TORYS

NEW YORK TORONTO

ENFORCEMENT AGAINST THE ASSETS OF A BUSINESS TRUST BY AN UNSECURED CREDITOR

Canadian Business Law Journal
November 1998, Vol. 31, No. 1

by

David A. Steele

Andrew G. Spence

Copyright © Jacob Ziegel
Used with Permission
Further reproduction of the article in whatever form, except for the personal use of the viewer, is prohibited.

INTRODUCTION

Business trusts[1] are an increasingly significant part of the Canadian commercial landscape.[2] As with other forms of business organization,[3] it will often be necessary to borrow money and to enter into a range of different contracts in order to carry on the trust's business. It appears to be frequently assumed by many commercial lawyers and their clients that where a contract is entered into with the trustee of a business trust in the course of the administration of the trust: (1) the contract will constitute a binding obligation of the business trust[4] and (2) the assets of the business trust will be available to satisfy a claim by the other party in the event of a default under the terms of the contract. The scope of the ability of a creditor to reach the assets of a trust is, regrettably, a matter of some uncertainty. This article examines the law in this area and attempts to describe the circumstances in which an unsecured creditor may and may not be able to reach the assets of a business trust.

---

1 Timothy Youdan in his article "Business Trusts: Avoiding the Pitfalls" in *Estate Planning Institute* (Toronto: The Canadian Institute, June 5, 1995) at p.1 has noted that:

> There is no technical definition of a business trust. The term is used to cover a variety of types of trusts, such as mutual fund trusts, pension trusts and other trusts providing employee benefits, trusts used in the context of securitization arrangements, real estate investment trusts, and more generally, trusts which engage in trade or business.

The term "business trust" as used herein refers to any trust created to facilitate a particular commercial transaction or to further a particular commercial objective. See also Robert D. Flannigan, "The Nature and Duration of the Business Trust" (1982-84), 6 E.T.Q. 181, at pp.181-82.

2 Witness, for example, the recent proliferation of income trusts and real estate investment trusts. See, generally, Ian Karlegg, "Income Trusts Can Beat GICs but Beware Pitfalls" *The Financial Post* (10 July 1997) 25 noting that twenty-three income trusts "came to market" in the first six months of 1997 having an aggregate value of more than $3.79 billion. See also "A Building Revival in Real Estate" *The Financial Post* (22 February 1997) 44 and "There's More Money in Real Estate Paper than Bricks and Mortar" *The Financial Post* (28 February 1998) IG5.

3 As will be discussed at greater length *infra*, a trust is not a legal entity but rather is in the nature of an equitable obligation binding a person to deal with property over which he has control for the benefit of one or more other persons. See D.J. Hayton, *Underhill and Hayton: Law Relating to Trusts and Trustees*, 15th ed. (London: Butterworths, 1995) at p.1; *Tobin Tractor (1957) Ltd.* v. *Western Surety Co.* (1963), 42 W.W.R. 532 at p.542, 40 D.L.R. (2d) 231 (Sask. Q.B.) The relevant party in a transaction involving a business trust will ordinarily be the trustee.

4 As to what this may mean in the context of commercial opinions, see the discussion in W.M. Estey, *Legal Opinions in Commercial Transactions*, 2nd ed. (Toronto: Butterworths, 1997) at pp.342-52.

1. Preliminary Matters: The Personal Liability of the Trustee and the Trustee's Right of Indemnification from the Trust Property

A trust is not a legal entity.[5] As Timothy Youdan has suggested, considerable confusion about liabilities and obligations in the context of business trusts will (and does) arise where lawyers and their clients fail to appreciate this most basic proposition.[6] Youdan reminds us:[7]

> It is orthodox dogma that trusts do not engage in trade, business or anything else . . . [Trusts] do not exist as legal entities; rather, a trust is a relationship between the trustees and the beneficiaries with respect to the trust property. When, therefore, it is said that a trust has made a contract, or that it has taken part in some other transaction, what is really meant is that the trustees of the trust made such a contract or entered into such other transaction.

Robert Flannigan has noted to similar effect:[8]

> The business trust, like any trust, is not a legal entity unless made so generally or for certain purposes by legislation. A trust is a relationship or an obligation. The trust *per se* has no status as an entity which can acquire rights and obligations. Rather, the trustee alone exists as the subject of legal consequences. The trustee is a principal with respect to trust property and operations. The trust itself is simply an obligation on the trustee, the legal person, to deal with particular property for the benefit of others.

Where a trustee contracts with or otherwise incurs liabilities to third parties,[9] the trustee is ordinarily acting as a principal.[10] As a principal, the trustee incurs full personal liability to the third

---

[5] See *Kingsdale Securities Co. Ltd.* v. *M.N.R.*, 74 D.T.C. 6674 (F.C.A.) and *Ablan Leon (1964) Ltd.* v. *M.N.R.*, 76 D.T.C. 6280 (F.C.A.). Certain statutes do, however, deem trusts to be separate legal entities for a particular or limited purpose. The *Income Tax Act*, S.C. 1970-71-72, c.63, for example, treats trusts as legal entities and subjects them to taxation as "individuals."

[6] Youdan, *supra*, note 1, at pp. 1-2.

[7] *Ibid.*

[8] Flannigan, *supra*, note 1, at p.190.

[9] Maurice Cullity, in his article "Personal Liability of Trustees and Rights of Indemnification" (1996), 16 E.T.J. 115, has noted at p.127:

> The possibility that problems with, and liabilities to, persons other than beneficiaries will arise is likely to be significantly greater with business trusts than with most family trusts. Such trusts are less common than family trusts and this, no doubt, provides the explanation for the fact that, although some of the principles that govern a trustee's position *vis-à-vis* third parties are fundamental and clear, there has been very little Canadian or English jurisprudence on other important issues that have been addressed in courts in the United States and in Australia where business trusts were used extensively in the relatively recent past.

[10] There are situations, generally referred to as "bare trusts," where a trustee will also be acting as an agent. Maurice Cullity has noted that "[the] distinguishing characteristic of the bare trust is that the trustee has no independent powers, discretions or responsibilities" and that the only responsibility of the bare trustee "is to carry out the instructions of his principals - the beneficiaries." Maurice C. Cullity, "Liability of Beneficiaries - A Rejoinder" (1986), 7 E.T.Q. 35 at p.36. A contract made by the "bare trustee" may bind the beneficiaries as

party, unless the trustee has, by contract,[11] limited its personal liability. However, even absent such a limitation of liability, so long as the obligation or liability is incurred in the proper administration of the trust, the trustee will be entitled to indemnification out of the trust property. As Professor Waters has observed:[12]

> It would be an extraordinary system of law which did not permit trustees to recover their out-of-pocket expenses incurred in the discharge of their duties and powers under the trust, and in fact courts of Chancery were never in any doubt that the trustee was entitled to such indemnification. Lord Eldon's remarks on this subject in *Worrall* v. *Harford* [(1802), 8 Ves. 4 at p.8] summarized the position, and this case has been a leading authority in both England and Canada. "It is in the nature of the office of trustee", said Lord Eldon, "whether expressed in the instrument or not, that the trust property shall reimburse him all the charges and expenses incurred in the execution of the trust. This is implied in every such deed."

Where a trustee incurs a liability to a third party in the course of the proper administration of the trust the trustee may, rather than meeting the liability from its own personal resources and then reimbursing itself from the trust property,[13] apply the trust property directly in satisfaction of the liability.[14]

---

principals. See *Trident Holdings Ltd.* v. *Danand Investments Ltd.* (1988), 64 O.R. (2d) 65 (C.A.) and Paul M. Perrell, "Trusts and trustees - Beneficiary liability - Piercing the trust veil" (1989), 9 E.T.J. 97.

[11] As Cullity has commented, any limitation of liability must generally be provided for by contract since the third party will not be affected by any such limitation contained in the terms of the trust instrument unless such terms are expressly or impliedly incorporated into the contract. Cullity, *supra*, note 9, at pp.127-8. See also Maurice C. Cullity, "Legal Issues Arising out of the Use of Business Trusts in Canada," in T. Youdan (ed.), *Equity, Fiduciaries and Trusts* (Toronto: Carswell, 1989) at pp. 198-200.

[12] D.W.M. Waters, *Law of Trusts in Canada*, 2nd ed. (Toronto: Carswell, 1984), at p.943. The right of indemnification has been codified in provincial and territorial trustee legislation. See, for example, section 33 of the *Trustee Act*, R.S.O. 1990, c.T.23, which provides:

> A trustee is chargeable only for money and securities actually received, despite signing any receipt for the sake of conformity, and is answerable and accountable only for the trustee's own acts, receipts, neglects or defaults, and not for those of any other trustee, nor for any banker, broker or other person with whom any trust money or securities may be deposited, nor for the insufficiency or deficiency of any securities, nor for any other loss, unless the same happens through the trustee's own wilful default, and may be reimbursed out of or pay or discharge out of the trust property all expenses incurred in or about the execution of the trust or powers.

[13] This right of reimbursement is sometimes termed the right of recoupment. The trustee who discharges the obligation from his own personal resources is given an equitable lien over the trust property to secure its right of reimbursement: *Stott* v. *Milne* (1884), 25 Ch.D. 710, at p.715 and *Octavo Investments Pty Ltd.* v. *Knight* (1979), 144 C.L.R. 360 (H.C.A.). The trustee's entitlement to indemnification for liabilities properly incurred entitles the trustee to retain the trust property, or part thereof, until its claim for reimbursement has been satisfied: *Jennings* v. *Mather*, [1901] 1 K.B. 108, at pp.113-114, and *Stephenson* v. *Barclays Bank Trust Co. Ltd.*, [1975] 1 All E.R. 625 (Ch.D.), at p.637.

[14] The right to discharge a liability directly from the trust property has been referred to as the right of exoneration. Following the lead of H.A.J., Ford and W.A. Lee, *Principles of the Law of Trusts*, 3rd ed. (Sydney: The Law Book Company, 1990), at para. 14000, the rights of recoupment and exoneration are referred to herein, without

However, the trustee's right of indemnification will not apply where the trustee has misconducted itself in incurring the liability. A recent report by the Trust Law Committee in the United Kingdom explains the basis for this limitation:[15]

> Clearly, the interests of the beneficiaries cannot be prejudiced by letting [the trustee] get away with acting in breach of trust and charging this to the trust fund: what [the trustee] does improperly he must do at his own expense, a salutary sanction for the proper administration of trusts . . . Acting in breach of trust covers a multitude of sins ranging from an unauthorized delegation of investment management or title-holding, to entering into a type of contract not authorised by the trust instrument or only authorised if entered into for a particular purpose or if approved by someone (e.g. the settlor or a protector[16] or a sponsoring employer) or by all the trustees (rather than a majority, where majority decisions are the expressed norm), to entering into an authorised transaction but in breach of the degree of care required of a trustee.

Importantly, for reasons that will be discussed more fully in section 2 of this article, the trustee may lose its right of indemnification in relation to an obligation that was properly incurred because of an unrelated breach of trust:[17]

> If [the trustee] has committed a breach of trust, so that he owes money to the trust fund of an amount that equals or exceeds the amount to which he would otherwise be entitled by way of indemnity, he is not entitled to any indemnity out of the trust fund. It does not matter whether this breach of trust arose with respect to the transaction giving rise to the liability or arose before such transaction or after such transaction, though there is extra reason to bar [the trustee's] claim where his liability to pay compensation for breach of trust arose from such transaction.

The trustee's right of indemnification against the trust property may also be limited or eliminated by express provision in the trust instrument. The trust instrument may, for example, restrict the trustee's right of indemnification to only particular assets forming part of the trust property.[18] A more extreme

---

distinction, as the right of indemnification. See section 33 of Ontario's *Trustee Act*, *supra*, note 12.

[15] Trust Law Committee, "Rights of Creditors against Trustees and Trust Funds" (April, 1997), at p.5 (hereinafter referred to as the "*Trust Law Committee Report*"). The Trust Law Committee was established under the chairmanship of retired judge, Sir John Vinelott, to promote law reform in the trust area. For a discussion of the committee's origins and projects to date see Emma Ford , "Rights of creditors against trustees and trust funds" (1997), N.L.J. Annual Charities Review 28.

[16] A protector may be defined as "a non-trustee having powers in relation to trust property": Antony Duckworth, "Protector - Fish or Fowl" (1995), 4 J. Int. Trust and Corporate Planning 131. Protectors are most commonly found in the context of "offshore" family trusts. In this context, the protector is frequently used to act as a monitor over the foreign trustee and is given powers to intervene in the trust's affairs to ensure that the administration of the trust does not go seriously awry.

[17] *Trust Law Committee Report*, *supra*, note 15, at p.5. See, for example, *Re Johnson* (1880), 15 Ch.D. 548. As the Trust Law Committee notes at p.5, "This reflects the principle that a defaulting trustee cannot claim any beneficial interest before making good his default, e.g. *Doering* v. *Doering* (1889), 42 Ch.D. 203; *Re Dacre*, [1916] 1 Ch. 344, at p.347." See also, the discussion in Ford and Lee, *supra*, at para. 14060.

[18] See, for example, *Ex parte Garland* (1804), 10 Ves. 110; 32 E.R. 786.

case is where the trust instrument excludes the trustee's right of indemnification against the trust property altogether.[19]

To complete the picture, it is important to consider whether the trustee may be entitled to claim indemnification from sources other than the trust property. Suppose, for example, the trust property is insufficient to provide complete indemnity for the trustee against a liability the trustee has properly incurred. A trustee is not generally entitled to indemnification from the beneficiaries of the trust. A trustee will, however, be entitled to indemnification from the beneficiaries in the following limited circumstances:

(a) where the trust instrument provides for such indemnification;

(b) where a beneficiary or beneficiaries has contracted with the trustee to provide such indemnification;

(c) where a beneficiary of full capacity has requested the trustee to become the trustee or to incur a particular liability;[20] and

(d) where there is a single capacitated beneficiary.[21]

As the authors of the *Trust Law Committee Report* note, a trustee will not, in the absence of an express contract between the settlor and the trustee providing for indemnification, have a personal right of indemnification against the settlor except where the settlor is itself the beneficiary, so that from its request to the trustee to act as the trustee for the benefit of the settlor, a promise by the settlor to reimburse the trustee for any liabilities incurred by the trustee may be inferred.[22]

From the perspective of the trustee, therefore, if the assets of the trust are inadequate to indemnify the trustee fully against a liability it has incurred, the trustee may be forced to fund the

---

[19] *RWG Management Ltd.* v. *Corporate Affairs Com'r*, [1985] V.R. 385 (S.C.Vic.). As the Trust Law Committee points out, citing *Re Johnson*, *supra*, note 17, equity will disregard a provision in a trust instrument that removes a trustee's right of indemnification against the trust property where such provision is fraudulently intended to frustrate the derivative claims of the creditors of the trustee. The nature of the trust creditor's derivative claim is considered in detail in section 2 of this article.

[20] *Ex parte Chippendale, Re German Mining Co.* (1854), 4 De G.M. & G. 19. Where there is more than one beneficiary so liable the beneficiaries must indemnify the trustee based on their proportionate beneficial interests: *Matthews* v. *Ruggles-Brise*, [1911] 1 Ch. 194.

[21] *Hardoon* v. *Belilios*, [1901] 1 A.C. 118 (P.C.). The Privy Council in *Hardoon* concluded that where a trustee held property on trust for a sole beneficiary of full capacity "the right of the trustee to indemnity against liabilities incurred by the trustee by his retention of the trust property has never been limited to the trust property; it extends further, and imposes upon the *cestui que trust* [i.e. beneficiary] a personal obligation enforceable in equity to indemnify his trustee." The precise scope of the *Hardoon* principle is uncertain. The principle has, however, been applied to trusts having multiple *sui juris* beneficiaries. See, for example, *J.W. Broomhead (Vic.) Pty Ltd. (in liquidation)* v. *J.W. Broomhead Pty Ltd.*, [1985] V.R. 891 (S.C. Vic.). See also, the discussion of the scope of the principle in the *Trust Law Committee Report*, *supra*, note 15, at pp.4-5, Youdan, *supra*, note 1, at pp.14-15 and A.H. Oosterhoff, "Indemnification of Trustees: The Rule in *Hardoon* v. *Belilios*" (1980), 4 E.T.Q. 180.

[22] *Trust Law Committee Report*, *supra*, note 15, at p.4. See *Balsh* v. *Hyam* (1728), 2 P. Wms. 453.

shortfall out of its own personal assets.[23] As noted above, the trustee will only be entitled to look to the beneficiaries or the settlor in very limited situations.

2. The Indirect Claim: Subrogation of the Creditor to the Trustee's Right of Indemnity

Suppose a lender, L, makes an unsecured loan of $1,000 to a trustee, T. Suppose also that T is empowered to borrow under the terms of the trust instrument and that this particular borrowing is properly made in the administration of the trust. If T defaults in making repayment of the loan, whom does L sue and what are L's possible sources of recovery? As discussed above, in the usual case, a trustee contracts with a third party as a principal and not as an agent for the beneficiaries.[24] Accordingly, L's claim will be brought against T alone. If T has adequate personal resources to satisfy L's claim then L will not need to concern itself with the question of what other sources of funds may be available to satisfy its claim.[25] L may levy judgment against T's personal assets.

What is L's position if T is insolvent, however? Will L be able to reach the personal assets of the beneficiaries of T's trust? As discussed in section 1 of this article, it is only in quite limited circumstances that a trustee will be entitled to indemnification from the beneficiaries of its trust. Canadian authorities are clear, however, that even in circumstances where a trustee will be entitled to claim personal indemnity against the beneficiaries, creditors of the trustee will not be subrogated to the trustee's right of indemnification.[26]

Will L be able to seek redress directly from the assets of the trust? The orthodox position in Commonwealth jurisdictions is that a creditor of a trustee cannot have a direct claim against the trust property and may only reach the trust property through the trustee's right of indemnification out of the

---

[23] Youdan, *supra*, note 1, at pp.3-4, explained the justification for this, quoting from Scott and Fratcher, *The Law of Trusts*, 4th ed. (Boston: Little, Brown & Co., 1993), vol. IIIA ("*Scott on Trusts*"), at pp. 421-422:

> If the trustee has not so contracted as to exclude his personal liability, he is personally liable even though the trust estate is insufficient to indemnify him. It may be hard upon the trustee in such a case, but he has voluntarily assumed the obligation. He is in the best position to know when he makes the contract whether the trust estate is sufficient to indemnify him, certainly in a better position than the third person with whom he contracts. If the third person has relied upon the personal liability of the trustee, it would be an injustice to him to deprive him of his remedy against the trustee merely because the trustee cannot be reimbursed out of the trust estate. If the trustee is unwilling to assume the risk that the estate will be insufficient to discharge the obligation, and if the third person is willing to assume the risk, it is always possible to provide in the contract that the trustees shall not be personally liable but that the third person shall look only to the trust estate.

As Youdan notes, the ability of the trustee to limit its liability when contracting with third parties, therefore, becomes a matter of great significance for the trustee. See Youdan, *ibid*., at pp.6-9 and Cullity, *supra*, note 9, at pp.128-134 for a discussion of the drafting of provisions intended to limit a trustee's liability.

[24] See the discussion *supra*, at note 10 and the corresponding text. The trustee does not contract as an agent for the trust either. As discussed above, a trust is not a legal entity.

[25] Assuming that T has not successfully limited its personal exposure by contract with L.

[26] *Williams* v. *Balfour* (1890), 18 S.C.R. 472. See, however, the recent unreported judgment in *John W. Harvey Real Estate Company Limited* v. *Baker* (5 December 1997), Toronto C24746 (Ont. C.A.).

trust property.[27] Under this analysis, the creditor's claim, being derivative in nature, is subject to any limitations attaching to the trustee's right of indemnification against the trust property.[28] As described in section 1 of this article, various actions on the part of the trustee, including committing a default that is subsequent and unrelated to the transaction at issue, may result in the loss or impairment of the trustee's right of indemnification.

To return to our hypothetical, if T is insolvent and its right of indemnification against the trust property is intact, L will be able to seek recovery against the trust property through T's right of indemnification. If, however, T has committed an unrelated breach of trust and is indebted to the trust fund for the sum of $600, T will only be entitled to be indemnified to the extent of the difference between its obligation to L and the sum that T owes to the trust fund, namely, $400. In substance, there is a set-off of any amount owed by T to the trust fund against any amount owed to T on account of expenses or liabilities properly incurred by T in the course of administering the trust.[29] If L's only right of recourse in the circumstances is through its subrogated claim, the result is manifestly harsh from L's perspective. The authors of the *Trust Law Committee Report* have observed:[30]

> It seems particularly hard on [the creditor] that, although it can check that no limitation on [the trustee's] rights of indemnity appears in the trust instrument and that

---

27 See, for example, Cullity, *supra*, note 9, at pp.130-131. As Estey points out, although the creditor's claim is sometimes referred to as a right of subrogation, that is, a right to "step into the shoes" of the trustee to assert its right of indemnification, "[it] is more accurate to describe the third party's right as a right to seek an order for specific performance against the trustee to compel it to apply trust assets in satisfaction of the third party's claim..." *Supra*, note 4, at p.347, footnote 91. See *Ex parte Edmonds* (1862), 4 De G.F. & J. 488 and *In re British Power Traction and Lighting Co. Ltd.*, [1910] Ch. 470. In the Australian case, *Re Suco Gold Pty. Ltd.* (1983) 33 S.A.S.R. 99 it was held that the right of indemnity of a corporate trustee in liquidation was property subject to appropriation by the liquidator. It was held, however, that proceeds realized by exercise of the indemnity right were only available for distribution among trust creditors and not the general creditors of the trustee. See the discussion of *Re Suco Gold* in B.H. McPherson, "The Insolvent Trading Trust" in P.D. Finn, ed., *Essays in Equity* (North Ryde, N.S.W., Law Book Co., 1985), at pp.153-154.

28 The authors of the *Trust Law Committee Report*, *supra*, note 15, comment at p.6:

> Because [the creditor's] right is a derivative right it is subject to all the limitations . . . relating to [the trustee's] right of indemnity. However, if the only limitation be the indebtedness of T1 [i.e. to the trust estate], where there are two trustees, T1 and T2, then [the creditor] can take advantage of T2's right of indemnity.

See, as an illustration, *Re Frith*, [1902] 1 Ch. 342.

29 One modern authority, *Re Staff Benefits Pty. Ltd. and the Companies Act*, [1979] 1 N.S.W.L.R. 207, a decision of the New South Wales Supreme Court, seems to suggest, in *obiter*, that in order to bar a creditor's claim, the trustee's default must be related to the subject-matter of the creditor's claim. The authors of the *Trust Law Committee Report*, *supra*, note 15, in discussing this case, comment at page 6:

> Fragmentation of the state of accounts between [the trustee] and the trust fund seems illogical. Logically, to the extent [the trustee] cannot recover, [the creditor] should not be able to recover.

Another authority has suggested that the court in *Re Staff Benefits* may have been excluding only breaches of trust that caused no loss to the trust estate or breaches that actually benefited the trust estate: Ford and Lee, *supra*, note 14, at para. 14060.

30 *Trust Law Committee Report*, *ibid*. See, generally, *In re British Power Traction and Lighting Co. Ltd.*, *supra*, note 27.

> the transaction between [the creditor] and [the trustee] is an authorised type of transaction, it may yet fail in its claim against the trust assets, either because [the trustee] failed to exercise the requisite degree of care in dealing with [the creditor] (or otherwise exercised his powers improperly) or because in some subsequent, totally unrelated transaction (or even in some secret earlier unrelated transaction) [the trustee] incurred a liability to the trust fund of an amount exceeding [the creditor's] claim. The former ground of failure means that if [the creditor] wishes to be able to fall back on a claim against the trust fund it must take steps to prevent [the trustee] from entering into a bad bargain with [the creditor] in breach of [the trustee's] equitable duty of care (or otherwise exercising his powers improperly), so placing [the creditor] in a position analogous to that of a fiduciary vis-a-vis [the trustee]! To [the creditor] this will seem preposterous, like the latter ground of failure where [the creditor] has no possible power to discover or do anything about such a fortuitous future event.

An American authority has noted to similar effect:[31]

> There is no question that the creditor should be permitted to reach the trust estate where the trustee is entitled to exoneration out of the trust estate. The only question is whether his power to reach the trust estate should be limited to the extent to which the trustee is entitled to exoneration. Where the trustee exceeded his powers in incurring the liability and no benefit was conferred thereby upon the trust estate, it seems unobjectionable to deny the creditor a right to reach the trust estate. But where the trustee acted within his powers in incurring the liability or where, although he exceeded his powers, a benefit was conferred upon the trust estate, it seems unjust to the creditor to deny him a recovery out of the trust estate merely because in some other matter the trustee has committed a breach of trust subjecting him to a surcharge. Although the trustee's right of exoneration is thereby cut down or extinguished, the creditor is in no way responsible for that. It would seem that the creditor should be entitled to reach the trust estate not merely indirectly through the trustee's right of exoneration, but even where the trustee is not entitled to exoneration.

If it is correct that an unsecured creditor of a trustee will only have recourse to the trust property through a claim of subrogation to the trustee's own right of indemnity against the trust property, then the law is not simply unfair from the creditor's perspective but is also quite clearly at odds with the expectations of commercial parties generally. As business trusts proliferate, this is obviously a matter of no small importance.

Consider the case of a real estate investment trust or "REIT", as they are commonly known. A REIT is ordinarily established by a declaration of trust. The typical declaration of trust will include a provision stating that creditors shall not have recourse against either the unitholders (i.e. the beneficiaries) or the trustees[32] personally but rather will have recourse only to the assets of the trust. In addition, any contract between the trustees of the REIT and a third party will likely repeat such limitations on the creditor's rights of recourse or will incorporate the relevant provisions of the declaration of trust by reference into the contract. If the creditor's only ability to reach the assets of the REIT is through the derivative claim, the creditor would have no other recourse if the trustees have lost

---

[31] *Scott on Trusts*, *supra*, note 23, at p.478.

[32] REITs typically have a board of individual trustees. Trust companies are generally unwilling to serve as trustees of REITs because of concerns about potential environmental liability associated with holding real property.

their rights of indemnity against such assets.[33] If a court were to accept this proposition (which this article concludes would be unlikely in circumstances involving a business trust), then the unsecured borrowings or issuances of debt by the trustees of a REIT may not be enforceable according to their terms. If a creditor of the trustees of a REIT were to be denied recovery from the assets of the REIT in the scenario just described the result would clearly be contrary to the expectations of all parties to the transaction. It is apparent that the drafters of the declarations of trust establishing REITs intend and assume that creditors will have recourse to, and only to, the assets of the REIT.

The remainder of this article considers whether, and ultimately concludes that, in most circumstances involving a business trust such as a REIT a creditor of a trustee may reach the assets of the trust other than by means of a subrogated claim.

3. Direct Claims by Unsecured Creditors Against the Assets of Business Trusts

As has been suggested above, the proposition that an unsecured creditor of a trustee of a business trust will only have recourse against the assets of the trust on the basis of a derivative claim through the trustee's right of indemnity is highly unsatisfactory from a commercial viewpoint. Although this proposition is frequently recited in English and Canadian trust literature,[34] there is no English or Canadian authority that squarely applies the proposition in the context of a modern business trust. The law in this area is much further developed in the United States and its development there is well summarized in the leading U.S. treatise *Scott on Trusts*.[35] The authors of *Scott on Trusts* note three principal exceptions to the proposition recited above that will permit a third party to whom a trustee has incurred an unsecured liability[36] in the administration of the trust to recover directly from the assets of the trust. These three exceptions and the key American authorities in support thereof are discussed below together with a brief description of some emerging trends in the American law and statutory

---

[33] Cullity has argued that a liability limiting provision that states that the trustee shall have no personal liability and that the liability shall be limited to the assets of the trust cannot be interpreted literally. Cullity suggests that it is impossible for the trustee, as a party to the agreement, to contract on a basis of no personal liability. Since a trustee contracts as a principal and not as an agent, Cullity asserts that the trustee must in all cases be bound personally. Cullity concludes that the only way to interpret a provision such as this, which manifests such a clear intention to limit the recourse by the other party to the assets of the trust, is that it limits the trustee's liability to the extent that the trustee is entitled to be indemnified out of the trust property. Cullity, *supra*, note 9, at pp.130-131. Even without an exclusion of personal liability, a personal claim against the trustees of a REIT will be of limited value since the trustees are individuals. The ability of a trustee to limit its liability in a contract is discussed in more detail in section 3 below.

[34] See, for example, Cullity, *supra*, note 9 and *Underhill and Hayton: Law Relating to Trusts and Trustees*, *supra*, note 3, at pp.787-788. See also, the Law Reform Committee (U.K.), 23rd Report, "The Powers and Duties of Trustees" (1982) at pp.7-11.

[35] *Supra*, note 23. An Australian author writing in 1993 has noted, in contrast to the American literature, that "It is a strange feature of the English and Australian law of trusts that although various rights and powers have been recognised there has been little attempt to state systematically all the rules that regulate the relationships between trustees and third parties." J.D. Merralls, "Unsecured Borrowings by Trustees of Commercial Trusts" (1993), 10 Aus. Bar Rev. 248, at pp.254-255. The situation has changed to some extent with the publication of the *Trust Law Committee Report*, *supra*, note 15.

[36] This article focuses on claims by unsecured creditors. It should, however, be noted that, where the trust instrument permits, a trustee may grant a creditor security over some or all of the trust assets. In these circumstances, the creditor will have direct recourse to the secured assets, subject to the perfection of the security interest. See *Trust Law Committee Report*, *supra*, note 15, at p.8.

reforms in this area. In reviewing these exceptions, this article suggests that the current Anglo-Canadian case law does not preclude the possibility of a Canadian court recognizing these exceptions and argues that a Canadian court should indeed do so, in order to bring this area of the law into accord with modern business realities, and, most importantly, into conformity with the reasonable expectations of commercial parties.

Exception 1: ***The creditor is entitled to obtain satisfaction of its claim out of the trust estate if and to the extent that the trust estate has been benefited by the transaction out of which the creditor's claim arose, even though the trustee is not entitled to indemnity out of the trust estate*.**[37]

This exception is founded on restitutionary principles: if the trust estate is enriched at the expense of a third person, it would be inequitable to deny the third person a recovery from the trust estate.[38] *Restatement (Second) of the Law of Trusts*[39] provides at §269 that "a person who has conferred a benefit on the trust estate and cannot obtain satisfaction of his claim out of the trustee's individual property can by a proceeding in equity reach trust property and apply it to the satisfaction of his claim to the extent to which the trust estate has been benefited, unless under the circumstances it is inequitable to allow him such a remedy." As the authors of *Scott on Trusts* note, where the creditor has an adequate remedy in an action at law against the trustee personally, the creditor will not be permitted to maintain a restitutionary claim in equity to reach the trust estate.[40] However, where the trustee is insolvent, so that the creditor cannot obtain satisfaction from the trustee, the creditor can reach the trust estate by a proceeding in equity to the extent to which the trust estate is benefited.[41]

The preponderance of American authorities suggests that this exception will be available even though the trustee is not entitled to indemnification from the trust assets, either because the trustee has exceeded its authority in incurring the obligation or because the trustee is in default to the trust estate.[42] So, for example, where a trustee, although not authorized to do so, borrows money from a third person and uses the borrowed money to discharge encumbrances upon the trust property, the lender, although not entitled *to enforce the contract* to repay him out of the trust estate, is entitled *to repayment* out of the trust estate to the extent to which it has been benefited through the use of the loaned money.[43]

---

[37] *Scott on Trusts*, *supra*, note 23, at p.480.

[38] *Ibid*.

[39] *Restatement (Second) of the Law of Trusts* (St. Paul, Minn.: American Law Institute, 1959). Hereinafter referred to as the "*Restatement of Trusts*".

[40] *Ibid*., at pp.480-481.

[41] *Ibid*., at p.481.

[42] *Ibid*., at p.481. See the numerous authorities cited at p.482. The authors of *Scott on Trusts* submit that such recovery should be permitted whether or not the creditor has notice that the trustee is exceeding its powers in incurring the liability and argue that "[the] trust estate should not be permitted to be unjustly enriched at the expense of the third person, except where the third person acts officiously in conferring the benefit upon the estate." *Ibid*., at p.483.

[43] *Ibid*., at p.483. See, for example, *Griley* v. *Marion Mortgage Co.* (1938), 132 Fla. 299, 182 So. 297, (1939) 135 Fla. 824, 185 So. 734 (S.C.Fla.); *McLoughlin* v. *Shaw* (1920), 95 Conn. 102, 111 A.62 (S.C. Errors Conn.); and *In re Estate of Manning* (1907), 134 Iowa 165, 111 N.W. 409 (S.C. Iowa).

Some support for this restitutionary exception may also be found in English and Canadian cases.[44] The authors of the *Trust Law Committee Report* comment that "[in] England, it is clear that the proceeds of *ultra vires* borrowings may be recovered by the lender to the extent that the trust fund is benefited, but the precise scope of this exceptional case is very much in course of development, though better established in the United States."[45]

Weldon v. *Canadian Surety Co.*[46] is an interesting Nova Scotia case involving a trustee creditor reaching the trust property on a restitutionary basis. The plaintiff, a solicitor, was retained by the administrator of a decedent's estate to provide legal services in connection with estate administration. The administrator failed to pay the plaintiff's fees when demanded and the plaintiff sued for and obtained a default judgment against the administrator. The plaintiff was, however, unable to realize on the judgment against either the administrator or the estate, which had been fully distributed to the administrator as the sole beneficiary. The plaintiff then brought an action against the defendant as surety under an administration bond. The plaintiff's ability to recover under the bond required him to show that he had a cause of action "against the estate" and that the administrator was in breach of the bond. The court held that the administrator was in breach of his duty to administer the estate properly - in part because of his failure to pay the plaintiff - and, hence, was in breach of the bond. The court, however, also concluded that the administrator had lost his right of indemnity against the estate because he had improperly converted the assets of the estate to his own use. The court commented:[47]

> The fact . . . that the administrator's creditors are subrogated only to the administrator's right of indemnity, creates a conceptual block to the creditor's recovery where the administrator has wasted or converted the assets, because, in that case, he has no right of indemnity . . . That is the case here, so that if the right of indemnification is the sole avenue of approach to the assets that the creditor can use, he is effectively blocked from them where the right of indemnification has been forfeited.

The court, however, found another "avenue of approach" on principles of unjust enrichment:[48]

> In the instant case, there is adequate cause for the performance of the services of the solicitor and these have benefited not only the administrator personally, but the estate . . . Perhaps I should add that, where I say the solicitor's services have benefited the estate, I am not talking of the estate as if it were a legal person, but merely as a convenient way of describing the ultimate owners of it after all just claims have been met. Indeed, in the case of an insolvent estate, such claimants may turn out to be

---

44 See, for example, *Devaynes* v. *Robinson* (1857), 24 Beav. 86 (Ch.) and *Vyse* v. *Foster* (1872), 2 Ch. 309. See *contra Re Evans* (1887), 34 Ch.D. 597. Some of these cases suggest, however, that the creditor's claim in such circumstances will be a derivative claim - *i.e.*, the creditor will be subrogated to the trustee's right of indemnity which in turn is limited to the extent of the benefit conferred on the trust fund. See also *Ex parte Chippendale*, *supra*, note 20 and H.A.J. Ford, "Trading Trusts and Creditors' Rights" (1981-82), 13 Melb. U.L. Rev. 1 at pp.15-18.

45 *Trust Law Committee Report*, *supra*, note 15, at p.7. Note that the authors of the *Report* describe the creditor's right in such circumstances as being "a direct non-derivative claim in equity to reach the trust assets to the extent that [the creditor] enriched or benefited the trust fund at its own expense." *Ibid*.

46 (1966), 64 D.L.R. (2d) 735 (N.S.Co.Ct.).

47 *Ibid*., at p.748.

48 *Ibid*., at p.750.

> ultimate owners in the sense that they will be the only beneficiaries. In this case, the estate has reaped an unjust enrichment by the act of the administrator in failing to pay his solicitor and in transferring the funds that might have paid him into the residue and then into his own hands as beneficiary.

While the restitutionary claim represents an important exception to the proposition that an unsecured creditor will only be able to reach trust assets on a subrogated basis, it has significant limitations from the perspective of the creditor. Most notably, because the extent of recovery is limited to the extent to which the trust fund is benefited, as opposed to the extent of the creditor's loss, the creditor is unlikely to be made whole under such a claim.[49] From the commercial lawyer's perspective, the restitutionary claim is obviously a very uncertain foundation on which to deliver an opinion that an unsecured borrowing is enforceable in accordance with its terms.[50]

Exception 2: ***The creditor is entitled to obtain satisfaction of its claim out of the trust estate if by the terms of the trust instrument it is provided that such claims shall be paid out of the trust estate*** .[51]

The authors of *Scott on Trusts* comment:[52]

> It has been held in a number of cases that where in the proper administration of a trust the trustee makes a contract with a third person, the third person is entitled to obtain satisfaction of his claim out of the trust estate, the court laying stress upon the fact that the settlor had manifested an intention that such claims should be paid out of the trust estate. Thus where a trust is created under which the trustee is authorized or directed to carry on the business, it has been held that the settlor thereby indicates an intention to subject the trust property employed in the business to the payment of liabilities incurred by the trustee in carrying on the business. If the settlor manifests an intention to subject the whole of the trust estate to the payment of obligations incurred by the trustee in carrying on a business and not merely the property used in the business, creditors can reach any part of the trust estate.

It will be a question of interpretation of the trust instrument whether and to what extent the settlor manifests an intention to confer power to reach the trust estate in favour of persons to whom liabilities are incurred in the administration of the trust. The *Restatement of Trusts* provides at § 270:[53]

> A provision in the trust instrument that the trustee shall not be personally liable for expenses incurred in the administration of the trust is ordinarily interpreted as manifesting an intention to confer upon creditors a power to reach the trust estate. If a trust is created to carry on business, an intention of the settlor may be inferred to subject the trust property employed in the business to the payment of liabilities incurred by the trustee in carrying on the business.

---

[49] As the authors of the *Trust Law Committee Report, supra,* note 15, at p.7, observe, the creditor's position may also be affected by the defence of change of position. See *Lipkin Gorman* v. *Karpnale Ltd.*., [1991] 2 A.C. 548 (H.L.) and *Rural Municipality of Storthoaks* v. *Mobil Oil Canada Ltd.*, [1976] 2 S.C.R. 147.

[50] See Estey, *supra*, note 4, at pp.346-348.

[51] *Scott on Trusts*, *supra*, note 23, at p.489.

[52] *Ibid*., at pp.489-490.

[53] *Supra*, note 39.

As the authors of *Scott on Trusts* note, this second exception should permit creditors to recover directly from the trust estate in the case of most business trusts, where it is ordinarily provided in the trust instrument that the trustee shall not be personally liable on contracts made by it but rather that the persons with whom such contracts are made should look solely to the trust estate for recovery.[54]

Support for this exception is found in the decision of the United States Supreme Court in *Gisborn* v. *Charter Oak Life Ins. Co.*[55] In this case, the defendant, Gisborn, sought to purchase the remaining 10/18 interest in a mine held by other co-owners. Stephens loaned the defendant the sum of $100,000 to purchase and, as security, the defendant made a deed of the entire mine property to Stephens in trust. The first clause of the deed stated that the property was to be used for "the payment of all expenses of operating said mine." In accordance with the terms of the deed, Stephens attempted to operate the mine. Unfortunately, in the process, Stephens incurred $52,000 of debts in what the Supreme Court termed "fruitless endeavours to find the lost vein." The plaintiff, Charter Oak, was the assignee of the various creditors. The plaintiff sued seeking direct recovery from the trust property. The Court ruled that the mine property itself was chargeable under the deed for the repayment of the $100,000 loan. The Court also held that the mine property was chargeable for the $52,000 in expenses owed to Charter Oak:[56]

> The trust, as disclosed by the first clause [of the deed], contemplated the continued operation of the mine, keeping it and its appurtenances in good repair, and the payment of taxes. Whatever expenses were legitimately incurred in the discharge of this part of the trust were chargeable upon the property.

Gisborn is a significant precedent because the language of the first clause of the deed was by no means as categorical as those commonly found in modern business trust instruments.[57]

Another interesting American authority is *Laible* v. *Ferry*,[58] a decision of the New Jersey Court of Errors and Appeals. In this case, the estate of a decedent included an operating brewery. The terms of the decedent's will permitted the operation of the brewery by the executors on specified trust terms. In the course of operating the brewery, the executors defaulted in paying a trade supplier. The trade supplier brought an action seeking direct recovery against the estate as the executors were themselves insolvent. The key issue in the case was *not* whether the creditor could recover from the estate, but whether he was limited to the property used in carrying on the business. The court ruled that:[59]

> Where a testator orders his business to be carried on after his death, *prima facie* only the fund employed in the business before his decease is answerable to the subsequent creditors; but that if, by clear and unambiguous language, he designates or

---

54 *Supra*, note 23, at p.491.

55 (1892), 142 U.S. 326; 12 S.Ct. 277.

56 *Ibid*., at pp.336-337.

57 For example, the limitation of liability provision in a declaration of trust establishing a REIT typically provides that "the assets of the Trust only are intended to be liable and subject to levy or execution . . . for satisfaction of any obligation or claim arising out of or in connection with any contract or obligation of the Trust or of the Trustees. . ."

58 (1880), 32 N.J. Eq. 791.

59 *Ibid*., at p.798.

> authorizes to be set apart any other portion of his estate to be embarked in the trade, such creditors may also resort to the fund thus appropriated.

There is English authority for this second exception as well. The authors of the *Trust Law Committee Report* comment as follows:[60]

> If the settlor manifests an intention that where liabilities are incurred in the proper administration of the trust the creditor is entitled to be paid out of the trust funds, then the courts will give effect to such intention unless the contract between [the trustee] and [the creditor] excludes this right in favour of [the trustee's] exclusive personal liability. Even if [the trustee] happens to be indebted to the trust fund so as not to have a right of exoneration out of the trust fund for any personal liability as trustee, this should be irrelevant because [the creditor] is not relying on any derivative right. The settlor's intention for the trust fund to be directly liable should be implemented. In principle, a settlor must be allowed to make such conditional provision as he wishes for the benefit of third parties dealing with his trustee; the beneficiaries take the benefits of the trust subject to any burdens.

Before considering the third exception, it is interesting to note a subtle difference of approach between *Scott on Trusts* and the *Restatement of Trusts*. In the passage from *Scott on Trusts* that began this section, it is stated that the settlor's intention that creditors be paid out of the trust estate will enable a creditor to recover from the trust estate even though the trustee has committed some unrelated default of its duties, so long as the contract with the creditor was made "in the proper administration of [the] trust."[61] The corresponding section of the *Restatement of Trusts* states that "[the] remedy under this section is available although no benefit was conferred on the trust estate, and the creditor is therefore precluded from reaching the trust estate under the rule stated in § 269 [*i.e.*, the unjust enrichment exception]."[62] The passage from *Scott on Trusts* emphasizes that the obligation must be incurred in the proper administration of the trust. The discussion in *Scott on Trusts* suggests that where an obligation is improperly incurred by a trustee and confers no benefit on the trust, as, for example, where a trustee borrows money ostensibly for trust purposes but converts the borrowed money for its own personal purposes, the creditor will have no right to direct recovery against the trust estate under the second exception.[63]

It is clear that in order for a creditor to rely on this second exception to secure a direct right of recovery against the trust fund, the creditor will have to take steps to ensure that the trustee is acting properly in incurring the obligation and that, in the case of a loan transaction, the loaned funds are being

---

[60] *Supra*, note 15, at p.7, citing as authorities *Ex parte Garland, supra*, note 18, and *Fairland* v. *Percy* (1875), L.R. 3 P.&D. 217. See also the Manitoba authority, *Morrison* v. *Canadian Surety Co.*, [1954] 4 D.L.R. 736 (C.A.).

[61] *Supra*, note 23, at p.489.

[62] *Supra*, note 39, § 270.

[63] The creditor will not have a subrogated claim against the trust estate either, as the obligation was not properly incurred in the administration of the trust. See *Farhall* v. *Farhall* (1871), L.R. 7 Ch.App. 123 and *Vroom* v. *Connor* (1894), 32 N.B.R. 565 (C.A.), affd (1895), 24 S.C.R. 701.

applied to acquire trust property or to satisfy legitimate trust expenses. Estey has examined this concern of the unsecured lender from the perspective of an opinion giver:[64]

> With respect to unsecured obligations, the opinion giver should (1) ensure that the proposed agreement, and the performance of its terms, are within the trustee's powers under the relevant trust instrument, and (2) ensure that: (i) any monies to be advanced under a loan agreement are used, in accordance with the terms of the trust instrument, to acquire trust property or to satisfy legitimate trust expenses; (ii) any goods or services provided under the agreement are used as trust property (in the case of goods), or are for the benefit of the trust (in the case of services), in each case in accordance with the terms of the trust instrument; and (iii) any intangible benefits, such as may be derived from the entering into of a guarantee agreement, are otherwise for the benefit of, and are in the best interests of, the trust within the terms of the trust instrument. Insofar as (1) is concerned, the opinion giver should review carefully the trust instrument to confirm that the requisite powers are conferred on the trustee therein. In some circumstances, it may be necessary to obtain a certificate from the trustee, or from an officer of the trustee, to confirm certain facts in this regard. Insofar as (2) is concerned, the opinion giver will often be able to confirm, by virtue of his or her participation in the transaction or in the closing of the transaction, that as a result of entering in the agreement, the trust received or acquired trust property or paid legitimate trust expenses, within the terms of the governing trust instrument. If this confirmation is not possible, or if the agreement is one where tangible benefits do not flow to the trust, an appropriate assumption to this effect may have to be made.

Exception 3: *The creditor is entitled to obtain satisfaction out of the trust estate if the contract provides that the creditor may look to the trust estate.* [65]

The authors of *Scott on Trusts* state that "[where] the contract is properly made by the trustee in the administration of the trust, and it is provided in the contract that the other party shall look only to the trust estate, the other party can obtain satisfaction of his claim out of the trust estate."[66] The *Restatement of Trusts* provides:[67]

> If the trustee makes a contract with a third person and the contract provides that the trustee shall not be personally liable upon the contract but that the third person shall look only to the trust estate, the third person can by a proceeding in equity reach a trust property and apply it to the satisfaction of his claim upon the contract, provided that the contract was properly made by the trustee in the administration of the trust.

---

[64] *Supra*, note 4, at p.350.

[65] *Scott on Trusts, supra*, note 23, at p.492.

[66] *Ibid.*, at p.493.

[67] *Supra*, note 39, § 271.

Scott on Trusts cites numerous American cases in support of this third exception.[68] The judgment of the Federal District Court for Maryland in *Limouze* v. *M.M. & P. Marine Advancement* provides a clear articulation of the exception:[69]

> In the proper performance of his duties, a trustee may enter into an *intra vires* contract which expressly excludes the trustee's personal liability. By such action, the trustee gives the contract creditor a direct remedy against the trustee in his representative, not individual capacity. Where the trustee can be sued as trustee, satisfaction of any judgment may be derived from trust funds.

The authors of *Scott on Trusts* note that the American authorities reveal two possible approaches to a provision in a contract that excludes a trustee's personal liability and states that the other party to the contract shall look solely to the trust property. Under the first approach, a court may find that the contract does not give the third party any direct claim against the trust property but simply exempts the trustee's individual property from liability.[70] On this approach, the creditor can reach the trust estate only to the extent that the trustee is entitled to indemnification; and if the trustee is in default to the trust fund, the other party to the contract is precluded from reaching the trust property to the extent of such default.[71]

Under the second approach, a court would find that such a contract gives the creditor a direct claim against the trust fund.[72] Under this approach, the creditor can reach the trust estate whether or not the trustee is entitled to exoneration out of the trust estate; the creditor's claim is direct and not founded on any derivative right.[73]

The two competing approaches are summarized in the *Trust Law Committee Report* in the following terms:[74]

> Where a contract is properly made by [the trustee] . . . and provides that [the trustee] shall not be personally liable, but that [the other party] shall look only to the trust fund for satisfaction of its claim, two constructions are possible. The contract can be narrowly construed as exempting [the trustee's] own property from liability, without

---

68 *Supra*, note 23, at pp.492-496.

69 (1975), 397 F.Supp. 784 at 789, citing the discussion in *Scott on Trusts*, *ibid*. and the American treatises G. Bogert, *Trusts & Trustees*, 2d ed. (St. Paul: West, 1960) at p.460 and G.G. Bogert and G.T. Bogert, *Law of Trusts*, 5th ed. (St. Paul, West, 1973) at pp.457-459.

70 *Scott on Trusts*, *ibid*., at p.494.

71 *Ibid*. See *Clack* v. *Holland* (1854), 19 Beav. 262 and *King* v. *Stowell* (1912), 211 Mass. 246.

72 *Scott on Trusts*, *ibid*. See, for example, *Purdy* v. *Bank of America National Trust & Savings Association* (1935), 2 Cal. 2d 298 (S.C. Cal.), where a trustee borrowed money for the trust as he was empowered to do and gave a promissory note to the lender executed by him as trustee. It was held that the lender could recover directly against the trust estate even though the trustee had misappropriated the money.

73 *Ibid*. See also *Restatement of Trusts*, *supra*, note 39, at § 271. The *Restatement of Trusts* states that "As a result of a contract by which it is provided that a third person may look to the trust estate, the third person although he acquires a power in equity to reach the trust estate does not acquire a lien upon it; one creditor does not acquire priority over subsequent creditors." Accord, *Trust Law Committee Report*, *supra*, note 15, at p.8. See the discussion in Youdan, *supra*, note 1, at pp.10-13.

74 *Supra*, note 15, at p.7.

> giving [the creditor] a direct claim against the trust fund, so [the creditor] can reach the trust fund only to the extent of [the trustee's] right of exoneration.
>
> The broader modern tendency in Australia and the United States is to construe the contract as giving [the other party] a direct independent right of recourse to the trust fund, so that it is immaterial that [the trustee] has no right of exoneration because indebted to the trust fund. The basis for this is the view that [the trustee's] power to agree to such a term in a contract does not need to be expressly authorised by the trust instrument: if he is authorised to make the type of contract in question then he is implicitly authorised to agree with [the other party] either for [the trustee's] personal liability or for the liability of the trust fund only to the extent of [the trustee's] right of exoneration or for the unlimited liability of the trust fund irrespective of [the trustee's] right of exoneration.

There are numerous Canadian cases that consider attempts to limit a trustee's liability under a contract.[75] The Canadian authorities suggest, as Cullity notes,[76] that clear language will be required to limit a trustee's liability under a contract. A simple notation following the trustee's signature at the end of the document indicating that the person is contracting "as trustee" will likely not be sufficient to reduce or exclude personal liability nor to render the trust estate liable in all circumstances.[77] Rather, the words "as trustee" are likely to be interpreted as being simply descriptive, and not as a limitation of liability.[78]

---

[75] See, for example, the cases referred to in Cullity, *supra*, note 9, at pp.128-133.

[76] *Ibid*., at pp.128-130.

[77] See, for example, *Shaver* v. *Young* (1919), 16 O.W.N. 16. But see *Gordon* v. *Roebuck* (1992), 92 D.L.R. (4th) 670, 9 O.R. (3d) 1 (C.A.). One of the issues in *Gordon* v. *Roebuck* involved the liability of a party to an agreement who had signed the agreement with the notation "in trust" on the signature page. McKinlay J.A., writing for the Court of Appeal, concluded at pages 9-10:

> All of the above facts lead to the inescapable conclusion that all parties to the litigation were fully aware at all times that they were dealing with Mr. Gordon in his capacity as trustee. All were parties to the original joint venture agreement. Although the nature of the trust is vague, there can be no doubt that all parties are beneficiaries of the trust. No breach of trust is alleged, and the evidence does not disclose any breach. Consequently, I see no reason why on the facts of this case, Mr. Gordon should be liable in his personal capacity.

Cullity, *supra*, note 9, at 132, has commented:

> It is difficult to estimate the significance of [*Gordon* v. *Roebuck*]. It would be tempting to regard it as merely recognition that the word "in trust" will now be regarded as a sufficient notation to indicate an intention to exclude personal liability. This would be a useful development which, although not consistent with previous Canadian or English authority, would be supported to some extent by cases in the United States.

Clearly, one of the weaknesses of *Gordon* v. *Roebuck* as a precedent in this context is that the case contains no discussion of existing authorities dealing with the ability of trustees to exclude personal liability under contracts. See also, the discussion of the case in Estey, *supra*, note 4, at p.344.

[78] *Ibid*. See, also, *Watling* v. *Lewis*, [1911] 1 Ch. 414.

The Ontario cases to date suggest that even where a contract reflects a clear intention to exclude a trustee's personal liability and to limit recovery to the trust fund, such provisions will not be given literal effect.[79] Cullity comments that provisions seeking to exclude a trustee's personal liability and limit recovery to the trust fund "can mean only that the personal liability of the trustee is limited to the value of the assets of the trust or that the trustee will be liable only to the extent that it is entitled to be indemnified or exonerated out of the trust property."[80] In Cullity's view, which corresponds to the first approach described in *Scott on Trusts* referred to above,[81] an express statement that the third party's rights are to be enforced directly against the assets of the trust cannot be given effect because "[those] rights are, in the absence of any statutory modification of traditional principles of equity, essentially rights to be subrogated to the trustee's right of indemnity or exoneration out of the assets and those rights may be lost as a result of future misconduct of the trustee."[82]

It is interesting to note that the authors of the *Trust Law Committee Report* express the hope - and clearly believe that the existing English jurisprudence does not foreclose the possibility - that English courts will adopt the second approach outlined in *Scott on Trusts* and permit creditors a direct and independent right of recourse to the trust fund where a contract so provides.[83] It is strongly urged that Canadian courts adopt the same approach and, in so doing, give effect to the clear intentions and expectations of commercial parties and their advisors.

4. A Possible Fourth Exception?

The *Restatement of Trusts* provides at § 271 A:[84]

> A person to whom the trustee has incurred a liability in the course of the administration of the trust may be permitted to obtain satisfaction of his claim out of the trust estate if it is equitable to permit him to do so although his claim does not fall within [the enumerated exceptions discussed above].

This fourth exception is intended to describe what the *Restatement of Trusts* refers to as "the modern trend" toward recognizing "that just as an agent or servant acting within the general scope of his authority can subject his principal to liability, so a trustee acting within the general scope of his authority can subject the trust estate, although not the beneficiaries personally, to liability."[85]

---

[79] See, for example, the discussion of Potts J. in *Davis* v. *Sawkiw* (1982), 38 O.R. (2d) 466 (H.C.J.), at pp.467-468, discussed in Cullity, *supra*, note 9, at pp.129-130.

[80] Cullity, *ibid*., at p.130.

[81] And what the authors of the *Trust Law Committee Report* refer to as the "narrow construction" of such provisions.

[82] Cullity, *supra*, note 9, at pp.130-131. Cullity acknowledges that, particularly in the context of business trusts, a case could be made for allowing third parties to have direct access to the assets of a trust irrespective of any unrelated misconduct of the trustee. See also the discussion in Youdan, *supra*, note 1, at pp.8-12.

[83] *Supra*, note 15, at p.7 and p.15.

[84] *Supra*, note 39.

[85] *Ibid*.

As this fourth exception describes an emerging trend, American case authorities for its acceptance appear to be quite sparse.[86] The authors of *Scott on Trusts* describe the application of this fourth exception in the context of contract creditors:[87]

> It is believed that the modern tendency is to make the trust estate responsible for contracts properly made by the trustee in the administration of the trust, even though the trustee is not entitled to exoneration out of the trust estate because in some other transaction he has become in default to the estate, and even though the contract did not result in a benefit to the trust estate. As we have seen, it is well settled that the other party to the contract can reach the trust estate where the contract so provides. Even if the contract does not so provide, it seems fair to hold that the expenses incurred in carrying on the economic enterprise involved in the administration of a trust should be borne by the trust estate, at least if the trustee is insolvent and cannot be compelled to make payment out of his individual property. The mere fact that the trustee has so administered the trust in other transactions that he is in default to the trust estate should not preclude the creditor from obtaining satisfaction out of the trust estate. Otherwise every attempt by a creditor to obtain satisfaction out of the trust estate would involve a complete investigation of the accounts of the trustee in order to determine whether he is in default to the estate. It is submitted, therefore, that if the making of the contract was within the powers of the trustee, the other party to the contract should be permitted to sue the trustee in his representative capacity and to obtain a decree that his claim be paid out of the trust estate, at least if the trustee is insolvent and the third person cannot obtain satisfaction from the trustee personally. It is submitted that the third person should have a direct right against the trust estate enforceable by a suit against the trustee in his representative capacity, and not merely a right to reach the trustee's right of indemnity. In other words, the third person should be able to enforce his claim against the trust estate on a contract properly made by the trustee in the administration of the trust, even though in some other transaction the trustee is in default to the estate. The third person should have a right to compel the trustee to apply the trust property to the discharge of his claim.

5. American Statutory Reforms

Many American states have adopted statutory reforms imposing liability on the trust estate for contracts entered into by the trustee in its capacity as trustee. The most comprehensive model for these statutory reforms is contained in the Uniform Probate Code which provides in subsection 7-306(c) that "claims based on contracts entered into by a trustee in his fiduciary capacity, on obligations arising from ownership or control of the trust estate, or on torts committed in the course of trust administration may be asserted against the trust estate by proceeding against the trustee in his fiduciary capacity, whether or not the trustee is personally liable therefor."[88] Statutes in many major commercial jurisdictions in the United

---

[86] Although the principle underlying it has been adopted by statute in several American jurisdictions. See the discussion below.

[87] *Supra*, note 23, at pp.500-501.

[88] Uniform Probate Code (St. Paul, Minn.: National Conference of Commissioners on Uniform State Laws, 1993). Subsection 7-306(a) provides:

> Unless otherwise provided in the contract, a trustee is not personally liable on contracts properly entered into in his fiduciary capacity in the course of

States, such as California, Florida, Illinois, Massachusetts, New Jersey, and Ohio, contain the same or similar provisions.[89]

Under the *Uniform Commercial Code*, it is provided that if a trustee signs a negotiable instrument "in a representative capacity" and in respect of a named trust, he is not personally liable on the instrument but is liable in his representative capacity only so that recovery is available out of the assets of the trust, assuming execution of the instrument was within the powers of the trustee.[90] Some

---

> administration of the trust estate unless he fails to reveal his representative capacity and identify the trust estate in the contract.

[89] *California Prob. Code*, §§18000-18002, 18004-18005; *Florida Stat. Ann.* §737.306; *Illinois Rev. Stat.*, c.17 §1674.4, as amended by Laws 1985, c.84-518, §263; *Massachusetts Ann. Stat.*, c.203, §14A, as enacted by Laws 1976, c.515; *New Jersey Stat.*, §§3B: 14-32 to 3B: 14-34, enacted by Laws 1981, c.405; and *Ohio Rev. Code*, §1339.65, enacted by Laws 1983, H.B. 288. A similar approach has been adopted by statute in various "offshore" jurisdictions. For example, section 31 of the Turks and Caicos Islands *Trusts Ordinance 1990* provides:

> 31.(1) Subject to subsection (2), and without prejudice to the liability of a trustee for any breach of trust, where in any transaction or matter affecting a trust a trustee informs a third party that he is acting as trustee, a claim by such third party in relation thereto shall extend only to the trust property.
>
> (2) Where the circumstances set out in subsection (1) exist, and the transaction or matter involved a breach of trust, and the third party knew that it involved a breach of trust, the third party shall have no claim against the trust property.
>
> (3) Where in any such transaction or matter a trustee fails to inform a third party that he is acting as trustee:
>
> (a) he shall be personally liable to such third party in respect thereof; and
>
> (b) he shall have a right of recourse to the trust property by way of indemnity against such personal liability unless he acted in breach of trust.
>
> (4) In this section "third party" means any person not being a settlor, trustee or beneficiary of the trust.

Section 26 of the Belize *Trusts Act 1992* is similar to the Turks and Caicos provision but adds the following:

> (4) A bona fide purchaser for value without notice of a breach of trust -
>
> (a) may deal with a trustee in relation to trust property as if the trustee were the beneficial owner thereof; and
>
> (b) is not affected by the trusts on which the property is held.
>
> (5) A third party paying or advancing money to a trust is not concerned to see -
>
> (a) that the money is needed in the proper exercise of the trust functions;
>
> (b) that no more than is so needed is raised; or
>
> (c) that the transaction or the application of money is proper.

[90] *Uniform Commercial Code* (St. Paul, Minn.: American Law Institute and National Conference of Commissioners on Uniform State Laws, 1995) §3-403. See also the discussion in G.T. Bogert, *Trusts*, 6th ed. (St. Paul, Minn.: West, 1987), at pp.454-455.

states have gone so far as to enact statutes that treat a trustee as "a general agent for the trust property," so that the trustee's acts, within the scope of its authority, bind the trust property to the same extent as the acts of an agent bind its principal.[91] The authors of *Scott on Trusts* criticize such statutes for conceiving of the trust estate as a principal.[92] Nonetheless, such statutes indicate one way in which American jurisdictions have responded to the uncertainty surrounding the ability of creditors to reach the trust estate as a matter of common law. The *Uniform Trusts Act*, adopted by the National Conference of Commissioners on Uniform State Laws in 1937, provides that whenever a trustee makes a contract that is within its powers as trustee, the other party to the contract may sue the trustee in its representative capacity and any judgment in favour of the plaintiff shall be recoverable from the trust property, even though the trustee could not have secured reimbursement from the trust funds if it had paid the plaintiff's claim.[93] The Act provides, however, that no such judgment shall be rendered unless the plaintiff notifies each of the beneficiaries of the claim, and provides that the beneficiaries may intervene in the action.[94]

CONCLUSIONS

While no Canadian court has dealt with the question of the enforceability of unsecured obligations against the trust assets of a modern business trust, the American authorities and approaches discussed in this article provide the necessary support for a Canadian court to respond sensibly to the commercial realities of business trusts and to permit such enforceability in the circumstances described in this article.[95] This conclusion is consistent with the opinion-giving practices of most, if not all, commercial lawyers who are opining about loans to or debt issued by business trusts such as REITs. These lawyers are regularly giving "clean" enforceability opinions about those loans or debts in circumstances where the loan or debt is authorized by the trust instrument and the proceeds are used for a valid trust object.[96]

David A. Steele is an Associate at Torys.

Andrew G. Spence is a Student-at-law at Torys. *The authors would like to thank John Cameron for helpful comments on earlier drafts of this article.*

---

91 For example, *Montana Code Ann.* 1983, §72-23-307 and *South Dakota Codified Laws* 1967, §55-3-7. *Scott on Trusts*, *supra*, note 23, at pp.501-502.

92 *Scott on Trusts*, *ibid*.

93 See the discussion in *Scott on Trusts*, *ibid.*, at pp.502-503.

94 *Ibid.*

95 In this respect, see the recent case *Re Christian Brothers of Ireland in Canada* (1998), 37 O.R. (3d) 367 (Gen. Div.) in which R.A. Blair J. held that tort claim ants could have direct recourse against the assets of a specific charitable trust.

96 See the discussion of enforceability opinions in the context of transactions involving trustees in Estey, *supra,* footnote 4, at pp. 342-352.