statutory law in Hong Kong is based upon the English *Trustee Act 1925*, which is supplementary to the equitable rules, principles and powers conferred upon trustees via the trust instrument. The existing and new trustee powers apply if and only so far as the contrary intention is not expressed in the trust instrument and only have effect subject to the terms of the trust instrument. Therefore, while modern trust deeds frequently empower trustees to do all the things (and more) that the existing and amending Ordinance empowers trustees to do they are to be welcomed where the trust terms are inadequate. The amending Ordinance applies to existing and post amendment trusts except where specifically provided.

The new statutory duty of care for trustees

Trustees have many duties of office, and trusteeship is, as we know, an onerous office. The main duties of a trustee may be said to be as follows:

- **to hold and control trust property and generally to segregate it from other trust property;**
- **to safeguard the value of assets;**
- **to act honestly and impartially between the beneficiaries;**
- **to account strictly to beneficiaries for trust assets of any kind;**
- **to exercise his powers with consideration, honestly and not to act capriciously;**
- **not to put his interests in conflict with his fiduciary duties and not to profit from office;**
- **to act personally unless authorised to delegate; and**
- **last, but not least, to take reasonable care in the exercise of his functions.**

The degree or standard of care a trustee owes depends upon whether the common-law standard applies or whether, from 1 December 2013, the statutory duty applies. I will examine the common-law standard of care, then the new statutory duty of care, when that statutory duty of care applies and to which acts it applies. The existing common-law standard of care varies according to whether the trustee is paid or unpaid. Unpaid trustees ought to conduct trust business as a prudent man of business would conduct his own. Paid trustees have a higher duty as expressed by Brightman J in *Barclays* v *Barclays Bank Trust Co Ltd* [1980] Ch 515 at 534:

'A trust corporation holds itself out in its advertising literature as being above ordinary mortals. With a specialist staff with ready access to financial information and professional advice, dealing with and solving trust problems day after day, the trust corporation holds itself out as capable of providing an expertise which would be unrealistic to expect and unjust to demand from the ordinary prudent man or woman who accepts, probably unpaid and sometimes reluctantly from a sense of family duty, the burdens of trusteeship... I think that a professional corporate trustee is liable for breach of trust if loss is caused to the trust fund because it neglects to use the special care and skill which it professes to have.'

That is a clear statement of principle though one not often easily applied in practice as evidenced in the many cases on this issue. The common-law duty undoubtedly has become stricter with the advent of professional trusteeships over time. It applies in Hong Kong until the 1 December 2013 and it continues to apply in so far as it appears from the trust instrument or enactment that the new statutory duty is not meant to apply. In other words, for new trusts it is possible for the settlor and the trustee to contract out of the new statutory duty and therefore retain the common-law duty.

For existing trusts, the new statutory standard applies unless it is specifically excluded by a deed made by either the settlor(s) of full capacity or where there is no settlor(s) of full capacity by all absolutely entitled beneficiaries of full capacity.

Let's now turn to examine what the new duty is and what it applies to. The new statutory duty is described in s3A of Part IA of the amendment Ordinance which provides as follows:

'3A. Statutory Duty of Care

(1) If the statutory duty of care applies to a trustee as provided in the Third Schedule, the trustee must exercise the care and skill that is reasonable in the circumstances, having regard to – (a) any special knowledge or experience that the trustee has or holds out as having; and (b) if the trustee is acting in a capacity in the course of a business or profession, any special knowledge or experience that is reasonably expected of a person acting in the course of that kind of business or profession.

(2) If the statutory duty of care applies to a trustee when exercising a power or doing an act, that duty has effect in place of any common-law rules and equitable principles regarding the duty and standard of care owed by the trustees to the beneficiaries of the trust when exercising the power or doing the act.'

The Third Schedule (referred to above) sets out the powers of a trustee that it applies to. Essentially, it applies to trustees' powers of

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investment (however conferred), the appointment of agents, nominees and custodians, the power to insure and to the exercise of various other powers concerned with the valuation and audit of the trust funds, the acceptance of property, severing or portioning trust funds, paying and compromising debts etc.

The standard of care for non-professional trustees is measured against the particular trustee's special knowledge and experience, judged subjectively or according to what the trustee holds himself out as having. Where the trustee is acting in the course of a business or profession he is judged also by reference to any special knowledge or experience that is reasonably expected of a person acting in the course of that kind of business or profession, i.e. he will be judged by both objective and subjective standards.

I am not sure of the extent to which the statutory standard is more onerous than the common-law standard as expressed above. However, it might be reasonably implied that the purpose of the relevant amendment must have been to impose a higher standard and to limit its application to specific acts such as investment and delegation. Clearly trustees must make sure they know what standard is required of them in relation to a particular act. For example, if the statutory standard is not excluded from either existing or new trusts then the statutory standard applies to all the matters in the Third Schedule while the common-law standard continues to apply to other acts.

Having examined the standard of care I next look at the new rules that place limits on a trustee in limiting his liability where there is a breach of trust and his rights to be indemnified out of trust property for such liability.

Control of trustees' rights to exemption and indemnity for liability for breach of trust

To what extent can a trustee exonerate himself from liability for a breach of trust? The current state of law is that exemption clauses may validly exclude liability for ordinary and gross negligence but not fraud or wilful neglect. This is so because the only core obligation of a trustee from which he may not be relieved is the mere duty to act honestly and in good faith. The rest can be dealt with by the trust instrument and exemption clauses, although construed strictly against trustees, are a complete defence to a claim. However, Part 4C of the amending Ordinance says otherwise:

'41W. Trustee is not exempted from liability for breach of trust

(1)Subject to subsection (2), this section applies to a trustee who—

(a) acts in a professional capacity;

(b) receives remuneration for the trustee's services provided to, or on behalf of, the trust...

(3)The terms of a trust must not—

(a) relieve, release or exonerate a trustee from liability for a breach of trust arising from the trustee's own fraud, wilful misconduct or gross negligence; or

(b) grant the trustee any indemnity against the trust property for the liability.

(4)A term of a trust is invalid to the extent to which it purports to—
(a) relieve, release or exonerate a trustee from liability for a breach of trust arising from the trustee's own fraud, wilful misconduct or gross negligence; or
(b) grant the trustee any indemnity against the trust property for the liability.
(5)A term of a trust is invalid to the extent to which it purports to – (a) relieve, release or exonerate a trustee from liability for a breach of trust arising from the trustee's own fraud, wilful misconduct or gross negligence; or (b) grant the trustee an indemnity against the trust property for the liability.'

These provisions apply to all trusts whenever created but with respect to trusts created before 1 December 2013, they apply only after 1 December 2014, thus giving paid professional trustees a one-year window to resign from the trusteeship if they do not wish to have their ability to exonerate themselves prescribed.

Hong Kong has therefore gone beyond *Armitage* v *Nurse* by outlawing gross negligence exemptions for paid professional trustees. It will be interesting to see how trustees react to this and also whether the common law will arrive at this position in due course. Trustees should review the terms of their professional indemnity insurance policies. If those policies cover liability for gross negligence, yet the new law does not permit exoneration for such liability, interesting issues might arise.

Reservation of investment powers to settlor

This is perhaps the most significant amendment and for that reason I set it out in full.

'41X. Reserve power of settlor–
(1)A trust is not invalid only because of the person creating the trust (the settlor) reserving to the settlor any or all powers of investment or asset management functions under the trust.
(2)If a power or function referred to in subsection (1) has been reserved by the settlor, a trustee who acts in accordance with the exercise of the power or function is not in breach of the trust.
(3)If a trust was declared invalid by the court before the commencement date of the 2013 amending Ordinance, subsection (1) does not operate to revive the invalid trust on or after that date.
(4)Subject to subsection (3), if the validity of a trust (whenever created) is being questioned, the court may take into account subsection (1) in determining the validity.'

Subsection (1) seems clear enough. It resolves the vexed question of whether the reservation of the investment powers or asset management functions to the settlor of itself invalidates the trust. It is therefore welcome. However, 'any or all powers of investment or asset management functions under the trust' is not defined. Several questions therefore arise.

Does this expression include, for example, the power to supervise a wholly owned subsidiary of the trust that conducts a trading business? Does it mean that by reserving such a power to the settlor the trust deed can validly empower the settlor to, for example, effectively vote the trust's shares in the subsidiary on matters such as board composition etc? Would it help to define in the trust instrument 'powers of investment or asset management functions under the trust' to include such powers over a subsidiary? Of course, this provision cannot change a shareholder's rights as that is a matter of corporate law. But does this provision allow, as a matter of trust law, a trustee to reserve to the settlor the exercise of these shareholders' rights?

Subsection 41X(2) is where it gets even more interesting and throws up additional questions. What the section says is that a trustee who acts in accordance with the exercise of the reserved power is not in breach of trust. What does this really mean? For example, assume a trust deed were to reserve to the settlor all of its shareholder's powers over a subsidiary conducting a trading business and the trustee was instructed by the settlor to vote the subsidiary's shares to appoint a new board of directors who were obviously and hopelessly

ill-suited to the task and who subsequently ruined the business. Would the trustee be in the clear? The provision does not seek to exonerate trustees from liability for breach of trust; it provides that there is no breach of trust.

What if the trust held its investments directly and its terms reserved to the settlor all investment powers and pursuant to which the settlor instructed the trustee to place all of the cash on Black 8 at the Venetian in Macau? If the trustee acted in accordance with that reserved power direction from the settlor in these circumstances would he be completely in the clear? I assume of course in this question that Black 8 did not come up!

Could it be a valid part of the reservation of the investment powers or asset management functions to the settlor to appoint him as the trustee's attorney or is this a power to delegate that is dealt with by different rules and principles?

Can a settlor delegate powers validly reserved to him to others? I think not. The JCTLR lobbied hard to allow the reservation of all sorts of powers to the settlor (and others), but the Hong Kong government rejected this approach as too radical a departure from the classic role of the trustee. The amending Ordinance also introduced new powers to trustees to delegate specific investment functions to agents, custodians and nominees. But it placed conditions on such delegation, such as requiring the trustee to supervise the delegate and indeed to intervene in certain situations. I doubt, in view of this, that the legislative intent was to allow a settlor to freely delegate the powers reserved to him by the trust. Can the settlor of an existing trust whose terms do not reserve investments powers to himself now have the trustee exercise a power of variation of the trust terms to permit such a 'reservation'? Or is it not possible for a trustee to 'reserve' powers to a settlor once they are vested in him?

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Whatever the answers to these questions, there is no doubt that a properly reserved power to a settlor means the trust is not invalidated by that reservation and the trustee is not in breach of trust where he acts on the settlor's direction. This means that, as a general proposition, settlors can validly participate in the investment functions of a trust and trustees can safely do the settlor's bidding. No doubt academic writings and case law will evolve to define the boundaries of this section. It may be that these limitations will be built around the concept of the exercise of a reserve power being construed to mean 'the proper exercise of the reserved power'. I note that Singapore has the equivalent of s41X(1) but not s41X(2). In fact, I am not aware of any other jurisdiction that has an identical provision.

Subsection (3) and (4) of s41X makes it clear that the validity provisions apply to the pre-and post-1 December 2013 trusts except those declared invalid before 1 December 2013. Subsection (2) also applies to existing and future trusts. However, as stated earlier, the section itself does not empower a settlor to reserve a power to himself; it merely makes it clear that the reservation will not invalidate the trust. This leaves open the issue as to whether it is possible to reserve existing trustee

powers to settlors or whether the reservation, or at least the ability to later reserve powers, must be in the trust terms.

Forced heirship provisions

The next section in the amending Ordinance (s41Y) contains what are now standard provisions which state that a law relating to inheritance or succession of a foreign jurisdiction does not affect the validity of the transfer of any movable property to be held on trust provided the transferor had capacity under Hong Kong laws, the law of the transferor's domicile or nationality, or the proper law of the transfer.

A further requirement is that the transferee trust must be governed by Hong Kong law and the trustees must be resident in Hong Kong if individuals or, if corporate, either be incorporated or centrally managed and controlled in Hong Kong.

Abolition of the RAP and the REA

Both these rules no longer apply with respect to trusts that come into existence after 1 December 2013, except that certain restrictions on accumulations continue to apply to charitable trusts and the amendment does not affect the rule regarding the duration of non-charitable purpose trusts. The existing perpetuity and accumulation rules continue to apply to wills executed before 1 December 2013, but not to special powers of appointment where the instrument creating the power takes effect after 1 December 2013.

Court-free removal of trustees

Most modern trust deeds vest power in a protector or appointor to remove the trustee. Absent that power, beneficiaries would have to resort to court to remove a trustee. The new provisions apply only if there is no person nominated by the trust instrument (or enactment) for that purpose and all the absolutely entitled beneficiaries have full capacity and agree. The provisions stipulate the method of giving trustees notice, including the right to nominate successors, oblige the retiring trustee to make a deed appointing a successor and for the vesting of the trust property in the successor trustees. There are like provisions giving beneficiaries similar rights and powers where trustees become incapacitated. This is a welcome addition to the trust law.

New trustee powers of delegation

These are probably the most technically complicated provisions in the amending Ordinance and given that most modern trust deeds already provide very wide powers of this kind I will not examine them in any detail. They are to be found in the new Part IVA. The scheme of the new part follows very closely the English *Trustees Act 2000* and the Singapore provisions, and authorises the delegation of 'delegable functions' to certain persons. The permitted delegable functions for non-charitable trusts are essentially anything not relating to distributions from the trust, the appointment of trustees or the delegation powers themselves. Charitable trusts may delegate the execution of all decisions, the making of decisions relating to the investment of assets and fund-raising except where that entails carrying on a business.

Trustees may delegate to one or more of the trustees. Where they appoint agents they must set the terms of that agency and not unnecessarily allow the agent to sub-delegate, allow conflicts to arise or appoint beneficiaries as agents. There are special restrictions regarding the delegation of asset management functions that essentially require trustees to make such appointments in writing, provide the asset manager with a written investment policy statement etc. With respect to nominees and custodians, trustees have wide powers but the appointments must be in writing and the nominee or custodian must conduct that kind of business. Trustees are similarly required to set terms of appointment as they are with agents referred to above. The exercise of these powers is subject to the statutory duty of care.

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For the first time in Hong Kong, the provisions require trustees to review the performance of the agent, nominee or custodian and, in the case of the investment delegation, review the policy statement, and with respect to all such appointments review the appointment as regularly as is necessary and, if required, terminate the appointment. Where trustees fail to exercise their powers as prescribed they lose the statutory protection that relieves them from liability of the acts or omissions of the agent, nominee or custodian. The policy objective is to empower trustees to delegate appropriate functions to the right delegates on the correct terms but to oblige them to continue to supervise those delegates.

Conclusion

The amending Ordinance significantly modifies and improves Hong Kong trust law and is to be welcomed. While the amendments do not go as far as many offshore trust administration centres, whose endless modifications of the trust law have made the trust something that is 'all things to all men', I think it strikes a sensible balance between making it more adaptable to modern business needs yet not robbing it of its central characteristics, i.e. a relationship around property built on the principle of dual ownership and subject to obligations based on genuine notions of fiduciary duty.

Looking at the new law comparatively there is no doubt that it puts Hong Kong on an at least equal footing with Singapore which over-hauled its trust law almost ten years ago. Singapore and Hong Kong now have similar trust statutes that are both based on the English 1925 Act. However, Hong Kong has, where Singapore has not, abolished the RAP and the RAE, provided for a court-free mechanism for beneficiaries to remove trustees, put limitations of trustee exoneration and indemnity clauses and, possibly most significantly, relieved trustees from potential breach of trust where they follow directions from settlors who have investment powers and assets management functions reserved to them.

It is hoped that when settlors and their advisors survey the world for suitable laws to govern their trusts they will look hard at what Hong Kong can now offer in addition to its other jurisdictional strengths.

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