

Trusts: the essentials

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I Introduction

With the burgeoning interest in, if not also reception of, the trust in civil law jurisdictions, several fundamental questions about the essential elements of the trust relationship have assumed ever greater importance. These include: are the beneficiary's rights attached to the trust fund or merely enforceable against the trustee's rights in the trust fund? In which of the trust parties should ownership of the trust fund be vested, if at all? Is it only essential for a trust that the trust assets and their substituted products be immune from claims against the trustee's estates, or must they also be protected from the claims of unauthorized third-party recipients?

In light of these questions, the present chapter seeks to explore the essential elements of the trust relationship.¹ In particular, given the growing adoption of the trust in civil law jurisdictions, the chapter hopes to spell out such essential rights and duties in their basic terms, without reference to the terminology they inherited from their historical or jurisdictional origin. It is hoped that such an articulation can help lay down a universal template for the comparative study of trusts.

At this juncture, a few preliminary remarks are in order. First, to keep it within manageable bounds, the present chapter will use as a paradigm case the private express trust for the benefit of human or corporate beneficiaries, where the trustee voluntarily agrees to take up the responsibilities of trusteeship. It will not deal with purpose trusts (whether private or charitable), or resulting and constructive trusts. The *dramatis personae* of the trust considered in this chapter are the settlor, beneficiary, trustee

¹ For similar projects in defining the essential (or core) elements of the trust, see D. J. Hayton, 'The Irreducible Core Content of Trusteeship', in A. J. Oakley (ed.), *Trends in Contemporary Trust Law* (Oxford University Press, 1996), p. 47; T. Z. Wei, 'The Irreducible Core Content of Modern Trust Law' (2009) 15 *Trusts and Trustees* 477.

and third parties (who are parties not falling within these three roles). Where the settlor is also the trustee, beneficiary or perhaps even a third party, his rights and duties in the additional capacities will be considered separately from those as settlor.

Secondly, in seeking to define the essential elements of a trust, one immediately needs to ask what a trust is. In particular, is it possible to identify an *a priori* concept of the trust and derive essential elements inherent in it, or does one make out the trust concept by drawing upon trust laws currently adopted around the world? Since trust is a legal construct, the present chapter will proceed from existing concepts of trust. It will distil the core or essential elements that are widely adopted by trust jurisdictions as necessary for the existence of a trust in contradistinction from other legal institutions such as agency or bailment.

Amongst these essential elements, there is a core minimum that is necessary for an arrangement to be defined as a trust, even though such a trust might not be practically useful or attractive as compared to other legal concepts. For example, for a trust to exist, it is only necessary for the trust assets to comprise the initial settled assets, but not their exchange products. However, such a trust will be practically useless in modern-day commerce. Accordingly, the present chapter will also treat as essential those elements that have been widely adopted in trust jurisdictions because they significantly enhance the usefulness of the trust without disproportionate costs.

Thirdly, a distinction needs to be drawn between essential and mandatory elements of the trust. The essential elements that are necessary for an arrangement to be a trust are clearly mandatory. Those essential elements that render the trust useful are also mandatory, because they are necessary for a trust to be practically functional. But not all mandatory rules of the trust are essential for the existence of the trust. For example, some mandatory requirements are based, say, on policy considerations, such as rules about illegality, perpetuities and public order,² or rules that confine trusteeship to qualified financial institutions.³

Fourthly, the essential features discussed in this chapter are universally applicable to all types of private express trusts. Given the wide range of private express trusts, there are additional features essential for

² See, for example, Uniform Trust Code [UTC], s. 105(b)(3); *Restatement (Third) of Trusts* (Philadelphia: American Law Institute, 2007), s. 29.

³ For example, article 2015 of the French *Code civil* (C. civ.), Title XIV 'Of the *fiducie*', provides that only certain financial institutions can act as trustees.

certain types of private trusts. For example, for a trust to be called a fixed trust, it needs to comprise both the essential characteristics applicable to all types of private express trusts, and additional ones such as the beneficiary's right to compel the trustee to transfer specific entitlements to him. The present chapter will only consider the essential feature at a general level.

II Essential features of a trust

Generations of scholars since Maitland and Scott have pondered upon the nature of the trust.⁴ Despite continuing differences of opinion as to details, there is growing consensus on the essential features of a trust.⁵ This chapter seeks to build on that consensus. Since a trust primarily involves the allocation of rights and duties amongst trust parties *inter se* and in relation to trust assets, the essential features proposed in the present chapter will be structured in the same manner. It will consider the essential features under each of the following aspects: (1) the relationship of the trustee and the trust assets; (2) the legal relationship of the trustee and the beneficiary; (3) the relationship of third parties to the trust assets; and (4) the relationship of the beneficiary to the trust assets and third parties.⁶ More specifically, these features are:

1. *With regard to the relationship between trustee and trust assets*, the trustee has powers to manage the property and to alienate the assets free from the beneficiary's rights;
2. *With regard to the relationship between third parties and trust assets*, the trust assets and properties representing them from time to time are immune from the claims of the trustee's heirs, spouses and personal creditors;⁷

⁴ F. W. Maitland, *Equity: A Course of Lectures*, 2nd edn (Cambridge University Press, 1949); A. W. Scott, 'The Nature of the Rights of the "*Cestui que trust*"' (1917) 17 Col. L. Rev. 269, 273 ff.

⁵ D. J. Hayton, S. C. J. J. Kortmann and H. L. E. Verhagen (eds.), *Principles of European Trust Law* (The Hague / London: Kluwer Law International, 1999); M. J. de Waal, 'In Search of a Model for the Introduction of the Trust into a Civilian Context' (2001) 12 Stellenbosch L. Rev. 63, 67. See also above, note 1.

⁶ Discussion about the relationship of the trustee and the third parties will be subsumed under that of the third parties to the trust fund.

⁷ H. Hansmann and U. Mattei, 'The Functions of Trust Law: A Comparative Legal and Economic Analysis' (1998) 73 NYU L. Rev. 434. Without this feature, the trust will just be like agency, whereby an agent manages property for the benefit of the principal.

3. *With regard to the beneficiary's rights vis-à-vis trust assets and third parties*, he has the right to obtain trust assets subject to the terms of the trust and to make claims against third parties who receive trust properties upon an unauthorized disposition by the trustee; and
4. *As between trustee and beneficiary*, there is a check and balance mechanism to ensure that the trustee uses such powers for the best interest of the beneficiary and not for his own benefit.

A. *Trustee and trust assets: the trustee's powers of management and alienation*

An essential feature of the trust is the vesting of sufficient powers with the trustee to deal with the trust assets as a full owner would. This allows the trustee to act in his own name without the inconvenience of regularly seeking authorization from the settlor or beneficiary for his dealings with the property. It also shields the beneficiary from the responsibilities of managing the trust assets.

Such a feature can be put in place by a variety of techniques. In common law and most civil law jurisdictions, the trustee is typically vested with ownership of the trust assets subject to the duty to use them for the benefit of the beneficiary. His ownership gives him the right to exclusive control of the trust assets and, in particular, positive powers to use, manage and alienate the property, to name but a few,⁸ as well as the negative right to exclude third parties from interfering with his right over the property.⁹ Such a bundle of rights and powers will enable him to manage and, if necessary, alienate trust assets. Strictly speaking, for a trust to exist, it is only necessary for the trustee to have the power to manage the trust property; it is not necessary that he also has the power to alienate it.¹⁰ A trust whereby the trustee's duty is not to sell but

⁸ See the list of incidents of ownership provided in A. M. Honoré, 'Ownership', in A. G. Guest (ed.), *Oxford Essays in Jurisprudence, 1st Series* (Oxford University Press, 1961), pp. 112–18.

⁹ A manifestation of the trustee's ownership is that at common law, only the trustee as legal owner has the right to sue tortfeasors: *Barbados Trust Co Ltd v. Bank of Zambia* [2007] EWCA Civ 148, [28]–[48]; *Leigh and Sullivan Ltd v. Aliakmon Shipping Co* [1986] AC 785, 812; *MCC Proceeds v. Lehman Brothers International (Europe)* [1998] 4 All ER 675. But see recently *Colour Quest Ltd & Ors v. Total Downstream UK Plc & Ors* [2010] EWCA Civ 180.

¹⁰ Perpetuity rules may mandate otherwise, but these are not essential rules as defined in this chapter.

manage and preserve, say, a historic building for the benefit of the beneficiary, is still a valid trust.¹¹ Paradigmatically, however, the use of the trust property for the benefit of the beneficiary will involve selling it to realize its economic value. Accordingly, it is submitted that the trustee's power to lawfully alienate trust property free from the beneficiary's rights can also be treated as essential for this broader policy reason.

The trustee's powers of management and alienation are subject to an important qualification: that unlike full owners, he does not have the liberty to exercise his ownership rights as he pleases. He owes an *in personam* duty towards the beneficiary – perhaps also the settlor or protector as the case may be¹² – to do so for the benefit of the beneficiary, and in any event not for his own benefit. However, typically in common law jurisdictions and maybe also in some civil law jurisdictions, even if he breaches his duty, the validity of his act of alienation will only be affected if the transferee does not meet the requirements for acquiring full title in the jurisdiction concerned.

Accordingly, the combined effects of the trustee's power to alienate trust assets free from the beneficiary's rights on the one hand, and his duty to exercise this power for the beneficiary on the other hand, are: first, if the trustee acts lawfully (that is, within the terms of the trust), he clearly has the power to alienate the trust assets free from any rights of the beneficiary, and hence pass good title to the transferee just as a full owner would.¹³ As explained above, this is an essential feature of the trust, for otherwise it will be extremely difficult for the trust assets to realize their economic value.

Secondly, if the trustee unlawfully alienates trust assets, he may still pass good title to a transferee (for example, a bona fide purchaser). In such a situation, the breach only gives rise to rights on the part of the beneficiary (or the settlor) to claim remedies from him.¹⁴ Furthermore, the enforcement of these (*in personam*) secondary rights is independent from, and does not affect, the trustee's power to pass good title to bona fide transferees free from the beneficiary's rights. The power of a trustee

¹¹ Assuming that the relevant rules of perpetuities are complied with.

¹² In some jurisdictions, such as China, settlors are given the right to enforce the trust: Trust Law of the People's Republic of China [Trust Law] (2001), Order of the President of the People's Republic of China (No. 50), (official trans. at www.npc.gov.cn), art. 22.

¹³ Assuming the absence of contrary stipulations in the relevant transaction.

¹⁴ Where the trustee obtains benefits in exchange for the wrongful alienation, such as getting proceeds from selling trust assets, the beneficiaries may instead adopt the sale and treat the proceeds as part of the trust assets.

to pass good title to, say, a bona fide purchaser even if he acts in breach is widely accepted in trust jurisdictions in common law and civil law. Despite its ubiquity, it is essential not because it is necessary for the trust to exist,¹⁵ but rather because of its practical usefulness in realizing the economic value of the trust assets and maintaining the smoothness of commercial transactions.

Thirdly, it is also common in almost all trust jurisdictions that if the trustee unlawfully alienates trust assets in favour of volunteers or individuals in bad faith, the recipient has at least a liability (and the beneficiary a correlative power) that the alienation be annulled. Additionally, depending on the law of the jurisdiction concerned, the specific trust assets may also be immune from the claims of the recipient's creditors,¹⁶ and the recipient may owe duties enforceable by the beneficiary to return the specific assets to the trust fund or to pay compensation. Such duties are not the same as those owed by the trustee to the beneficiary; for example, the recipient owes no duty to manage the assets, let alone one to act in the best interest of the beneficiaries, but only the duty to return them.¹⁷ It is submitted that the beneficiary's power to annul the unlawful transaction is essential, because by strengthening the beneficiary's rights through (*in personam*) remedies enforceable against the transferee, it crucially makes the trust more useful; the costs it brings – of overriding the rights of, say, purchasers in bad faith and volunteers – are not excessive. After all, all jurisdictions subscribe to a system of rules for resolving competing rights pertaining to the use of property, such as the rule on bona fide acquisition.

In the final analysis, amongst the essential features of a trustee's powers over the trust assets, only that to manage the trust property is essential for the existence of the trust. However, since such a limited power will not make the trust practically useful, save in exceptional cases of property preservation mentioned above, it is also essential to give the trustee power to alienate trust assets lawfully and hence pass good title to a transferee that meets the requirements for obtaining such a title, such as a bona fide purchaser. For the same reasons of practical usefulness, it is

¹⁵ If, as explained above, not even the trustee's right to alienate trust property is necessary for the existence of a trust, it must be doubly so for his right to alienate trust property free from the beneficiaries' rights when he acts in breach.

¹⁶ Hayton, Kortmann and Verhagen, *Principles of European Trust Law*, above, note 5, p. 59.

¹⁷ The rights of the beneficiary against these third-party recipients are not necessarily the same as those against the original trustee: R. Nolan, 'Property in a Fund' (2004) 120 L.Q.R. 108.

also essential for a beneficiary to have the right to annul unlawful dispositions vis-à-vis, say, a volunteer or purchaser in bad faith.

Common law jurisdictions and an overwhelming majority of civil law jurisdictions grant the power of management to the trustee through giving him titulary ownership of the same kind enjoyed by a full owner. However, the vesting of ownership rights with the trustee is only a common, if not an extremely efficient means to grant him the essential powers to administer and alienate the trust assets. A jurisdiction can choose to empower the trustee with the same essential powers, which are typically associated with ownership, rather than ownership itself. A well-known legislative example of this model is the Québec Civil Code, which does not give ownership of the trust assets to the settlor, let alone any party in the trust relationship.¹⁸ The trustee is given powers of control and exclusive administration over the trust assets.¹⁹ The Civil Code also gives him, in the broadest terms, the ‘exercise of all the rights pertaining to the patrimony’.²⁰ Another example is the *bewind* trust under Dutch law and a similar form evolved in South Africa and recognized by legislation, albeit they are much less than trusts involving the transfer of ownership to trustees. In such forms, ownership is granted to the beneficiary but the trust property is ‘placed under the control of [the trustee] to be administered or disposed of according to’ the trust.²¹

B. *Third parties and trust assets*

If the trust arrangement had only consisted of granting the trustee with powers to manage the trust assets, it would have just been a variant of contract or agency. One of the distinguishing features of the trust that gives it comparative advantage over, say, agency or mandate, is the immunity or ring-fencing of the trust assets from the claims of the heirs, spouses and personal creditors of the trustee, particularly in the event of

¹⁸ Civil Code of Québec, art. 1261 (C.C.Q.): ‘The trust patrimony, consisting of the property transferred in trust, constitutes a patrimony by appropriation, autonomous and distinct from that of the settlor, trustee or beneficiary and in which none of them has any real right.’ D. W. M. Waters, ‘The Institution of the Trust in Civil and Common Law’, *Recueil des Cours* (Boston / London / Dordrecht, 1995), vol. 252, pp. 396–407.

¹⁹ See M. Cantin Cumyn, ‘The Legal Power’ (2009) 3 *European Review of Private Law* 345.

²⁰ C.C.Q., above, note 18, art. 1278.

²¹ Trust Property Control Act, 1988 (South Africa), s. 1, discussed in M. J. de Waal, ‘The Uniformity of Ownership, *Numerus Clausus* and the Reception of the Trust into South African Law’ (2000) 3 *European Review of Private Law* 439, 449.

his death, divorce or bankruptcy.²² This allows the settlor to relinquish ownership and possession of the trust property in favour of the trustee-manager without fear of the latter's insolvency, and distinguishes the trust from other institutions such as mandate, agency or contracts for the benefit of third parties.

To ring-fence the trust assets, it is both necessary and sufficient that the trustee's personal creditors be subject to a disability that prevents them from compelling the trustee to satisfy his personal liabilities with trust assets.²³ This gives the beneficiary a correlative immunity from the creditors' claims. It also entails – although it would be prudent for trust statutes to stipulate this separately and additionally – the trustee owing a duty to refrain from using trust assets to meet his personal liabilities.²⁴ The trust assets should only be used to satisfy his trust liabilities.²⁵

Segregation of the trust assets could be achieved, in civil law jurisdictions, by the creation of two separate patrimonies held by the trustee, whereby trust creditors can only claim against trust assets, and the trustee's personal creditors can only claim against the trustee's own assets.²⁶ In common law jurisdictions, insolvency legislation typically provides that only assets beneficially owned by the bankrupt trustee owner will fall within the bankrupt estate.²⁷ In fact, since it is not the purpose of the trust to ring-fence the trustee's own assets from trust liabilities, the trustee's duty is also consistent with permitting

²² H. Hansmann and U. Mattei, 'The Functions of Trust Law: A Comparative Legal and Economic Analysis' (1998) 73 NYU L. Rev. 434.

²³ This will need to be achieved by legal enactment.

²⁴ *Bennet v. Wyndham* (1862) 4 De G F & J 259. Personal liabilities broadly include liability for the claims of heirs and spouses, and debts incurred by the trustee in all his other affairs outside of the relevant trust at issue.

²⁵ Trust liabilities refer to debts incurred by the trustee for the management of trust affairs. This could be achieved by requiring the trustee to provide personal security: see, for example, Trust Property Control Act, 1989 (South Africa), s. 6(3).

²⁶ See also, K. Reid, 'Conceptualising the Chinese Trust: Some Thoughts from Europe', SSRN Working Paper Series, available at <http://papers.ssrn.com> (last visited 4 April 2011). In fact, even when two separate patrimonies are created, the law of a particular jurisdiction can still allow trust creditors to claim against both patrimonies. For the position in Latin America, see N. Malumian, *Trusts in Latin America* (Oxford University Press, 2010), pp. 21–2.

²⁷ See, for example, Insolvency Act 1986 (UK), s. 283(3)(a), in relation to individual trustees; the same assumption is adopted in relation to corporate trustees. Before express legislative provisions, the trustee for bankruptcy was treated as standing in exactly the same position as the bankrupt himself: P. Watts, 'Constructive Trusts and Insolvency' (2009) 3 J. Eq. 250, citing *Copeman v. Gallant* (1716) 1 P Wms 314; 24 ER 404.

trust creditors to claim from the trustee's personal assets, as is the approach taken in common law jurisdictions.²⁸

In this connection, it needs to be clarified that even if the trust assets are protected from the claims of the trustee's personal creditors, this is not necessarily because the trust assets fall into the same pool of assets that are also available to the creditors, and that the beneficiary has *in rem* rights against the trust assets that defeat the creditors' *in personam* rights against the trustee in having their liability met by these assets. Rather, the beneficiary's rights can still be understood as personal rights against the trustee only. It is just that they belong to a partitioned part within all the assets of the trustee, and such a part is protected, in that assets falling within it are not available to meet the personal creditors of the trustee.²⁹ Accordingly, the creation of the separate (trust) patrimony readily explains why the beneficiary's rights are protected from the claims of the trustee's personal creditors. The beneficiary never needs to enforce his rights, let alone any *in rem* rights, against the personal creditors directly. All he needs are *in personam* rights against the trustee to be paid out of the protected trust patrimony.

A feature that is also practically essential for a trust to be a tool for managing a changing portfolio of assets is that the trust assets should not be limited to the initial settled sum, but should also include assets derived from and representing it from time to time.³⁰ To achieve this, the law can simply treat it as a standard implied term in the trust undertaking that the trustee holds the subsequent assets under the same terms as the original ones. Trust legislation can also define trust property to include assets derived from the original settled sum. The tracing rules that determine which new asset is treated as representing the original assets are just evidentiary in nature.

Seen in this light, the rights of the beneficiary to enforce the trust in relation to the new, traceable products of the original trust assets still do not require any *in rem* explanation. If the new assets are derived from a lawful exercise of the trustee's right to alienate trust assets, they are simply brought within the scope of the trustee's personal trust undertaking. If the new assets are the exchange products of an unlawful

²⁸ L. Smith, 'Trust and Patrimony' (2009) 28 E.T.P.J. 332; (2008) 38 R.G.D. 379.

²⁹ H. L. E. Verhagen, 'Trusts in the Civil Law: Making Use of the Experience of "Mixed" Jurisdictions' (2000) 3 E.R.P.L. 477, 488.

³⁰ Nolan, 'Property in a Fund', above, note 17, 108. There may also be mandatory rules in particular jurisdictions governing the type of property that may not be subject to a trust. Additionally, it is also essential that only present property (as opposed to a *spes*) can be trust property.

transaction, the beneficiary has the right to adopt or authorize them. Once the transaction is adopted, the benefits obtained from it are treated as falling within the trust assets.³¹ Put another way, the trustee who owns or has powers of control over the benefits of the trust simply owes the same personal obligations in relation to these benefits as he does in relation to the original trust assets.

To summarize, the essential rights of a trust that are often treated as showing that it is a 'proprietary' institution can, on close examination, be explained as *in personam* rights. These include the immunity of the trust fund from the claims of the trustee's personal creditors, and the substitution of the original trust fund by its traceable products. Accordingly, in so far as the trust assets are still in the hands of the trustee, it is submitted that the trust can be fully accommodated within the law of obligations.

Thus far, this section has only discussed the position of one type of third parties to a trust arrangement, namely the trustee's personal creditors. The other major groups concerned are transferees of trust assets and parties who interfere with the trustee-beneficiary relationship through assisting in a breach of trust or otherwise intermeddling with trust affairs.³² As the next section will seek to show, it is not an essential element of the trust that such parties stand in any particular legal relationship vis-à-vis the trust assets. Their position will be discussed in the next section on the relationship between the beneficiary and third parties.

C. Beneficiary and the trust assets / third parties

As a preliminary attempt in identifying the essential rights and duties of the parties to a trust, the present chapter only focuses on private express trusts for beneficiaries. In a private express trust, the beneficiary plays the ultimate role in enforcing obligations against the trustee and third parties. It is submitted, therefore, that for a practically useful trust to exist, it is only essential for the beneficiary (or anyone representing him in legal actions) to have the capacity to enforce rights.³³

³¹ If the unlawful transaction is a sale, the purchaser (who may be the trustee himself) will take free from the beneficiaries' rights; the proceeds from the sale will fall within the trust assets.

³² In common law terminology, one who assumes the role of trustee is called a trustee *de son tort* and is subjected to the obligations of a trustee; this will not be discussed in this chapter.

³³ In so far as there is a mechanism for legally representing unborn, disabled or incapacitated beneficiaries, it is submitted that the law should not prohibit them from being beneficiaries.