

Rights of Creditors Against Trustees and Trust Funds

April 1997

A Consultation Paper by the Trust Law Committee

**in association with
Society of Trust and Estate Practitioners (STEP)
and**

Tolley's Trust Law International

PREFACE

This Consultation Paper (drafted by Professor Hayton with the assistance of a Working Party and a researcher, Ms Emma Ford) very helpfully analyses the current unsatisfactory state of the law in more depth than can be found elsewhere. It then proposes a range of solutions to enable the law to meet current and foreseeable needs. I strongly urge you to respond to the questions at the end of the Paper. The greater the response the greater will be the likelihood of legislative reform. Such reform is necessary because nineteenth century case law creates problems for wary creditors, let alone unwary creditors, and disadvantages creditors who deal with trustees rather than absolute beneficial owners: some levelling of the playing field seems needed in modern conditions.

The Trust Law Committee has already made much progress in its efforts to modernise the law of trusts. The Lord Chancellor extended the programme of the Law Commission to include trustees' powers of investment and collective delegation of trustees' administrative powers and duties so that it could work with the Trust Law Committee in those areas. As a result, the Treasury, which is responsible for the Trustee Investments Act 1961, after receiving favourable responses to a Consultation Document issued in May 1996 and prepared with input from the Law Commission and the Trust Law Committee, submitted to Parliament on 3rd February a draft Order under the Deregulation and Contracting Out Act 1994. However, to ensure that the Order is *intra vires* the 1994 Act, the Order does not, as the Consultation Document proposed, repeal the 1961 Act and confer upon trustees (subject to contrary intent) power to invest as if they were absolute beneficial owners subject to observing the duties and standards of care required of trustees. Instead, the Order simply removes the need to divide a trust fund into two parts before it is possible to invest in wider-range investments, and then removes the need for wider-range companies to satisfy the requirements of paragraphs 1, 2 and 3 of Part IV of Schedule I to the 1961 Act. However, the Treasury proposes to exercise its power under section 12 of the 1961 Act to extend significantly the range of investment to be permitted under the Act. The Law Commission is currently preparing a Consultation Paper on Collective Delegation of Administrative Powers and Duties by Trustees, based largely on a lengthy background Paper prepared by the Trust Law Committee. It is hoped that the Consultation Paper will be published in May 1997.

Because the Law Commission's resources are already fully stretched for an ambitious programme over the next two years, the Trust Law Committee has to take up the running on its own in respect of creditors' rights against trustees and trust funds. I agree with the Committee's view that this topic urgently needs reform and note that the Financial Law Panel independently is preparing a Paper to try to find ways of resolving doubtful issues that arise for those dealing with trustees in financial markets.

With your assistance in responding to this Consultation Paper it should prove possible to produce an impressive Report with powerful backing. Law reform has to be thoroughly researched and reforming proposals thoroughly considered: it is a tough business. Professor Hayton and his Working Party have already put in many unpaid hours so that we can understand what the law is and how it may be improved. We do not want all those hours to be wasted, which they will be unless you, too, are prepared to devote some of your busy time to making the law simpler and fairer. Please, please respond to the questions at the end of this Paper.

The Right Honourable The Lord Browne-Wilkinson

*Lord of Appeal in Ordinary, formerly Vice-Chancellor
of the Chancery Division of the High Court*

7 March 1997

Please respond by 31st July to: Professor David Hayton, School of Law, King's College, Strand, London WC2R 2LS.

STOP PRESS: The early announcement of the General Election has, unfortunately, collapsed progress under the Deregulation and Contracting Out Act 1994. It is to be hoped that the new Parliament will reintroduce the draft Order.

CONTENTS

	<i>Page</i>
Chapter 1 – Introduction	1
Chapter 2 – The Law	3
1. Trustees' contractual liability	3
2. Trustees' right of indemnity	3
(a) Against the trust fund	3
(b) Against the settlor or some beneficiaries	4
3. Limitations on trustees' rights of indemnity	5
(a) Limitations in the trust instrument	5
(b) Trustee indebted to the trust fund	5
(c) Liability incurred in transaction in breach of trust unless T has thereby in good faith benefited the trust	5
(d) Charitable endowments	5
4. Creditors' subrogation to trustees' rights of indemnity	6
5. Creditors' direct recourse to trust funds	7
(a) Where the trust fund is benefited: unjust enrichment	7
(b) Where the trust instrument provides for the trust fund to be liable	7
(c) Where contract provides for the trust fund to be liable	7
(d) Where the trust instrument provides for the grant of security over specific assets	8
(e) Where trust instrument provides for grant of security over fluctuating assets within trust fund	8
(f) Creditors' rights of set-off or netting	9
6. Creditors' rights against directors of corporate trustees	10
7. Creditors' liability to account in equity	10
8. Trustees' tortious liability	11
9. Liability for taxes and as title-holder	11
10. Insolvency	11
(a) Of the trustee	11
(b) Of the trust fund	12
Chapter 3 – Problems in How Creditors can Cope with the Law	13
1. Relying on trustees' personal liability and right of exoneration	13
2. Insisting on a direct right of recourse to the trust fund	14
(a) Secured claims	14
(b) Unsecured claims	14
3. Financial markets and netting rights	15
Chapter 4 – Reform	17
1. Direct but unsecured right of recourse to trust fund	17
2. Possibility of personal liability of T to X	18
3. Personal indemnity rights	18
4. Employment of agents	18
5. Need for insolvency netting for quasi-mutual dealings	19
6. Need for clarifying position on insolvency of trust fund	19
7. Need for broad express powers to create charges	19
8. Secured claims	19
9. Tortious claims against the trust fund	19
10. Liability of trustee as title-holder	20
11. Application of reforming legislation	20
12. The overall position of beneficiaries vis-a-vis creditors	20
Chapter 5 – Summary of Questions for Responses	21
Appendix – Trust Law Committee publishes Second Annual Report in October 1996	24

INTRODUCTION

- 1.1 Contractual liabilities are increasingly being incurred on behalf of trusts by trustees (or their delegates) whether by way of borrowing money or purchasing on credit or entering into transactions on the financial markets. The value of family trusts, commercial trusts and financial trusts is increasing all the time, as are the numbers of professional trustees, professional fund managers, skilled lawyers and bankers. Thus, a great variety of trust structures has developed with a corresponding variety of powers of investing or even of sensible speculation. In the financial markets these powers may be exercised to use derivatives either for the purpose of controlling or limiting risk, or for speculation.
- 1.2 Inevitably, the question arises whether trust law principles developed in the eighteenth and nineteenth centuries can adequately cope with the new uses to which trust funds are being put. A balance needs to be struck between the interests of trust beneficiaries and of creditors, while not neglecting the interests of the trustee as pig in the middle.
- 1.3 Interesting parallels can be drawn with companies and their creditors when one sees how much traditional company law principles have had to be modified to keep pace with social and economic change. The position of those who deal with companies externally has changed much, while leaving the internal company/shareholder relationship largely as it was. The sting of the *ultra vires* and constructive notice doctrines has been drawn by relatively recent statutory provisions,¹ after the courts, with the rule in *Turquand's case*,² had in the nineteenth century mitigated the effects of the constructive notice doctrine by allowing creditors to assume that internal procedures had been complied with. Agency rules of apparent or ostensible authority also assisted creditors of companies³ because companies are legal persons, unlike trusts which cannot therefore be regarded as principals having agents.
- 1.4 Nowadays, if a transaction with a third party dealing in good faith is effected on behalf of a company by its *de jure* or *de facto* board of directors or by a person actually or apparently authorised by such board, the transaction will bind the company.⁴ This is a far cry from the current position for third parties dealing with trustees (as will be seen in Chapter 2, which attempts to set out the current law).
- 1.5 Of course, trusts traditionally have had a very different role to play from the role of companies, so that the courts have developed principles that strongly tilt the balance away from creditors in favour of beneficiaries. The problem with this is that it creates traps for unwary creditors while discouraging the wary from dealing with trustees, so that worthwhile opportunities may be missed and the value of the fund may not develop as the settlor intended it should. It seems time to tilt the balance somewhat towards creditors in order to facilitate dealings with third parties even if this does create more risk for beneficiaries than formerly.
- 1.6 The majority of trusts are still traditional family trusts and in their Green Paper on Trusts in 1991 the Revenue stated that they knew of approximately 260,000 of these of which the vast majority were simple life interest trusts, many of which were of comparatively small value. With so much more professional expertise of all kinds being available these days, most of the modern family trusts confer very extensive powers to invest or apply the trust fund 'as if the trustees were beneficial owners thereof'. However, it is rare in fact for such trustees to venture outside the traditional investment categories of property, quoted shares, unit trusts, gilts and cash deposits. They rarely go into derivatives even though they may have powers to acquire them. It is, nonetheless, true that some large trusts carry out major commercial property purchases and borrow substantial sums, so that there is no particular reason why the remedies of creditors against trustees should be less than against most other parties. This is particularly true when one considers the following commercial or financial uses of trusts and the fact that by far the vast majority of wealth held on trust is held on such types of trust and not on family trusts.

¹ European Communities Act, s 9(1); Companies Act 1985, ss 3A, 4, 35, 35A and 35B as amended by Companies Act 1989, ss 108 and 110.

² *Royal British Bank v Turquand* (1856) 6 E & B 327.

³ For example *Freeman & Lockyer v Buckhurst Park Properties Ltd* [1964] 2 QB 480.

⁴ See Gower, *Principles of Modern Company Law* (5th edn, 1992) Ch 8.

- 1.7** For collective investment purposes there are unit trusts (worth over £120,000 million) and pension trusts (worth over £300,000 million). Trusts are used for secured syndicated lending, project financing and the issue of secured loan stock and eurobonds. The trustee holds legal title to the borrower's assets or a charge over those assets on a trust which confers security on a class of creditors, who may assign their interests to someone who takes over the same priority as they had, or novate loans without causing the security to collapse. Indeed, for administrative convenience of borrower and lender, unsecured loan stock or bonds are usually held on trust for the lenders by a trustee who will have the benefit of the borrower's covenants. Subordination trusts are used to ensure the effectiveness of commercial arrangements for junior creditors to be subordinated to a senior creditor of the debtor, so that the agreed priority ranking prevails in the insolvency of a party to the arrangements. A securitisation transaction may involve shares in a special purpose vehicle being held on trust so as to take assets off a company's balance sheet. Trusts may be used to confer benefits on non-contracting parties so as to avoid the privity of contract doctrine. Thus, in placing and underwriting agreements the benefit of contractual warranties given by the issuer to the underwriting bank is taken by the bank for itself and as trustees for the placees or sub-underwriters, while in mergers and acquisitions the benefit of warranties can be taken by the purchaser for itself and as trustee for group companies, enabling post-acquisition intra-group reorganisations to be made with the benefit of warranty cover.
- 1.8** The 1982 Law Reform Committee 23rd Report 'The Powers and Duties of Trustees' accepted that the relationship between trustees and third parties was seriously in need of clarification⁵ but did not fully deal with this.⁶ This Consultation Paper is an attempt to do that. It is also an attempt to flush out problems that arise in practice in order to see if the current law operates satisfactorily or is in need of reform. It is believed that some fundamental reforms are needed so that such reforms are canvassed. If some consensus on such reforms develops in response to this Paper, we will produce a Report which we will seek to have implemented by Parliament, so as to bring our law up to date for the needs of the twenty-first century.

⁵ Cmnd 8733, para 2.17.

⁶ Cmnd 8733, para 1.6. See also Final Report of the Legal Risk Review Committee, October 1992.

THE LAW

- 2.1 This chapter is primarily concerned to set out the law relating to creditors' contractual rights against trustees and trust funds but, incidentally, considers creditors' potential liabilities to account in equity as the other side of the coin. It is also concerned to examine the situation where the trustee or the trust fund or both become insolvent and, incidentally, touches upon the liability of trustees to third parties for torts, for taxes and other liabilities affecting title-holders of property. We have been forced to deal with the law in some detail because many grey areas require clarification, not being fully dealt with elsewhere. It is hoped that such detail will lead to well-informed responses.

Trustees' contractual liability

- 2.2 When a trustee enters into a contract, unless he is bound no-one can be bound because he has no principal. The trust fund cannot be a principal because it has no legal personality. The beneficiaries cannot be principals because they cannot tell the trustee what to do;¹ the fundamental function of a trustee is to act independently and to do what he considers best fulfils the purposes of the settlor.
- 2.3 Thus, except to the extent that the contract may relieve the trustee, T, from personal liability by providing for recourse only to be had to trust assets, T is personally liable to the full extent of his own assets to satisfy the full contractual liability,² so that T voluntarily assumes the risk of the trust assets being insufficient to discharge his liability. Normally, this liability will actually be discharged out of the trust assets if the contract was properly made by T in the administration of the trust (though only to the extent that T is not indebted to the trust³), but if he does not ensure that the contract is properly made by him he will be prevented from obtaining an indemnity out of the trust assets, so that the beneficiaries will not suffer from his breaches of trust.
- 2.4 If T makes it clear to the third party, X, that he is not prepared to take on personal liability, then X knows that it is assuming the risk of the trust assets being insufficient and so will need to take appropriate measures to protect its interests. If T undertakes personal liability, X will need to consider T's creditworthiness and will also need to consider whether, in the event of T being unable to satisfy the liability, it will be possible to take advantage of any right of T to obtain an indemnity out of the trust assets by way of equitable subrogation to such right. In a rare case it may even be possible for X to take advantage of any right of T to obtain an indemnity from the settlor or some beneficiaries personally.

Trustees' right of indemnity

(a) Against the trust fund

- 2.5 The right of indemnity of a trustee, T, is a right to be reimbursed out of the trust fund for moneys properly paid out of T's own pocket or a right to be exonerated from paying out his own money through the power to pay due debts out of the trust fund (whether capital or income⁴) in the first place.⁵ The right of reimbursement or the right of exoneration will extend to the whole range of trust assets except for that part of such assets excluded from being used for the trust activity (e.g. a business) giving rise to the relevant liability.⁶
- 2.6 T's entitlement to be indemnified out of trust assets for payments actually made and liabilities incurred in the due administration of the trust entitles him to retain the trust assets or an appropriate part of them until his claim for reimbursement or exoneration has been satisfied,⁷ e.g. by payment of the relevant sum of money or by a new

¹ Except where the trustee's holding of assets is part of an agency or nominee relationship for one person or for partners in an enterprise.

² Even if T acts in breach of trust he will be liable, all contracts being *intra vires* an individual, while persons contracting in good faith with a corporate trustee are unaffected by the old corporate *ultra vires* doctrine (Companies Act 1985, ss 35, 35A).

³ See para 2.19.

⁴ Trustee Act 1925, s 30(2); *Stott v Milne* (1884) 25 ChD 710, at p 715.

⁵ *Re Blundell* (1888) 40 ChD 370, at p 376.

⁶ *Fraser v Murdoch* (1881) 6 App Cas 855; *Dowse v Gorton* [1891] AC 190.

⁷ *Kemtron Industries Pty Ltd v CSD (Qld)* [1984] 1 Qd R 576, at p 587; *Re Suco Gold Pty Co* (1983) SASR 99, at p 109; *Jennings v Mather* [1901] 1 KB 108, at pp 113-114, *Stephenson v Barclays Bank Trust Co Ltd* [1975] 1 All ER 625, at p 637.

trustee either giving him an indemnity⁸ against future liabilities or taking over T's liability by novation of the contract with X.

- 2.7 T's right of indemnity is more than a mere right of retainer, being an equitable proprietary interest in the fluctuating trust fund in the nature of an equitable lien (or charge)⁹ which, of course, will be subject to earlier charges created in favour of secured creditors, but superior to the equitable interests of the beneficiaries under the trust¹⁰ and any transferees of such interests: such transferees can be in no better position than the beneficiaries themselves.¹¹ Where T has a lien and then grants security to a creditor, T will normally be taken to have intended to waive his lien so as to give priority to the creditor if, indeed, T's interest in the fluctuating trust fund is not overreached in favour of the creditor.
- 2.8 Because an equitable lien does not depend upon possession of the property to which it relates, it seems that if T ceases to be a trustee but is later sued on a contract properly entered into by him when he was administering the trust, then his right of indemnity will extend to the trust assets in the hands of the new trustee: he will be in the position of a creditor of the new trustee so as to be subrogated to whatever rights of indemnity the new trustee may have.¹²
- 2.9 Exercising the equitable lien so as to realise the right of indemnity may be delayed if no money can be made available by sale or charge without defeating or substantially impairing the accomplishment of the purposes of the trust.¹³

(b) Against the settlor or some beneficiaries

- 2.10 If the trust fund be insufficient to provide indemnity to T the question arises whether T may obtain indemnity from the settlor, S, or from a beneficiary, B.
- 2.11 In the absence of an express contract between S and T for indemnifying T, T has no personal right of indemnity against S except where S himself is the beneficiary, so that from his request to T to undertake administration of the trust for the benefit of S, a promise by S to reimburse T for liabilities incurred by T can be inferred.¹⁴
- 2.12 Where a beneficiary of full capacity requests T to become trustee or to incur a liability then the beneficiary is personally liable to indemnify T.¹⁵ Where several beneficiaries are so liable they indemnify T in proportion to their shares in the beneficial interest.¹⁶
- 2.13 In *Hardoon v Belilios*¹⁷ the Privy Council held that where T holds on a bare trust for B of full capacity 'the right of the trustees 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 [ie, beneficiary] a personal obligation enforceable in equity to indemnify his trustee'. As part of a business venture, partly paid shares had been vested in T, leading T to have to pay several calls on the shares which turned out to be worthless. T was held to be able to recover the amount of his payments from the defendant to whom a syndicate had assigned its beneficial interest, which it had received from T's employer, a firm of stockbrokers.
- 2.14 On a broad view,¹⁸ *Hardoon* could extend to apply where T holds on trust for A, B and C or for A for life, B for life and then C absolutely, where A, B and C are all of full capacity so as to have *Saunders v Vautier*¹⁹ power to call for legal title to be vested in them: from such power one could arguably infer a continuing request by them to T to incur liabilities as trustee.

⁸ Pursuant to Trustee Act 1925, s 15(f) or an express power.

⁹ *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360; *Custom Credit Corp Ltd v Ravi Nominees Pty Ltd* (1992) 8 WAR 42; cp *Chief Commissioner of Stamp Duties v Buckle* (1995) 38 NSWLR 574. The amount of the lien will not be determined until the taking of accounts between T and the trust fund.

¹⁰ *Dodds v Tuke* (1884) 25 ChD 617; *Re Griffith* [1904] 1 Ch 807.

¹¹ *Re Knapman* (1881) 18 ChD 300; *Re Exhall Coal Co Ltd* (1866) 35 Beav 449.

¹² *Re Johnson* (1880) 15 ChD 548, at p 552. Probably, he and the other creditors will rateably share the new trustees' lien, as diminished by any indebtedness of such trustees to the trust fund, once a balance has been established in favour of the trustees (see also HAJ Ford and WA Lee, *Principles of the Law of Trusts* (3rd edn, 1996) Ch 14, at p 19.

¹³ *Darke v Williamson* (1858) 25 Beav 622; cp *Re Pumfrey* (1882) 22 ChD 255.

¹⁴ *Balsh v Hyam* (1728) 2 P Wms 453.

¹⁵ *Ex parte Chippendale, Re German Mining Co* (1854) 4 De GM & G 19, at p 54; *Jeffray v Webster* (1895) 1 ALR 65.

¹⁶ *Matthews v Ruggles-Brise* [1911] 1 Ch 194.

¹⁷ [1901] 1 AC 118, at p 123.

¹⁸ See *JW Broomhead (Vic) Pty Ltd (in liquidation) v JW Broomhead Pty Ltd* [1985] VR 891.

¹⁹ (1841) 4 Beav 115.

- 2.15** On a narrower view *Hardoon* should be restricted to liabilities flowing from retention of burdensome original trust assets held as part of a speculative or business venture. In *Wise v Perpetual Trustee Co*²⁰ the Privy Council distinguished the *Hardoon* principle: 'As was then pointed out, this principle by no means applies to all trusts and it cannot be applied to cases in which the nature of the transaction excludes it ... Clubs are associations of a peculiar nature ... They are not partnerships; they are not associations for gain; and the feature which distinguishes them is that no member as such becomes liable to pay any money beyond the subscriptions required by the rules of the club ... It is upon this fundamental condition, not usually expressed but understood by everyone, that clubs are formed'.
- 2.16** If a club makes a profit, this benefits the members and not the trustee, so that if a trustee is to have a right of indemnity against beneficiaries personally for a type of trust other than a trust for business purposes, one would expect it here, but the Privy Council rejected this. In the case of testamentary or *inter vivos* family trusts there seems less reason to make the beneficiaries personally liable: they certainly would not expect personal liability to arise just because they were beneficiaries.
- 2.17** The better view, therefore, seems that, as in the United States,²¹ beneficiaries of family trusts are not personally bound to indemnify T for liabilities incurred by him as trustee unless they (expressly or impliedly) agreed to indemnify him for such liabilities.

Limitations on trustees' rights of indemnity

(a) Limitations in the trust instrument

- 2.18** A trust instrument may limit T's indemnity to a particular part of the trust property²² or oust T's indemnity against the trust property²³ or against the beneficiaries personally (e.g. unit trusts).²⁴

(b) Trustee indebted to the trust fund

- 2.19** If T 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.²⁵ 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 T's claim where his liability to pay compensation for breach of trust arose from such transaction.

(c) Liability incurred in transaction in breach of trust unless T has thereby in good faith benefited the trust

- 2.20** Clearly, the interests of the beneficiaries cannot be prejudiced by letting T get away with acting in breach of trust and charging this to the trust fund:²⁶ what T does improperly he must do at his own expense, a salutary sanction for the proper administration of trusts. Exceptionally, where the beneficiaries are not, in fact, prejudiced but are benefited where T acted in good faith, then, to prevent their unjust enrichment, it is equitable for T to be entitled to an indemnity for the amount of the benefit thereby conferred.²⁷
- 2.21** Acting in breach of trust covers a multitude of sins ranging from an unauthorised 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 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.

²⁰ [1903] AC 139, at p 149.

²¹ *Scott on Trusts* (4th edn, 1988) Vol IIIA, at p 354.

²² *Ex parte Garland* (1804) 10 Ves 110.

²³ *Trustee Act 1925*, s 69(2); *RWG Management Ltd v Corporate Affairs Comr* [1985] VR 385, at p 395; *Ex parte Chippendale, Re German Mining Co* (1854) 4 De GM & G 19, at p 52. Where such ouster is fraudulently intended to frustrate creditors' derivative claims, equity should ignore it (*Re Johnson* (1880) 15 ChD 548, at p 550).

²⁴ *McLean v Burns Philp Trustee Co Pty Ltd* (1985) 2 NSWLR 623, at p 641.

²⁵ *Re Johnson* (1880) 15 ChD 548; *Re Frith* [1902] 1 Ch 342; *Re British Power Traction & Lighting Co* [1910] 2 Ch 470. 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 ChD 203; *Re Dacre* [1916] 1 Ch 344, at p 347.

²⁶ *Re Oxley* [1914] 1 Ch 604; *Vacuum Oil Pty Ltd v Wiltshire* (1945) 72 CLR 319.

²⁷ *Vyse v Foster* (1872) 8 Ch App 309; *Re Leslie* (1883) 23 ChD 552; *Re Smith's Estate* [1937] Ch 636; *Ex parte Chippendale* (1854) 4 De GM & G 19.

(d) Charitable endowments

- 2.22 In the past, charitable trustees' rights of indemnity have not been allowed to be exercised over the permanent endowment or future income of the charity,²⁸ but the Charities Act 1993²⁹ allows a more flexible approach to be taken if this will not defeat or substantially impair carrying on the purposes of the trust.

Creditors' subrogation to trustees' rights of indemnity

- 2.23 Where T is personally liable, the creditor, X, has no problems if T is good for the money. However, a common law judgment cannot be levied against trust assets as opposed to T's own assets. Where the common law remedy was going to be fruitless, because of the insolvency or poverty of T, it became possible to maintain a bill in equity against T (or T's successor as trustee) for equitable execution,³⁰ so that X's claim could be satisfied out of the trust assets that could not be reached at common law. However, in equity, X's claim can be satisfied only to the extent that the current trustee is entitled to an indemnity out of the trust assets because equitable execution is only against the amount found to be due to the trustee by way of indemnity.
- 2.24 Because X's right is a derivative right³¹ it is subject to all the limitations set out above relating to T's right of indemnity. However, if the only limitation be the indebtedness of T1, where there are two trustees, T1 and T2, then X can take advantage of T2's right of indemnity.³²
- 2.25 It seems particularly hard on X that, although it can check that no limitation on T's rights of indemnity appears in the trust instrument and that the transaction between X and T is an authorised type of transaction, it may yet fail in its claim against the trust assets, either because T failed to exercise the requisite degree of care in dealing with X (or otherwise exercised his powers improperly) or because in some subsequent, totally unrelated transaction (or even in some secret earlier unrelated transaction) T incurred a liability to the trust fund of an amount exceeding X's claim.
- 2.26 The former ground of failure means that if X wishes to be able to fall back on a claim against the trust fund it must take steps to prevent T from entering into a bad bargain with X in breach of T's equitable duty of care (or otherwise exercising his powers improperly), so placing X in a position analogous to that of a fiduciary vis-a-vis T! To X this will seem preposterous, like the latter ground of failure where X has no possible power to discover or do anything about such a fortuitous future event.
- 2.27 No doubt, X would like to see the courts³³ or the legislature circumvent these problems so that it can reach the trust assets in these two situations where T could not reach them. Currently, it seems that X may have a better way of protecting itself, without relying on T's personal rights, by contracting for some direct right of recourse against the trust assets, as is discussed later.³⁴
- 2.28 Where T is insolvent and the unpaid X is subrogated to T's right of exoneration then X alone (and not also T's private creditors) will benefit.³⁵ X will be paid in full where T was not in default and the trust fund is solvent. If it is insolvent then it seems that the benefit of T's right of exoneration in the nature of an equitable lien will be available to all trust creditors, like X, when the trust is wound up under a creditor's administration order.³⁶ It may well be³⁷ that such creditors will share rateably what is left after payment of secured creditors, of the costs of realisation of trust assets and of any preferential creditors.

²⁸ *Attorney-General v Mayor of Newark* (1842) 1 Hare 395; *Attorney-General v Archbishop of York* (1853) 17 Beav 495.

²⁹ Sections 36-40.

³⁰ See *Scott on Trusts* (4th edn, 1988) para 268; see also *Re Wilson* [1942] VLR 177, at pp 181-183.

³¹ *Ex parte Edmonds* (1862) 4 De GF & J 488, at p 498; *Re Pumfrey* (1882) 22 ChD 255; *Marginson v Potter* (1976) 11 ALR 64, at p 75.

³² *Re Frith* [1902] 1 Ch 342.

³³ In oracular *obiter dicta* Needham J in *Re Staff Benefits Pty Ltd* [1979] 1 NSWLR 207, at p 214 indicates that T's default should be related to the subject matter of the claim to bar X's claim but in context the *dicta* may be explained on the basis that the employment of the manager was beneficial and caused no loss. Fragmentation of the state of accounts between T and the trust fund seems illogical. Logically, to the extent T cannot recover, X should not be able to recover.

³⁴ See paras 2.33-2.36.

³⁵ *Re Richardson* [1911] 2 KB 705, at p 715; *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360, at p 371.

³⁶ RSC O 85.

³⁷ See para 2.62.

- 2.29 Where T is entitled to exoneration from a beneficiary, B, personally, as opposed to the trust fund, it seems³⁸ that the unpaid X should be subrogated to T's right so as to be able to recover the sum due from B. If T be insolvent then X alone (and not T's private creditors) will benefit.³⁹ X will be paid in full if B is solvent, though if B be insolvent then X will rank as an ordinary unsecured creditor.

Creditors' direct recourse to trust funds

(a) Where the trust fund is benefited: unjust enrichment

- 2.30 Irrespective of whether or not T, with whom X dealt, is indebted to the trust or acted in good faith in exceeding his powers, X has a direct non-derivative claim in equity to reach the trust assets to the extent that X enriched or benefited the trust fund at its own expense, where X did not act officiously or gratuitously or with knowledge that T was not acting in good faith in exceeding his powers in dealing with X, so that it is unconscionable for the trust fund to retain the benefit.⁴⁰ 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,⁴¹ but the precise scope of this exceptional case is very much in course of development, though better established in the United States. A creditor, in having to rely on restitutionary principles, needs to be aware that his claim is limited to the extent the trust fund is benefited and may be affected by the developing defence of change of position.⁴²

(b) Where the trust instrument provides for the trust fund to be liable

- 2.31 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 T and X excludes this right in favour of T's exclusive personal liability.⁴³ Even if T 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 X is not relying on any derivative right. The settlor's intention for the trust fund to be directly liable should be implemented.
- 2.32 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.

(c) Where contract provides for the trust fund to be liable

- 2.33 There is a strong presumption that a trustee will be personally liable when contracting as trustee, so that a contract entered into by a trustee 'as trustee' renders him personally liable.⁴⁴ The onus is on the trustee to show that the parties intended the trustee not to be personally liable. If the trustee contracts 'as trustee and not otherwise' then he will be personally liable only to the extent that he has a right of indemnity against the trust fund so as not to be out of pocket.
- 2.34 Where a contract is properly made by T (on which see paragraphs 4.1 and 4.2) and provides that T shall not be personally liable, but that X shall look only to the trust fund for satisfaction of its claim, two constructions are possible. The contract can be narrowly construed as exempting T's own property from liability, without giving X a direct claim against the trust fund, so X can reach the trust fund only to the extent of T's right of exoneration.
- 2.35 The broader modern tendency in Australia and the United States⁴⁵ is to construe the contract as giving X a direct independent right of recourse to the trust fund, so that it is immaterial that T has no right of exoneration because indebted to the trust fund. The basis for this is the view that T'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 X either for T's personal liability or for the liability of the trust fund only to the extent of T's right of exoneration⁴⁶ or for the unlimited liability of the trust fund irrespective of T's right of exoneration. It is to be hoped that English courts will take this modern approach, especially if the contractual terms exclude ambiguity by expressly providing for unlimited direct recourse to the trust fund.

³⁸ *Scott on Trusts* (4th edn, 1988) para 278; *Poland v Beal* 192 Mass 559 (1906); *Countryside (No 3) Pty Ltd v Bayside Brunswick Pty Ltd* (unreported, NSW Sup Ct, Brownie J, 20 April 1994); Underhill & Hayton, *Law of Trusts and Trustees* (15th edn, 1995) at p 799.

³⁹ *Re Richardson* [1911] 2 KB 705.

⁴⁰ *Scott on Trusts* (4th edn, 1988) para 269. Contrary *dicta* in *Clack v Holland* (1854) 19 Beav 262, at pp 276-277 and *Re Evans* (1887) 34 ChD 597, at pp 601-602 mistakenly treat X's right as derivative, ignoring development of X's independent restitutionary right.

⁴¹ *Devaynes v Robinson* (1857) 24 Beav 86; cp *Boscawen v Bajwa* [1995] 4 All ER 769, at pp 780-781.

⁴² *Lipkin Gorman v Karpnale Ltd* [1991] 2 AC 548.

⁴³ *Ex parte Garland* (1804) 10 Ves 110; *Fairland v Percy* (1875) LR 3 P & D 217.

⁴⁴ *Muir v City of Glasgow Bank* [1879] 4 App Cas 337, at p 362; *Re Robinson's Settlement* [1912] 1 Ch 717, at p 729.

⁴⁵ See JG Merralls QC (1993) 10 Aust Bar Rev 248; *Scott on Trusts* (4th edn, 1988) Vol IIIA, at pp 499-500.

⁴⁶ There may well be an implied warranty of authority by T here, so that T is personally liable if X cannot reach the trust fund (*Scott on Trusts* (4th edn, 1988) para 263.3).

- 2.36 Where X can reach the trust fund it seems it has no lien upon it, so that if T subsequently contracts with Y and Z on similar terms, X, Y and Z are not entitled to be paid in the order in which the contracts were made, as they would be if they had liens, but have equal rights to be paid rateably according to the value of their debts if the trust fund be insufficient.

(d) Where the trust instrument provides for the grant of security over specific assets

- 2.37 Trustees may have statutory⁴⁷ or wider express powers by virtue of a trust instrument to grant a creditor legal or equitable security by way of a charge over specific assets. In such cases, the chargee will as such have direct rights of recourse to the relevant assets, subject to the charge being properly protected (e.g. by registration) against other creditors.

(e) Where the trust instrument provides for grant of security over fluctuating assets within the trust fund

- 2.38 A trust instrument may confer express power on individual or corporate trustees to create an equitable interest in the *trust fund* (in other words, the assets from time to time subject to the trusts) in favour of a creditor as security for its debt. After all, the beneficiaries have equitable interests in the trust fund, while the trustee has an equitable lien (or charge) over the trust fund to cover reimbursement of his expenses. It follows that a trustee should be able to make someone a beneficiary for value by granting him an equitable charge over the whole or part of the fluctuating pool of trust assets if there be an express power in such behalf. This fluctuating charge is in the nature of the well-known floating charge.⁴⁸ It will therefore create an immediate equitable interest in the trust fund⁴⁹ in favour of the creditor which will ultimately have priority over the equitable interests of the beneficiaries and of the trustee and of subsequent creditors granted a similar floating charge.⁵⁰
- 2.39 However, the floating charge of the creditor, being merely an interest in the trust fund from time to time, is, like the equitable interests of the beneficiaries and the trustee, inherently capable of being overreached or defeasible by exercise of the trustee's powers of sale or charge of specific assets in favour of third parties and even by exercise of the trustee's distributive powers of appointment or advancement in favour of beneficiaries, unless the trust instrument requires beneficiaries to take such distributed property and its traceable product subject to rights of creditors who have floating charges. Indeed, the trustee will also be able to repay loans and pay debts incurred in the ordinary administration of the trust whether or not the floating charge was created prior to the incurring of such loans or debts. The chargee as beneficiary for value has to rely for protection on the trustee's duty to exercise his powers with due regard for the interests of the chargee as of any other beneficiary.⁵¹
- 2.40 Thus, when the floating chargee claims to enforce its charge it will only affect the assets then comprising the trust fund unless, exceptionally, the trust instrument stipulates that to the extent that the charge is not satisfied out of the trust fund then it is to be satisfied out of assets distributed to beneficiaries after the creation of the fluctuating charge and the traceable product of such assets. It seems that the beneficiaries of the settlor's conditional gift will have to take the burdens along with the benefits.
- 2.41 The position of an equitable floating chargee is better than the right of a creditor with contractual rights only⁵² against the contracting trustee (and not against successor trustees) but only slightly better than that of creditors having a direct right of recourse to the trust fund. When a creditor's administration order is made due to the insolvency of the trust fund, an equitable floating chargee will normally have priority over subsequent such chargees, who will have priority over creditors having a direct right of recourse to the trust fund. No doubt, a prospective floating chargee should take a contractual warranty from the trustee that there are no such prior charges other than any specified by him.
- 2.42 It should be noted that the Bills of Sale Acts 1878 and 1882 apply only to chattels and, probably,⁵³ only to individuals, so as not to cover intangible assets or assets held by a corporate trustee, while section 395 of the

⁴⁷ For example Trustee Act 1925, s 16; Settled Land Act 1925, s 71; Administration of Estates Act 1925, s 39; Trusts of Land and Appointment of Trustees Act 1996, s 6.

⁴⁸ See the Law Reform Committee Report on the Powers and Duties of Trustees (Cmnd 8733 (1982)) paras 2.21-2.23.

⁴⁹ *Re Margaret Properties* [1985] BCLC 314; *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979, at p 999; Gower, *Principles of Modern Company Law* (5th edn, 1992) at p 414.

⁵⁰ See *Re Automatic Bottle Makers Ltd* [1926] Ch 412.

⁵¹ Law Reform Committee Report (Cmnd 8733 (1982)) para 2.20.

⁵² The floating charge has outgrown its purely contractual origin so that it should not be destroyed on a change of trustee.

⁵³ See *Slavenburg's Bank v Intercontinental Ltd* [1980] 1 WLR 1076, at pp 1097-1098.

Companies Act 1985 only applies to companies that create charges over their own property as opposed to trust property.⁵⁴ after all, trust property will not in any event be available on the liquidation of the corporate trustee to meet the claims of the company's own creditors. This is of particular assistance to creditors with floating charges over trust funds and to creditors supplying goods to a corporate trustee under contracts containing reservation of title clauses that amount to the creation of an equitable charge⁵⁵ in favour of the creditor.

(f) Creditors' rights of set-off or netting

- 2.43** Set-off of mutual debts or the broader process of netting both produce the effect of conferring security on a creditor. Settlement netting is the netting of reciprocal payments which fall due on the same date so that only the balance is payable. If a counterparty, C, owes a defaulter, D, £100 and D owes C £105, then if C pays £100 to D, but D defaults before paying its £105, C has lost £105. However, where netting is applicable, C's exposure to D is only £5.
- 2.44** Close-out netting is the cancellation of open contracts on default by a party and the set-off of losses and gains on all the contracts between the parties. If D has two contracts with C for the purchase by D of securities and D becomes insolvent before the date on which the securities are to be delivered and paid for, let us suppose that C would have a profit of £5 if it resold securities under the first contract but a loss of £5 if it resold securities under the second contract. If C can cancel both contracts on D's insolvency and set off the profit of £5 against the loss of £5, then C's exposure is zero.
- 2.45** The effect of netting⁵⁶ is substantially to reduce exposure on a default so as to mitigate systemic risks of cascade insolvencies, to reduce transaction costs and credit costs and to enable parties to enter into many more bargains than would otherwise be the case. Commercial trusts like pension funds, unit trusts and investment trusts which are not companies can thrive like other participants in financial and commercial markets if they have the benefit of netting arrangements.
- 2.46** The question for counterparties dealing with a trustee is whether they can net in the event of insolvency of the trustee or of the trust fund, while a trustee is concerned to see if netting arrangements are effective in the insolvency of a counterparty. Netting is merely administratively convenient where both parties are solvent, but its availability is crucial where insolvency of a party occurs.
- 2.47** The position is then governed by the insolvency set-off and netting clause in section 323 of the Insolvency Act 1986 for individuals and Rule 4.90 of the Insolvency Rules for a company. Such clause requires that there have been mutual credits, mutual debts or other mutual dealings between the defaulter, D, and the creditor, C. Mutuality requires that C and D must be personally liable on the debt each owes and be beneficially entitled to the debt due from the other.⁵⁷ A trustee is not beneficially entitled to a creditor's debt only due to the trustee in his capacity as such⁵⁸ (even if he is personally liable under the contract, not having expressly excluded such liability) so that mutuality is lacking; moreover, the *British Eagle*⁵⁹ principle prevents the parties by contract ousting the statutory restrictions in section 323 and Rule 4.90 so as to allow netting despite lack of mutuality. The statutory position is thus most unsatisfactory for a counterparty suing an insolvent trustee or for a trustee suing an insolvent counterparty.
- 2.48** However, if the trust fund is solvent despite the insolvency of the trustee, D, it should be immaterial that C is supposed to pay out where C can force the trust fund to pay out by virtue of a direct right of recourse against the trust fund (or even by way of subrogation to the trustee's rights). Thus the netting arrangement (unless dependent upon deficient rights of exoneration of the trustee) should be effective, so that C should not have to pay out if its claim exceeds the claim of the trust.
- 2.49** Where the trust is insolvent it is not an insolvent individual or an insolvent company. It follows that the above statutory restrictions in section 323 and Rule 4.90 that limit the concept of mutual dealings cannot apply. There is thus scope for the court to treat a trust as a quasi-person involved in bilateral mutual dealing with C and falling within the spirit of the statutory rules. The trust will be wound up by the court under a creditor's administration

⁵⁴ For this reason the Insolvency Act 1986, s 344 does not apply to make registrable as a bill of sale a general assignment of the trust's existing or future book debts.

⁵⁵ For example *Clough Mill Ltd v Martin* [1985] 1 WLR 111; *Modelboard Ltd v Outer Box Ltd* [1993] BCLC 623; *Re Highway Foods International Ltd (in administrative receivership)* [1995] 1 BCLC 209.

⁵⁶ PR Wood, *Title Finance, Derivatives, Securitisation, Set-Off and Netting* (1995) Ch 10.

⁵⁷ PR Wood, *English & International Set-Off* (1989), at pp 159, 288-289.

⁵⁸ It does not seem that his inchoate right to a lien in respect of the amount found available to satisfy his right of exoneration, once accounts between the trustee and the trust fund have been finalised, should be regarded as giving D a beneficial interest in C's debt owed by the trust.

⁵⁹ *British Eagle International Airlines Ltd v Compagnie Nationale Air France* [1975] 2 All ER 390.

action under RSC Order 85. Assuming that the contract with C is authorised under the trust and that the netting provision is a common term of such contracts so as to be implicitly authorised, it is believed that the court would give effect to the netting arrangement enabling C to net directly against the insolvent trust, but the position is uncertain and so needs clarifying.

- 2.50** The further question arises, in the absence of contractual netting provisions, whether the courts or the legislature should develop an automatic doctrine of set-off, by analogy to the existing insolvency set-off provision for individuals and companies, so that where both liability and asset are attributable to the trust fund, set-off is available, perhaps after accounts have been taken to discover whether the creditor's claim is reduced by the trustee's indebtedness to the trust fund if the creditor's claim be a derivative one through the trustee rather than a direct claim against the trust fund. After all, insolvency set-off was originally developed by case law before being codified in 1705. Moreover, under the doctrine of retainer⁶⁰ if C is liable to contribute to a fund but is entitled to a share of the fund as a beneficiary or creditor then T, the trustee of the fund, may retain C's share to cover the unpaid contribution, so that T has protection against an insolvent counterparty despite the lack of statutory mutuality. At the heart of the doctrine of retainer is the belief that it is unconscionable that one should have to pay a defaulter (which is at the heart of set-off). Perhaps, a reciprocal or reverse retainer with the effect of a set-off could develop to benefit C against an insolvent trust fund if C owes it more than it owes C.

Creditors' rights against directors of corporate trustees

- 2.51** In the case of a corporate trustee, if the company be insolvent or virtually insolvent the question arises whether any action may lie against its directors. Although the basic rule is that directors of a corporate trustee owe no fiduciary duties to beneficiaries,⁶¹ they may become personally liable as an accessory to the company's breaches of trust if they dishonestly assist the company in such breaches.⁶²
- 2.52** It would further seem that in the special case of a creditor with a floating charge such creditor would be regarded as a beneficiary for value having an equitable beneficial interest in the fluctuating trust fund like the primary beneficiaries, so that the corporate trustee would have to exercise its powers with due regard for the interests of fluctuating chargees as of any other beneficiaries⁶³ or be liable for breach of trust to the beneficiary-creditor.
- 2.53** If a corporate trustee goes into liquidation, then on the application of the liquidator, a director may be ordered to make such contribution to the company's assets available for creditors as the court thinks proper. Such order can only be made where, before the commencement of winding up, the director knows or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.⁶⁴

Creditors' liability to account in equity

- 2.54** Creditors may become personally liable to account in equity as constructive trustees if they dishonestly assist the trustee to commit a breach of trust or if they knowingly receive trust property in breach of trust.
- 2.55** Acting dishonestly or with a lack of probity, which is synonymous, means simply not acting as an honest person would in the circumstances known to him at the time. This is an objective standard. The defendant is expected to observe the standard which would be observed by an honest person placed in those circumstances. An honest person does not participate in a transaction if he thinks it involves a misapplication of trust assets to the detriment of the beneficiaries. Nor does an honest person in such a case deliberately close his eyes and ears or deliberately not ask questions, lest he learn something he would rather not know, and then proceed regardless. It is dishonest to take a risk to the prejudice of another's rights, when such risk is known to be one which there is no right to take. However, beneficiaries cannot personally expect that all the world dealing with the trustee should owe them a duty to take care lest the trustee is behaving dishonestly.⁶⁵
- 2.56** Where a creditor receives trust property for its own benefit (e.g. is paid trust money for its services⁶⁶) it becomes

⁶⁰ See *Cherry v Boulton* (1839) 2 Keen 319; *Re Ackerman* [1891] 3 Ch 212, at p 219; *Turner v Turner* [1911] 1 Ch 716; PR Wood, *English & International Set-Off* (1989) at p 405.

⁶¹ *Bath v Standard Land Co Ltd* [1911] 1 Ch 618, at p 625.

⁶² *Royal Brunei Airlines v Tan* [1995] 2 AC 378.

⁶³ Law Reform Committee Report on the Powers and Duties of Trustees (Cmd 8733 (1982)) para 2.20.

⁶⁴ Insolvency Act 1986, s 214.

⁶⁵ All sentences in this paragraph are taken from *Royal Brunei Airlines v Tan* [1995] 2 AC 378.

⁶⁶ For example the solicitor in *Stanier v Evans* (1886) 34 ChD 470.

personally liable to account for it as a constructive trustee once it knows it is trust money to which it may well not be entitled⁶⁷ unless it was a bona fide purchaser for value without notice or can otherwise make out the defence of change of position.⁶⁸ Indeed, the beneficiaries will have a proprietary tracing claim against the trust property or its product in the hands of the creditor unless it was a bona fide purchaser for value without notice⁶⁹ or has the defence of change of position available to it.

Trustees' tortious liability

- 2.57 If T in the proper or improper administration of the trust by act or omission causes tortious loss to X, T is personally liable to X to the extent of T's whole fortune, irrespective of the value of the trust fund. If the tort occurred without any breach of trust or fault by T then T can exercise his right of exoneration and pay X directly out of trust money or T can pay X out of his own pocket and then reimburse himself out of trust money.⁷⁰ Otherwise, T has to pay only out of his own pocket.
- 2.58 Where T has a right of exoneration against the trust fund, X can take advantage of it by way of subrogation.⁷¹ Independently of such derivative right, it seems that X can have a direct right of access to the trust fund if T's tort benefited the trust, to the extent that the trust was benefited (e.g. if T misappropriated X's property and applied it to paying off charges on the trust estate)⁷² or if the trust instrument reveals an intention that liabilities, including tortious liabilities, incurred in the administration of the trust should be discharged out of the trust fund.⁷³

Liability for taxes and as title-holder

- 2.59 If T properly holds trust property and properly incurs a personal liability as property-holder he is entitled to indemnity out of the trust fund, but, otherwise, he is not.⁷⁴ Presumptively, T is fully liable to the extent of his fortune as if he were the legal and beneficial owner, but, in the absence of statutory provisions, the courts may well be prepared to limit T's liability to the extent to which the trust fund is sufficient to indemnify him where he is without fault for the liability and for the insufficiency of the fund to be able to satisfy the liability.⁷⁵
- 2.60 For inheritance tax purposes a trustee is only liable to the value of property that he has received, disposed of or become liable to account for to the beneficiaries and of any other property which is in his hands for the payment of tax (or would have been but for his own neglect or default).⁷⁶ Income tax, however, is charged on the trustee in whose name trust income arises and on any subsequent trustee of the trust without any limitations.⁷⁷ For capital gains tax purposes the trustees are treated as a single and continuous body of persons distinct from the persons who may from time to time be the trustees, while on any default of the trustees capital gains tax may be charged to beneficiaries who have received the relevant assets.⁷⁸

Insolvency

(a) Of the trustee

- 2.61 If the insolvent trustee, T, remains trustee then T's right of exoneration with the supporting equitable lien for the amount ultimately found due to T is an asset available for the unpaid⁷⁹ trust creditors and not T's private creditors.⁸⁰ Where T1 is replaced by a solvent T2, the unpaid creditor, X, will have to take advantage of T1's derivative claim against T2's right of exoneration, so that X will be detrimentally affected by any indebtedness of T1⁸¹ or of T2 to the trust fund.

⁶⁷ *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] 2 All ER 961, at p 988; *Eagle Trust plc v SBC Securities* [1992] 4 All ER 488, at p 509.

⁶⁸ *Lipkin Gorman v Karpnale Ltd* [1991] 2 AC 548.

⁶⁹ *Macmillan v Bishopsgate Investment Trust plc* [1995] 3 All ER 747, at pp 769, 783.

⁷⁰ *Benett v Wyndham* (1862) 4 De GF & J 259.

⁷¹ *Re Raybould* [1900] 1 Ch 199.

⁷² *Whiting v Hudson Trust Co* (1923) 25 ALR 1470 (Cardozo J); *Scott on Trusts* (4th edn, 1988) para 269.2.

⁷³ *Scott on Trusts* (4th edn, 1988) para 270.2.

⁷⁴ *Scott on Trusts* (4th edn, 1988) para 248.

⁷⁵ *Scott on Trusts* (4th edn, 1988) para 265.4; Restatement (Second) of Trusts, para 265.

⁷⁶ Inheritance Tax Act 1984, s 204(2); see also ss 201 and 204(3) for default powers against beneficiaries to the extent of their interests.

⁷⁷ Finance Act 1989, s 151(2).

⁷⁸ Taxation of Chargeable Gains Act 1992, s 69(1) and (4).

⁷⁹ If trust creditors have been paid off by T then T's right of reimbursement will be an asset available for T's private creditors.

⁸⁰ *Re Suco Gold Pty Ltd* (1983) 33 SASR 99; *Re Richardson* [1911] 2 KB 705.

⁸¹ It will be possible for the liquidator of T1 to retain sufficient assets to pay X if there is a clear account between T1 and the trust (*Re Exhall Coal Co* (1866) 35 Beav 449, at pp 452-453).

(b) Of the trust fund

- 2.62** A trust fund is neither an individual nor a company, so that the statutory regimes applicable to insolvent individuals or companies in respect of their own property have no relevance, even if it turns out that the individual or corporate trustee is insolvent like the trust fund itself. The proper procedure is thus for a creditor's administration order under RSC Order 85⁸² to be sought. After seeing to secured creditors, the costs of realisation of assets, and preferential creditors, it seems that floating chargees should normally be paid in order of creation. After that it is uncertain what the court would direct, though it is clear that creditors with derivative rights under the trustee's right of exoneration are limited to the sum the trustee, T, could claim. If T can claim only £10,000 and C1, C2, C3 and C4, to whom debts of £5,000 each were incurred in that order, claim payment, it seems likely they would each be able to put in a claim for £2,500 rather than C1 and C2 being able to prove for £5,000 each and C3 and C4 for nothing. If C5, C6, C7 and C8 had, in that order, each provided £5,000 under a contract effectively giving them direct rights of recourse against the trust fund (irrespective of T's position) then it seems likely that they should each prove for £5,000 and that a rateable dividend should be paid to each rather than preference being accorded to the earliest debt. It would seem that C1, C2, C3 and C4 (as to £2,500 each) and C5, C6, C7 and C8 (as to £5,000 each) would rank at the same level for priority purposes. The position is rather uncertain and needs to be clarified.
- 2.63** Where the trustee, T, is solvent and personally liable to particular creditors one would expect them to sue, and get paid by, T, so that T would then rank as the relevant creditor with the same priority as the creditors he paid off. Once the RSC Order 85 procedure commences T should stop entering into any contracts and only do such acts as are necessary to preserve or realise the trust fund.
- 2.64** Where T is an insolvent company and its liquidator is winding up the company and the trust, in principle the two should be kept separate, so that trust assets should not be used in winding up the corporate trustee but only in winding up the trust.⁸³ However, in Australia⁸⁴ it has been held that where the company has trust liabilities it is reasonable to regard the winding-up costs of the liquidator and petitioning creditor as debts of the company incurred in discharging duties imposed by the trust.

⁸² See PR Wood, *English & International Set-Off* (1989) at p 1044.

⁸³ *Re Byrne Australia Pty Ltd (No 2)* [1981] 2 NSWLR 364; *Re Matheson* (1994) 121 ALR 605, at p 615.

⁸⁴ *Re Enhill Pty Ltd* [1983] VR 561; *Re Suco Gold Pty Ltd* (1983) SASR 99.

PROBLEMS IN HOW CREDITORS CAN COPE WITH THE LAW

- 3.1 This Chapter examines how creditors can cope with some of the legal difficulties explained in Chapter 2. Clearly, it is only if they know that they are dealing with a trustee that they can consider taking steps in excess of those they would take if dealing with beneficial owners. Even where they have the best legal advice on such steps, they have to consider the extra time and cost involved in taking such steps; they may also fear driving away business if they insist on legalistic steps being taken for their comfort. They may well take the policy decision either never to deal with trustees (except for mega-wealthy ones) or to deal with trustees just as if they were beneficial owners. If significant amounts of money are involved it is better not to deal with trustees or only if strong protective steps can be taken in the available time.
- 3.2 In financial market transactions time constraints create significant difficulties where a counterparty knows it is dealing with a trustee. It will be very much at risk if it does not appreciate that it is dealing with a trustee, though it can require persons it deals with to warrant that they are neither trustees nor agents acting for trustees.

Relying on trustees' personal liability and right of exoneration

- 3.3 If the trustee, T, is good for the money there is no problem even if he acted in breach of trust, so checking on T's credit rating is important. Otherwise, the creditor, X, needs to rely on T's right of exoneration out of the trust fund.¹
- 3.4 X will need to check that:
- (i) the trust instrument (a) does not oust or limit T's right of exoneration and (b) empowers T (or his agent) to deal with X in the relevant transaction;
 - (ii) T (or his agent) is properly authorised and properly exercising such power(s); and
 - (iii) T is not already indebted to the trust in an amount exceeding the amount likely to be due to X;
- while X will need to hope that:
- (iv) T, when X's debt falls due, will not have become indebted to the trust for a sum exceeding X's debt;
- unless*
- (v) the trust instrument ousts (i), (ii), (iii) and (iv) by a clause in favour of creditors enabling them to recover from the trust fund itself moneys due to them, irrespective of the state of the accounts between T and the trust fund, so long as they had no actual knowledge of any breach of trust when contracting with T.
- 3.5 Unfortunately, (v) is very rare. Thus, (i)(b) may create some problems in grey areas, while (ii) can create real difficulties over X ascertaining internal irregularities and may even put X in the position of a fiduciary wondering whether T's bargain with it is poor enough or in breach of T's duty to diversify investments so that X should tell T that he is in breach of his duty of care. Checking on (iii) creates practical difficulties and will normally require reliance on the word of T.

¹ In the unusual event of T having a personal indemnity from the settlor or a beneficiary X should contract with T for the benefit of it if not paid by T, thereby avoiding any technical arguments over the existence of rights of subrogation to personal indemnities.

- 3.6 Whilst X can check for past breaches, checking for breaches to be made by T *after* X's contract with him is impossible. X can only check that T is the 'right sort' who would be unlikely to become indebted to the trust. However, if T1 is replaced by T2, X's rights will further depend on the state of accounts between T2 and the trust fund. This will be so even if T2 gives T1 an express indemnity against T1's contractual liability to X or if T2 takes over T1's liability to X by novation of the contract.²
- 3.7 Finally, X has to remember that subrogation to the right of exoneration out of the trust fund depends upon how much the trust fund is worth. By the time X comes to exercise the right of subrogation, the fund may have been depleted or exhausted by payment of liabilities to creditors and the Revenue, and by distributions of assets to beneficiaries. To guard against this, X may require T to contract not to grant security interests over the trust assets and not to make distributions to beneficiaries so as to leave unencumbered assets worth less than £y without the consent of X. However, if T commits the prohibited acts, there is only a personal damages liability to X, the value of which will depend upon T's wealth. There seem to be no rights against beneficiaries to whom T transferred trust assets by virtue of the beneficiaries' interests, so that such assets became the beneficiaries' own assets.³ T could not exercise his right of exoneration against such assets, so neither can X whose rights derive only from T's right. T (and therefore X) could only hope to recover what they are owed from beneficiaries' shares remaining in the trust fund or from future income arising from such shares where such trust fund remains in T's hands,⁴ but that is not the case in this postulated example.
- 3.8 Exceptionally, it seems, in principle, that T and X could have rights against beneficiaries to whom trust assets had been transferred if the trust instrument specifically authorised this burden to attach to the benefits provided for the beneficiaries, e.g. by a provision that trust assets and the traceable product thereof could be recovered by T to the extent that T would otherwise not be able to obtain payment of liabilities properly incurred by him as trustee. However, a beneficiary could then take steps to ensure that the assets transferred to him became untraceable, e.g. by being converted to money, if not already money, and then being dissipated.

Insisting on a direct right of recourse to the trust fund

(a) Secured claims

- 3.9 As an alternative to, or in addition to, the personal liability of T, X may bargain for some security over specific trust assets or the fluctuating trust fund, but only if T has power to grant such a security by virtue of the trust instrument and any statutory powers. Of course, X will need to check that T is properly exercising the power with any requisite consents, and will then need to protect itself by perfecting its charge as necessary under the Land Registration Act 1925 or the Land Charges Act 1972 or the Bills of Sale Acts 1878 and 1882 or by notice, but not under section 395 of the Companies Act 1985.
- 3.10 Floating equitable charges over the trust fund will normally rank according to date of creation, so a personal warranty may be sought from T that no earlier floating charges have been created. Because such charges only affect the fund from time to time, X should also seek contractual undertakings from T that, without X's consent, T will create no future charges over specific assets nor enter into liabilities in excess of £y nor distribute assets to beneficiaries so as to leave unencumbered trust assets worth less than £z.

(b) Unsecured claims

- 3.11 If X is to rely on a personal claim directly against the trust fund, it will help if the trust instrument specifically makes liabilities payable out of the trust fund if incurred by T in favour of someone who had no actual knowledge of any breach of trust when contracting with T or who had checked that T had power on the face of the trust instrument to enter into the contract with X, whether or not such power was properly exercised by T. The former of these alternatives, of course, provides better protection for X.

² It is possible that X may require T1 to contract not to retire and appoint a new trustee without arranging for the new trustee, T2, to provide T1 with an express indemnity or for the novation of X's contract, but breach of this contract only makes T1 liable in damages.

³ Even if the *Ministry of Health v Simpson* [1951] 2 AC 251 personal action could apply beyond administration of deceaseds' estates to *inter vivos* trusts the beneficiaries are not wrongful payees, while X is the creditor of T and not of the trust estate which was vested in T.

⁴ See Goff & Jones, *Law of Restitution* (4th edn), at pp 154-155; HAJ Ford and WA Lee, *Principles of the Law of Trusts* (3rd edn, 1996) paras 9330 and 14170.

- 3.12 In the absence of such protection in the trust instrument, if T on the face of the trust instrument is authorised to enter into a contract of the type proposed with X, it seems that he may well be implicitly authorised to agree with X for T's personal liability or for the independent direct liability of the trust fund. In the latter eventuality, because X's claim is not derived through T, it is to be expected that X will still have a direct right of recourse even if T exercised his fiduciary power improperly, so long as X was not actually aware of this (as is discussed in paragraphs 4.1 and 4.2).
- 3.13 In the event of the trust fund being inadequate to allow creditors to be paid in full, then what is left after satisfaction of creditors with security over fixed assets and of floating chargees may, perhaps, be divided rateably between creditors with direct recourse against the trust fund and creditors with a derivative right via T's right of recourse against the trust fund, though this derivative factor may well extinguish or reduce the claims of creditors reliant thereon. Of course, at the end of the day there is the problem (discussed at paragraph 3.7) that the value of creditors' rights in the trust fund depends upon the value of the fund.

Financial markets and netting rights

- 3.14 Increasingly, trustees are entering into transactions in financial markets, e.g. to use derivatives as a means of minimising risk but sometimes as a form of speculation. Where X is a counterparty it faces the following problems:
- (i) the risk that T or T's fund manager has no authority under the trust or is improperly exercising such power so that a beneficiary may restrain performance of the contract by injunction (e.g. where the market has moved against T) and trust assets will not be available to meet obligations created by the contract;
 - (ii) the risk that a completed contract made in breach of trust may be set aside by a beneficiary if X was not a bona fide purchaser without notice of the breach of trust at the time of performance of the contract, so X has to be cautious if aware of the existence of the trust;
 - (iii) the concern that if X is dealing with a trustee or fund manager of several trust funds it may be difficult to make a proper assessment of the credit risks involved;
 - (iv) the risk that X may be unable to set-off obligations because of a lack of mutuality;
 - (v) the risk that X's right of subrogation to T's right of exoneration out of the trust fund may be *pro tanto* defeated by an earlier or a later breach of trust by T making him indebted to the trust fund, even though X's contract with T was properly entered into; and
 - (vi) in the time available insufficient precautionary steps can be taken.
- 3.15 It is not surprising that a few counterparties may refuse to deal with trusts if the credit rating of the trustee personally is inadequate for the sums involved.
- 3.16 Where debits and credits are going to arise between the parties to financial market transactions there will be a bilateral master netting agreement to cover all bargains between the parties, e.g. relating to swaps, currency, repos and stock borrowings. On the occurrence of specific events of default by one party, the other party can cancel outstanding contracts, calculate losses and gains and then set them off so that only a net balance is payable either way. Such bilateral close-out netting is regarded as effective on insolvency where X deals with Y, a beneficial owner.⁵
- 3.17 If the agreement between X and T excludes T's personal liability then there can be no question of contractual or statutory netting between X and T in respect of trust assets and liabilities. If it is agreed that T will be personally liable for debts to X incurred on behalf of the trust, T and X can by contract net where X owes money to the trust via T, but on the insolvency of T or X such netting will not be allowed due to the lack of mutuality between X and T (as seen in paragraph 2.47).

⁵ See Financial Law Panel Guidance Notices, 'Netting of Counterparty Exposure' (19 November 1993) and 'Netting of Counterparty Foreign Exchange Dealing' (20 September 1994); see also Arden, (1994) 1 *Receivers, Administrators and Liquidators Quarterly*.

- 3.18** Often, the agreement between X and T will exclude T's personal liability so that netting is by way of direct recourse to the trust fund, a balance being taken between what X owes to the trust via T and what the trust via T owes to X. The state of accounts between T himself and the trust should be irrelevant (as seen in paragraph 2.35). Effect will be given to the agreement while the parties are solvent and ought to be given even where the trust itself is insolvent (as discussed in paragraph 2.49). If it is X which is insolvent, lack of mutuality puts it outside the statutory insolvency netting provision applicable to individuals or to companies, but it seems that the doctrine of retainer would apply,⁶ T being able to retain X's share until X pays what it owes into the trust so that, in effect, netting occurs.

⁶ *Cherry v Boulton* (1839) 2 Keen 319.

REFORM

Direct but unsecured right of recourse to trust fund

- 4.1 By contract it seems possible already¹ for the creditor, X, to stipulate for a direct (but unsecured) right of recourse against the trust fund (so that the state of accounts between the trustee, T, and the trust fund is immaterial) where the liability is properly incurred by T. Thus, the transaction must be authorised by virtue of the trust instrument or any statutory power applicable thereto so as to be within the powers of T. The question arises whether such powers must also be properly exercised by T so as not to be exercised by him in breach of his equitable duty. This can be difficult if not impossible for X to check for certain, the possible defects ranging from lack of consent of some other person,² to breach of the duty to diversify investments in accordance with modern portfolio theory, to breach of T's duty of care to invest as if investing for persons for whom he is morally obliged to provide unless the trust instrument creates a lesser standard of care. The position is exacerbated if X is dealing with a portfolio manager, M, appointed by T, in case M was not validly appointed or was appointed subject to certain restrictions having to be complied with or was appointed but given more leeway than T could authorise without being in breach of his equitable duty to the beneficiaries. The position is even worse if X does not know that M is acting for a trustee.
- 4.2 It is to be hoped that in the light of the case-law developments in company law³ aimed at protecting creditors of companies from internal irregularities, and in the light of the absurdity of requiring X in a commercial dealing with T to warn T if T be making a bad bargain so as to be in breach of T's duty of care, the courts would allow X a direct right of recourse, even if T exercised his equitable powers improperly, so long as X was not knowingly assisting T in such breach of trust.
- 4.3 At the very least, reforming legislation should clarify this point, but it seems that legislation should go further. In the context of claims to make third parties liable for knowing receipt or dishonest assistance, Millett J⁴ (as he then was) and Lord Nicholls⁵ appear to allow third parties to assume a trustee has wide investment powers. Indeed, Lord Nicholls states:⁶ 'Beneficiaries cannot reasonably expect that all the world dealing with their trustees should owe them a duty to take care lest the trustees are behaving dishonestly'. It is *prima facie* dishonest for a trustee deliberately to incur liabilities improperly.
- 4.4 On this basis one could recommend that creditors should have an original primary right of direct recourse to the trust funds⁷ by suing the current trustee in his representative capacity as trustee if the creditor knowingly dealt with a trustee, acting as such, in circumstances where the creditor was not thereby dishonestly assisting in a breach of trust (as it would be if it knew the trustee had no power to enter into the liability or had no requisite consent necessary for the exercise of such power). Any liability of the trustee to the beneficiaries for breach of trust would remain, but if the trustee were insolvent then the beneficiaries would suffer to the extent that recourse was had to the trust fund where this would not previously have been possible.
- 4.5 A lesser right of direct recourse would exist if legislation made it clear that a creditor knowingly dealing with a trustee acting as such has such right of recourse if the trustee had power to incur the liability by virtue of statute or provisions in the trust instrument. Thus creditors would need to check the trust instrument if the transaction was not covered by statutory powers, but would not be concerned to check whether the relevant power was being properly exercised, as the courts might hold to be the position today in any event. However, rather than oust creditors' direct rights of recourse if, strictly, the relevant liabilities fell outside the scope of the trustee's powers,

¹ See para 2.35.

² In the conveyancing context of sales and mortgages of land it is sensible to require the purchaser to check that requisite consents have been obtained (e.g. as assumed by the Law of Property Act, s 26) though, significantly, the Trusts of Land and Appointment of Trustees Act 1996, s 16(2)(b) and (3)(b) protect purchasers without *actual* notice of trustees' failure to obtain consents or satisfy other requirements.

³ Rule in *British Royal Bank v Turquand* (1856) 6 E & B 327.

⁴ *El Ajou v Dollar Land Holdings plc* [1993] 3 All ER 717, at p 743.

⁵ *Royal Brunei Airlines v Tan* [1995] 3 All ER 97, at pp 107-108.

⁶ *Royal Brunei Airlines v Tan* [1995] 3 All ER 97, at p 108.

⁷ As in Jersey, Guernsey, Florida, Turks & Caicos Islands and South Africa.

why should creditors not be protected if they reasonably believed the trustee to have power to enter into the contract⁸ or if they reasonably believed the situation to be so urgent that the contract should be entered into without time being taken to verify the trustee's powers, or, perhaps, if they acted upon a written warranty from the trustee that he had the relevant power?

- 4.6 What about the position where a creditor, X, deals with T not knowing him to be a trustee (or where X deals with a fund manager acting for an undisclosed principal, T)? If the liability were properly incurred (because within powers which were exercised properly) why should X's rights depend upon the state of accounts between T and the trust fund and the fact that T happened to forget to mention he was acting as trustee? Thus, clause 12 of the United States Uniform Trust Act of 1937 provides that wherever a trustee or a predecessor trustee makes a contract that is within his powers as trustee the other party may sue the trustee in his representative capacity, and any judgment shall be collectible out of the trust property even though the trustee could not have secured reimbursement from the trust fund if he had paid the plaintiff's claim. It further provides that the plaintiff may hold the trustee personally liable if the contract does not exclude such personal liability, but the addition of the word 'trustee' or the words 'as trustee' after the signature of the trustee shall be deemed presumptive evidence of an intent to exclude the trustee from liability.
- 4.7 There is much to be said for such approach which extends to the case where the transaction was within T's powers but he exercised the powers improperly, i.e. the transaction was within the scope of T's authority though such authority was improperly exercised. However, it is possible that T, in not disclosing that he was a trustee, was really acting for himself and not for the trust,⁹ but when a loss arises, he tries to place the loss on the trust estate. Thus, in the situation where X did not originally know he was dealing with T as a trustee, clause 12 prevents X obtaining a judgment against T in his representative capacity as trustee unless X has taken such steps as are practicable to notify each of the beneficiaries of full capacity, who are entitled to intervene in X's action against T.

Possibility of personal liability of T to X

- 4.8 It is, of course, currently open to X to contract with T that T is to be personally liable if direct recourse to the trust fund does not satisfy X's claim and such possibility will remain if the law is reformed to make the trust fund itself originally liable. It may seem harsh on T, but if T agreed to it, this seems fair when T was in the best position to assess the value of the trust fund and to preserve trust assets by postponing distributions to beneficiaries until liabilities had been met.
- 4.9 Usually, recourse to the trust fund will suffice for X, but there is a possibility that T may become personally liable because after appointing T2 to replace him, the fund in the hands of T2 becomes dramatically depleted. It should be made clear that T has a right to retain sufficient trust assets to cover the potential liability unless novation of the contract occurs or he is satisfied with personal covenants of indemnity from the new trustee.

Personal indemnity rights

- 4.10 In the rare family trust case where T may have a right of personal indemnity from the settlor or some beneficiaries for liabilities properly incurred by him as trustee and where the trust fund may prove insufficient to satisfy X's claim, it should be made clear that X will automatically acquire by subrogation T's right of personal indemnity.

Employment of agents

- 4.11 Where T employs an agent who acts within the scope of the business of such a type of agent, then, on reform of the law relating to T's position, it may seem proper to allow the creditor, X, to have direct recourse to the trust fund if X would have had such recourse if dealing with T directly, unless X was aware that T's appointment of the agent was a breach of trust, so that X was dishonestly assisting a breach of trust.

⁸ The settlor and the beneficiaries deriving title under him should suffer from any ambiguities in the trust instrument (e.g. whether a power to charge trust assets allows a floating charge to be created over the trust fund); otherwise, perhaps, one ought to extend the court's relieving power under the Trustee Act 1925, s 61 to relieving creditors from losing their direct right of recourse to the trust fund.

⁹ Where incurring the liability to X is outside the scope of T's authority as trustee, then T should not be allowed to claim that he was acting as trustee in contracting with X unless expressly contracting as such.

Need for insolvency netting for quasi-mutual dealings

- 4.12 The recommended original primary direct liability of the trust fund itself emphasises the need to allow contractual netting and automatic set-off where there are quasi-mutual dealings because both liability and ownership of the debt are attributable to the trust fund. New statutory insolvency provisions should allow for this.

Need for clarifying position on insolvency of trust fund

- 4.13 The order of priority needs to be clarified so that after seeing to secured creditors, the costs of realisation of assets and preferential creditors, fluctuating chargees should be paid in order of creation, followed rateably by the claims of the remaining creditors according to the amounts due to them from the trust fund if reforming legislation makes the trust fund primarily liable. In the absence of such reform it would seem helpful for legislation to provide that in assessing rateable shares of creditors, creditors with direct recourse rights are credited with the full amount of their claims but creditors with derivative rights under the trustee's right of exoneration are credited only with a rateable amount of the amount of the trustee's right of exoneration.
- 4.14 Trustees will be clearly worried about consequences for themselves if they pay off a creditor when it is likely other creditors will suffer because the trust may well be insolvent. They should clearly apply to the court under RSC Order 85 for directions and should refrain from entering into new liabilities except in the course of preserving or realising the trust assets. It may well be that some self-sufficient statutory provisions are required rather than leaving matters to RSC Order 85 proceedings. We welcome views.

Need for broad express powers to create charges

Secured claims

- 4.15 The modern trend¹⁰ is to create trusts which confer very broad powers on professional trustees in the belief that it is much better for them to have power to do something, even if they decide it is better in the circumstances not to exercise the power, rather for them not to have power to do something, so that they cannot do something beneficial without the time, trouble and cost of obtaining the power from the court under section 57 of the Trustee Act 1925 (or risking liability for breach of trust if by some odd eventuality loss arises from what was originally beneficial). We thus believe you can trust trustees with broad powers, so that statute (subject to contrary intention of the settlor) should confer on all trustees power to create any type of charge over trust assets or the trust fund as a fluctuating fund to secure liabilities incurred in the proper administration of the trust.
- 4.16 The Law Reform Committee in their 23rd Report¹¹ recommended that, although they did not doubt that an express power to create a floating charge could be conferred on trustees, legislation should make it clear that such a power can be created. The statutory power recommended in paragraph 4.15 makes this clear.
- 4.17 The equitable interests of floating chargees will under the general rule as to priorities rank among themselves according to their creation unless the conduct of the earlier chargee is such as to estop it from claiming its priority in time.¹² Statute could provide for such chargee to lose its priority if it fails to have a memorandum of the transaction endorsed on the trust instrument or for priority to depend upon date of endorsement of such memorandum on the trust instrument. We believe this to be cumbersome and unnecessary, while the expensive alternative of creating a public register of such charges for all trusts does not seem practical or justifiable.¹³ However, we would be interested to receive any contrary views.

Tortious claims against the trust fund

- 4.18 It is difficult as a matter of policy to see why the risk of loss from torts committed by the trustee in the administration of the trust should not be borne by the trust fund rather than the victim of the tort if satisfaction cannot be

¹⁰ See Treasury Consultation Document of May 1996 on Trustee Investment recommending very broad powers of investment to replace the limited powers under the Trustee Investments Act 1961 and the approach in the forthcoming Law Commission Consultation Paper on Delegation of Trustees' Administrative Powers and Duties.

¹¹ Cmnd 8733, para 2.21.

¹² Law of Property Act 1925, s 137 is not applicable to the creation of new beneficial interests.

¹³ There are obvious problems about the name under which a trust should be registered and against which searches could satisfactorily be expected to be made. A possible exception may be made for pension funds because a Pensions Registry currently exists.

obtained from the trustee personally. We believe that for the victim of the tort to reach the trust fund it should be sufficient that the tort was committed by the trustee in the administration of the trust even though the trustee himself is not entitled to exoneration out of the trust fund, whether because he was personally negligent or is indebted to the trust. Since, in some cases, a claim can be made either in contract or in tort,¹⁴ it makes sense for the trust fund to be primarily liable in both cases.

Liability of trustee as title-holder

- 4.19 In the absence of English case law it seems it would help to clarify matters if, in the absence of statutory provisions, the liability of a trustee as title-holder of property were limited to the extent the trust fund is sufficient to exonerate him from personal liability where he is without fault for the liability and for the insufficiency of the fund to be able to satisfy the liability. This may become of particular significance for environmental liabilities, a developing area of considerable complexity where a variety of Acts may be applicable.

Application of reforming legislation

- 4.20 It seems sensible for the new statutory provisions to apply to all trusts. It appears difficult to justify distinguishing between family trusts and commercial or financial trusts or between private trusts and charitable trusts. However, we welcome views on this. Most provisions (except the new power to create fixed or floating charges) could apply to trusts whether created before or after the new Act comes into force. We welcome views on this.

The overall position of beneficiaries vis-a-vis creditors

- 4.21 Clearly, the canvassed reforms, to a greater or lesser extent, appear to tilt the balance away from protecting the interests of beneficiaries to protecting the interests of creditors (so that beneficiaries have to rely more on claims against the trustees for breach of trust). After all, creditors will have a greater chance of becoming secured creditors or of obtaining unsecured direct rights of recourse against the trust fund, despite any conduct of the trustees which previously would have prevented recourse against the trust fund. However, it seems in any event that the English courts could well begin to look with favour upon creditors with the benefit of contractual terms allowing them to have direct recourse against the trust fund, irrespective of the trustees' position, so long as there was power to enter into the transaction on the face of the trust instrument or, perhaps, even if such power was normally available to trustees.
- 4.22 The clear modern trend is for settlors to trust trustees and confer very broad powers indeed upon them, so persons dealing with trustees increasingly expect them to have the broadest possible powers of investing and efficiently utilising trust funds. However, settlors' advisers rarely consider or fully understand the need to insert trust provisions to encourage creditors to deal with the trustees, so that fullest advantage can be taken of the trustees' broad powers intended by settlors to further the financial interests of the beneficiaries. Thus, having desired the 'end' of promoting what they consider to be in the best interests of their beneficiaries, settlors have not provided adequate means for this end, so that creditors have to continue to run the risks discussed in this Paper or not knowingly deal with trustees.
- 4.23 Our provisional view is that once one gets into the commercial and financial marketplace there is no reason in principle why creditors should be more at risk when dealing with trustees for beneficiaries than when dealing with absolute beneficial owners. We do, however, recognise that there are some instances where there must be protection for the beneficiaries of trusts against a dishonest trustee.

¹⁴ *Henderson v Merrett Syndicates Ltd* [1995] 2 AC 145.

SUMMARY OF QUESTIONS FOR RESPONSES

Responses, please, by 31st July 1997, to Prof D Hayton, School of Law, King's College, Strand, London WC2R 2LS

1. Should there be no reform of the law because the current law is satisfactory, the apparent deficiencies mentioned in this Paper either not really being deficiencies or being based on a misunderstanding of the law?

There should be no reform ☐ There should be reform ☐

2. Would it suffice if the current law were clarified or developed so as conclusively to establish:

- (a) a trustee has a right to retain sufficient trust assets to cover his potential liability to a creditor unless he is satisfied with personal covenants of indemnity from the new trustee or novation of the contract with the creditor (see paragraphs 2.6 and 4.9);

Yes ☐ No ☐ Unnecessary ☐

- (b) a trustee's right of indemnity as an equitable lien is not dependent upon possession of the property to which it relates (see paragraph 2.8);

Yes ☐ No ☐ Unnecessary ☐

- (c) a creditor is entitled by way of subrogation to any right of a trustee to a personal indemnity from the settlor or any beneficiary in respect of obligations properly incurred by the trustee (see paragraph 2.29);

Yes ☐ No ☐ Unnecessary ☐

- (d) a trustee (unless prohibited by the trust instrument) has a right when contracting with a creditor to afford the creditor a direct unsecured right of recourse to the trust fund independent of the state of accounts between the trustee and the trust fund (see paragraphs 2.33-2.35);

Yes ☐ No ☐ Unnecessary ☐

- (e) once a transaction with a creditor falls within the scope of a trustee's powers then a creditor is not concerned with whether or not such powers have been properly exercised so that he is unaffected by any improper exercise of such powers unless he knew of the impropriety (see paragraphs 2.25-2.27, 4.1 and 4.2);

Yes ☐ No ☐ Unnecessary ☐

- (f) what precisely is the order of priority of creditors upon the insolvency of the trust fund (see paragraphs 2.62-2.64)?

Yes ☐ No ☐ Unnecessary ☐

Please tick 'Yes' if you think that the provision would be sufficient taken together with other provisions to which you have answered 'Yes' in question 2. Please tick 'Unnecessary' if you do not believe that such a provision would be necessary or advisable even if no fundamental reform along the lines envisaged in question 3 is carried out.

3. Is fundamental reform required so that the trust fund itself should normally be primarily liable (with the creditor having an independent direct personal right of recourse to it) and the trustee should have a secondary personal liability unless excluded by the contract with the creditor (or only if included in the contract)?

Yes ☐ No ☐ Unless excluded ☐ Only if included ☐

4. In what circumstances should the trust fund not be primarily liable, when it should clearly be so liable if the transaction were within the scope of a power which was properly exercised (the state of accounts between the trustee, T, and the trust fund being irrelevant) and even if it was improperly exercised but the creditor had no knowledge of the impropriety, and when the fund clearly should not be liable if the creditor, C, were dishonestly assisting T in a breach of trust (see paragraphs 4.1-4.7 and 4.11)?

- (a) Where C knowingly dealt with T, acting as such, should the trust fund (i) be liable so long as C reasonably believed the transaction to be within the scope of a power or (ii) always be liable unless C was dishonestly assisting T in a breach of trust; and does any statutory guidance need to be provided as to C's duties to help to determine whether C was acting unreasonably or dishonestly?

(i) ☐ (ii) ☐ Statutory guidance Yes ☐ No ☐

Such as?

- (b) Where C did not knowingly deal with T as trustee, should the trust fund only be liable if the transaction were within the scope of T's power as trustee which was properly exercised, though the personal liability of T would remain; and are any safeguards (other than T's personal liability to the beneficiaries for breach of trust) required for the case where T is thereby enabled to use trust money to pay for a transaction actually entered into on his own behalf but subsequently stated by T to be a trust transaction when a loss, instead of a profit, arose?

Yes ☐ No ☐ Safeguards Yes ☐ No ☐

Such as?

- (c) Where C knowingly dealt with A, as agent of T acting within the scope of business of such an agent, should the trust fund be liable so long as C reasonably believed A to be validly empowered to enter into the transaction; and does any statutory guidance need to be provided as to C's duties of inquiry to help to determine whether C was acting reasonably?

Yes ☐ No ☐ Statutory guidance Yes ☐ No ☐

Such as?

- (d) Where C dealt with A, not knowing him to be acting for a trustee, should the trust fund be liable not just where T was properly exercising his powers but also where A reasonably believed T to be acting within the scope of his powers, though A should also be personally liable?

Yes ☐ No ☐

5. On the insolvency of a creditor or of the trust fund should contractual netting and automatic set-off be available to cover their bilateral dealings where in substance there is mutuality though not in the strict statutory sense (see paragraphs 2.43-2.50, 3.14-3.18 and 4.12)?

Yes ☐ No ☐

6. In implementing the primary liability of the trust fund should there be laid down an order of priority of creditors upon the insolvency of the trust fund and what should that order be (see paragraphs 2.62-2.64 and 4.13-4.14)?

Yes ☐ No ☐

Order:

7. Should statute confer on all trustees (subject to any contrary intention in the trust instrument) power to create any type of charge over trust assets or over the trust fund as a fluctuating fund, with floating charges over the

trust fund being subject to the current rules regulating priority of floating charges (see paragraphs 2.37-2.42 and 4.15-4.17)?

Yes ☐ No ☐

8. Should the trust fund be primarily liable for claims in tort as well as in contract (see paragraphs 2.57-2.58 and 4.18)?

Yes ☐ No ☐

9. Should the liability of a trustee as title holder of property be limited, in the absence of statutory provisions, to the extent of the trust fund where the trustee is without fault for the liability and for the insufficiency of the trust fund to satisfy the liability (see paragraphs 2.59 and 4.19)?

Yes ☐ No ☐

10. Should the new legislation apply to all types of trust (see paragraph 4.20)?

Yes ☐ No ☐

If 'No' please state to what type of trust it should not apply:

11. To what extent do the new provisions (other than any new power to create fixed or floating charges or any new provision making trustees personally liable only if such a term be included in the contract, which currently is not a favoured option) need to apply only to trusts created after the provisions take effect?

The provisions should be retrospective ☐ prospective only ☐ some only should be retrospective ☐ , e.g.

12. Do you have any further comments?

APPENDIX

PATRONS

Lord Browne-Wilkinson
Lord Nolan
Lord Nicholls
Lord Justice Millett

COMMITTEE

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Professor David Hayton

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David Pollard
John Quarrell
Geoffrey Shindler
Professor Adrian Shipwright
William Swadling
Mr Justice Walker
Nicholas Warren QC
Philip R Wood

Observers

Charles Harpum
Robert Venables

Trust Law Committee publishes Second Annual Report in October 1996

Major reforms of trust law on the way

The Trust Law Committee has recently published its Second Annual Report.

Trustee Investments

HM Treasury should very soon be publishing a draft Order under the Deregulation and Contracting-Out Act 1994 for the abolition early in 1997 of the Trustee Investments Act 1961 in response to pressure from the TLC and with its help in formulating the Consultation Paper on Trustees' Investment Powers published in May 1996. This will be a major reform of the current law, permitting the vast majority of trustees to select their investments from all the kinds of investment available, rather than from the very restricted list which today binds very many of them.

This may have a radical effect on stock markets and investment in land and buildings. It has implications for charities, private trusts and intestate estates, as well as for many funds administered by local authorities and NHS trusts.

Delegation by trustees

Following ground-breaking work by the TLC, the Law Commission is likely to publish a new Consultation Paper on Collective Delegation by Trustees early in 1997. This should hopefully lead to legislation in 1997 or 1998 to permit collective delegation by trustees, particularly in the area of investment management. Such reform will dramatically increase trustees' ability to enter into discretionary investment mandates to harness the wider powers of investment to be given to trustees next year under the Deregulation Order referred to above. This is likely to have a positive impact on the City and financial institutions generally as well as helping trustees to manage their portfolios more efficiently and economically.

Future plans

Working parties are currently in the process of producing reports proposing reform in the following key areas:

- (1) creditors' relations with trustees and trust funds;
- (2) apportionment between capital and income, including demergers, enhanced scrip dividends and building society conversion bonuses; and
- (3) a new Table A of trustees' powers, comparable with Table A in the Companies Acts, containing a set of default powers to deal with trusts efficiently and economically in the 21st century.

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Second Annual Report, October 1996

Chairman's report

The Committee has made considerable progress in the past year. There is now the prospect in 1997 of legislation to reform the Trustee Investments Act 1961 and a consultation paper from the Law Commission on collective delegation by trustees. Both of these events are due in significant part to the efforts of the Working Parties of this Committee.

We have been considerably encouraged by the support of the work of the Committee expressed by the Lord Chancellor, Lord Mackay, and by Dame Mary Arden, Chairman of the Law Commission, at a House of Commons lunch hosted by Mr Geoffrey Shindler, Chairman of the Society of Trust and Estate Practitioners (STEP) earlier this year, and by Mrs Angela Knight, Economic Secretary to the Treasury, when announcing the Government's proposed reforms on trustee investment in November 1995.

First Working Party

Under the chairmanship of Professor David Hayton of King's College London, this Working Party has been very active in the past year on three discrete projects:

- the investment powers of trustees;
- collective delegation by trustees; and
- rights of creditors against trustees and trust funds.

Following strong representations by this Committee, the Law Commission and others, HM Treasury produced the Trustee Investment (Division of Trust Fund) Order 1996. The effect of this Order is, with effect from 11 May 1996, to permit the trustees of funds governed by the Trustee Investments Act 1961 to invest up to 75 per cent of their funds in wider-range investments instead of the 50 per cent limit in place since 1961.

In May 1996 HM Treasury published a consultation paper on the Investment Powers of Trustees, based in large measure on the work of this Committee and the Law Commission, proposing the abolition of the schedule of permitted investments in the Trustee Investments Act 1961 subject to two safeguards, namely the trustees' duties to diversify their investments and to take advice when appropriate. The consultation period has now closed. It is understood that there was overwhelming support for this proposal and that HM Treasury will lay a draft Order to this effect under the Deregulation and Contracting-Out Act 1994 before Parliament before the end of this year.

We wish to compliment the Treasury for their hard work and progress in this area and also the Deregulation Unit of the Cabinet Office, without whose support progress might not have been so rapid.

In 1994 and 1995 this working party also prepared a draft consultation paper on collective delegation by trustees. It was agreed that this paper should be re-cast by Richard Nolan of St John's College, Cambridge into the standard form of Law Commission consultation papers with a view to publication by them during the course of this year.

The draft revised paper has been delivered to the Law Commission and it is understood that a consultative paper based on it will be laid before the Law Commission for approval this year, but may only be published in early 1997. This delay has been occasioned by a very heavy workload at the Commission and a perceived need to develop certain areas for consultation in even more depth. We are indebted to the Law Commission, particularly Charles Harpum and the property team, for their efforts and encouragement on this project.

The rights of creditors against trustees and trust funds has long been a matter of great concern to trustees, bankers, lawyers and their clients. The working party has examined this area with fresh eyes and come forward with a draft consultative paper full of practical and novel ideas. It is hoped that this will find a means of publication in the near future.

This list of activities is evidence of a large amount of hard work. Our thanks are due in particular to our researcher Emma Ford and to the chairman David Hayton, but also to all the members of the Working Party.

Second Working Party

As the year progressed, pressure grew for the Committee to establish a second Working Party to consider apportionment between capital and income; not only the old rules of equitable apportionment, but also the more novel issues relating to demergers, enhanced scrip dividends and bonus entitlements arising on the takeover of building societies and the demutualisation of insurance societies. The chair of this working party has been taken by John Mowbray QC, with the assistance of Dr Sarah Worthington of Birkbeck College, London as Secretary and Research Writer. The need for significant reform in this area following *Sinclair v Lee*, the ICI demerger case, is clear. Proposals will be forthcoming from this Working Party during the course of the next year. In the meantime, we must commend the efforts of its members and wish them well with their proposals.

HM Customs & Excise

This authority has established a Working Group on registration of the business activities carried on by trustees, with particular regard to the issues arising from Value Added Tax Act 1994, s 51A and related problems. This section has not been brought into force because of the problems associated with it which became clearer after its enactment. Michael Jacobs, our Secretary, represents this Committee on that Working Group.

Funding

Financial contributions have been received from the Society of Trust and Estate Practitioners (STEP), the Association of Corporate Trustees, Macfarlanes, Schroder Executor and Trustee Company Limited, the Association of Solicitor Investment Managers, the Association of Private Client Investment Managers, and others. The Committee has also had the support of the Financial Law Panel, the Charity Law Association, the National Association of Pension Funds Limited, and others.

Promoting discussion

Achieving reform in any area of the law requires a recognition that there are real and acute problems to be resolved and that they are worth resolving. The law relating to trusts is in many ways central to the efficient operation of London as a major world centre of financial operations and investment management; it also sets out the basic framework for private family trusts, charities, pension funds, intestate estates and other statutory trusts. However, the problems of having an out of date law in this area are often not seen as being as pressing as other legal, financial and social problems. Accordingly, the Committee has also been working to raise the profile of the relevant issues together with other interested parties, in particular the Society of Trust and Estate Practitioners (STEP), who have not only made very generous financial contributions to the work of the Committee, but also widely promoted its aims. A long note on the progress of the Committee was included in the supplement to *The Legal Times* produced in conjunction with STEP in July 1996.

Publicity

Regular reports on the progress of the Committee have been appearing in Tolley's *Trust Law International*, a journal which specialises in this area of the law, and in whose pages the original open letter to the Lord Chancellor calling for establishment of a Trust Law Commission was first published. Periodic updates are also kindly published in the STEP Newsletter which is distributed to over 4,500 of its members.

By these means, as well as by directly promoting proposals for reform, the Committee hopes to prepare the way for achieving the reforms which are its main goal.

Sir John Vinelott, Chairman

Membership of the Working Party

Professor David Hayton (Chairman)

Martin Day

Emma Ford

Martyn Frost

Michael Hayes

Judith Ingham

Michael Jacobs

Simon Jennings

Victoria Love

Simon Mackintosh

Helen Ratcliffe

Daniel Schaffer

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