The two-party rule and transactions between trusts with a common trustee

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Abstract

In the modern world, it is commonplace for individuals and companies, particularly professional trustee companies, to act as trustee in respect of more than one trust at the same time. Moreover, anecdotal evidence suggests that it is relatively common for such trustees to purport to give effect to loans and other transactions between trusts of which they are trustee. If that is the case, an important question arises as to whether it is fundamentally possible for a trustee of two trusts to give effect to transactions between the two trusts, notwithstanding the general rule (known as 'the two-party rule') that a person cannot contract with himself.

Suppose that a settlor settles two trusts and appoints a single professional trustee company as the sole trustee of both trusts. Two years later, the settlor writes to the trustee with a request that a loan be made from one trust to the other. The trustee might or might not see fit to accede to the request as a matter of discretion. However, there may be more fundamental questions for the trustee to consider, including in particular whether it is possible for such a loan to be made at all.

The two-party rule

The two-party rule states that, subject to statute, a person cannot contract with himself or convey property to himself and therefore a contract or conveyance purportedly entered into between a person and himself or between a person and himself and others is void. The rule is well illustrated by *Grey v Ellison*, where it was held that an insurance company that had purported to take out insurance with itself had not effected a policy of insurance at all. Sir John Stuart V-C described the difficulty as follows:

> What is produced is an instrument by which some members of this company agreed with other members of the company that, in a certain event, the company shall pay to the company a certain sum of money. It is only necessary to state the terms of such a contract to shew that it is merely an empty formality—an instrument that means nothing. Nobody could sue upon it; no remedy could be obtained in respect of an instrument of this sort by any one member of this company against any other member . . .[1]

It is clear, at least as a matter of English law, that the two-party rule applies notwithstanding that the single party to a transaction is acting in one capacity on one side of the transaction and in another capacity on the other. Thus in *Williams v Scott*, where a trustee of certain property purported to purchase that property in his personal capacity, it was said to be:

> clear undisputed law that a trustee for the sale of property cannot himself be the purchaser of it—no

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1. (1856) 1 Giffard 438, at 444.

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> person can at the same time fill the two opposite characters of vendor and purchaser,[2]

and in *Rye v Rye* it was common ground that, aside from under the statutory provisions discussed below, it was not possible for two owners of land to grant a tenancy of that land to a partnership in which they were the partners.[3] It is therefore apparent that the two-party rule is in principle applicable to transactions purportedly entered into by a trustee in his capacity as such with himself in his personal capacity, and to transactions purportedly entered into by a trustee in his capacity as trustee of one trust with himself in his capacity as trustee of another trust.

Statutory limitations on the two-party rule

In England, the two-party rule has been significantly qualified by statute. In particular, Section 72 of the Law of Property Act 1925 provides that a person may convey property to himself or to himself and another and Section 82 of the same Act provides that any covenant or agreement entered into by a person with himself and one or more other persons shall be construed and be capable of being enforced as if the covenant or agreement had been entered into with the other person or persons alone. Where English law applies, these statutory provisions will often enable a trustee who is aware of the two-party rule to avoid falling foul of it.[4]

However, other jurisdictions whose law is derived from or closely related to English law may not have equivalent statutory provisions. In addition, even in England, there are some single party transactions which will not be saved from the two-party rule by Sections 72 and 82. It is to be noted that Section 82 does not enable a person to contract with himself alone, which means that the transaction described in the introduction above would fall foul of the two-party rule even if English law applied to it. It is also to be noted that transfers of property otherwise than by conveyance will not generally fall within the scope of Section 72.[5]

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The importance of the two-party rule in the trusts context

Where the single party to a transaction is acting in a fiduciary capacity on at least one side of the transaction, the two-party rule is only one of a number of rules under which the transaction may be impugned. The other rules that are most relevant to such situations in the trusts context are:

- 'the genuine transaction rule', which states that a trustee's ordinary powers to sell or otherwise deal with trust property do not authorize the trustee to sell to or deal with a person with whom he cannot deal at arm's length (such as a nominee for himself) and that a sale or other transaction with such a person, while it may be valid at law, is void in equity;[6]
- 'the self-dealing rule', which states that a purported purchase of trust property by a trustee is voidable

2. [1900] AC 499, PC.
3. [1962] AC 496, HL, at 504.
4. In Jersey, the Fifth Amendment to the Trusts (Jersey) Law 1984 will, when it comes into force, deal more specifically with the problems posed by the two-party rule for transactions between trusts with a common trustee. A new Art 31(3) is to provide:

> . . . despite any other enactment or rule of law to the contrary, a person may in the capacity of a trustee of one trust enter into a contract or other arrangement with himself or herself in the person's capacity as a trustee of one or more other trusts.

5. As to the meaning of 'conveyance', see s 205 of the Law of Property Act 1925 and *Rye v Rye* [1962] AC 496, HL.
6. See *Lewis v Hillman* (1852) 3 HLC 607, at 629 to 630; *Ingram v IRC* [1997] 4 All ER 395, CA, at 425 (the dissenting judgment of Millett LJ was approved on appeal: [2000] 1 AC 293, HL).

at the instance of the beneficiaries, even if the purchase was effected by means of a public auction or through a process of negotiation between the purchasing trustee and his co-trustees;[7] and

- 'the no conflict rule', which states that a trustee must not put himself in a position where his duty as trustee conflicts with his interest or with another duty.[8]

The combined effect of the above rules is that, generally speaking, a transaction entered into by a trustee with himself in another capacity will not be allowed to stand irrespective of the operation of the two-party rule. However, it does not follow that the two-party rule is unimportant in the trusts context. On the contrary, there are at least three reasons why it may be critically important to determine whether a transaction contravenes the two-party rule or merely one or more of the other three rules referred to above.

First, there may be some situations in which the two-party rule applies but the other three rules referred to above do not or at least arguably do not. For example, suppose that a professional trustee company, T, is a trustee of Trust A and also a trustee of Trust B. Trust A has three other trustees apart from T. Trust B also has three other (different) trustees apart from T. The individual employees of T who deal with Trust A are different from the individual employees of T who deal with Trust B. Imagine that the trustees of Trust A purport to sell some trust property to the trustees of Trust B. The sale is proposed by and negotiated between the independent trustees of each trust and the sale price is in accordance with a valuation obtained from an independent third-party valuer. It would seem to be at least arguable that the transaction cannot be impugned under the genuine transaction rule, the self-dealing rule or the no conflict rule.[9] However, subject to the statutory provisions discussed above, the transaction does contravene the two-party rule.

Second, one important feature which the genuine transaction rule, the self-dealing rule and the no conflict rule have in common is that it is clear that their operation can be excluded by express provisions in the trust instrument.[10] By contrast, the operation of the two-party rule cannot, as such, be excluded in this manner. In *Napier v Williams*,[11] a testator by his will left certain land to trustees on trust. The will included a provision that purported to grant an option to CR, who was named one of the trustees of the will trust, to take a lease of the land on particular terms. After the testator's death, CR purported to exercise the option and the trustees (including CR) purported to grant a lease in his favour. Subsequently, CR assigned the lease to a company, which in turn assigned the lease to the trustees of a debenture trust. A dispute arose as to whether the trustees of the will trust could enforce the covenants contained in the lease against the trustees of the debenture trust. Warrington J held that the covenants, having been purportedly entered into in breach of the two-party rule, could not be enforced against the debenture trustees. This was so notwithstanding that the testator's will had purported to authorize CR and the other trustees to grant a lease containing covenants to CR.

Third, whereas the consequence of a breach of the genuine transaction rule is that the transaction in question is void in equity, and whereas the consequence of a breach of the self-dealing rule or the no conflict rule is that the transaction in question is voidable in equity, the consequence of a breach of the

7. See eg *Re Thompson's Settlement* [1986] Ch 99. It should be noted that the self-dealing rule is sometimes said to be an aspect of the no conflict rule.
8. See eg *Wright v Morgan* [1926] AC 788, PC.
9. See eg *Public Trustee v Cooper* [2001] WTLR 901 on the self-dealing rule and the no conflict rule. The rationale for the genuine transaction rule would appear not to apply where there has been a genuine arms' length negotiation.
10. In the case of the genuine transaction rule, this is inherent in the rationale of the rule, which focuses on whether the trustee is authorized to enter into a transaction of the type in question; see also *Lewin on Trusts* (18th edn, 2008) at 20–62. As to the self-dealing rule, see *Breakspear v Ackland* [2009] Ch 32, at paragraphs 114 ff. As to the no conflict rule, see *Edge v Pensions Ombudsman* [1998] Ch 512, at 540 (affirmed [2000] Ch 602).
11. [1911] 1 Ch 361.

two-party rule is that the transaction in question is void at law. This distinction may have important implications where third parties are involved.

The two-party rule in equity

The genuine transaction rule, the self-dealing rule, and the no conflict rule are rules of equity. By contrast the two-party rule is, at least primarily, a rule of law. However, commentators generally proceed on the basis that, although the two-party rule is first and foremost a rule of law, it is a rule which is nevertheless mirrored in equity. For instance, McPherson has argued as follows:

> In *Tito v Waddell (No 2)*, the self-dealing rule was said to apply 'if the trustee purchases trust property from himself'. This accords with orthodox formulations in standard English texts . . . What it overlooks is that you cannot make a contract with yourself . . . It is true that [the two party rule] is a rule of law; but it is not one that attracts the statutory provision that equity prevails over the common law, which applies only where there is a conflict or variance between equity and common law. There is no such conflict or variance here. In this respect equity follows the law. It does not insist that there is a contract where the law denies it. It follows that a trustee cannot purchase the trust property from himself; or, which is the same thing, sell it to himself.[12]

There is at least one sense in which it appears to be correct to state that equity does not insist that there is a contract where the law denies it: in a claim based squarely and exclusively on contractual rights, the two-party rule cannot be overcome merely by an appeal to equity.

In *De Tastet v Shaw*,[13] a member of a partnership who owed money on his partnership account purported to covenant with himself and his partners that he would pay the amount due. Following his death, a claim was brought against his executors by a third party and an issue arose as to whether his executors were entitled to recognize and rely upon the debt purportedly created by the covenant. Lord Ellenborough CJ held that they were not, and that the invalidity of the covenant was an obstacle that could not be surmounted merely by an appeal to equity.

In *Ellis v Kerr*,[14] a settlor assigned a policy of assurance to three trustees on the trusts of a marriage settlement and the settlor and two of the trustees purported to covenant with the three trustees to pay the premiums and maintain the policy. When the settlor and the two trustees who had given the covenant subsequently ceased to pay the premiums, the then third trustee sued the settlor and the other two trustees on the covenant. The two defendant trustees succeeded in having the action dismissed on the basis of the two-party rule, and Warrington J specifically rejected the plaintiff's argument that the covenant created an equitable debt that could be sued upon in the same way as a legal debt.[15]

However, it does not necessarily follow from the above that the two-party rule is a rule of equity as well as a rule of law, or that equity does not recognize single-party transactions as being capable of giving rise to equitable rights and obligations. There is another possible explanation for the cases discussed above, namely that single-party transactions are capable of giving rise to equitable rights and obligations but such rights and obligations simply cannot be enforced by way of an ordinary contractual claim. A closer look at the authorities suggests that the latter view is the correct one.

12. McPherson, 'Self-dealing Trustees' in Oakley (ed), *Trends in Contemporary Trust Law* (1996) at 136–7. See also *Lewin on Trusts* (n 10) at 20–59 ff and Underhill and Hayton, *Law of Trusts and Trustees* (18th edn, 2010) at 55.13 ff which, while not going so far as to state that the two-party rule applies in equity as well as at law, do not suggest that a fundamental distinction of type is to be drawn between the two-party rule and the equitable doctrines that prevent self-dealing by trustees.

13. (1818) 1 B & Ald 664.

14. [1910] 1 Ch 529.

15. See also *Boyce v Edbrooke* [1903] 1 Ch 836 and *Napier v Williams* [1911] 1 Ch 361.

In *De Tastet v Shaw* (discussed above) Lord Ellenborough CJ, while rejecting the suggestion that the executors could rely on the debt purportedly created by the covenant in an action brought by a third party, nevertheless contemplated that the debt could have been enforced as between the executors and the other partners by means of an action for an account. This implies that, notwithstanding the two-party rule, the dealings between the covenantor on the one hand and himself and his partners on the other gave rise to equitable rights and obligations.[16]

In *Ellis v Kerr* (discussed above), Warrington J, while dismissing the argument that a covenant entered into in breach of the two-party rule was directly enforceable in equity by means of an action on the covenant, specifically left open the possibility that such a covenant might give rise to equitable rights and obligations which could be enforced in some other manner (eg by an action for an account). He said:

> Now I want to guard myself . . . against being supposed to say that a decision in favour of the applicants in this case, though it would put an end to the present action, which is merely an action on the covenant, would entirely conclude the question whether in some other form of proceedings these two defendants may or may not be liable to somebody. The only question that I am asked to determine is whether they are liable to the plaintiff on this covenant. It is important to bear that distinction in mind, because in an action founded on . . . equitable considerations there may be a defence also on equitable considerations which might not be available as a defence to an action such as this is . . .

In Ellis v Kerr (discussed above), Warrington J, while dismissing the argument that a covenant entered into in breach of the two-party rule was directly enforceable in equity by means of an action on the covenant, specifically left open the possibility that such a covenant might give rise to equitable rights and obligations which could be enforced in some other manner

And in *Napier v Williams* (discussed above), the same judge went further and positively suggested that a transaction in breach of the two-party rule could give rise to equitable rights capable of being enforced as between trustees and beneficiaries. He said:

> At law then I think the plaintiffs' case ought to fail. Have they any better right in equity? It may be conceded that the relations between the lessee himself and his co-trustees and the beneficiaries, and the circumstances under which the lease was granted, would render him liable to perform the obligations which the lease purported to impose upon him . . .

The above cases show that judges have been careful to avoid suggesting that the two-party rule precludes single-party transactions from giving rise to equitable rights and obligations as between trustees and their co-trustees or beneficiaries or, as the case may, as between the partners in a partnership.

More concrete authority for the proposition that single-party transactions can give rise to or otherwise affect equitable rights and obligations may be found in *Space Investments Ltd v Canadian Imperial Bank of Commerce Trust Co (Bahamas) Ltd.*[17] In that case, a bank was the trustee of a number of settlements that contained a clause permitting the trustee to open and maintain savings accounts with any bank, including itself, and to deposit trust money to the credit of such account. The bank purported to deposit trust money with itself. When the bank subsequently went into liquidation, an issue arose as to whether the money which the bank had purported to deposit with itself was still trust property or was available for

16. See also the discussion of *De Tastet v Shaw* in *Ellis v Kerr* [1910] 1 Ch 529. See also *Boyce v Edbrooke* [1903] 1 Ch 836.

17. [1986] 1 WLR 1072, PC. See also *Re Waterman's Will Trusts* [1952] 2 All ER 1054, which could be read as suggesting that a trustee can make a loan to itself if authorized to do so by the trust instrument but could also be read as being concerned merely with the exclusion of personal liability arising out of such a transaction.

distribution among the unsecured creditors of the bank. The Privy Council held that the bank had been duly authorized by the trust instruments to deposit trust money with itself and that, when it did so, the money became the property of the bank in equity. Lord Templeman explained the effect of the transactions as follows:

> When M.B.T. as trustee lawfully deposited trust moneys with M.B.T. as banker pursuant to the authority in that behalf conferred by the settlement and the amount of the trust fund so deposited was credited to a trust deposit account, the beneficiaries interested under the trust did not become entitled to any interest in any asset or in all the assets of M.B.T. The sole right of the beneficiaries was for a sum equal to the amount standing to the credit of the trust deposit account, to be applied by M.B.T. in any manner authorised or required by the settlement or by law as and when M.B.T. decided to make such application in the proper exercise and discharge of its discretionary powers and duties in the due course of administration of the trust. If M.B.T. ceased to be trustee and a new trustee were appointed then it would be for the new trustee to decide whether to close the trust deposit account with M.B.T. and to require M.B.T. to pay to the new trustee the amount standing to the credit of the trust in the MBT trust deposit account. There would be nothing to trace.
>
> When M.B.T. became insolvent and went into liquidation the beneficiaries were entitled to obtain and have obtained the appointment of a new trustee in the place of M.B.T. The new trustee can only prove in the winding up of M.B.T. for the amount standing to the credit of the trust with M.B.T. in the trust deposit account at the date of liquidation. The claim of the new trustee will be as an unsecured creditor ranking pari passu with the claims of a customer proving for the amount standing to his credit with M.B.T. in the customer's deposit account.
>
> There is no justification for the intervention of equity. The settler has allowed trust money to be treated as if it were customers' money. The settler has allowed M.B.T. to appropriate trust money and to treat the trust money as belonging absolutely and beneficially to M.B.T. By depositing money with M.B.T. a customer accepted the risk of M.B.T.'s insolvency. By allowing M.B.T. to treat trust money as a deposit with M.B.T. the settler accepted the risk of M.B.T.'s insolvency. In these circumstances it would be inequitable if the trust were in a better position than the customer.

Lord Templeman did not discuss the two-party rule as such. Nor did he refer to the other cases discussed above, although one case in which *Ellis v Kerr* and *Rye v Rye* were discussed was cited in argument.[18]

It has been suggested that *Space Investments* shows that, although the terms of the trust instrument cannot exclude the two-party rule as such, they can remove the effect of the rule by enabling a trustee to deal with trust property in a way which frees the property from the trusts in favour of the beneficiaries.[19] That may be so, but in order to understand the true limits of the two-party rule in the trusts context it is important to consider why it is so. It seems clear that *Space Investments* cannot be read as deciding that the two-party rule is disapplied *at law* wherever the transaction in question is authorized in the relevant sense. If that were the case the rule would never apply to absolute owners of property. So the decision must depend upon a distinction between the position at law and the position in equity whereby a transaction which is void at law can nevertheless have some effect in equity.

> *It seems clear that Space Investments cannot be read as deciding that the two-party rule is disapplied at law wherever the transaction in question is authorized in the relevant sense. If that were the case the rule would never apply to absolute owners of property*

18. The case is *Rowley, Holmes & Co v Barber* [1977] 1 WLR 371, a decision of the Employment Appeal Tribunal which, insofar as it suggests that the two party rule (at law) does not prevent a person from contracting in one capacity with himself in another capacity, is inconsistent with other and higher authority.
19. *Lewin on Trusts* (n 10) at 20–61.

Once that is accepted, one is compelled to question whether the two-party rule really exists in equity at all. In light of *Space Investments* and the cases of *De Tastet v Shaw*, *Ellis v Kerr* and *Napier v Williams*, the better view appears to be that the two-party rule is merely a rule of law which is not, as such, mirrored in equity. On this view, whether a transaction with a self-dealing element is valid at law depends on the two-party rule, and whether such a transaction is valid in equity depends upon the genuine transaction rule, the self-dealing rule and the no conflict rule (but not the two-party rule).[20] The transactions in *Space Investments* were valid in equity because the genuine transaction rule, the self-dealing rule and the no conflict rule were disapplied by reason of the authority conferred by the trust instruments. The fact that the transactions were invalid at law (irrespective of the terms of the trust instruments) was not material to the outcome of the case.

It should be borne in mind, however, that there will be other cases in which the position at law will be decisive notwithstanding that the single party to the transaction in question was in a fiduciary position. Three particular situations are worthy of mention. First, a statute may focus the court's attention exclusively on the position at law. Thus in *Boyce v Edbrooke*,[21] where a life tenant of certain settled land had purported to grant a lease of the settled land to himself and two others, and one of the issues in the case was whether the lease contained certain covenants as required by the Settled Estates Act 1887, Farwell J held that the covenants required by the Act were legal covenants that could be sued upon at law 'and not some right which might, or might not, arise from equitable considerations'. Thus the position in equity was irrelevant. Second, there may be no equity between the parties in relation to the property in question. This may be the case where a dispute arises between a trustee and a stranger to the trust, or where a trustee acting in his personal capacity agrees to confer some additional benefit on the trust.[22] Third, the rights and remedies recognized in equity may be different from the rights and remedies available in relation to transactions which are valid at law. For example, in *Napier v Williams* (discussed above), it was contemplated that the invalid covenants had some effect in equity on the trustees of the debenture trust, in that if those covenants were not performed the trustees of the will trust were entitled to terminate the lease, but it was nevertheless held that those equitable rights were not sufficient to enable the trustees of the will trust to bring proceedings asserting personal liability on the part of the trustees of the debenture trust.

Implications for transactions between trusts with a common trustee

An individual or professional trustee company acting as trustee of more than one trust must always be careful to ensure, when considering giving effect to a loan or other transaction between trusts of which he or she or it is trustee, that the proposed transaction does not contravene the genuine transaction rule, the self-dealing rule or the no conflict rule (whether because transactions of the type proposed are specifically authorized by the trust instrument or otherwise). Subject to that, it would appear that in many cases the trustee's exposure to a claim by the beneficiaries ought not to be increased by reason of the fact that the transaction contravenes the two-party rule at law.

This can be illustrated by reference to the example of a loan between two trusts posed in the introduction above. In that example, the first issue which arises is that, unless both trust instruments specifically authorize the trustee to lend money to and borrow money

20. See also the judgment of Nourse LJ in *Sargeant v National Westminster Bank Plc* (1991) 61 P&CR 518, CA, which, while not containing any focussed analysis of the nature of the two party rule, is at least consistent with this view. The analysis of Millett LJ in *Ingram v IRC* [1997] 4 All ER 395 (approved on appeal: [2000] 1 AC 293) is also consistent with this view.

21. [1903] 1 Ch 836.

22. *Ellis v Kerr* [1910] 1 Ch 529 (discussed above) was such a case. Warrington J did not discuss whether an action for an account (as opposed to an action on the covenant) might have succeeded but it seems quite possible that such an action would have failed on the basis that there was no equity between the parties in relation to the trustees' promise to pay the premiums.

from other trusts of which it is trustee, the proposed transaction may well contravene the no conflict rule.[23] However, assuming that the proposed transaction does not contravene the no conflict rule, it seems that the two-party rule is unlikely to pose additional difficulties. The proposed transaction will, if carried out, be void at law. This implies the obvious further proposition that the trustee will not be able to sue itself for repayment of the loan, either in debt or for breach of contract. However, the transaction is capable of taking effect in equity. The lender trust will cease to have an equitable proprietary interest in the monies lent but will gain a personal right against the trustee to have an equivalent sum repaid out of the assets of the borrower trust. The borrower trust will gain an equitable proprietary interest in the monies borrowed but in due course the trustee will be entitled to repay the loan out of the assets of the borrower trust. The fact that the transaction is void at law does not matter, at least to begin with.

However, it is worth considering two potential issues that could arise further down the line. The first potential issue is what happens if the borrower trust becomes insolvent and unable to repay the loan. In such a situation an issue may arise as to whether the trustee is personally liable to repay the loan to the lender trust in full (and is merely entitled to an indemnity out of the assets of the borrower trust, whatever that may be worth) or whether the rights of the lender trust against the trustee are confined to the amount recoverable from the borrower trust. This is likely to depend on what the terms of the loan were expressed to be when it was made. Accordingly, if when it is considering making the loan the trustee is not willing to take the risk of the borrower trust's insolvency but considers it proper, as a matter of discretion, that the lender trust should take that risk, the trustee would be well advised to keep a clear documentary record that the loan is being made on that basis. The second potential issue is what happens when one or both trusts undergoes a change of trustee. Clearly, an incoming trustee of the lender trust needs to be able to enforce the loan and an incoming trustee of the borrower trust must be liable to have the loan enforced against it. However, it seems unlikely that a legal debt that did not exist while there was a single trustee is created spontaneously upon that trustee being replaced as trustee of one or other of the trusts. The solution where the original trustee retires as trustee of the borrower trust may be that the original trustee is entitled to require the incoming trustee to create a legal debt in favour of the lender trust but unless and until it does so the original trustee remains personally liable to the beneficiaries of the lender trust subject to a right of indemnity against the trust fund of the borrower trust. The solution where the original trustee retires as trustee of the lender trust may be that the incoming trustee is entitled to require the original trustee (in its capacity as trustee of the borrower trust) to create a legal debt in its favour.

Other types of transaction between trusts with a common trustee may similarly be possible notwithstanding the two-party rule, even where the statutory limitations on that rule which exist in England are not applicable. However, each transaction must be considered on its own facts. Particularly where a proposed transaction is complex or involves assets to which special rules often apply (such as land or shares) or is likely to involve or affect third parties, the two-party rule may be significant even if, on a proper analysis of the authorities, it does not exist in equity.

23. It should be noted, however, that even if the proposed transaction is not specifically authorized by the trust instruments it may, depending on the detailed facts, be arguable that the no conflict rule does not apply: see the discussion in *Public Trustee v Cooper* [2001] WTLR 901.