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Legal Update

Mayer Brown Achieved Successful Outcome In High-profile Trust Dispute: *Zhang Hong Li & Ors v DBS Bank (Hong Kong) Limited & Ors* [2019] HKCFA 45

Hong Kong Court Of Final Appeal Clarified Duties Of Trustees And Effect Of Anti-Bartlett Clauses

Introduction

Mayer Brown represented the appellants in the long-running case of *Zhang Hong Li & Ors v DBS Bank (Hong Kong) Ltd & Ors*, which has been closely followed by the trust and private wealth industry around the world as it raises important issues relating to duties of trustees and the effect of "anti-Bartlett" clauses in trust instruments.

On 22 November 2019, the Hong Kong Court of Final Appeal (CFA) handed down its judgment notwithstanding a post-hearing settlement between the parties because of the general public importance of the issues involved. The CFA confirmed the effect of the anti-Bartlett clauses in the case and stated that had the case not been settled, it would have unanimously overturned the decisions of the Court of First Instance (CFI) and the Court of Appeal (CA), both of which found liability against the trustee and the corporate director of the trust's private investment company (PIC) for breach of a "high level supervisory duty", notwithstanding the existence of the otherwise effective anti-Bartlett clauses.

The CFA's decision came as a huge relief as anti-Bartlett clauses have long been regarded as an effective tool and widely used to limit duties of trustees. Certainty over their effect is highly important to all stakeholders in the trust world.

Brief facts

The first and second Plaintiffs (respectively "P1" and "P2") are husband and wife. In 2004, P2 incorporated the fourth Plaintiff (Wise Lords), a BVI company to make investments with the family's wealth through a private banking account with the first Defendant (the "Bank"). P2 was the sole shareholder and director of Wise Lords.

In early 2005, P1 and P2 settled a trust under Jersey law, appointed the second Defendant (the "Trustee") as its trustee, with themselves and their two minor sons as beneficiaries (the "Trust"). P2 transferred the sole share in Wise Lords to the Trustee and herself was replaced by the fourth Defendant (the "Director") as the sole director of Wise Lords.

Despite setting up the Trust, P2 remained in control of Wise Lords' investments: By a Letter of Wishes to the Trustee, P1 and P2 expressed their wish for the Trustee to consult P2 in all matters and her recommendations were final; By an Investment Advisor Agreement, Wise Lords appointed P2 as its investment advisor; The Director granted P2 the authority to give investment directions to the Bank.

Importantly, the Trust Deed contained a set of comprehensively drafted clauses, which is commonly referred to as "anti-Bartlett" clauses, which seek to define and limit the scope of the trustee's duties. These clauses provided, among other things, that:

- The trustees are not under any duty to interfere in the business of any company in which the Trust is interested. They are not under any duty to supervise such company's directors, officers or other persons so long as the trustees do not have actual knowledge of any dishonesty. They can assume the business and affairs of such company are being carried on competently, honestly, diligently and in the best interests of the trustees until such time as they have actual knowledge to the contrary.
- The trustees are not under any duty to obtain any information regarding the administration, management or conduct of the business or affairs of any company in which the Trust is interested from the persons involved in the administration, management or control. They can assume that such information as is supplied to them is accurate and truthful unless the trustees have actual knowledge to the contrary.

After the Trust was settled, at the direction of P2, Wise Lords entered into numerous investment transactions and engaged credit facilities advanced by the Bank to leverage its investments. The Trustee and the Director reviewed and/or approved these transactions after they were entered.

When the financial crisis hit in August 2008, Wise Lords suffered significant losses from substantial foreign currency exposure, particularly in Australian dollars (AUD), and heavy leverage as AUD fell sharply against US dollars (USD).

Proceedings in the courts below

The relationship between the parties turned sour and the third Plaintiffs (the "New Trustees") were appointed to replace the Trustee. In February 2011, P1, P2, New Trustees and Wise Lords brought proceedings against the Bank, the Trustee, the Director and several other related parties.

The CFI dismissed all of the Plaintiffs' claims against the Bank and the other defendants, but found the Trustee and the Director liable for grossly negligent breaches of trust and fiduciary duty respectively and ordered them to pay equitable compensation to New Trustees and Wise Lords. Specifically, the CFI found that the Trustee and the Director failed to discharge their "high level supervisory duty" in allowing (i) the purchase of USD 83 million worth of AUD between 25 July and 5 August 2008; (ii) the increase of the credit facilities from USD 58 million to USD 100 million; and (iii) the purchase of three decumulators in August 2008 (collectively, the "Transactions").

Both sides appealed to the CA and both appeals were dismissed. The CA also refused to grant leave to either side to further appeal to the CFA. But the CFA granted the Trustee and the Director leave to appeal.

Key issues relating to duties

The key issues before the CFA were: (1) whether the Trustee and/or the Director owed the Trust and Wise Lords respectively a "high level supervisory duty", as found by the CFI and the CA; and (2) if so, whether there was a grossly negligent breach of applicable duties which warranted an award of equitable compensation.

"HIGH LEVEL SUPERVISORY DUTY" OR DUTY TO ACT PRUDENTLY?

The CFA held there was no "high level supervisory duty" in the case. The CFA explained that such a duty, "*which would require the trustee to query and disapprove of the transactions entered into by Wise Lords, thereby obviously interfering with [P2]'s management of the company's investment business which she had been duly authorised to conduct*" is inconsistent with the anti-Bartlett clauses in the Trust Deed; There was no actual knowledge of dishonesty, which was the only

exception provided in the Trust Deed requiring the Trustee to intervene.

In analysing the comments made by the Trial Judge in the CFI Judgment, the CFA also made it clear there are no free standing duties to "*act with due diligence, as would a prudent person, to the best of the trustee's ability and skill; and observe the utmost good faith*". Such language came from Articles 21(1) and (2) of the 1984 Trust (Jersey) Law. The CFA explained that these "*operates to lay down the **standards** which trustees must adhere to in executing their duties or in exercising their powers.*"

Where relevant duties are disapplied by anti-Bartlett clauses, the standards do not come into play.

RESIDUAL OBLIGATIONS?

The CFA further considered the CA's finding that the Trustee was under a non-derogable residual obligation to exercise available powers "*where no reasonable trustee could lawfully refrain from acting*", which the CA equated to the "high level supervisory duty" found by the CFI.

The reference of "*residual obligation*" was made in the evidence of one of the Jersey law experts, who commented that "*there is a residual obligation cast on the trustee which [the anti-Bartlett clauses] do not exclude*".

The CFA disagreed with the CA's interpretation of the expert's comment, which suggested the existence of a broad implied residual obligation arising outside of, and contradicting or overriding, the anti-Bartlett clauses in the Trust Deed. Instead, the CFA took the view that the Jersey law expert simply meant the anti-Bartlett clauses preserved an obligation to interfere where there is actual knowledge of dishonesty. The CFA warned that "*to postulate that the parties' chosen scheme may be overridden by some implied, non-derogable external duty arising in circumstances "where no reasonable trustee could refrain from exercising otherwise excluded powers" would be to introduce an amorphous and ill-defined basis for undermining a legitimate arrangement consciously adopted by the parties, exposing the trustees to unanticipated risks of liability and sowing confusion as to the extent of their duties*".

The CFA also specifically noted that the purported "residual obligation" is not to be equated with the "*irreducible core of obligations*", described by Millett LJ in *Armitage v Nurse* [1998] Ch 241; The "*irreducible core obligations*" consist of "*[t]he duty of the trustees to perform the trusts honestly and in good faith for the benefit of the beneficiaries*", but they do not include "*the duties of skill and care, prudence and diligence*"; They also do not posit some broad duty for the trustees to exercise available powers in circumstances "*where no reasonable trustee could lawfully refrain from exercising those powers*"; Importantly, they do not operate to override express terms of the Trust.

ASSUMPTION OF NON-DEROGABLE OBLIGATION THROUGH EXERCISE OF POWERS?

At the CFA, Counsel for New Trustees and Wise Lords advanced a further argument to justify the finding of breach of trust. It was argued that by choosing to exercise the power to supervise by approving Wise Lords' investments, the Trustee subjected themselves to the non-derogable obligations to exercise this power in accordance with the standards laid down in Article 21(1) of the 1984 Trust (Jersey) Law. The CFA rejected the argument.

Factually, the CFA held that the Trustee had not exercised any power of supervision, as the so-called "approvals" only took place after the relevant transactions had been fully executed and did not amount to any meaningful form of supervision. In addition, the CFA held that the anti-Bartlett clauses not only relieved the Trustee of their duties, they also restricted the Trustee's *powers* to interfere in the conduct of Wise Lords' business. The supervisory powers contended to have been exercised were as a matter of fact unavailable to the Trustee.

The CFA made it clear that one may not rely on a *power*, as opposed to a *duty*, to circumvent the anti-Bartlett clauses which relieve the trustees of their relevant duties. The CFA explained that "*for the exercise of a power to constitute a breach of trust, such exercise must occur in such an improper or deficient manner as to amount to violation of a duty on the part of the trustee. What starts off as a deficient exercise of a power must attain the status of a breach of duty if it is to found the equitable claim. Thus, on a proper analysis, the anti-Bartlett*

provisions cannot be avoided simply by asserting that the complaint relates to a grossly negligent exercise of a power."

THE DIRECTOR

Regarding the Director, the CFA held that it had not exercised any power of supervision for the same reason given in respect of the claim against the Trustee and there was no other basis to justify a high level duty on the part of the Director.

However, the CFA accepted that the Director could have been held liable if it could be shown to have failed in its fiduciary duties as a director of Wise Lords, which is discussed below.

ANY BREACH OF APPLICABLE DUTIES?

After considering the issue of existence of duty, the CFA moved on to consider the issue of breach.

In relation to the Trustee, the CFA remarked that, even if contrary to its holding, the Trustee was under a duty to supervise Wise Lords' investments instigated by P2, for the Plaintiffs' claim to succeed, they would still have to show that the Trustee's breach of duty constituted gross negligence, i.e. "*a serious or flagrant degree of negligence*". This is because exculpatory clauses in the Trust Deed protected the Trustee from liability for any acts or omission falling short of fraud, wilful misconduct or gross negligence. Regarding the Director, there are similar exculpatory provisions in the Service Agreement exempting liability and indemnities except "*in the case of gross negligence*".

The CFA questioned the CFI and the CA's failure to give reasons for their finding of gross negligence and held instead that no basis had been shown for concluding that approval of the Transactions constituted negligence to a "serious and flagrant degree" on the part of the Trustee and the Director.

Equitable compensation

Despite their findings of absence of duty and breach, the CFA still addressed the issue of relief on the basis of its importance.

The CFA disagreed with the CFI and the CA's approach to equitable compensation and held that even if the Trustee and the Director were liable, it was not a case of misapplication or loss of the trust property. Instead, the case involved a lack of skill or care causing diminution in the value of the Trust's assets, and as such the common law rules of causation, foreseeability and remoteness should apply to the assessment of equitable compensation. The CFA's analysis highlighted the importance of correctly identifying the nature of the breach in assessing equitable compensation for breach of duty.

Concluding remarks

The CFI and the CA's findings of a "high level supervisory duty" or "residual obligation" which could not be ousted by an otherwise effective anti-Bartlett clause raised alarm within the trust and private wealth industry. The CFA's decision confirming the effectiveness of anti-Bartlett clauses will therefore be welcomed by the industry.

It should however be noted that the result was mainly due to the specific set-up of the Trust and the existence of a set of comprehensive and well drafted anti-Bartlett clauses in the Trust Deed, which effectively limited and relieved the Trustee of the relevant duties. The case serves as a helpful reminder to trust participants about the importance of respecting the arrangements consciously adopted by the parties and the risk of treading outside the boundaries of such arrangements.

By way of practical guidance, trustees and directors of a PIC, and indeed all stakeholders in trust arrangements, should pay attention to the following:-

1. The importance of carefully drafted trust instruments, which give effect to the intention of the parties. Trustees should ensure that well drafted anti-Bartlett provisions are in place to avoid uncertainty over the scope of their duties.
2. Trustees and directors of a PIC should familiarise themselves with the provisions of the trust and corporate instruments, identify their powers and duties, ensure that applicable powers and duties are properly discharged and avoid unintended assumption of duties, which may not be subject to any anti-Bartlett provisions. Practitioners should consider reviewing existing practice and procedures to ensure compliance with the above.
3. Duties owed by directors of a PIC are different from duties owed by the trustees, though in practice they may perform similar functions in the operation of the PIC and execution of the trust.

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