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.

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Chapter 1

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 companies[3] 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.

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[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 clarification[5] 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.

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[5] Cmnd 8733, para 2.17.

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

Chapter 2

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 trust[3]), 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 income[4]) 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

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[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 indemnity[8] 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 trust[10] 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.

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[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 property[22] or oust T's indemnity against the trust property[23] 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.

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[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 1993[29] 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 right[31] 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 courts[33] 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 be[37] 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.

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[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 seems[38] 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 States[45] 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 exoneration[46] 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.

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[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 statutory[47] 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 fund[49] 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 only[52] 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

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[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 charge[55] 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 netting[56] 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 debits 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 such[58] (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

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[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 retainer[60] 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 beneficiaries[63] 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 services[66]) it becomes

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[60] See *Cherry v Boultbee* (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 (Cmnd 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 *Staniar 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 entitled[67] 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 notice[69] 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 unpaid[79] 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 T1[81] or of T2 to the trust fund.

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[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).