Trust Law Implications of Proposed Regulatory Reform of Mutual Fund Governance Structures

A Background Research Report to Concept Proposal 81-402 of the Canadian Securities Administrators

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I. INTRODUCTION AND BACKGROUND

1. INTRODUCTION

As one part of their review of the law and regulation of the Canadian mutual fund industry, the Canadian Securities Administrators (CSA) are seeking ways to enhance the governance structures of Canadian mutual funds. Since most Canadian mutual funds are organized as trusts,[1] the current view is that it is preferable to effect some reform of the law and practice of mutual fund governance that is consistent with and draws on the strengths of the law of trusts. It is also accepted that the principal component of the reform will be a requirement that all mutual funds have an independent "governance agency"[2], which, like a board of directors of a corporation or a board of trustees of a trust, will be equipped to ensure that mutual funds are governed in the best interests of unitholders.

This study assumes that the reform is aiming to implement a proposal of this sort and contributes to the reform process in two ways: (1) by describing the private law – the law that applies between citizen and citizen (as opposed to public law, meaning the law that applies between state and citizen) – context in which mutual funds currently operate; and, (2) on the basis of that description, suggesting ways the reform proposal can be implemented.[3]

The conclusions of the study can be summarized as follows:

(1) From the private law perspective, mutual funds are trusts or corporations controlled or managed by trustees, directors, managers, and others, all of whom are fiduciaries owing fiduciary obligations to unitholders or shareholders to pursue stated investment objectives in a loyal and competent manner. The main areas of private law implicated in these structures, therefore, are fiduciary law, trust law, corporate law and contract law. Trust law, contract law, and corporate law

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1 S.I. Erlichman, *Making it Mutual, Aligning the Interests of Investors and Managers*. (Toronto: OSC, 2000) [hereinafter, *Making it Mutual*] at 19.

2 "Governance agency" is a neutral term coined for the purpose of this memorandum to denote an entity which has the powers and responsibilities of a board of directors or a trustee. Each fund in a fund family would not be required to have its own independent "governance agency". The proposal assumed here is a governance agency at either the fund or the fund family level at the option of the mutual fund manager.

3 The principal area of private law of concern to this study is trust law and, in particular, the business trust. There are a limited number of articles on the business trust in Canada: D.A. Steele and A.G. Spence, "Enforcement Against the Assets of a Business Trust by an Unsecured Creditor" (1998) 31 C.B.L.J. 72.; D.A. Steele, "Disclosure of Trust Documents Revisited" (1996) 15 Est. & Tr. J. 218.; D.A. Steele, "Exculpatory Clauses in Trust Instruments" (1995) 14 Est. & Tr. J. 216.; D.A. Steele, "Business Trusts: Some Key Issues for the Trust and Estates Lawyer" (Law Society of Upper Canada CLE Program, Second Annual Estate and Trusts Forum, November 1999); M.C. Cullity, "Legal Issues Arising Out of the Use of Business Trusts in Canada" in T. Youdan, ed.. *Equity Fiduciaries and Trusts* (Toronto: Carswell, 1989) 181; M.C. Cullity "Liability of Beneficiaries - A Rejoinder" (1985) 7 Est. & Tr. Q. 35, M.C. Cullity "Liability of Beneficiaries - A Further Rejoinder to Mr. Flannigan" (8) Est. & Tr. Q. 130.; M.C. Cullity, "Personal Liability of Trustees and Rights of Indemnification" (1996) 16 E. & T.J. 115.; R.D. Flannigan, "Beneficiary Liability 3.in Business Trusts" (6) Est. & Tr. Q. 278.; R.D. Flannigan, "Business Applications of the Express Trust" (1998) 36:3 Alta. L. Rev. 630.; R.D. Flannigan, "Business Trusts - Past and Present" (1984) 6 Est. & Tr. Q. 375; R.D. Flannigan, "Commercial Fiduciary Obligation" (1998) 36:4 Alta. L. Rev. 905.; R.D. Flannigan, "The Control Test of Principal Status Applied to Business Trusts" (1986) 8:2 Est. & Tr. Q. 97; R.D. Flannigan,"Trust or Agency: Beneficiary Liability and the Wise Old Birds" in S. Goldstein, ed., Equity and Contemporary Legal Developments (Jerusalem: Hebrew University of Jerusalem, 1992) 275.; and, T. Youdan, "Business Trusts: Avoiding the Pitfalls" in *Estate Planning Institute* (Toronto: The Canadian Institute, June 5, 1995). Leading American writing includes: J.H. Langbein, "The Secret Life of the Trust: The Trust as an Instrument of Commerce" (1997) 107 Yale L.J. 165 and "The Contractarian Basis of the Law of Trusts" (1995) 105 Yale L.J. 625.

are highly flexible areas of the law that place relatively few restrictions on fund promoters in the design of fund constitutions or on fund managers in their operation. Only the imperative components of fiduciary law and the legal pre-conditions of limited liability (for investors and fiduciaries) give rise to significant design and operational constraints. As a consequence, the most significant influences on the design of mutual fund structures are tax law and regulatory law, as well as the commercial and economic imperatives of the market for mutual fund securities. As far as private law is concerned, a mutual fund is basically a contract and freedom of contract prevails.

(2) The issue of how to implement the reform proposal raises two main questions: how as a matter of legal form or structure can a governance agency be imposed on the great variety of mutual fund structures that currently exist? and, What precisely should the content of the governance powers and responsibilities be? The answers to these two questions vary depending on whether the mutual fund is organized as a trust or a corporation.

As far as mutual funds organized as trusts are concerned, two plausible answers to the "form" question emerged during the course of this study.[4] One approach is to require all mutual funds organized as trusts to have a majority of trustees who are individuals and who are, or a majority of whom are, independent of the fund manager. A second, less intrusive approach, is to require all mutual funds organized as trusts to have a governance agency[5] comprised of individuals – not necessarily the trustees - who are, or a majority of whom are, independent of the fund manager. Under the first approach, the question of the content of the powers and responsibilities becomes a question of restricting the extent to which powers and responsibilities of the independent trustees can be delegated to the fund manager or others, rehabilitating, if it can be put that way, the trustee function in these structures. Under the second approach, the content question becomes a question of designing an appropriate carve-out of the powers and responsibilities of the trustee and fund manager to be assigned to the independent governance agency.

During the course of this study the second option emerged as the preferable answer largely on the basis that it achieves the governance reform objective in the least intrusive or disruptive way. This solution, moreover, has already been implemented to some extent on a voluntary basis by a large number of fund managers.[6]

For mutual funds organized as corporations the task is much easier. There is only one answer to the form question: since modern corporations law does not permit a delegation of the board's powers and responsibilities, the independent governance agency has to be that board. Further, since the content of board powers cannot be modified under modern corporations law, the only design question is to what degree and how to make that board independent of the manager.

The memorandum is divided into five main parts. Part I - *Introduction and Background* sets the stage for the discussion by framing the issue and by describing how it has been addressed to date. It comprises Section 1, *Introduction* and Section 2, *Background*. Part II, *The Mutual Fund Industry* provides a description of the empirical background of the study: how are mutual funds organized and why are they organized the way they are? In particular, Section 3, *Current Structures and Practice*s, describes current practice in the mutual fund industry and, based on that practice, classifies mutual funds into various relevant types for the purpose of this study. Section 4, *Reasons for Common Structure*s, examines why mutual funds are organized the way they are. Part III - *The Private Law of Mutual Funds* is the main part of the study. It provides a comprehensive review of the private law that governs or affects mutual funds.

4 There was a significant empirical component to the study which involved the review of a large number of trust instruments. See Appendix A - "Summary of Trust Instruments" (available on request).

5 See *supra*, note 2.

6 Voluntary implementation of independent fund governance mechanisms has largely been a reaction to a report prepared for the CSA by G. Stromberg, *Regulatory Strategies for the Mid-90's: Recommendations for Regulating Investment Funds in Canada* (Toronto: OSC, 1995) ("Stromberg Report"), as well as a recognition that better governance practices are required if Canadian mutual funds are to remain competitive in this regard with funds from other jurisdictions.

In particular, Section 5, *Fiduciary Law and Mutual Fund*s, discusses the law of fiduciary relations as it applies to mutual funds; Section 6, *Trust Law and Mutual Funds* - *The Trust Concept* reviews the basic elements of the trust and the business trust; Section 7, *Trust Law and Mutual Funds – Trust Administration* reviews the doctrines governing the administration of trusts; Section 8, *Trust Law and Mutual Funds* - *Accessorial Liability of Trust Strangers* reviews the developing law of liability of strangers to the trust for breaches of trust; Section 9, *Trust Law and Mutual Funds –The Civil Law Trust* reviews the basic features of the trust in Quebec; and Section 10, *Trust Law Adaptations* reviews three examples of significant adaptations of trust law that demonstrate that the proposal made in Section 11 is quite feasible. As much as possible, the discussion in Part III focusses on the issues raised as they affect mutual fund trusts. Part IV, *Proposa*l, sets out a.4 proposal as to how an independent governance agency might be integrated in the variety of mutual fund structures described in Section 3.

2. BACKGROUND

The topic of "governance" deals with the economic and legal relationship between a principal and an agent, the person whose business or affairs are being managed and the person who is managing the business or affairs. The topic of mutual fund governance, therefore, addresses the economic and legal relationship between the mutual fund investor and the mutual fund manager. It addresses the question: In what manner and to what extent is the manager accountable to or controlled by the investor in regard to its management of the investor's money?

Mutual fund governance arises as a serious question only to the extent that mutual funds are conceived of as ownership structures in which managers and others act as agents of investors. Historically, the issue has been whether this conception is true or whether mutual funds are merely products produced and delivered by fund sponsors. Under this latter characterization, mutual funds are regarded as vehicles for the pooled *purchase* of sophisticated investment advice.

No one seriously contends that the second characterization is accurate. It is clear beyond question that mutual fund investors *delegate* control over *their* property to others. The real question is where on the continuum of ownership structure versus product mutual funds sit and whether, in particular, they are far enough towards the ownership end of the continuum to warrant the statutory or regulatory imposition of governance structures similar to those currently required of public corporations.

There has been a change in recent years in the consensus view on this issue. That view now clearly regards the mutual fund as an ownership structure and not as a product. With this change has come an increase in the demand for a larger say for investors in the governance of mutual funds.

It is clear that, like the shareholders of the modern public corporation, mutual fund investors have neither the resources nor the inclination to police mutual fund managers in the execution of their fiduciary duties. Their only viable alternative in the face of doubts about the loyalty or competence of their fund fiduciary is and always has been to "exit". The task of supervising mutual funds therefore has fallen by default on securities regulators. The reform question now posed is whether it makes sense to move a step or two closer to the public corporation model of governance by requiring mutual funds to be governed by an independent governance agency which is competent - financially, intellectually, and legally - to look after the interests of unitholders and which owes its allegiance exclusively to them. This study assumes that the decision to move in this direction has been made and that the question now is how, and how far. Prior to attempting an answer to these questions it is useful to review briefly how the consensus view developed.

The first Canadian study to take up the question of mutual fund governance was a joint federal provincial effort in the late 1960's. That effort resulted in the publication of a report in 1969 entitled *Report of the Canadian Committee on Mutual Funds and Investment Contracts* (the *"1969 Report*").[7] The *1969 Report*

[7] *Report of the Canadian Committee on Mutual Funds and Investment Contracts - Provincial and Federal Study*, 1969 (Ottawa: Queen's Printer, 1969) [hereinafter *1969 Report*].

was commissioned in response to the substantial growth in the Canadian investment fund industry that occurred in the late 1960's and the consequent concern of Canadian regulators that mutual funds were not properly regulated. Although mutual funds were subject to regulation, the legislation that applied to them was designed with other financial intermediaries and other types of commercial entities - specifically, public corporations – in mind. The feeling developed that the mutual fund, as a new and unique sort of financial intermediary, required a tailor-made legislative solution.[8]

The *1969 Report* described the inherent conflicts in the common mutual fund structures: the persons with the power to control investment decisions were largely unsupervised and could make those decisions in ways that favoured their own interests, rather than the best interests of the mutual fund investors, and they could do this without serious risk of detection or consequence.[9] The report suggested that the best mechanism to regulate these conflicts was to subject the actions of fund managers to independent scrutiny, but in a way that did not interfere with their autonomous decision-making powers. In the final analysis, however, the *1969 Report* concluded that imposing independent directors on all mutual funds would be counter-productive. The authors concluded that the US experience with this type of regulation under the *Investment Company Act*[10] had not achieved its goal. They argued that a requirement that all mutual funds have independent directors would be costly to implement and to maintain and that, since the independent directors would not have a direct stake in the investments, they would not be properly motivated to ensure adequate governance in any event.[11]

In 1974, the Department of Consumer and Corporate Affairs published a second major study dealing with the regulation of mutual funds, *Proposals for a Mutual Funds Law for Canada* (the *"Proposals*"**).**[12] The *Proposals* contained a draft statute that attempted to incorporate current knowledge and practice in the area.[13] This effort was a response, in part, to the *1969 Report's* call for a tailor-made legislative solution. While the *Proposals* did not focus in any detail on the issue of mutual fund governance - since in this regard as in most others it followed the recommendations of the *1969 Report* - it did touch on some areas of interest to the present study. The *Proposals* concurred with the *1969 Report* in recommending shareholder and unitholder voting on key management issues and management changes. It also set out a standard of care and duty of loyalty for fund managers similar to that now found in s. 116(1) of the *Securities Act* (Ontario):[14]

> Every person responsible for the management of a mutual fund... shall exercise the powers and discharge the duties of his office honestly, in good faith and in the best interests of the mutual fund, and in connection therewith shall exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.[15]

The *Proposals* also recommended that shareholders and unitholders be given the power to ominate an alternative to the incumbent fund management. In the end, no legislation was enacted as a result of the *Proposal*s.

The issue of mutual fund governance did not attract much public attention again until the early 1990's.[16] Stephen Erlichman, in the early-to-mid 1990's presented several papers at mutual fund conferences in which he outlined what appeared to him to be serious problems with the way mutual funds were run. In

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8 *Ibid*, Preface.

9 *Ibid* at para 6.07.

10 54 Stat. 789 (15 U.S.C. 80a-1 et seq.)

11 *1969 Report, supra* note 1 at para 6.67.

12 J.C. Baillie & W.M.H. Grover, Consumer and Corporate Affairs, *Proposals for a Mutual Fund Law for Canada*, Vols. I & II (Ottawa: Information Canada, 1974). [hereinafter, *Proposals*].

13 *Ibid* Vol. II, at 1.

14 *Securities Act,* R.S.O. 1990, c. s. 5, s.116(1).

15 *Proposals, supra* note 12 at *Vol II*, 37.

16 S. I. Erlichman "Fiduciary Obligations: Implications for Financial Institutions" (1996) (InConference, Insight Information) ("Implications") noted that there had been very little of substance written in Canada dealing with conflicts of interest and fiduciary obligations since the *Proposals.*

one paper he described the inherent conflicts of interest which arise on a daily basis in the Canadian mutual fund industry.[17] In a second, he pointed to a number of situations in the United States in which mutual fund managers or their employees had been involved in questionable activities and asked how these types of situations might be handled in Canada.[18] In a third paper he described similar situations that by then had occurred in Canada.[19] In the second of these papers Erlichman suggested that the new tool of class actions might one day, perhaps on a serious market downturn, be used against fund companies. In the first, in 1993, he suggested that an independent governance agency like that required under the *Investment Company Ac*t, might be the solution for Canada.[20] Erlichman's papers helped renew the debate on the inherent conflicts in common Canadian mutual fund structures.

In 1995, the Canadian Securities Administrators published an extensive study on mutual fund regulation, *Regulatory Strategies for the Mid-'90s: Recommendations for Regulating Investment Funds in Canada* ("*Stromberg Report*").[21] In the introduction to the report, Glorianne Stromberg, the report's author, described the issue of mutual fund governance in the following terms:

> there is something inherently wrong with a structure that permits all of the functions that are required to be carried out in respect of an investment fund to be carried out by related parties on terms that are in effect unilaterally imposed without there being some degree of review by unrelated persons who are considering the merits solely from the perspective of the best interests of the investment fund and its investors.[22]

While recognizing that it would be neither viable nor optimal to require fund managers to obtain shareholder or unitholder approval for every decision, the *Stromberg Report* maintained that there had to be some mechanism to place a check on the inherent conflicts arising in the investment fund and fund manager relationship. According to the *Stromberg Report,* these conflicts were exacerbated by the fact that "investment organizations are under considerable pressures to build critical mass and to secure access to distribution channels in order to survive."[23] The *Stromberg Report* emphasized that at a very minimum "there should be a requirement that mechanisms be in place to ensure that someone is

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17 S.I. Erlichman, "Managing Potential Conflicts of Interest" in *Mutual Funds: New Products, New Competitors, New Rules* (Toronto: The Canadian Institute, 22 October 1993) ("Potential Conflicts").

18 Implications *supra* note 16, *passim*.

19 S.I. Erlichman, "Fiduciary Duties and Conflicts of Interest in the Canadian Mutual Fund Industry - An Update" in *Business Practice Codes in the Investment and Fund Industries* (Toronto: Insight Press, 1997).

20 Erlichman wrote in "Potential Conflicts", *supr*a, note 17 at 26-27:

> Another line of thought follows the premise that certain actions may have gone on for many years in the mutual fund industry, and may still be going on, which have not been brought to light because the disclosure requirements are not sufficient or, if adequate, are not followed. In addition, one may argue that the security holder approval requirements are not very effective as many security holders do not understand what they are asked to approve and, in the vast majority of cases, security holders approve almost anything that the manager of a mutual fund is asking them to vote on. *If one follows this school of thought, then one might consider requiring independent informed persons to monitor conflicts of interest and, in some cases, to approve conflicts of interest. For example, the Investment Company Act in the United States has, among other things, the following requirements to monitor or approve possible conflicts: (i) a board of directors, 40% of whom must be independent, whose functions is to oversee the operations of the mutual fund and to police conflicts of interest; and (ii) shareholder voting to, among other things, elect board members, approve or disapprove fee arrangements, and accept or reject changes in a mutual fund's investment policies.* These requirements were reviewed in the 1969 Mutual Funds Report and also in the 1974 *Proposals for a Mutual Fund Law for Canada* and were rejected for Canadian mutual funds. It is interesting to note that in a 1992 United States Securities and Exchange Commission staff report entitled *Protecting Investors: A Half Century of Investment Company Regulation*, the staff of the Securities and Exchange Commission recommended that the 40% independent director requirement be increased to in excess of 50%. Staff also recommended that independent director vacancies be filled by persons chosen by the remaining independent directors and that independent directors be given express authority to terminate advisory contracts. In light of the 1992 study by the United States Securities and Exchange Commission and the 25 years which have elapsed since the 1969 Mutual Funds Report, is it time to re-examine potential conflicts of interest in the mutual fund structure and the possible role of independent directors to monitor or approve such conflicts?" [emphasis added].

21 Stromberg Report, *supra* note 6. See also *OSC Regulating Conflicts of Interest in the Management of Mutual Funds The Current Regime* (1995)

22 *Ibid* at 14.01, 88.

23 *Ibid* at 18.04(1), 152.

reviewing all actions to insure that they are in the best interest of the investment fund and its investors,"[24] and that where "an investment fund organization deviates from the principles of good corporate governance it should include, in the base disclosure document for the investment fund *and* in the annual report of the investment fund, the reasons for any deviation from these guidelines."[25] The report recommended the adoption of a requirement that all mutual funds have an independent governing body with duties and responsibilities akin to those of a board of directors of a corporation.

In 1996, the Investment Funds Steering Group responded to the recommendations of the *Stromberg Report* with *The Stromberg Report: An Industry Perspective* ("*Steering Group Report").*[26] The *Steering Group Report* agreed with the recommendation of the Stromberg Report that investment funds be required to put in place an independent board of governors, or advisory committee with responsibilities akin to those of the board of directors of a corporation. It recommended, however, that this requirement need be met at the fund family level only.[27]

A second response to the *Stromberg Report* was prepared by the Commission des valeurs Mobilières du Quebec Consultative Committee on the Regulation of Mutual Funds. This Committee, in its report, *La Modernisation du Cadre Normatif dans le Contexte Québécois* ("*Quebec Report*"),[28] recommended that fund families have boards but that these boards need not be independent. The *Quebec Report* also suggested that the existence of independent members on a supervisory board of a fund family should result in some reduction of direct regulation and in the relaxation of certain rules on conflicts of interest.[29]

A second study by Glorianne Stromberg was published in 1998, *Investment Funds in Canada and Consumer Protection: Strategies for the Millennium ("Second Stromberg Report").*[30] The parts of the *Second Stromberg Report* dealing with mutual fund governance simply reiterated the themes of the *Stromberg Repor*t, concluding that "the need to implement the recommendations aimed at improving the governance provisions in respect of investment funds remains."[31]

In 1999 the Senate Committee on Banking Trade and Commerce entered the fray with its repor*t, The Governance Practices of Institutional Investors (the "Senate Committee Repor*t").[32] This report strongly endorsed the need for a majority of independent directors in the governance of mutual funds. *The Senate Committee Report* also recommended that legislation be passed recognizing a business trust structure

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24 *Ibid* at 18.04(4), 153.

25 1969 Report, *supra* note 11 at 18.04(3), 153.

26 Investment Funds Steering Group, *The Stromberg Report: An Industry Perspective*, Prepared for the Canadian Securities Administrators (Toronto: Queen's Printer, November 1996). [hereinafter *Steering Group Report*].

27 It made a number of other recommendations. It recommended that the CSA (a) develop a system for the registration of, and continue to directly regulate, fund managers; (b) recast the conflicts regime to take into account the existence and duties of fund boards and to recognize alternatives to strict prohibitions that may exist, and (c) work with the industry to facilitate the development of good business practices, internal controls and infrastructure for both dealers and fund managers. The *Steering Group Report* also recommended that a code of ethics and business conduct be adopted for fund managers, that adoption of this code be a requirement of registration, and that the independent board of directors be responsible for monitoring the fund managers' behaviour in accordance with the code guidelines. This code would be filed with the CSA and be made available to investors upon request. Furthermore, the *Steering Group Report* recommended that managers invest in more human and technological capital to manage and control the funds as they grow, that they meet certain senior management requirements for registration, that they meet certain minimum capital requirements, that managers maintain insurance for certain insurable risks, and that managers maintain at least a three person board of directors. However the *Steering Group Report* specified, contrary to the *Stromberg Report,* that this particular board need not be independent. *Ibid* at 50-51.

28 Consultative Committee on the Regulation of Mutual Funds, *La Modernisation du Cadre Normatif dans le Contexte Québécois*, Prepared for the Quebec Securities Commission (January 1997). [hereinafter *"Quebec Report*"].

29 The *Quebec Report* made several other recommendations, including: (a) that mutual fund managers should be registered; (b) that the minimum level of regulatory capital should take into account the impact of capital requirements on managers with assets under administration of less than $100 million; and (c) that there should not be compulsory registration of external providers of services but mutual fund managers should have ultimate responsibility for such service providers. *Ibid* at 10 and 40-44, as summarized in *Making it Mutual*, *supra*, note 11, 60.

30 G. Stromberg, *Investment Funds in Canada and Consumer Protection: Strategies for the Millennium*, (Ottawa: G. Stromberg, October 1998) [hereinafter *Second Stromberg Report*].

31 *Ibid* at 135-137.

32 *Report of the Standing Senate Committee on Banking, Trade and Commerce: The Governance Practices of Institutional Investors* (November 1998) (Chair: M. Kirby) [hereinafter *Senate Committee Report*].

similar to a corporate structure. It included provisions for directors and officers of the trust elaborating the extent of their independence and their accountability to unitholders and mechanisms for its enforcement. The enactment of legislation in this area was recognized as being of the utmost importance on the basis that:

> [i]nvestors are entitled to know the risk management and governance practices of their mutual fund manager. They have a right to know what processes are in place to monitor the decisions taken on the risk exposures of the mutual fund, and if that monitoring is taking place.[33]

Finally, in June 2000, Stephen Erlichman prepared a report for the CSA describing mutual fund governance regimes in other countries and making specific recommendations for reform in Canada, *Making it Mutual: Aligning the Interests of Investors and Managers – Recommendations for a Mutual Fund Governance Regime for Canada ("Making it Mutual").*[34] As *Making it Mutual* is the immediate precursor to the present study, it is useful to quote from it on the governance question at length (emphasis added). *Making it Mutual* recommended that every fund family be required to have an independent board with the following characteristics:

> The board should consist of at *least three individuals of whom at least a majority and preferably at least two-thirds are independent of the manage*r. The definition of what constitutes an "independent" member should be modelled on the Dey Report's definition of "unrelated director" rather than on the complex and detailed rules used in the U.S. *Investment Company Act* of 1940.
>
> There should be no restriction on the *same individuals being on the boards of more than one or all of the mutual funds in a fund comple*x.
>
> The independent members of the board initially would be selected and appointed by the manager. Thereafter the independent members would be *appointed by the full board* (and not by the manager nor by the independent members alone) or in the case of a corporate mutual fund they would be elected by the fund's shareholders as required by the fund's governing corporate statute, in either case based upon the recommendations of a nominating committee composed of at least a majority of directors who are independent of the manager.
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> The salaries of the independent members should be determined by the board, but in the first instance they could be established by the manager and the board jointly.
>
> The salaries of the independent members, as well as any additional expenses of having a board, could be paid either by the mutual fund or by the manager.
>
> The board, as well as the independent members as a separate group, should have the power to seek whatever professional advice and incur whatever expenses they reasonably require to carry out their duties, with the cost of such advice being borne either by the mutual fund or by the manager. These expenses would be paid by the mutual fund if the manger does not agree to pay them.
>
> The board should have the general responsibility to supervise the management of the business and affairs of the mutual fund in order that decisions affecting the mutual fund are made in the best interests of the security holders of the mutual.11 fund. The board need not have a detailed list of specific duties, but certain minimum responsibilities should be established. The minimum duties could include: (i) evaluating the performance of the manager in various categories (including in providing an adequate level of service

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33 *Senate Committee Report, Ibid* at 135-137.

34 *Supra*, note 1.

to security holders and in producing acceptable investment returns for the mutual fund, before and after expenses, in comparison to appropriate benchmarks that take into account the mutual fund's risk profile); (ii) reviewing the financial statements of the mutual fund; (iii) checking that the mutual fund is following its investment objectives; (iv) monitoring the manager's compliance with the mutual fund's compliance plan; and (v) making decisions on behalf of a mutual fund whenever conflict of interest issues arise between the mutual fund and any other party. In addition to the specified minimum duties, the board should have the flexibility to determine what else it should do to fulfill its broader general mandate. The board should not have the right to terminate the manager. The board should be given sufficient power to carry out its responsibilities.

Board members should have a *standard of care similar to that of directors of a business corporation.*

Each board should have a lead member, who will be one of the independent members. The lead member should be responsible for managing the processes of the board. The lead member should monitor the mutual fund on a regular basis and should be the key person who interacts with the fund manager on issues relating to the mutual fund.

Each board member should be entitled to be indemnified from the assets of the mutual fund (and, if these are not sufficient, from the assets of the manager) for liabilities incurred while carrying out his or her duties, provided the board member has not fallen below the board's standard of care.

The board should be authorized to purchase appropriate liability insurance for the benefit of its members at the expense of the mutual fund, but such insurance should not cover any liability resulting from not satisfying the board's standard of care.

If the board and the manager cannot agree on any issues, the board or the manager should report such matters to the CSA or to the security holders of the mutual fund or, in appropriate circumstances, call a meeting of mutual fund security holders to vote on the issues. To whom the report is made and whether a security holder meeting will be called will be a decision of the board or the manager, as the case may be, based upon the nature of the matter in dispute. The CSA, however, should not be required to function as a mediator.

The manager, directly or through a trade organization, should provide sufficient education programs to new board members and to all board members on an ongoing basis. Board members also should have the right to supplement these education programs by attending outside seminars at the expense of the manager or, if the manager is unwilling to pay the costs, at the expense of the mutual fund.[35]

The present study, in a sense, aims to discover how a model of governance such as this might be implemented. This investigation involves two main elements. First, what are, as a matter of private law, mutual funds and why are fund managers motivated to design them the way they do? Second, what private law rules apply to them, and how do the private law rules that apply to them facilitate or constrain fund managers the design of mutual funds. All of this is with a view to proposing where and how in the private law "reality" presented by mutual funds a governance agency might be imposed.

With this in mind, the next Part examines the empirical reality of mutual funds (Section 3) and the reasons why they are organized the way they are (Section 4). The following six Sections in Part III describe the private law that applies to mutual funds. Part IV outlines the structural proposal, that is, how or where in the current structures of mutual funds described and categorized in Part II, can an independent governance agency be imposed.

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[35] *Making it Mutual supra* note 1 at 164.

II. THE MUTUAL FUND INDUSTRY

3. CURRENT STRUCTURES AND PRACTICES

Common Mutual Fund Structures

Open-end mutual funds[36] are investment funds organized primarily as trusts but occasionally as corporations and, very rarely, as limited partnerships. The funds organized as trusts - the vast majority - are established by a declaration of trust or a settlement made by the fund promoter or fund manager and contained in the trust instrument - the deed of settlement, trust agreement, trust declaration or settlement. Funds organized as corporations are simply incorporated under a general corporations law. The investor - the unitholder or shareholder - is entitled to redeem their trust units or shares on demand for a proportionate share of the net asset value of the trust or corporation. The units or shares are typically non-transferrable. The investor looks to the fund for liquidity and the fund, as a consequence, is in a state of constant liquidation and distribution.

The trust instrument in the case of a trust and the articles of incorporation in the case of a corporation establish the basic constitution of the mutual fund.[37] The constitution deals with the investment objectives and restrictions of the fund (generally defined in terms of their risk characteristics), the redemption and valuation procedures, including an extensive definition of "net asset value", unitholder rights, including meeting rights and rights to vote on amendments to the constitution, the powers of the trustee, including a power to delegate trust powers to others, and liability protection for the trustee, unitholders and others.

Economically, mutual funds offer the average investor a number of distinct investment advantages not generally available to individual investors alone. These include: (1) diversification - mutual funds provide individual investors access to a broader range of securities than are available to individuals alone; (2) liquidity of investments - mutual funds permit investors to redeem their mutual fund investment on demand and to receive their proportionate share of the net asset value of the mutual fund; (3) professional investment management – the mutual fund portfolio is managed by professional investment advisors; and (4) choice, convenience and accessibility - the mutual fund market over the last twenty years has developed so that there is a broad range of easily accessible mutual funds from which to choose.[38]

The principal player in the commercial reality is the fund promoter or fund manager. The manager is typically a corporation in the financial services or mutual fund industry. It initiates the pooling of capital in the fund, controls the formulation of the fund’s constitution, and controls or manages the fund’s distribution, administration, and operation. Typically, the promoter or manager will draw together all of the other service providers to the fund or agree to provide some or all of the services itself. The main service providers required are: the custodian, who possesses the investments as bare or custodial trustee; the trustee (in the case of mutual funds organized as trusts) who is the legal owner of the investments such

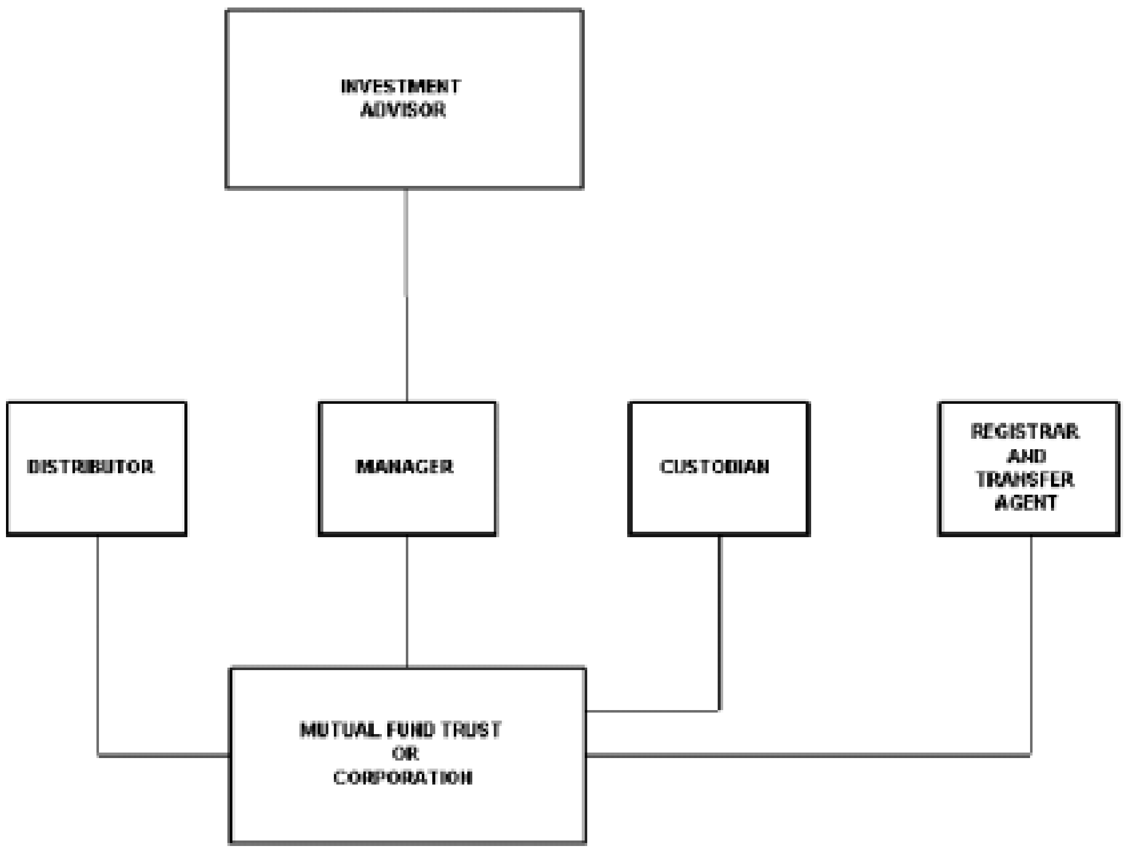
36 This study focusses on open-end mutual funds exclusively. The defining characteristic of an open end mutual fund is the right of the investor to redeem at any time their investment for an amount (less fees) equal to the underlying investments. The *Securities Act* defines “mutual fund” to include “an issuer of securities that entitle the holder to receive on demand, or within a specified period after demand, an amount computed by reference to the value of a proportionate interest in the whole or in a part of the net assets, including a separate fund or trust account, of the issuer of the securities”. Closed-end funds are not dealt with in this study.

37 The constitution is or can be set out in a variety of documents. The main ones are: a master declaration of trust, with supplementary trusts creating individual funds; a master declaration of trust creating individual trusts by schedule; individual trusts created by declaration or settlement; articles of incorporation and by-laws; and service contracts, including contracts between the trustee and the fund manager and custodian.

38 See: M.A. Convery, "Material Players and Material Contracts", in *Structuring and Marketing Mutual Funds: A Legal, Regulatory and Business Course* (Toronto: Insight Press, 1994) at 32 and K.A. Malatest,"Overview of the Mutual Fund Industry" in *Structuring and Marketing Mutual Funds: A Legal, Regulatory and Business Course* (Toronto: Insight Press, 1994) at 16.

that a trust is created having beneficial ownership interests lying elsewhere (with the unitholders); the investment adviser, who provides expertise in the investment of the capital; the registrar and transfer agent; and, the distributor. A neutral representation of the fund complex - neutral in the sense that is does not precisely indicate the underlying legal relationships involved - is contained in the following diagram. Except for the manager/trustee relationship which is discussed in greater detail in the remainder of this part, the lines in the diagram indicate contractual relationships.

BASIC RELATIONSHIPS



The Importance of the Investor/Manager Relationship

There are a considerable variety of arrangements in which all of these activities are performed. Since the current regulatory interest is governance, however, the only important element of these structures for present purposes is the legal relationship between the investor - the principal or owner - and the manager - the agent. If it is intended to impose by statute, regulation or otherwise a different or enhanced model of governance, then it is this relationship that requires examination since it is this relationship which will have to be modified.

The investor/manager relationship is mediated by the legal entity which actually owns the investment assets. That entity, the mutual fund trust or the mutual fund corporation, will have its own governance structure as part of its definitional law (i.e., the law that defines what it is and therefore that identifies the elements that are required to create it): the trustee in the case of the trust and the directors of the corporation in the case of the corporation. For the purposes of this study it is helpful to have a common term to refer to the *individuals* who, as a matter of this definitional law, are *ultimately* responsible (even if fully indemnified or insured) for the governance of an entity. I will use the term "formally responsible agent" for this purpose. Note that, by this definition, in structures where the trustee is a corporation, the formally responsible agent of the trust is the board of that corporation. The purpose of this term is to identify the *individuals* ultimately legally in charge since governance is concerned with how *individuals* behave as agents for other *individual*s.

The interesting question for the present project is how the power over the fund is moved as a matter of law from the formally responsible agent of the trust or fund corporation to (the formally responsible agent of) the fund manager.

With respect to the trust, logically, the manager can enter the picture in a limited number of ways: as settlor, as protector (discussed further below in Section 10), as trustee, as contractual delegate of the trustee or, given the inherent flexibility of trusts, in some other *sui generis* manner; with respect to the fund corporation, logically, the manager can enter the picture as controlling shareholder or as a contractual delegate of the fund corporation.

Examining the trust first, as settlor, the manager can exercise great initial control through the drafting of the trust instrument, and therefore in the design of the unitholder rights and trustee powers. The settlor's position, however, is not strong enough to exercise the kind of ongoing control that the manager requires. I will return to the institution of protector in another part of this study, but it also is not a relevant solution to the manager's problem since it offers powers of negative control only. It can, however, be one of the levers of control that the manager can use to wrest or keep powers acquired by contractual delegation. The manager can certainly control the trust if it is trustee. Whether a sui generis role works depends only on the powers it is given. In actual fact, all three approaches to manager control - contract, trustee, and sui generis role – are common.[39] The common thread in all of them is an entirely legal "usurption" or "infiltration" of the trustee.

The corporate fund structures are fairly straightforward and require little comment. The only viable technique of ongoing control for the manager is for the fund manager to control the fund corporation. Contractual delegation by the corporation of power to the manager is not viable if the corporation is otherwise independent of the manager since that contract can be terminated at any time. The only guaranteed control technique is for the manager to control the election of the corporation's directors. This is achieved by the manager controlling the voting shares of the corporation.[40]

The intriguing issue for the trust or corporate lawyer who happens on these structures for the first time is the extent to which the mutual fund legal reality inverts the normal legal form. The normal legal form regards the trustee of the trust as the central authority, with all of the power and all of the fiduciary responsibilities owed exclusively to the beneficiaries. In some mutual fund trust structures by contrast, the trustee is little more than a service provider: the trustee provides the (absolutely essential) service of bifurcating ownership into legal title (the trustee's formal title) and equitable or beneficial title (the unitholder's economic interest). Normal corporate law regards the directors of the corporation as acting

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39 One result of the structural variety and complexity that this conclusion highlights is that one can find on a close reading of Annual Information Forms and constitutional documents misapprehensions and errors as to the existence or nature of legal obligations among the various elements of a mutual fund complex or a mix of concepts drawn from other areas of the law.

40 It is interesting to speculate whether the manager in this type of structure owes, as majority shareholder, a fiduciary obligation to the investors. Canadian courts have been reluctant to say that such shareholder/shareholder obligations exist but this structure is so peculiar and so extreme, it invites such an intervention in the appropriate case. See Jeffrey G. MacIntosh, Janet Holmes and Steve Thompson, "The Puzzle of Shareholder Fiduciary Duties" (1991), 19 C.B.L.J. 86, Jeffrey G. MacIntosh, "Fiduciary Responsibilities of Shareholders", *Law Society of Upper Canada Special Lecture Series*, Fall 1990, and Jeffrey G. MacIntosh, "Minority Shareholder Rights in Canada and England: 1860-1987" (1989), 27 Osgoode Hall L.J. 561. See also *Brant Investments Ltd. v. KeepRite Inc.* (1987), 60 O.R. (2d) 737, 42 D.L.R. (4th) 15, (H.C.J.), Supplementary reasons, 61 O.R. (2d) 469, 43 D.L.R. (4th) 141; *Exco Corp. Ltd. v. Nova Scotia Savings & Loan Co.* (1987), 78 N.S.R. (2d) 91, 35 B.L.R. 149 (S.C.); *Re Olympia & York Enterprises Ltd. and Hiram Walker Resources Ltd.*(1986), 59 O.R. (2d) 254 (H.C.J.), aff'd (1986), 59 O.R. (2d) 254 (Div. Ct.); and *First City Financial Corp. v. Genstar Corp.* (1981), 33 O.R. (2d) 631, 125 D.L.R. (3d) 303 (H.C.J.)

exclusively in the interests of their shareholders who themselves constitute, in some sense, a shareholder democracy. In most mutual fund corporate structures, the investors have few of the rights of public corporation shareholders.

Securities law addresses this reality by regulating, through registration requirements, prospectus requirements and governance requirements, the sponsor or manager.[41] With respect to governance, securities law looks behind the legal form to fix the fiduciary obligation on the manager, where it really belongs. Thus s.116 of the *Securities Act* (Ontario) states:

(1) Every person or company responsible for the management of a mutual fund shall exercise the powers and discharge the duties of its office honestly, in good faith and in the best interests of the mutual fund, and in connection therewith shall exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.

(2) For the purposes of subsection (1), a person or company is responsible for the management of a mutual fund if he, she or it has legal power or right to control the mutual fund or if in fact the person or company is able to do so.

The *Securities Act* (Ontario) Sections 110 to 121 and National Instrument 81-102, Section 4, deal in detail with conflicts of interest in the mutual fund industry.[42]

Under section 213 of the *Loan and Trust Corporations Act*[43] a corporation that is not registered under that statute cannot act as a trustee unless, in the case of a corporation that "manages" a mutual fund trust, it is approved by the Ontario Securities Commission (the "Commission"). By approval 81-901 dated January 14, 1997[44] (the Commission granted approval to any body corporate that manages a mutual fund trust to act as trustee of a mutual fund in Ontario if:

(a) the body corporate is the manager, within the meaning of National Policy Statement No. 39 or any rule replacing National Policy No. 39 of the mutual fund trust; and

(b) securities of the mutual fund trust are distributed by means of a prospectus or simplified prospectus for which a receipt has been issued by the director under the Act.

As a consequence of this approval any body corporate that manages a mutual fund distributing under a prospectus or simplified prospectus is qualified to act as trustee of the mutual fund. Any body corporate that intends to act as trustee of a mutual fund that does not distribute by means of a prospectus or simplified prospectus must apply to the Commission for approval. Different provinces have addressed the issue of which corporations can act as a corporate trustee in different ways.

As we shall see in more detail in Part III, private law does exactly the same.

The Fiduciary Conflicts of the Manager

Before moving to describe a more detailed classification of common mutual fund structures based on this preliminary sketch, it is helpful to describe the scope of the governance issues involved by describing the types of fiduciary conflicts that arise in the mutual fund industry. Managers, and those who work for managers, find themselves, because of the very nature of their business, in situations where their pecuniary interests conflict with their fiduciary duty or in situations where they have a diminished interest in pursuing the best interests of their beneficiaries.

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41 The manager as distributor or the manager as investment advisor would have the relevant registration under the provincial *Securities Acts*.

42 See Appendix "D" (available on request).

43 R.S.O. 1990, c. L.25.

44 (1997) 20 O.S.C.B. 200 replacing Interim OSC Policy 11.1 which was rescinded effective January 14, 1997,

For the sake of brevity, since the topic is covered in detail elsewhere,[45] the main conflict situations, can be summarized as follows:

(1) The manager has a pecuniary interest in ensuring that it or its service providers in the same corporate group continue to be engaged by the fund entity, even if their performance -as advisers or marketers or trustees, - is not acceptable.

(2) The mutual fund pays its own operating expenses. These include the expenses of regulatory compliance, legal fees and the fees of service providers. The manager has a reduced interest in minimizing these.

(3) The manager has a pecuniary interest in allocating expenses it shares with the mutual fund - rent, administrative support - in a way that is favourable to it.

(4) The manager has a pecuniary interest in maximizing the fees it charges the fund, since these are its principal source of revenue.

(5) The manager has a pecuniary interest in increasing sales of fund securities and might engage in practices - trailer fees - to provide incentives to sales forces to sell *its* fund securities in preference to others.

(6) The manager may be connected economically with the service providers and therefore have a pecuniary interest in selecting and paying fees - via soft dollar arrangements and reciprocal commissions - to its related service providers.

(7) The manager has a pecuniary interest in the allocation of scarce securities to its various funds, some of which may pay higher percentage fees or which require a boost because of recent poor performance.

(8) The manager has a pecuniary interest in marketing its funds in a way that maximizes its return, not necessarily the return of the investors in its funds.

(9) Portfolio managers have a personal pecuniary interest in maximizing their personal investment return and therefore may be in conflict in the allocation of a scarce security or in the use of useful investment information.

In two of his papers in the 1990's, Stephen Erlichman reviewed a number of U.S. decisions involving breaches of fiduciary obligations in the mutual fund context. These give a sense of the reality of the conflicts and are summarized briefly in what follows:

1. *In the Matter of Joan Cona*n,[46] dealt with a portfolio manager who learned of an investment opportunity while performing research for the funds and purchased for herself securities which she subsequently sold at a substantial profit. The SEC found the portfolio manager liable for improper personal trading on the basis that she had taken an opportunity which rightfully belonged to the funds.

2. *In the Matter of Account Management Corporation*[47] dealt with a registered investment advisor who had two sets of client accounts. Over a period of time the investment advisor favoured one set of clients over another with respect to certain "hot IPO's" which the investment advisor would purchase and flip within two or three days of purchase for a significant short term profit. These were typically allocated to one set of clients in preference to the other. The SEC found that the investment advisor regularly breached its fiduciary duties to its clients by “consistently allocating

45 Erlichman, “Potential Conflicts” *supra* note 17.

46 *In the Matter of Joan Conan* (September 30, 1994), SEC Release No. 34-34756.

47 *In the Matter of Account Management Corporation, et al.,* (September 29, 1995), IA Release No. 1529.

short term trading opportunities in "hot IPO's" to a limited group of eligible accounts, without adequately disclosing this practice".

3. In a 1993 SEC administrative proceeding, *In the Matter of Aetna Capital Management Inc.,*[48] an investment advisor paid a registered broker $1.8 million in sales commissions and consulting fees in exchange for the broker soliciting purchasers for the investment advisory services. The fee paid to the broker was not disclosed to the investment advisor's clients. The SEC found the investment advisor in violation of several sections of the *Investment Advisors Act* of 1940.

4. *In the Matter of Stein, Roe & Farnham Incorporated*[49] involved an investment advisor who identified and recommended that brokerage commissions be directed to a list of "friends" in recognition of client referrals received from the friendly brokerage firms. The SEC determined that the investment advisor had violated the *Investment Company Act* of 1940 because it "received compensation, in the form of client referrals, with a purchase or sale of property to or for investment companies".

5. In *Krinsk v Fund Asset Management Inc.*[50] the United States Court of Appeal held that section 36(b) of the *Investment Company Act* of 1940 "places on the investment adviser ... "a fiduciary duty with respect to the receipt of compensation for services paid by the investment company". A shareholder sued the fund manager in a derivative action for negotiating excessive advisor fees. The court held that there had been no breach of fiduciary duty.

Conflicts of interest are the principal example of a fiduciary's breach of their duty of loyalty. There are other elements of the duty of loyalty and more is said about it in Part III.

The other main element of a fiduciary's duty is the duty of competence. None of the examples of breaches mentioned so far deal with breaches of the duty of competence. Competence issues arise in the day to day execution of the typical fund managers typical tasks. Such daily tasks as executing transactions, keeping pricing records and accounting records, regulatory compliance and market and securities analysis require skilful and diligent attention. Erlichman in his survey of US decisions cites two examples of this type of breach of duty:

6. *In the Matter of Mark Bailey and Company*[51] involved a investment advisor who failed to negotiate commissions on the client's behalf with brokerage firms as stipulated in the investment advisors contract with the client.

7. In *In the Matter of Merrill Lynch Pierce, Fenner & Smith Inc.*[52] the SEC determined that Merrill Lynch had miscalculated the net asset value of certain unit investment trusts such that it underpaid unitholders of 570 investment trusts. The mispricing led to the underpayment of unitholders.

In summary, the fund manager and its employees, like all fiduciaries or agents, may be tempted to breach its duty of loyalty or breach its duty of competence. Economists are always quick to point out, correctly, that market competition encourages efficient behaviour and so helps to minimize the costs that arise because of deficient agency behaviour. However, as in other areas of social and economic life, market inducements to efficient behaviour are seldom sufficient to generate the levels of loyalty and competence

48 *In the Matter of Aetna Capital Management, and Aetna Financial Services, Inc.*, Admin. Proc. File No. 3-8119, 1993 SEC LEXIS 2090 (August 19, 1993).

49 *In the Matter of Stein Roe & Farnham Incorporated,* Admin. Proc. File No. 801-27653 Admin. Proc. File No. 3-7303, Securities and Exchange Commission, Investment Advisors Act of 1940, Release No. 1217; Investment Company Act of 1940, Release No. 17316, 1990 SEC LEXIS 71; 50 S.E.C.

50 *Krinsk v. Fund Asset Management, Inc.*, 875 F.2d 404, 414 (2d Cir. 1989).

51 *In re Mark Bailey*, (February 24, 1988), Investment Advisers Act Release No. 1105.

52 In the Matter of Merrill Lynch, Pierce, Fenner & Smith, Inc., (November 9, 1977), Release 14149, published in 13 SEC Docket 646.

investors are entitled (by contract) to expect. Market failure is endemic. The only regulatory question is whether a regulatory intervention can make things better at a cost that is not too high.

The governance reform proposed by others and assumed by this study is to place an independent governance agency between - in some precise legal sense yet to be specified (see Part IV) – the manager and the investor so that the risks and costs of fiduciary breaches of duty are further minimized.

Classifications of Mutual Funds - The Legal Constitution

Since the point is to identify the techniques by which the manager takes legal control of the investments, the key characteristic of each legal mechanism about to be described is the legal relationship between the formally responsible agent of the fund and the formally responsible agent of the fund manager.

As we proceed through the techniques, it is useful to observe whether the fiduciary conflicts that arise, arise as a matter of structure or as a matter of factual circumstances or situations. Conflicts - divided loyalties - arise as a matter of structure in circumstances where individuals find themselves occupying two positions or offices simultaneously where the positions or offices themselves, by virtue of the definition of their duties, are in conflict. The positions of referee and team member in a hockey game are in conflict, and any individual who occupied both positions simultaneously would be in a *structural* conflict. A conflict is situational where the source of the divided loyalties of the fiduciary are the fiduciary's own personal interest, such as when the referee is compromised because his daughter plays on one of the teams in the game he is refereeing.

The general (but not sole) solution to structural conflicts is to prohibit any one person from occupying the two conflicting positions. The general solution to situational conflicts is to prohibit the conflicted individual from occupying the relevant position. A less severe approach in both cases is to regulate the conflicted individual in the execution of their duties. The seriousness of situational conflicts is a question of fact in each case - it all depends on the relevant fiduciary's other interests and loyalties. The seriousness of structural conflicts depends on the conflicting loyalties inherent in the two offices.

Our review of mutual fund instruments suggests there are basically six legal structures or forms.

1. <u>Type A - Manager-Trustee Trust</u>: In this model, a trust is created either by declaration or settlement and the manager is the trustee. As such, the manager has and exercises all of the traditional powers, including investment powers, of a trustee. This is a common structure: the fund manager controls because the fund manager is the trustee. If there is any delegation of responsibility it occurs internally within the fund manager's organization. The internal delegates are either employees of the fund manager or a subset of the board of directors (a board committee). Services are purchased by the "trustee" (but the trustee is the manager) by contract.

   In this type of mutual fund structure the divided loyalties arise as a matter of structure since the formally responsible agents of the trust (the board of the manager) are the formally responsible agents of the manager. The same individuals occupy positions or offices that are in conflict. As trustee, their duty is to maximize unitholder returns but as directors, their duty is to maximize the manager's return. The existence of structural conflict does not mean that some important aspects of the interests are not also mutual. For example, the economic interest of the manager is to make its business prosper by producing a good product and a good product is also what unitholders want. The existence of a structural conflict only means that the ultimate interest of the manager (return on equity for its shareholders) is not the same as the ultimate interest of the unitholders (return on the pooled investments) and that therefore there will be occasions when the manager might choose to advance the first to the detriment of the second.

2. <u>Type B - Captive-Trustee Trust</u>: In this model, a trust is settled or declared with a corporation or individuals as trustee(s). The trustee, however, is part of a mutual fund complex - either an affiliate or associate (B1) or an employee (B2) - and delegates by contract, pursuant to an ample power to do so in the trust instrument, fund management responsibilities to another entity, the

fund manager, in the complex. Where the trust is created by settlement, the settlor is often the fund manager or the parent of the manager and the corporate trustee. The "first" fund manager might even be mentioned in the instrument. This structure is used most commonly by mutual fund complexes which have a captive trust company or employee/executives willing to serve as trustees.

The divided loyalties in the case of the corporate trustee are typically situational. The corporate trustee is 100%-owned by the manager or the manager's parent and subject to its controlling shareholder's direct control. Its board may have little independence from the parent's board. They might even be the same or some of the same individuals, in which case the conflict is structural.

The divided loyalties in the case of the individual trustees are typically situational. Because they are individuals, they are legally independent of the manager. As a practical matter, however, they are unlikely to disregard the economic interests of their employer. If the individuals, however, are also the directors of the manager, the conflict is structural.

3. <u>Type C - Compliant - Trustee Trust</u>: In this model, a trust is settled by the manager on an unaffiliated trustee company which is in the business of offering its trustee services to fund managers. As in the Captive-Trustee Trust, the trust instrument names the fund manager as the "first" manager and the manager is subsequently engaged by contract. In this type of structure the divided loyalties are situational, not structural, since the trustee is legally independent of the fund manager. However, the practical reality is that the trust corporation is in the business of offering its trustee services and it is unlikely that it would ever act to remove the fund manager. If it did, it might be replaced as trustee by a power to do so in favour of the fund manager in the trust instrument or through some more subtle exercise of power by the fund manager.

4. <u>Type D NewTrust</u>: In the previous models, the power of the fund manager is conferred on it in a legally straight-forward way, either directly by the instrument because the manager is also trustee or indirectly by contractual delegation by the trustee to the fund manager. In the New Trust, the trust instrument itself divides traditional trustee powers and responsibilities between the trustee and the fund manager such that a new "quasi-trustee" position is created for the fund manager directly in the instrument in which the trust, with a separate "stripped down" trustee, is also created. This model is difficult to analyse legally. In some instances, the simple analysis is that the "stripped-down" trustee is nearly redundant in terms of governance issues - a bare trustee or custodian - and that the fund manager is the real trustee in all but name. In this model the conflict is structural since the manager has all the power and its board is therefore the formally responsible agent for the New Trust and for the manager.

5. <u>Type E - The Mutual Fund Corporation</u>: Mutual funds organized as corporations are relatively rare in Canada, for income tax reasons which are explained further below. In this type of mutual fund, the beneficial interests are organized as shares of a corporation which invests the pooled fund in accordance with its objects or in accordance with investment objectives established in respect of each class of share. The fund manager is engaged by the corporation by contract. In older and more common versions of this structure, the investors have the traditional power of shareholders which, like public corporation shareholders, they exercise passively. In newer less common versions of this structure, there is a separate class of "control" shares owned by the manager and the investors have few of the typical shareholder rights. In this model, the conflict is typically situational because the individuals on the fund corporation board are typically different from the individuals on the manager or parent board. However, where the parent or manager controls the election of the fund corporation board with its "control" shares, the conflict is nonetheless serious. It was suggested above[53] that this structure might lead a Canadian court one day to find for the first time that the shareholder-to-shareholder relationship is fiduciary.

53 *Supra*, note 42

6. Type F - Mutualized Mutual Fund: There are some mutual funds in Canada which are mutualized or owner-operated in the sense that the manager is owned by the investors or by groups or associations representing the investors. These arrangements might use any one of the above structures, but because the ultimate ownership of the manager is the investors or a group or association representing investors, there are no divided loyalties.[54]

Trust instruments use a variety of other tools to reinforce manager control. Two common ones are the power to appoint successor trustees and the power to terminate the fund. Managers will also typically reserve the rights to trademarks and trade names.

I return to use this topology in Part IV on proposals.

4. REASONS FOR COMMON STRUCTURES

Two sets of reasons govern the selection by a fund sponsor of the organizational form: taxation reasons and reasons relating to the inherent governance attributes of the form. Each is discussed in turn.

Taxation Reasons[55]

Tax considerations have played the dominant role in the selection of the trust and the corporation over the partnership, and in the selection of the trust in preference to the corporation. The tax considerations are of two main types. First, eligibility for investment by the deferred income vehicles - RRSP, RRIFs DPSPs, RPPs - is restricted in ways that advantage mutual fund trusts and mutual fund corporations over partnerships. Second, the *Income Tax Act* (the "Act") contains provisions which facilitate flow-through tax treatment of income earned by the fund if the fund meets certain conditions. Separate but similar flow-through rules apply to mutual fund corporations and mutual fund trusts. The flow-through rules that apply to trusts, however, apply to all types of income earned by the trust; the flow-through rules that apply to corporations apply to only dividend income and capital gains of the corporation. Hence, the preference for the trust form.

The principal characteristic of trust and partnership taxation is flow-through tax treatment. This means, simply, that income earned through a trust or a partnership is taxed at only one level. Flow-through treatment is achieved in different ways in each case. The basic concept of partnership taxation is that income is calculated at the entity level, but allocated annually (whether distributed or not) to the partners in accordance with their partnership interests. It is therefore taxed only in their hands, retaining (for the most part) its source characteristics for income calculation and other purposes. The basic concept of trust taxation is that income is taxed at the trust level at the highest marginal rate, but in calculating its income the trust may deduct amounts paid or payable to beneficiaries, in which case the amount paid or payable is taxed in the hands of the beneficiary, retaining its source characteristics for income calculation and other purposes.

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54 Fonds des professions inc. in Quebec is owned by the professional associations whose members are the investors. Profits or fee income are returned ultimately to the professional associations. There are no acquisition, transfer or withdrawal fees.

55 On taxation of mutual funds generally, see: K.A.S. Monaghan “Mutual Funds: The Basics From a Tax Perspective” in *Structuring and Marketing Mutual Funds* (Toronto: Insight Press, 1994); R. Richler “Use of Pooled Funds by Registered Plans”, *Report of Proceedings of Forty-Eighth Tax Conference* (Toronto: Canadian Tax Foundation, 1997), 63:1-39; D.J.W. McMullen “Real Estate Investment Trusts: The Latest in the Series?” *1997 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation 1997) 13:1-29; P. Botz, “Mutual Fund Trusts and Unit Trusts: Selected Tax and Legal Issues” (1994), vol. 42, no. 4 *Canadian Tax Journal*, 1037-1058; J.A. Brussa, “Royalty Trusts, Income Trusts, and Search for Yield: A Phenomenon of a Low-Interest-Rate Environment?”, *Report of Proceedings of the Forty-Eighth Tax Conference,* 1996 Tax Conference (Toronto: Canadian Tax Foundation, 1997), 19:1-27; H. Chasmar, “Mutual Fund “Switch Funds” in “The Taxation of Corporate Reorganizations” (1998), vol. 46, no. 1 *Canadian Tax Journal*, 172-194; S.J. Fyfe and C.J. Webster, “Current Mutual Fund Developments and Projects”, draft paper presented to the Canadian Tax Foundation’s 52nd Tax Conference, 2000; E.M. Krasa, “Income Tax Implications of Joint Investment by Pension Plans Through a Private Pooled Fund Vehicle” (1997), vol. 45, no. 1 *Canadian Tax Journal*, 1-24; and, R.G. Witterick, QC and T. S. Wach, “REITs: The Canadian Experience” in *Corporate Tax Planning in a Changing Business Environment*, 1994 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 11:1-20.

This basic model of trust taxation applies to mutual fund trusts with minor adaptations. The only important variation is one that allows for redemptions of trust units in a way that does not tax realized or unrealized capital gains twice. I will describe that mechanism below. The trust form thus offers the mutual fund manager complete integration: income flowed to the unitholder is received by the unitholder with its source characteristics preserved and is taxed only once in their hands. It is, in this regard, ideal and, as we shall see, incomparable.

The dominant model of taxation of corporations and their shareholders subjects the income earned by the corporation to tax at both the corporation and shareholder levels. The dividend tax credit (claimed by shareholders on account of a portion of the tax already paid on the underlying income by the corporation) provides some relief against double taxation in the case of the public corporation. It provides complete relief against double taxation in the case of active business income (up to $200,000) of Canadian Controlled Private Corporations, and, together with the refundable dividend tax mechanism and the capital dividend account, it provides complete relief against double taxation in respect of investment income and capital gains of certain private corporations. Inter-corporate dividends, subject to certain exceptions, are tax free to the recipient corporation since they represent income that has already been taxed at the corporate level. Where, however, a corporation might be used as a recipient of dividends in order to defer shareholder level taxation, refundable Part IV tax is payable by the recipient corporation. Part IV tax is refunded when the recipient pays a dividend to its shareholder.

Mutual funds are subject to this Part IV refundable tax. Provided they pay out their dividend income, mutual fund corporations are a tax efficient method of holding investments which generate dividend income. Realized capital gains, however, require a special regime, as do realized and unrealized capital gains on the redemption of shares. The latter will be described below, with its mutual fund trust analogue. The treatment of the former is fully integrated through a refund mechanism. The mutual fund corporation pays tax on its capital gains as they are realized at the regular corporate rate. An account, the "refundable capital gain tax on hand "account tracks taxes paid on capital gains on a cumulative base. Another account, the "capital gains dividend" account keeps track of the net capital gains realized by the mutual fund corporation and the "capital dividends" paid out of this account cumulatively. When a mutual fund pays a dividend out of its capital dividend account, it is entitled to a refund of the capital gains tax out of the refundable capital gain tax on hand account equal to 14% (the federal tax rate of 28% times the 50% inclusion rate for capital gains) of capital gains dividends paid. These dividends are received by the shareholder and taxed as capital gains in the shareholders hands. Thus, perfect integration in respect of capital gains.

In respect of other types of income - interest, rent, royalties - mutual fund corporations pay a corporate level tax which is not refunded when the income is distributed by dividend to shareholders. As with all other public corporations, the dividend tax credit provides only partial relief against double taxation, with the consequence that the mutual fund corporation is not tax efficient for these types of income.

The unitholder/shareholder on a redemption is entitled to their proportionate share of the net asset value of the corporation. That net asset value will therefore reflect both realized and unrealized gains and losses in the trust or corporation. A problem arises with respect to unrealized gains. The unitholder/shareholder, when they redeem, should be taxed on the amount received in respect of unrealized gains. However, there should be some mechanism that precludes this amount from being taxed again when the mutual fund trust or corporation disposes of the underlying assets giving rise to the unrealized gain. This is achieved in the case of the trust and the corporation in the same way. The amount of any particular redemption that is equal to the redeeming unitholder’s/shareholder’s share of realized and unrealized capital gains is calculated as the "capital gain redemption" and is paid to the unitholder/shareholders as a capital gain or a capital dividend. A trust is entitled to a refund at the rate of 21.75% and a corporation is entitled to a refund at the rate of 21% of its capital gains redemptions out of its refundable capital gains tax for the year. Hence integration in respect of unrealized gains on redemption.

To be eligible for the favourable treatment just summarized fairly strict criteria must be met.

Under the Act a corporation must satisfy the following criteria in order to qualify as a "mutual fund corporation":

- it must be a Canadian corporation that is a public corporation;

- its only undertaking is (i) investing of its funds in property (other than real property), (ii) the acquiring, holding, maintaining, improving, leasing or managing of any real property that is capital property of the corporation, or (iii) any combination of these two; and

- the issued shares of the capital stock of the corporation includes shares having a condition attached thereto that requires the corporation to accept on the demand of a holder the surrender of the shares or shares that are qualified in accordance with the prescribed conditions relating to the redemption of the shares, and the fair market value of such issued shares that have these conditions or are so qualified was not less than 95% of the fair market value of all of the issued shares of the capital stock of the corporation.

In essence, to qualify as a mutual fund corporation, the share capital must be designed so that the shareholders can be expected to look to the corporation, through share redemptions, for liquidity.

Under the Act, a trust is a "mutual fund trust" if it meets the following conditions:

- its only undertaking is (i) investing of its funds in property (other than real property); (ii) acquiring, holding, maintaining, improving, leasing or managing of any real property that is capital property of the trust, or (iii) any combination of these two and it complied with prescribed conditions relating to the number of its unit holders, dispersal of ownership of its units and public trading of its units; and

- it was a "unit trust."

There is a further more complicated requirement, which need not be described here, which prevents mutual fund trusts from being used by non-residents to avoid tax in Canada.

A unit trust, is defined in subsection 108(2) of the Act. To be a unit trust, the beneficial interest must be describable by reference to units. If this condition is met, then a trust is a unit trust if any one of the three further conditions is met, only two of which need be mentioned. (1) If 95% of the fair market value of all of the issued units of the trust are redeemable at the option of the holder at prices determined and payable in accordance with conditions or meet certain other prescribed conditions in relation to the redemption of units, the trust is a unit trust. (2) If the units do not meet this redemption condition, then the trust can still qualify as a unit trust if a further series of investment conditions are met, namely:

- the trust is resident in Canada;

- the trust's only undertaking was investing of funds in property (other than real property) or acquiring holding maintaining, improving, leasing or managing in a real property that is capital property of the trust or both;

- at least 80% of its property consisted of shares, cash, bonds, debentures, marketable securities, real property and rights to interests in any rental or royalty;

- not less than 95% of its income is derived from or from the disposition of these investments; and

- not more than 10% of its property consists of bonds, securities or shares in the capital stock of any single corporation.

In essence, mutual fund trusts are defined in a way that ensures that unitholders achieve liquidity by looking to the trust for redemptions.

A key part of both the mutual fund corporation and mutual fund trust definitions is that the mutual fund must restrict its activities to "the investing of funds." This term has been defined by Canada Customs and Revenue Agency Revenue Canada to include the acquisition of commodity futures contracts, securities lending, writing covered call options, and the acquisition of real estate.

Finally, mutual fund corporations offer a tax advantage not available to mutual funds organized as trusts. There is no rollover of investments when a unit of a mutual fund trust is redeemed and another is purchased; a mutual fund corporation established with several classes of shares which track different investment objectives can be designed in a way that permits a tax free rollover when the investor switches from one fund to another by simply converting their shares. Another tax advantage to organizing as a corporation is the accessibility of tax free rollovers in the case of corporations. It is much more difficult to reorganize a mutual fund trust on a tax neutral basis.

Governance Reasons

The strong preference for the trust form is also a reflection of the fact that the trust form historically is the preferred private law institution for the creation of common interests in passive investments. Passive investing, in contrast to active business operations, requires a simpler governance structure since, beyond the actual selection of the investments and relatively minor administrative tasks in looking after them, there is very little in the way of daily operations requiring coordination and delegation. This observation is less true in the case of mutual funds compared to a family trust containing passive investments. Nonetheless, General Motors is a vastly more complex and complicated operation than any of the most complex mutual funds and therefore requires a more complex organizational law.

There is no legal or practical reason why complex governance structures suitable for complex operational enterprises cannot use the trust form however. Nor, conversely, is there any legal or practical reason why corporations cannot be used for passive investment businesses. The contemporary uses of the business trust demonstrate the first point clearly and the use of corporations for mutual funds in Canada and the U.S. demonstrate the second point clearly. The main reason corporations are historically preferred to trusts for operational enterprises is the clearer protection that shareholders and directors have against liability for the torts of the corporation. Although beneficiaries are protected completely against tort liabilities incurred by the trustee as trustee, a trustee’s protection is only as good as the value of the trust assets since the trustee is personally liable for torts committed in the conduct of the trust’s business, although entitled to be indemnified out of the trust assets. If those assets are not sufficient to meet the trustee's tort liabilities incurred in their capacity as trustee, then the trustee must pay with their personal funds.

A second reason trusts are the preferred vehicle for passive investments is the flexibility of the trust form in designing successive beneficial interests in the multi-generational setting. Obviously, in the case of mutual funds, this factor plays only a minor role, if any, since the design of the mutual fund interests as "trust units" is no more or less challenging than the design of such interests as shares.

A third explanation for the preference of the trust form over the corporate from is the legal fact that the beneficiaries actually have an ownership interest - beneficial ownership in equity - in the trust corpus. Shareholders in a corporation have no direct interest in the property of the corporation. Perhaps this is only a cosmetic or marketing advantage as this legal distinction is not reflected in a significant way in the economic reality.

The point about ownership does not make the trust superior to the corporation, but it does make it superior to promise. Professor Langbein describes this advantage in the pension context but the point he is making applies with equal force in all commercial trusts including mutual funds:

> Were the pension promise merely a liability of the firm...the employee or retiree would be a creditor like any other. Were the employer to become insolvent – a common enough occurrence in commercial life – the pension claims would be exposed to reduction or loss in like measure with the employer's other debts. Under the trust mechanism, however, the employer creates and funds a separate trust to defray the pension promises, and the employer's insolvency need not disrupt the pension plan because the plan's assets are segregated in the trust. Present and future beneficiaries look to the trust, not the bankrupt employer, for payment of their pensions.[56]

III. THE PRIVATE LAW OF MUTUAL FUNDS

So far, I have described the background to the current view that mutual funds require an independent governance agency and I have examined and identified the common types of mutual fund structures in Canada today, as well as the reasons for the preference for the trust form.

Recall that the objective of this study is to determine where in the various structures of mutual funds to place the independent governance agency. This is a private law or "technical" question. A successful answer will tell mutual fund managers how, as a matter of the private law, this independent governance agency will fit into their structures.

In order to provide a full answer to this question, it is necessary to review all of the private law that affects mutual funds. This Part provides that review. In part, the purpose of this Part is to show that there is no serious issue as a matter of private law with the adoption or implementation of the proposals set out in Part IV. To that end, the review is comprehensive and touches on some topics that are not necessarily central to the analysis of mutual fund trust as a matter of private law. This is useful, however, since the point of the study is to demonstrate that there are no real private law problems in the adoption or implementation of the proposals in Part IV.

5. FIDUCIARY LAW AND MUTUAL FUNDS

General Principles of Fiduciary Responsibility in Canada

The law of fiduciary obligations applies to any individual who finds himself or herself in a "fiduciary relationship". Directors and officers of corporations and trustees of trusts are fiduciaries per se - by virtue of their office - but so are many other persons by virtue of the facts and circumstances of their relationships with others. Certainly, anyone with a possessory interest or power in respect of mutual fund assets is prima facie in a fiduciary relationship with the fund investors. As such, they owe a fiduciary obligation to the beneficiary. Contemporary thinking on fiduciary relationships makes clear that the categories of the fiduciary relationship, like the categories of negligence, are not closed.[57]

In simplified terms, and as already suggested, the fiduciary obligation is comprised of two parts, a duty of loyalty and a duty of competence. The duty of loyalty, formulated positively, simply requires that the fiduciary use their fiduciary powers exclusively to pursue the best interests of the beneficiary of the obligation. Formulated negatively, the obligation of loyalty means that: (i) a fiduciary may not place himself or herself in a position where their duty to the beneficiary is in conflict with their personal interest

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56 Langbein, *supra* note 3 at 180.

57 *Guerin v. R..,* [1984] 6 W.W.R. 481, 13 D.L.R. (4th) 321 at 341. In *Guerin v R.* Mr. Justice Dickson for the majority of the Supreme Court of Canada in 1984 stated as follows:

> "it is sometimes said that the nature of fiduciary relationships is both established and exhausted by the standard categories of agent, trustee, partner, director, and the like. I do not agree it is the nature of the relationship not the specific category of the actor, involved that gives rise to the fiduciary duty. The categories of fiduciary [relationship]...should not be considered closed".

(the "conflict" rule); (ii) a fiduciary must not profit personally from their office (the "profit" rule); (iii) a fiduciary cannot delegate the duty of loyalty (the "personal performance rule"); (iv) a fiduciary must act impartially towards the beneficiaries of the obligation (the "even hand" rule); and (v) a fiduciary may not, in general, fetter their fiduciary discretion. Looked at from the point of view of the beneficiaries' remedies, the obligation of loyalty entails an obligation to disclose what has happened in the matter or "account" for the exercise of the fiduciary powers and to disgorge any profits made from the breach of the obligation of loyalty. The latter will typically lead to a constructive trust of the profits in favour of the beneficiary.[58]

The duty of competence divides logically into two parts, a duty of skill and a duty to exercise that skill diligently (to pay attention). The duty of competence requires that the fiduciary exercise, when and as appropriate, the requisite level of skill for the benefit of the beneficiary of the obligation. Breach of the duty of competence gives rise to an obligation to make good the loss caused.

The best and perhaps most famous expression of the trustee's obligation of loyalty is the following statement of Cardozo J. in *Meinhard v. Salmo*n:

> ...the duty is of the finest loyalty...a trustee is held to something stricter than the morals of the market place. Not honesty alone but the punctilio of an honour, the most sensitive, is...the standard of behaviour.[59]

The two most important aspects of the fiduciary's obligation of loyalty - the profit rule and conflict rule - are expressed well by Professor John McCamus in the following passage:

> The fiduciary duty of loyalty imposed on such persons is normally expressed in two proscriptions: one who occupies a fiduciary position must not secure a personal profit by virtue of that position (the "profit rule"); and, further, one must not place one's self in a position where self-interest may come into conflict with the interests of the person to whom the duty is owed (the "conflict rule"). Simply put one must not engage in undisclosed self-dealing and one must not make a secret profit by virtue of the position held. What is enjoined, then, is a particular kind of exploitation or profiteering. In the event of a breach of duty, the principal remedies available to the victim - constructive trust or an accounting of profits –force the faithless fiduciary to disgorge the profits secured through breach. Both remedies are equitable in nature. Their distinguishing feature is that the accounting of profit leads to a monetary award whereas the constructive trust confers a proprietary remedy by determining that the defendant holds certain assets as their constructive trustee on the plaintiff's behalf. Where the self-dealing involves the transfer of an asset to or from the principle, a decree of rescission may be available.[60]

The classic formulation of the conflict rule is stated in the decision of Lord Herschell in *Bray v For*d:

> it is an inflexible rule of a court of equity that a person in a fiduciary position...is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in position where his interest and duty conflict. It does not appear to me that this rule is as has been said founded upon principles of morality. I regard it, rather, as based on the consideration that human nature being what it is, there is a danger in such circumstances of the person holding a fiduciary position being swayed by interest rather

[58] On fiduciary obligations see: T. Frankel, "Fiduciary Law" (1983), 71 Cal. L. Rev. 795; J.C. Shepherd, *The Law of Fiduciaries* (Toronto, Carswell, 1981); M.V. Ellis, Fiduciary Duties in Canada, looseleaf (Toronto, Carswell, 1988); E.J. Weinrib, "The Fiduciary Obligation" (1975), 25 U.T.L.J.1; and A.W. Scott, "The Fiduciary Principle" (1949), 37 Cal L. Rev. 539.

[59] 249 N.Y. 458, 164 N.E. 545 (1928).

[60] J. McCanus "Equitable Compensation and Restitutionary Remedies: Recent Developments" *1995 Special Lectures of the Law Society of Upper Canada* (Carswell: Toronto, 1995) at 300.

> than duty, and thus prejudicing those whom he was bound to protect. It has therefore been deemed expedient to lay down this positive rule.[61]

There are several Supreme Court of Canada decisions in which the fiduciary relationship is described or defined. *Frame v. Smith*[62] is an oft-cited case which lays out a test for determining whether a fiduciary relationship exists. In that case Wilson J. stated (in dissent) as follows:

> relationships in which a fiduciary obligation have been imposed seem to possess three general characteristics: (i) a fiduciary has a scope for the exercise of some discretion or power. (ii) the fiduciary can unilaterally exercise that power or discretion so as to affect the beneficiaries' legal or practical interests. (iii) the beneficiary is peculiarly vulnerable to or at the mercy of the fiduciary holding the discretion or power.[63]

Analysed carefully this test is not a definition. It merely identifies the characteristic attributes of a fiduciary relationship. To illustrate this point, consider the example of a lawyer/client relationship. A lawyer/client relationship clearly satisfies the *Frame* test: the lawyer has power to act on behalf of the client, in a way that affects the client's interests, and the client, as a consequence, is vulnerable. The lawyer's obligations of loyalty and competence, however, do not *flow from* these facts. They flow from the undertaking or contract the lawyer makes to act on behalf of the client. In that undertaking or contract, the lawyer promises loyalty and competence in respect of the power given by the client to the lawyer. The essence of the fiduciary relationship, then, is the obligation of loyalty and competence in respect of the exercise of power and the source of that obligation, in the case of the lawyer and in the vast majority of cases, is the contract or voluntary undertaking of the fiduciary.

It may be possible, however, for a fiduciary obligation to arise in situations where there is no promise or undertaking of loyalty. The authorities are not clear and there is some academic debate.[64] Two recent cases of the Supreme Court of Canada provide useful illustrations of the contemporary thinking on this question.

In the first, *Lac Minerals Ltd.* v *International Corona Resources Limited,*[65] the Supreme Court of Canada dealt with a relationship between the plaintiff, a junior mining company, and the defendant, a senior mining company, arising out of the disclosure of confidential information by the plaintiff to the defendant. Mr. Justice LaForest, dissenting on the issue of fiduciary obligation, found that a fiduciary relationship existed because of the reasonable expectations of the plaintiff arising out of the plaintiff's dealings with the defendant. Those reasonable expectations were based in part on certain industry practices in regard to the exchange of confidential information. The majority decision written by Mr. Justice Sopinka determined, using the *Frame* test, that there was no fiduciary obligation between the plaintiff and defendant since the plaintiff was not in a position of dependency or vulnerability. The plaintiff, he reasoned, could have protected itself by contract. Neither Justice focussed on the need for some undertaking. In this they may have been misled by its absence in the *Frame* test which was their starting point. Alternatively, they may have been of the view that none is required, and that a certain set of facts and circumstances is sufficient.

The 1994 Supreme Court of Canada decision in *Hodgkinson v. Simms*[66] dealt with a relationship between an accountant and an investor. The investor sought the accountant's advice on an investment matter. The issue became whether their relationship was fiduciary. Mr. Justice La Forest stated as follows:

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61 *Bray v. Ford* [1896] A.C. 44 at 51 (H.L.).

62 *Frame v. Smith* [1987] 2 S.C.R. 99 42 D.L.R. (4th) 81.

63 *Ibid.*, at para 61.

64 See A.W. Scott, "The Fiduciary Principle" (1949), 37 Cal L. Rev. 539. "A fiduciary is a person who undertakes to act in the interests of another person. It is immaterial whether the undertaking is in the form of a contract. It is immaterial that the undertaking is gratuitous."

65 *Lac Minerals Ltd. v. International Corona Resources Limited*, 61 D.L.R. (4th) 14 (S.C.C.)

66 *Hodgkinson v. Simms* [1994] 3 S.C.R. 377, 117 D.L.R. (4th) 161.

> ...the relationship of an investor to his or her discount broker will not likely give rise to a fiduciary duty, where the broker is simply a conduit of information and an order taker. There are, however, other advisory relationships where, because of the presence of elements such as trust, confidentiality, and the complexity and importance of the subject matter, it may be reasonable for the advisee to expect that the advisor is in fact exercising his or her special skills in that other party's best interests, unless the contrary is disclosed.[67]

In determining for the majority that there was a fiduciary relationship, Mr. Justice LaForest applied a reasonable expectations test, which, as formulated in the following passage appears to require a mutual understanding and, by implication, an undertaking:

> ...whether given all the surrounding circumstances one party could reasonably have expected that the other party would act in the former's best interests with respect to the subject matter at issue. ...thus, outside the established categories what is required is evidence of a mutual understanding that one party has relinquished its own self interest and agreed to act solely on behalf of the other party.[68]

What the passages quoted above reveal is that there is a lack of clarity in Canadian jurisprudence on fiduciary obligations. In *Hodgkinso*n, it is not clear whether the "reasonable expectations" of the investor that the advisor would exercise his special skills in the investor's best interests was sufficient to give rise to fiduciary obligations. It is more likely, given Justice LaForest's reference to a "mutual understanding", that what was also required was an implied undertaking on the part of the advisor to assume a position of trust. In fact, the "reasonable expectations" test itself suggests that what is required is objective evidence that a relationship of trust and dependency was contemplated by both parties.

Fiduciary Obligations in the Mutual Fund Context

As a matter of private law is the fund manager a fidiciary? Are the other actors in the mutual fund relationship fiduciaries? There is no question that the fund manager in most structures is a fiduciary.

As one author has said:

> It seems unquestionable that the extent to which the manager in such cases is subject to the fiduciary standards applicable to trustees should depend on what can reasonably be considered to be the intentions and expectations of the promoter and the investors. Obviously, the manager could be intended to be the agent of the investors or the trustee and if that intention is clear it should be possible to characterize the relationship as such.[69]

A recent Australian decision[70] dealt with the question whether a manager of two trusts owed a fiduciary obligation to the beneficiaries of the trusts. Mr. Justice Finn reasoned as follows:

> Turning directly to the fiduciary question. My preferred approach is to resolve it by reference to what [the manager] in fact did for the trusts and to the context in which this occurred...
>
> Even if it is the case that [the manager] can properly be said as a matter of legal form to be the manager for, or the agent of the trustees... in performing services for the trusts, this by no means precludes a finding that it is, as well, in a direct fiduciary relationship with the beneficiaries of the trusts when providing those services.

67 *Ibid*, at 410

68 *Ibid* at 409-10.

69 See M.C. Cullity, "Legal Issues Arising Out of the Use of Business Trusts in Canada, *supra* note 3 at 196.

70 *Australian Securities Commission v. AS Nominees Limited*, (1995), FED No. 915/95 (FCTD) (Aust.).

> When one has regard (i) to the functions actually performed for the trusts by Windsor [the person who controlled the manager] who is [the manager's] alter ego (ii) to the level of responsibility for identifying and securing trust investments in fact conceded to Windsor by the boards of [the two trustees]; (iii) in the case of [the two trusts], to the terms of the respective trust deeds and of the manager's undertakings in them; (iv) to the appreciation Windsor must reasonably be taken to have had of the vulnerability of the trusts to the manager's actions; and (v) to the awareness he must reasonably be taken to have had that the function the manager was performing was for the benefit of the trust beneficiaries – the conclusion in my view is irresistible that the manager was in a fiduciary relationship with the beneficiaries of the respective trusts in rendering services to them.[71]

What this reasoning suggests, in the context of a mutual fund trust governed by Canadian law, is that a typical fund manager, responsible for decision-making with respect to the day to day affairs and operation of the fund, will be in a fiduciary role vis a vis the unitholders of the fund. This is the likely outcome whether one has resort to the standard of care set out in the relevant securities legislation or to the common law principles that have developed for determining the existence of fiduciary obligations.

A second instance of how a fiduciary relationship analysis might apply in a mutual fund context is provided by the British Columbia Court of Appeal 1996 decision in *Froese v. Montreal Trust Company of Canad*a.[72] In that case a trust company had custody and management of a company pension fund until 1985 when the company took over the investment responsibilities. The trust company, Montreal Trust Company Limited, stayed on in its capacity as a custodial trustee. The plaintiff was a former employee of the corporation who sued the custodial trustee for breach of duty based on the trust company's failure to warn the plaintiff that the company was not making regular contributions to the pension plan. The British Columbia Court of Appeal, by a majority, held that the trust company was liable under an over-arching trust obligation:

> I therefore conclude that there is what academics call an over-arching obligation upon a custodial or administrative trustee to pay attention to the interests of the beneficiaries additional to its contractual duties provided in the trust indenture. This obligation is not unlimited: it arises only within the function assigned to, or assumed by the trustee. ...
>
> One cannot read the literature on this question without being struck by an understandable trend towards increased responsibility on the part of trustees, including custodial trustees, to exercise reasonable care for the position of the beneficiaries. ....there are opportunities for conflicts of interest unless care is taken on at all levels to protect the vulnerable and necessarily passive beneficiaries who literally trust others to protect their pensions. Trust companies often speak proudly of the vast amount that they have under administration. In this case it is necessary to consider what responsibilities should be imposed on such a function. ...
>
> A custodial trustee will almost invariably owe a common-law duty of care to the beneficiaries, though such a duty of care is not unlimited. It arises only within the scope of the trustee's engagement. The custodian administrator for example, would not usually have a duty of care relating to actuarial or investment functions.
>
> An administrator, however, has an opportunity, and I think an obligation, to recognize the reasonably apparent danger signals. ...thus in my view the responsibility of a custodial or administrative trustee in particular circumstances should include at least a function of a watchdog.[73]

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71 *Ibid*, at para. 69.

72 *Froese v. Montreal Trust Company of Canada*, (1996) 137 D.L.R.(4th) 725 (C. of A.).

73 *Ibid*, at 737-739.

This reasoning has potentially far reaching implications. At the least it means that persons invested with fiduciary responsibilities have an obligation to ensure that other fiduciaries with whom they work discharge their fiduciary obligations. As Stephen Erlichman concludes, in the mutual fund context:

> a trustee of a mutual fund which delegates all or the vast majority of its powers and duties to a manager in accordance with a trust indenture, or a custodian which enters into a custodial agreement for a mutual fund which clearly sets out the duties of the custodian, may find out that it is responsible and liable for much more than it bargained (and incidently for much more then it was receiving remuneration) if the mutual funds manager or investment advisor breaches its obligations to the mutual fund.[74]

6. TRUST LAW AND MUTUAL FUNDS - THE TRUST CONCEPT

The Business Trust

The trust is a simple and flexible legal institution that is capable of a variety of uses. It is particularly well-suited to its traditional use of inter-generational wealth transfers, but has for decades now been the legal instrument of choice in a variety of institutional and business contexts. Trust lawyers will invariably affirm that any arrangement that can be effected through a corporation can be effected through a trust. This is not entirely true, but is largely so.

Mutual funds organized as trusts are but one species of the genus business trust. The term "business trust" has a range of meanings.[75] It is not a term of art. Narrowly construed it refers to situations in which a trust is used as the legal form to conduct a trading enterprise. Broadly construed it includes situations where the trust is used for a wide variety of commercial purposes, including business and investment trusts, pension trusts, employee benefit trusts, environmental reclamation trusts, securitization trusts, real estate investment trusts and mutual fund trusts.

As the modern commercial uses of the trust have matured, so have the variety of commercial transactions involving trusts, to the point where we have recently witnessed sophisticated reorganizations and takeover bids in Canada involving business trusts. As another indication of this developing maturity, certain common law jurisdictions have enacted tailor-made legislation to provide a more substantial default law (i.e., the law that the court will apply in the absence of a specific contractual provision provided by the parties) for the specific non-traditional uses of the trust peculiar to their jurisdiction.[76] The

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74 "Fiduciary Duties and Conflicts of Interest in this Canadian Mutual Fund Industry - An Update", *supra*, note 19.

75 There is no formal definition of the term "business trust". See Timothy Youdan , "Business Trusts: Avoiding the Pitfalls" in *Estate Planning Institute* (Toronto: The Canadian Institute, 1995) at 1:

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

Another author, Robert Flannigan, "Business Trust - Past and Present" (1984), 6 E.T.Q. 375 at 375 offers the following definition:

> The business trust may be viewed as a union between the unincorporated joint stock company and the trust. It is a true trust but it has an internal structure (e.g., a board of trustees manages with exclusive management authority, freely transferable trust interest, annual meetings of beneficiaries) very similar to that of a joint stock company. Like the joint stock company (and the partnership), the business trust is set up and regulated under terms dictated by its members. Because of the imposed trust it is a contract to carry on a business in which the benefit from that business is separate from the management of the business.

76 Various common law jurisdictions have consolidated local commercial practice in codifications of business trust law. Delaware has a business trusts act, *Delaware Business Trusts Act,* 66 Del. Laws 279 (1988). Bermuda and Cayman Island have novel trusts legislation. *Trusts (Special Provisions) Amendment Act 1998* (Bermuda) and *Special Trusts Alternative Regime Law* (Cayman). Note that the *Proposals* in 1974 proposed such a statute for mutual fund trusts in Canada, as did the Stromberg Report in 1995 and the Senate Report in 1999 did the same.

extent to which the business trust is currently used, however, cannot be quantified, for the simple reason that there is no registration or publication requirement in respect of trusts.

The merits of the trust form in a commercial context are, principally, (1) the separation of equitable and legal ownership, (2) the vast body of default fiduciary law (i.e., the law summarized in Section 5), (3) the relative absence of imperative statutory law and the consequent relative freedom in designing trusts and (4) the lack of a publication requirement.

Tax considerations aside, the trust is a popular form for mutual funds for precisely these reasons. (1) It allows for the separation of the investment management function and the ownership function in its division between legal and equitable ownership. (2) In doing so, it ties in to a vast body of default law - both case law and, to a limited extent, statutory law - governing the trust relationship such that the mutual fund constitution need not specify every detail of that relationship. (3) At the same time, that body of law is relatively liberal in the freedom it allows managers in the design of fund constitutions. Hence, the great variety of mutual fund structures in Canada. (4) And, until recently, all of this could be done in relative secrecy in the sense that trust instruments did not have to be published.[77] All of these points merely reiterate the point made at the end of Section 4 that, although the tax motivations in favour of the trust form are strong, the trust form itself has inherent attractions for fund sponsors.

Even if the trust has been adapted to a wide variety of business uses by business lawyers, the business trust is still just a trust and remains subject to the general law of trusts.[78] Most of that law is default law, or what civilians term suppletive (as opposed to imperative) law. Settlors of trusts, for the most part, are free to design trusts as they please and if some necessary element of the design is not specified in the trust instrument - investment powers, say - the default or suppletive law provides the missing rule. Some of that law is imperative law, stating the rules that define the legal institution or, for reasons of public policy, restrict its use.

Much of this inherited trust law was developed in case law dealing with family trusts and intergenerational wealth transfers. Much of it, therefore, simply does not apply to mutual fund trusts. One significant factual difference between the mutual fund trust (and other business trusts) and family trusts is that the interests of the beneficiary in the former are usually very precisely defined and are not subject to any dispositive discretion on the part of the trustee. Most of the suppletive trust law regulating dispositive powers is therefore of no relevance in the mutual fund context. The unitholder’s interest in a mutual fund trust is also, invariably, a full capital and income interest. In the family context the capital (or remainder) and income (or life) interest are usually separated. Most of the suppletive law regulating investment powers, including the even hand rule (which requires trustees to pay due regard to the interests of the capital and income beneficiaries by not over-emphasizing income investments or growth investments) has no application in the mutual fund context.

Conversely, certain areas of the inherited suppletive and imperative law are quite underdeveloped, insofar as the business trust is concerned. Three examples will suffice. (1) Limited liability of beneficiaries and trustees is of acute concern in the context of business trusts including mutual fund trusts, but of limited relevance in the family wealth context. (2) Mutual fund trustees are constantly issuing new units in exercise of their powers under their trust instrument. If the power is construed as a power of appointment and not a power of sale, it might be invalid for violating the rule against perpetuities.[79] (3)In the case of

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77 Securities legislation always required mutual funds managers to make trust declarations available to anyone who wanted to review them during business hours. Today, trust declarations are "material contracts" under N181-101 and they must be filed publically on SEDAR.

78 Robert Flannigan "The Nature and Duration of the Business Trust", *supra*, note 3 has remarked at 184:

> This is not to say that the practical differences between the usual form of business trust and an ordinary trust cannot be used to classify or segregate the business trust for particular purposes. The only point made here is that such differences as do exist do not support the position that a business trust is a new distinct legal form. It is simply the recognized flexibility of trust law which allows for the pursuit of a business in the trust form.

79 If so, that would be a case of an irrelevant imperative rule being applied in a harmful way. The rule against perpetuities prohibits certain kinds of future interests in order to promote the policy in favour of free alienability or property. It makes sense

closed-end mutual funds there is some difficulty explaining how, if all the interests are vested, the unitholders can be prevented from calling for their interest at will as they could, if another imperative rule, the rule in *Saunders v Vautier*[80] were applied. The prevailing view is that the unitholder has agreed with the trustee not to so call, thus varying his trust right in a contract.

The general theme of the discussion in this section and in the next two sections is that, because the trust is essentially a contract, there is great flexibility in how it can be used. As with the law of contracts, justice in any particular circumstance depends more on the terms of the particular contract and the specific facts of the relationship that gave rise to the dispute, than it does on the law of contracts in general.

For a variety of reasons, Canadian lawyers and judges seem more mystified by the trust form and equity than, once studied, the subject matter warrants. This feature of the Canadian legal landscape, together with the tendency of precedent-based systems of law to turn rule applications into rules, presents the danger to business trusts that doctrines developed for one set of factual circumstances - intergenerational wealth transfers - will be applied to them. In *Target Holdings Ltd. v. Redferns*[81] the English House of Lords expressed this point in the following way:

> [In] my judgement it is in any event wrong to lift wholesale the detailed rules developed in the context of traditional trusts and then seek to apply them to trusts of quite a different kind. In the modern world the trust has become a valuable device in commercial and financial dealings. The fundamental principles of equity apply as much to such trusts as they do to the traditional trust in relation to which those principles were originally formulated. *But in my judgment it is important, if the trust is not to be rendered commercially useless, to distinguish between the basic principles of trust law and those specialist rules developed in relation to traditional trusts which are applicable only to such trusts and the rationale of which has no application to trusts of quite a different kind.* (emphasis added).[82]

Although it is true there is an irreducible minimum of trust obligations, it is unlikely that these basic or imperative standards could ever be applied in a way that will undermine the commercial assumptions underlying most business trust arrangements.[83] It is possible however that some less relevant trust law doctrine developed and applied in a different factual context will one day be applied mistakenly by a court to a business trust. Another author has suggested that this danger can be met with careful draftsmanship:

> There have been discussions involving business trusts in Canada where the commercial context and the business experience and expectations of the parties have clearly influenced a decision that no breach of fiduciary standards had occurred[84]. These decisions support the suggestion that the problem is not so much one of principle; it is one of ensuring that sufficient care and attention is given to the question when the instruments that will govern business trusts are prepared. The real danger for the careful draftsman is not whether his attempts to exclude particular standards are permitted by law but that the courts may assume that all standards commonly applied to the trustee of

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in the family wealth context but not in the mutual fund context. On this basis it is likely a court would construe the trustee's power to issue new units on a power of sale.

80 (1841) Beav. 115, 49 E.R. 282, aff'd. (1841), 1 Cr 8 Ph. 240, 41 E.R. 481. The rule in *Saunders v Vautier* states that if all the beneficiaries are identified and are sui juris, and all their interests are vested, they can require the trustee to transfer their interests in the trust corpus to them.

81 [1996] A.C. 421, [1995] 3 All E.R. 785 (H.L.).

82 Ibid, at para. 32.

83 In *Armitage v. Nurse* [1998] Ch 241, L.J. Millett stated at para. 33, "[T]here is an irreducible core of obligations owed by the trustees to the beneficiaries and enforceable by them which is fundamental to the concept of a trust. If the beneficiaries have no rights enforceable against the trustees there are no trusts. But I do not accept that these core obligations include the duties of care and skill, prudence and diligence. The duty of the trustees to perform the trusts honestly and in good faith for the benefit of the beneficiaries is the minimum necessary to give substance to the trusts.".

84 See, for example, *Dominion Minerals Development Ltd. v. Globe Oil (1958) Ltd.* (1963), 39 D.L.R. (2d) 462 (Alta. T.D.); *Pine Pass Oil & Gas Ltd. v. Pacific Petroleum Ltd.* (1968), 70 D.L.R. (2d) 196 (B.C.S.C.). [Footnote in original.]

a family trust will be applicable unless they are excluded by words specifically addressed to the situation that has subsequently arise.[85]

The Trust Concept

A trust is an obligation enforceable in equity under which a trustee holds property which he or she is bound to administer for the benefit of a beneficiary or beneficiaries (a private trust), or for the advancement of certain purposes (a purpose trust)[86]. The property may be of any kind. Trusts are established expressly by a settlor in a trust deed or a testator in a will (an express trust) or by implication (a resulting trust). They may also be established by operation of law (constructive trust) or by statute (e.g. personal representative under the *Estate Administration Act*[87]). In the case of the express and resulting trust, the obligations of the trustee are voluntarily assumed; in the case of the constructive trust, they are imposed by courts. The intention that expressly creates the express trust may be expressed explicitly or implicitly. The trustee's primary duty is to act loyally and prudently in the administration of the trust property. The trustee's obligation is enforceable by the beneficiary, in the case of a private trust, and the Attorney General or the Crown, in the case of a charitable purpose trust.

The trustee is said to be the legal owner of the property held in trust; the "equitable" owner, in the case of a private trust, is the beneficiary. The language of property is used to describe the interests of the trustee and beneficiary because their rights are said to be *in rem,* not merely personal or contractual. The legal title/equitable title nomenclature also reflects the fact that the trust was developed by courts of equity (as opposed to courts of common law). If the trustee conveys the trust property to a good faith purchaser for value, the beneficiary's title is, in most circumstances, extinguished. If the conveyance is made in breach of trust, the beneficiary has only a personal claim against the trustee. The beneficiary may, however, apply the tracing rules. These allow the beneficiary of the trust to identify property unlawfully substituted for the trust property in the hands of the trustee and to have it treated as the trust property.[88]

The trustee's obligations in respect of the property may range from a simple duty to convey the property when requested to do so to a duty to administer it and distribute it in specified ways. The trust, thus, has a variety of uses. These include: to benefit the future generations of a family through the establishment of successive equitable interests in property; to benefit employees through the holding of a company's shares or other assets in trust for their benefit; to hold funds for public investment (a mutual fund or unit trust); to carry on a business (a business trust or Massachusetts trust); to hold debt claims (and associated enforcement rights) for the benefit of a company's creditors (a debenture or trust for bondholders); to create rights of security; to hold the property of an unincorporated association; and, to advance a charitable purpose. Trusts are also created legislatively for a variety of purposes.[89]

A trust does not have legal personality or legal capacity. It does not own property. It is not a titulary of rights. It has no civil existence as such. Commercial lawyers often use the word "trust" as though it were an analogue of the word "corporation". Under this mode of thinking the trustee is thought of as analogous to the director, and the beneficial interest, or unit, as analogous to the share. Thus we speak of "issuing" units. This is false. It is better to analogize to the concept "partnership". Trusts and partnerships do not enter agreements. In the case of the trust, only the trustee has the legal authority to enter agreements and, in entering those agreements, to bind the trust corpus to the performance of the obligations incurred. The trustee is the only *person* who is liable on those contracts, but he may, and so may the creditor through him, seek an indemnification out of the trust corpus if the trustee’s promise is not performed. I return to this point below.

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85 M.C. Cullity, "Legal Issues Arising out of the Use of Business Trusts in Canada" *supra* note 3 at 198.

86 Subject to a limited number of exceptions, purpose trusts must be charitable to valid. Subsection 16(1) of the *Perpetuities Act*, R.S.O. 1990.C 1 p. 9 treats other purpose trusts as powers.

87 R.S.O. 1990 C. E22.

88 L. Smith, *The Law of Tracing* (Oxford: Clarendon Press, 1997).

89 See for example, s. 67(2) of the *Bankruptcy and Insolvency Act*, R.S.C. 1985 c. B-3 and the *Income Tax Act*, R.S.C. 1985 5th Supp.

Creation of the Express Trust

As a matter of legal structure or legal form, the essence of any private law institution is articulated most clearly in the juridical act by which it is created. The express trust is created in two (basically similar) ways: (1) by a declaration of trust pursuant to which a person, the settlor, declares himself or herself to be a trustee of a certain property, the trust corpus, for the benefit of other persons, the beneficiaries (or a charitable purpose); and (2) by a settlor settling property on a trustee in trust for the benefit of certain beneficiaries.

This central feature of the trust as a legal institution has shaped the whole development and exposition of trust law. The comparable central feature of the corporation is the conferral of legal personality in the act of incorporation. From this flows automatically the idea of limited liability which is simply the recognition in law that the corporation, as a separate person, is solely responsible for its juridical acts and facts. The act that creates the trust is both a transfer of property and an undertaking by the trustee. As a result of this operation and of its conventional uses in the family wealth context, the trust in both the common law and the Quebec civil law is typically understood as an aspect of property law (conveyance) or the law of gifts, and not as part of the law of contracts.

The ritual which results in the creation of this trust is the simultaneous existence of the "three certainties". (1)There must be a clear intention on the part of the settlor to create the trust. In the family wealth context this test is addressing the possibility that the settlor in the text that is the subject of the interpretation was expressing a mere wish, that his words were merely precatory, and there was therefore no intention to transfer or create a proprietary interest in the beneficiary. This test has no application in the context of business trusts where there never is any doubt in regard to intention of the settlor. (2) The subject of the trust - the property transferred or declared to be held in trust - must be identified with certainty. This test emphasizes the proprietary dimension of the trust and simply requires the obvious, that for there to be a trust by settlement or declaration, there must be property. In the mutual fund context this requirement is met often by the settlor settling a nominal amount on the trust corporation in the trust instrument. (Subsequent transfers due to purchases of trust units are not strictly speaking further settlements.) What appears to be a minor formality in these instruments - this initial settlement of $10 by the manager on the trust company - is actually absolutely necessary to get the trust up and going. Its corporate law analogue is the registration of the articles of incorporation. (3) The object of the trust -the person or charitable purpose who or which is to benefit - must be identified with certainty. Like the first test, this one also has little impact in the context of mutual fund or other business trusts since it will always be clear who the unitholders are. Its corporate law analogue is that a corporation must have shareholders. The usual application of the test responds to problems in the family wealth context transfers where gifts are sometimes made to poorly defined classes. It is common in that context, for example, to want to confer a benefit on future generations who can often be identified by description (class) and not by name.[90] The cases on the third certainty deal with situations where the class is poorly defined. They have no relevance to the business trust.

The Trust Distinguished From other Institutions of Private Law

There really is no great mystery to the trust concept. Partly because, to non-equity lawyers, there does still seem to be some mystery, it is usual when defining the trust to show how it is different from other similar institutions of private law. This is also a useful exercise in the present context because it helps explain in part some of the worries that go into drafting trust declarations for mutual funds.

[90] A classic formulation of the test to determine whether a trust exists is the following:

> All that is necessary to establish the relation of trustee [beneficiary] and cestui que trust is to prove that the legal title was in the plaintiff and the equitable title in the defendant. This might be proved in many ways. The mode of proof is quite immaterial. Being proved, no matter how, the relation of trustee and cestui que trust was thereby established. *(Hardoon v. Belilios*, [1901] A.C. 118 (P.C.) at p. 123.)

Contract

The trust in the common law tradition is said to be distinct from contract. It is thought of as a sui generis institution. The main internal evidence in favour of the thesis that the trust is not a contract is as follows.

(1) The trust is created prior to the trustee accepting the responsibility of trustee and the beneficiaries of the trust play no role in its creation. Therefore, neither the trustees nor the beneficiaries are the other party. The settlor of the trust has, at least historically, no standing to sue for its enforcement. Therefore, the settlor is not the other party. If a trust is contract who is the other party?

(2) There is no need for consideration in the creation of a trust but there is for a valid contract. Trust law purists are critical of their commercial law colleagues who speak of "mutual covenants" and "consideration" in their business trust deeds, since no consideration or mutuality is required.

(3) Trusts by their nature involve the settlement of property whereas there need not be any property in any part of a contractual arrangement in order for the arrangement to be contractual.

(4) The trust creates property rights in favour of both the trustee and the beneficiaries whereas there is no necessary proprietary element to a contract.

(5) The trust of its nature breaches the contract privity rule since, in the typical trust, the beneficiaries are third party beneficiaries of an arrangement between two other individuals, the settlor and the trustee. The basic rule in contract law is that a person who is not a party to a contract may not sue on the contract.

These are all, in my view, facile arguments which have only persuaded common lawyers because of the stark historical separation of law and equity. On a technical level, trust lawyers still express dismay that business lawyers call their trust instruments "agreements", not settlements or declarations. There is a lot of history but very little of real legal substance in these debates.

The trust, rather, is essentially a contractual relation that creates a third party benefit, coupled with conveyance. Professor Langbein argues the point forcefully:

> I have elsewhere made the point that even in the law of donative transfer the trust functions as a deal, in the sense that what trust law does is to enforce the trustee's promise to the settlor to carry out the terms of the donative transfer. Thus, although the typical trust implements a donative transfer, it embodies a contract-like relationship in the underlying deal between the settlor and the trustee about how the trustee will manage the trust assets and distribute them to the trust beneficiaries...When, therefore, we enforce a trust, even the conventional donative or personal trust, we are already in the realm of contract-like behaviour. That is why not much turns on the distinction between donative and commercial trust...The key insight is that the great principles of trust fiduciary law, loyalty and prudence, do not depend upon the transferor's motive, whether making a gift or doing a deal.[91]

In the mutual fund context, this controversy leads commercial lawyers drafting fund instruments to consult their estate lawyers to ensure that their trust instruments are in compliance with trust law. In fact, they learn that there is as much freedom in drafting these instruments as there is in drafting any contractual relationship.

91 J. H. Langbein, *supra*, note 3 at 185-6.

Fiduciary Relationship

The trust is the principal and the original example of the fiduciary relationship. The trust is different from other fiduciary relationships in two ways. For a trust to be valid there must be trust property. Not all fiduciary relationships involve property. Second, the trust is perhaps the most extensive fiduciary relationship because the typical trustee has the greatest capacity to exercise authority over the legal position of the beneficiary held in trust.

Agency

The trust relationship is similar to the agency relationship. Both the trustee and the agent are fiduciaries and therefore both are under an obligations of loyalty and competence. However, there are a number of features of the two institutions which mark them as separate institutions.

(1) The trust has a proprietary dimension: both the trustee and the beneficiary are characterized as owners. In the common law analysis of the agency relationship, the agent typically has no proprietary interest in the property owned by the principal even though the agent may have possession of the property and may have power to effect a transfer of title of the property.

(2) Perhaps more importantly, the trustee is independent of the beneficiaries and has full power and control over the trust corpus. The trustee does not take instructions from the beneficiaries. An agent is always subject to the control of their principal.

(3) In the common law tradition, agency is thought of as being created by a contract directly between the principal and the agent, whereas the trust relationship may but need not be created by a contractual arrangement between the settlor and the beneficiaries and/or the settlor and the trustee.

(4) Because the agent may bind the principal at law the agent has the power to make the principal liable at law. The trustee has no such power over the beneficiaries. The beneficiaries are immune from the legal consequences of the acts of the trustee. In general, the trustee's right or recourse against the beneficiaries is against the assets held in trust out of which the trustee may be indemnified for any harms caused to the trustee in the administration of the trust. There are some exceptions, discussed below. Subject to these exceptions, neither the trustee nor any third party can sue the beneficiaries. In this sense, the trust creates limited liability for the beneficiaries of the trust. The principal, by contrast, is by definition fully liable for the acts of the agent.

(5) The agency relationship normally terminates on the death of the principal or the agent whereas a trust is not necessarily terminated on the death of the settlor, trustee or beneficiaries. Typically, also ,an agency relationship may be determined at will, whereas a trust relationship cannot be determined at will by the trustee or by the settlor.[92]

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92 In *Smith-Anderson* (1880), 15 Ch D 247 (C.A.) at 275-276 the distinction between trust and agency is described as follows:

> To my mind the distinction between a director [agent] and a trustee is an essential distinction founded on the very nature of things. A trustee is a man who is the owner of the property and deals with it as principal, as owner, and as master, subject only to an equitable obligation to account to some persons to whom he stands in the relation of trustee, and who are his *cestuis que* trust. The same individual may fill the office of director [agent] and also be a trustee having property, but that is a rare, exceptional, and casual circumstance. The office of director is that of a paid servant of the company. A director never enters into a contract for himself, but he enters into contracts for his principal, that is, for the company of whom he is a director and for whom he is acting. He cannot sue on such contracts nor be sued on them unless he exceeds his authority. That seems to me to be the broad distinction between trustees and directors.

Another judge has said the following:

> I have read the in *Crowther v. Thorley* (1884), 50 L.T. 43 (C.A.) at 45 case of *Smith v. Anderson* very carefully, and I understand all the learned judges who took part in that judgment to say this, that there is no magic in the name by which the carriers on of the business are called – trustees, agents, or what you will – that the substance is to be looked at. And that it follows from this, that where trustees carry on the business in their own name, according to their own discretion, and are

Partnership

Drafters of mutual fund trust declarations are often very careful to state that the relationship created among the fund participants is not a partnership. It is possible depending on how the relationships are actually defined that what appears to be a trust is in substance a partnership. The *Restatement*[93] puts the issue this way:

> Where a number of persons transfer property to a person, designated as a trustee, who is to do business with such property for their benefit, the relation thus created may be a partnership. Whether or not it is...depends upon the amount of control reserved by the contributors. If, as a group, they have the power, not only to elect the trustee, but also to direct the conduct of the business by the trustee, there is a partnership, and the person designated as "trustee" is the agent of the members of the group.

The modern corporation evolved out of the joint stock and deed of settlement companies of mid-nineteenth century England. Under these arrangements, assets (the joint stock) owned nominally by a trustee or trustees (for ease of administration) would be subject to the management control of a management committee selected by the stockholders. This is essentially a partnership arrangement with a delegation of management authority to a central agency. The key difference between this structure and a trust is the general liability of partners. All of the property of each of the partners is ultimately liable for obligations of the joint stock company whereas in a true trust relationship, the trustee has power to bind only the assets subject to the trust.

These observations are important in the mutual fund context because the drafters of the trust instruments want to ensure that they have drafted something that guarantees limited liability to the beneficiaries. Obviously, it is not enough to merely label the instrument a "trust." Rather, the question is whether the total power of the beneficiaries/unitholders amounts to the power of a principal, in which case the arrangement could be classified as a partnership, with consequent loss of limited liability to the beneficiaries.

Bailment

The trust is to be distinguished from bailment since the bailee also does not have legal title, nor, unlike the agent, does the bailee have the power to convey legal title to a good faith purchaser for value.

Debt

Because the beneficiary has equitable title in the trust property, a trust obligation is also not the same as a debt: the beneficiary may always seek an accounting by the trustee of the use of trust property; the beneficiary may follow the trust property into the hands of a purchaser who is not in good faith and for value; and, the beneficiary may claim its recovery in priority in the event of the trustee's own bankruptcy.

The Bare Trust

The bare trust sits on the boundary of trust law and agency law. The bare trustee is treated as an agent, and therefore is not primarily liable for his juridical acts performed for the principal within the scope of his mandate. Whether he is still also a trustee and if so, in what sense, is not clear. It would appear that he is a trustee only to the extent of having legal title to property for the purposes of the agency relationship. It is also not clear just when the status of bare trustee is engaged.

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themselves responsible to third parties upon the contracts they may make, then they carry on the business as trustees only, and not as agents for their *cestuis que trust*.

93 Restatement of the law. 2nd. Trusts 2d (St. Paul : American Law Institute Publishers, 1959).

There are a variety of definitions of bare trusts.

(1) "...a trustee may be an agent as well as a trustee. Where he is a trustee because he holds the legal title to the trust property, but where in addition he has undertaken to act for the beneficiaries and under their control, he is also their agent, and as such can subject them to personal liabilities by acts done by him within the scope of the employment. Where the trustees are also agents of the beneficiaries, the beneficiaries are personally liable upon contracts made by the trustees in the administration of the trust, unless it is otherwise provided in the contracts. So also the beneficiaries are liable to third persons for torts committed by the trustees in the administration of the trust if they are also agents of the beneficiaries...By the weight of authority it is held that the beneficiaries are not personally liable if the trustees are merely trustees. But where the beneficiaries have power to control the conduct of the trustees to such an extent that the trustees are their agents, the beneficiaries are personally liable as principles... It is not always easy to draw the line between trust and agency in such cases, since the difference is one of degree. Where there is sufficient power of control over the trustees so that there is an agency relationship and not merely a trust, the beneficiaries are liable as partners in the carrying on of the business".[94]

(2) "... a trustee to whose office no duties were originally attached, or who, although such duties were originally attached to his office, would, on the requisition of his *cestuis que* trust, be compellable in equity to convey the estate to them, or by their direction, and has been requested by them so to convey it".[95]

(3) "I should have thought that a "bare trustee", or a "naked trustee", meant a trustee without any beneficial interest".[96]

(4) "A bare trust is one where the trustee holds property merely as a depository or nominee, with no active duties to keep a fair balance between beneficiaries with successive interests, so that he must transfer the property to or to the order of the *sui juris* absolutely entitled beneficiary or beneficiaries. Such beneficiary or beneficiaries are regarded as the absolute owner(s)".[97]

(5) "The bare trust is a situation where either the trustees have ceased to have active duties to perform, and wait transference to the beneficiaries, or where the trustee has no personal interest in the trust property. Most standard texts today are agreed on the former meaning, and this is the usage familiar in the courts today. Moreover, in most cases, the term is merely one of expression, and nothing turns on it".[98]

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94 R.P. Austin, "The Role and Responsibilities of Trustees in Pension Plan Trusts: Some Problems of Trusts Law" in T. Youdan, ed.. *Equity Fiduciaries and Trusts* (Toronto: Carswell, 1989) 111.

95 *Christie v. Ovington* (1875), 1 Ch.D 279 (V.-C. Hall) at p. 281.

96 *Morgan v. Swansea Urban Sanitary Authority* (1878), 9 Ch.D. 582 (M.R.) at p. 585.

97 *Law of Trusts* (1989), pp. 30-1.

98 D. Waters, *Law of Trusts in Canada*, 2nd ed. (Toronto: Carswell, 1984), at 28.

(6) "... generally views [a bare trust] to be a trust under common law where the trustee has no significant powers or responsibilities, and can take no action regarding the property held by the trust without instructions from the settlor. Normally the trustee's only function is to hold legal title to the property. Furthermore, the settlor is also the sole beneficiary and can cause the property to revert to him at any time. Thus a bare trust does not include a blind trust or other trusts in which the trustee has established powers and responsibilities".[99]

In some business trusts the trustee is meant to be a bare trustee with the beneficial owners being co-owners of undivided interests. There is less danger in a mutual fund trust slipping into this characterization than into a partnership characterization, but it will remain a concern of the person drafting the instrument. Arrangements aiming at this characterization would refer to the trustee as custodian and the investors as owning undivided interests. The nominal owner would be a bare trustee. Property held by a bare trustee for co-owners could be disposed of separately by each of the co-owners. It would therefore be difficult to slip into the co-ownership characterization. The Partnership characterization is a more realistic danger leading to the same result - loss of limited liability to beneficiaries.[100]

Legal Position of Trustee Vis a vis Third Parties

Since there is no trust entity, when the trustee enters a contract he engages his personal liability.[101] When the trustee commits a tort or when an agent or employee of the trustee engaged to act in a trust matter commits a tort, the trustee is, respectively, personally or vicariously liable. In both cases the trustee is entitled to indemnification out of the trust fund, if he has paid the liability and to pay the liability directly out of the trust fund if he has not. This is the case only if the liability has been incurred in the conduct of the trust business and the trustee has not otherwise engaged in misconduct.[102]

Third party claimants may therefore only claim against the trust fund through the trustee. They are entitled to be subrogated to the claim of the trustee to be indemnified out of the trust fund. The contract or tort creditor's claim against the fund is only as good as the trustee's right, which may be impaired by misconduct, even misconduct occurring subsequent to the claim.[103] This arrangement is quite a bit

99 Canadian Tax Foundation, *Corporate Management Tax Conference 1989*, at p. 8:1; Revenue Canada, *Income Tax Act: Technical News*, No. 7, February 21, 1996.

100 *A.E. LePage Ltd. v. Kamex Developments Ltd.* (1977), 78 D.L.R. (3d) 223, 16 O.R. (2d) 193 aff'd 105 D.L.R. (3d) 84, [1979] 2 S.C.R. 15*5.*

101 *Watling v. Lewis*, [1911] 1 Ch. 414 where Warrington J. said at p. 423:

A covenant by a person as 'trustee' does not render his trust estate liable, it is a covenant by himself. It is exactly as if an executor entering into an obligation not merely in respect of some debt of his testator, but in respect of some obligation which he in his capacity as executor has himself undertaken since the death of the testator, covenants 'as executor' to pay. That is a covenant by himself.

102 *Worall v. Harford* (1802), 8 Ves. 4; *Kingsdale Securities Co. v. M.N.R.* [1974] 2 F.C. 760, [1975] C.T.C. 10 (C.A.).

103 *Supra* note 101.

Shaver v. Young (1919), 16 O.W.N. 16 where Sutherland J. said at 16:

The defendant was described therein as 'physician, trustee', and he denied personal liability; but the learned Judge held that, having regard to the terms of the mortgage, and to the fact that no provision was made therein to protect the defendant from the personal covenant for payment therein contained, the word 'trustee' must be regarded as merely descriptive, and not as limiting the personal liability of the defendant.

Schell v. Trusts and Guarantee Co. Ltd., [1939] O.W.N. 434, where the master said at p. 435:

There is in the mortgage no limitation as to the liability of the trustee, and it is well settled law that, unless the liability on a covenant is expressly limited to the assets of the trust estate, a personal liability attaches. See Falconbridge on Law of Mortgages, 2nd edition, pages 364 and 365; Watling v. Lewis, [1911] 1 Ch. 414, which is a case directly in point.

Falconbridge on Mortgages, 4th ed. (Agincourt: Canada Law Book, 1977), at p. 428-49.

different from the analogous operation in corporate law where the creditor's claim is always against the fund and never against the director.

It is possible, and in the context of business trusts probable, that third party creditors stipulate for greater rights against the trust fund than a claim via the trustee's right of indemnification. In some instances trustees purport to contract on the basis that they are not personally liable and that the only claim is against the fund. A plausible interpretation of such a provision is that the trustee has contracted a limited recourse obligation which restricts his personal liability and allows the creditor to claim directly against the fund. There is no reason why the trust instrument could not provide for such a construction. In fact, in the context of business trusts, this would seem to be the obvious intention.[104]

Where the trustee's powers are restricted it will generally be necessary to provide for a limitation of liability of the trustee and a right of indemnification in favour of the trustee for breaches of fiduciary obligation committed by the other fiduciaries.

There is a possibility that restrictions on liability and exclusions from liability contained in a trust instrument may not work to limit the liability of the fund trustee in some circumstances. One of the leading cases on limitation of liability clauses in Ontario, *Tilden Rent-A-Car v Clendenning* (1978), 83 D.L.R. 3d 400 (Ontario C.A.) suggests that it is necessary to disclose the limitation of liability clause to unitholders prior to their purchase of units. On the basis of *Tilden* it could be argued by unitholders that the limitation of liability clause is not binding on them because it was not drawn to their attention prior to their purchase of trust units.

Legal Position of Beneficiaries vis à vis Third Parties

In general, beneficiaries of a trust do not, as beneficiaries, have personal liability. The trustee has no power to engage them personally in respect of any contracts entered or torts committed by the trustee and they are not, in general, personally obliged to reimburse or indemnify the trustee with respect to the trustee's liability.

That said, there are a limited number of circumstances at common law and under the *Trustee Acts* of most jurisdictions in which a trust beneficiary can be held liable personally to indemnify the trustee: (i) where the trustees undertook to act as trustees at the request of the beneficiaries,[105] (ii) where the beneficiary is the settlor of the trust[106] and (iii) where the beneficiaries are entitled to call for the trust property.[107] A recent comprehensive statement of the law with respect to this last rule is summarized in the Australian decision in *J.W. Broomhead (Vic.) Ptg. Ltd. (in liquidation) v J.W. Broomhead Pty Ltd.*[108] The effect of that decision has been summarized by one author as follows:

1. The general principle is that a trustee is entitled to an indemnity for liabilities properly incurred in carrying out the trust and that right extends beyond the trust property and is enforceable in equity against a beneficiary who is *sui juris*.

If the trustee or personal representative covenants to pay, he will be personally liable on his covenant, even though he covenants as trustee or as personal representative, and even though he adds a proviso that he shall not be personally liable, such proviso being repugnant to the covenant to pay and therefore void. He may, however, validly limit his liability without destroying it, as, for example, if the covenant is to pay out of a certain fund, with a proviso that the covenantor shall not be liable after he ceases to be entitled to administer the fund. So, if a trustee covenants 'as trustee and not otherwise', or 'qua trustee only', or if an executor covenants 'as executor, and as executor only', the covenantor is personally liable to pay, but only to pay out of the assets of the estate or to the extent that he has assets.

All of these passages were quoted in *Davis v. Sawkiw* (1982), 38 O.R. (2d) 466 (H.C.J.) at 467-8.

104 See *Gordon v. Roebuck* (1992) 92 D.L.R.(4th) 670, 9 O.R. (3d) 1.

105 Section 34, *Trustee Act* (Ontario) R.S.O. 1990 c.T23. [Repealed 1998, c. 18, Sch. B, s. 16(1)]

106 *Matthews v Ruggles-Brize* [1911] 1 Ch. 194.

107 *Hardoon v Belilios*.[1901] A.C. 118 (P.C.).

108 [1985] V.R. 891 S.C. Vic.

2. The basis of the principle is that the beneficiary who gets the benefit of the trust should bear its burdens unless he can show some good reason why the trustee should bear the burdens alone.

3. The right of indemnification is not confined to the case where there is only one beneficiary. It applies to cases of multiple beneficiaries as long as they are all *sui juris* and entitled to the same interest as absolute owners of the trust property between them.

4. The personal liability to indemnify the trustee will exist where two or more persons have requested another person to act as trustee.

5. Even though the beneficiaries held different numbers of units, they were between them the absolute beneficial owners of the trust fund on the basis of the rule in *Saunders v Vautie*r.

6. The liability to indemnify could apply to trustees of subtrusts that were beneficiaries of the principal trust.
7. *Prima faci*e, the beneficiaries share the liability in proportion to the extent of their respective beneficial interests in the trust.[109]

The situation in the United States is less clear, but it appears that the regime of beneficiary personal liability is considerably wider. It seems that the American rule extending personal liability to beneficiaries would apply in circumstances where the beneficiaries had some control over the trustees, although the precise quantum of control that is required to trigger this liability is not clear.[110]

Besides the three possibilities mentioned, there is also the possibility that as a factual matter, as stated above in the discussion of agency and partnership, the relationship between the trustee and the beneficiaries was intended to be one of principal and agent. This will likely be the case where the trustee is a bare trustee.[111]

In *Trident Holdings Ltd. v Danand Investments Ltd.*[112] the court approved *in obiter* the American doctrine after it had already held that the parties in that case had intended a principal/agent relationship. It may be the case, therefore, that the American doctrine has found its way into Canadian law.

As a consequence of these uncertainties, it is common for prospectuses in some business trust contexts (not, however, including mutual funds) to state as follows on the question of beneficiary limited liability:

> Because of uncertainties in the law relating to closed end and mutual fund investment trusts there is a risk (which is considered by counsel to be remote in the circumstances) that a unitholder could be held personally liable for obligations of the Trust (to the extent that claims are not satisfied by the Trust) in respect of contracts or undertakings which the Trust enters into and for certain liabilities arising otherwise than out of contract including certain statutory duties, such as the obligation of the Trust to pay taxes. The Trustees intend to cause the Trust operations to be conducted in such a way as to minimize any such risk and, in particular, where feasible, to cause every written contract or commitment of the Trust to contain an expressed disavowal of liability upon the unitholders and a limitation of liability to Trust property. In the opinion of counsel, no personal liability will attach in Canada to the holders of trust units for claims arising out of any disagreement or contract containing such a disavowal and limitation of liability. In the

[109] M.C. Cullity, "Liability of Trustees and Indemnification" (1996) 16 Estates and Trusts Journal 115 at 135.

[110] G.G. Bogert, *The Law of Trusts and Trustees*, 2nd ed. (St. Paul Minnesota: West Publishing Co. 1964), 593.

[111] *Trident Holdings Ltd. v. Danand Investments Ltd.* (1988), 49 D.L.R. (4th) 1, 64 O.R. (2d) 65, 30 E.T.R. 62 C.A.).

[112] *Ibid*. *Trident* has been followed in a number of decisions. See: *500 Glencairn Ltd. v. Farkas* (1994), 36 R.P.R. (2d) 270 (Ont. Ct. (Gen. Div.)); *International Pentecostal City Mission Prayer Centre of Toronto Inc. v. Cabot Trust Co.* (1994), 36 R.P.R. (2d) 231 (Ont. Ct. (Gen. Div.)); *Dawson v. Rexcraft Storage and Warehouse Inc.* (1995), 57 A.C.W.S. (3d) 203, [1995] O.J. No. 2998 (Ont. Ct. (Gen. Div.)); *475920 Ontario Ltd. v. Forty Gerrard Apartments Ltd*. (1994), 46 A.C.W.S. (3d) 26, [1994] O.J. No. 1499 (Ont. Ct. (Gen. Div.)).

event that a unitholder should be required to satisfy any obligation of the Trust, such unitholder will be entitled to reimbursement from any available assets in the Trust.

7. TRUST LAW AND MUTUAL FUNDS - TRUST ADMINISTRATION

Sources of Trust Law

All Canadian common law jurisdictions have adopted Trustee Acts modeled largely on the English statute of the same name enacted in various parts throughout the nineteenth century and culminating in a final version in 1893. The 1893 English Act forms the basis of most of the Canadian trustee statutes, although Manitoba and Prince Edward Island have adopted some of the consolidating measures adopted in England in 1925.

The Trustee Acts deal with the position of trustees, their administrative and investment powers, appointment and discharge and their remuneration and indemnification. The statute grants a jurisdiction to the Court to give advice and directions to a trustee, appoint and discharge trustees in certain circumstances, make vesting orders and to relieve trustees from liability in appropriate cases. The statutes generally simply supplement or modify common law rules developed by courts on the issues they address. The statutory provisions are thus largely suppletive, not imperative and because of the statute's vintage, also largely dated.

Legislators have responded to the diverse use of the trust form with specific legislation for specific types of business or commercial trust. The trusteeship in bankruptcy is dealt with exclusively in the *Bankruptcy and Insolvency Ac*t.[113] Pension trusts are dealt with largely but not excessively in the pension benefits legislation enacted in the various provinces and federally. Trusts for bondholders are governed by special provisions in the modern Canadian corporations statutes. As stated already, however, there is no special legislation for the investment trusts. To some extent, the proposal assumed by this study is the first attempt to fashion something along these lines.

Trustee's Duty of Competence

The common law imposes on the trustee the duty to act with the care and diligence that the "ordinary prudent man of business" would exercise in conducting his own business.[114] In *Fales v. Canada Permanent Trust*[115], the leading Canadian decision on this question, Dickson J described the duty as "vigilance, prudence and sagacity". The trustee must exercise this level care in good faith, in the honest belief that what he proposes to do on behalf of the trust is proper and appropriate. To the extent that a breach of this duty causes a loss to the trust, the beneficiaries may sue.

The standard is objective in the sense that it is sometimes said that it does not matter what level of skill the trustee brings to the job. There is older English authority, however, to the effect that all the trustee need have is the honest belief that what he has done or is about to do is in the best interests of the beneficiaries.[116] More recently, there is jurisprudence which has held that a higher standard is expected of professional trustees.[117]

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113 R.S.C. 1985 c. B-3.

114 *(Learoyd v. Whitely* (1887), 12 App. Cas. 727), *Speight v. Gaunt* (1883) 9 App. Cas. 1(HL):

115 (1976), [1977] 2 S.C.R. 302.

116 *Re Speight* (1883), 22 Ch. D.727 (C.A.)

117 Dickson, J., in *Fales, Wohleben v Canada Permanent Trust Co.*, *supra* note 15, delivering the judgment of the Court, stated as follows, at 316, 317 and 319:

> The weight of authority to the present, [except in the exercise of the statutory judicial excusing power,] has been against making a distinction between a widow, acting as trustee of her husband's estate, and a trust company performing the same role. Receipt of fees has not served to ground, nor to increase exposure to, liability. Every trustee has been expected to act as the person of ordinary prudence would act.

Donovan Waters, in *Law of Trusts in Canada*,[118] describes the position of a custodian trustee as follows:

> The custodian trustee is a person, natural or corporate, who is vested with title to the trust property, while the management of the trust is left in the hands of other trustees who are known as managing trustees. In Canada the terms is used in connection with pension or other investment trusts when the portfolio is vested in the so-called custodian trustee, but the investment policy and decisions are determined by investment managers or consultants. It is a moot point as to whether such a trustee can defend itself against a breach of trust action for a wrongful investment on the ground that it was merely appointed to supply security by the placing of the investments in its name, and was otherwise required by the trust instrument to implement the decisions of the investment managers. This defence would appear to be particularly thin when the investment managers are not themselves trustees, so that the existence and extent of their personal fiduciary obligation is in question.[119]

Perhaps the best explanation for the variation in standards is the fact that there are a variety of types of trustees and therefore significant variation in the reasonable expectations of beneficiaries.

The Trustee Acts permit an application to the court to excuse breaches of the duty of competence. Section 35(1) of the *Trustee Act* (Ontario) R.S.O. 1990 c.T.23, for example, provides:

If in any proceeding affecting a trustee or trust property it appears to the court that a trustee, or that any person who may be held to be fiduciarily responsible as a trustee, is or may be personally liable for any breach of trust whenever the transaction alleged or found to be a breach of trust occurred, but has acted honestly and reasonably, and ought fairly to be excused for the breach of trust, and for omitting to obtain the directions of the court in the matter in which he committed the breach, the court may relieve the trustee either wholly or partly from personal liability for the same.

The provision was adopted and has been applied largely to allow courts to excuse trustees for technical breaches of trust.

It is not necessary to decide whether a higher standard of diligence should be applied to the paid professional trustee, for Canada Permanent failed by any test.

I have no doubt that in an appropriate case a paid professional trustee may seek and obtain relief under s.98 [the judicial power to excuse trustees under the British Columbia *Trustee Act*.] Section 98 in terms admits of that possibility. All of the circumstances would have to be considered, including whether the trustee was paid for its services.... Among other relevant considerations is...whether the trustee is someone who accepted a single trust to oblige a friend or is a company organized for the purpose of administering estates and presumably chosen in the expectation that it will have specialized departments and experienced officials; above all, whether the conduct of the trustee was reasonable.]

There is recent English authority to the effect that the standard of care is higher in the case of professional trustees. This has found some support in Ontario. In *Ford v. Laidlaw Carriers* (1994) 1 E.T.R. (2nd) 117 (O.C.G.D.) aff'd (O.C.A), the employer and the plan trustee made an error with respect to the calculation of certain payout amounts to retiring beneficiaries under the plan. Those beneficiaries retired on the basis of the mistaken representations made to them with respect to the payout amounts by their employer. After retirement the error was uncovered by the plan trustee. The employees sued the employer and the trustee. The employer cross-claimed against the trustee. The trustee ultimately escaped liability but was denied its costs because "of its incompetence and lack of familiarity with the terms of the trust documents governing the plans it was paid to administer." (Court of Appeal)

In an unreported English decision *Galmerrow Securities Ltd. et al v. National Westminster Bank, PLC* (cited in J. Forgie "Legal Issues Surrounding Custodianship of Pension and Employee Benefit Plans" (1996)) at page 22 the court stated:

However high a standard of skill and care is imposed by the general law, and I would wish to impose the highest standard on trustee departments of major clearing banks, the duty has still to be defined by reference to the actual trust deed in the case before the court.

118 2nd ed (Toronto: Carswell, 1984).

119 *Ibid* at 104.

In exercising this power Canadian courts have shown a propensity to distinguish between professional trustees and non-professional trustees. In *Fale*s, the SCC excused a trustee, the widow of the deceased, on the basis that her experience was limited but held the professional trustee liable for breach of trust.[120]

The imposition of a (suppletive) higher standard has been recommended by the American Law Institute in *Restatement of the Law Second: Trusts* (St. Paul: American Law Institute Publishers, 1959) and by other reforming agencies. Typically the recommendation is that if a trustee holds out that it has special skills and is appointed trustee accordingly, it is required to exercise those skills.

It is common for trust instruments in Canada and elsewhere to opt out of the common law standard of care by exonerating trustees for acts of mere negligence. It is common, for example, to find clauses that restrict trustee liability to acts or omissions that are dishonest or wilful.

The Trustee's Duty of Loyalty

The duty of loyalty in regard to trustees is set out clearly in the famous case of *Keech* v *Sanford.*[121] In that case the court held that the trustee was required to disgorge a benefit he received by virtue of his office as trustee, even though it was conceded that the trust itself had suffered no loss. The cases since then have consistently reiterated this theme: the trustee may not profit from his position as trustee and may not place himself in a situation where his duty conflicts with his interest. This rule goes so far as to prohibit the trustee from receiving any remuneration for his activities as a trustee.

This is the common law rule, however. Authority or consent to deal with the trust may be granted in the trust instrument, by the beneficiaries, by the statute or by the court. In the case of the beneficiaries, since they are the only ones who can sue for a breach of trust, they may forgive a breach unanimously. Courts have an inherent jurisdiction to approve dealings between the trust and the trustee. And the Trustee Acts permit trustees to be compensated as trustees[122].

Duty to Act Personally - Delegation of the Trustee's Duties

The common law position is that a trustee may delegate only in situations where it is necessary to do so or where it is the common course of business of persons engaged in the tasks the trustee is engaged in to delegate.[123] The trustee must select an appropriate agent and supervise the agent in the execution of the assigned tasks. Failure to provide the required level of supervision can lead to liability. Under s 20 of the *Trustee Act* (Ontario), trustees are provided statutory authority to delegate to bank managers and solicitors to receive and give a discharge for any money or valuable consideration. Trust instruments today typically give a much broader power of delegation. Investment trusts would typically oblige the trustee to hire professional investment managers.

At common law trustees are permitted to rely on the advice of professional advisors provided they do so reasonably and in good faith

Trustees Act with Unanimity

The common law position is that trustees must act unanimously. This can be and invariably is modified in trust instruments.

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120 *Supra* note 115.
121 (1726), Sel Cas. T. King 61, 25 E.R. 223
122 *Trustee Act* (Ontario) R.S.O. 1990, c.T. 23, s. 61
123 *Ex Parte Belchier* (1754) Amb 218, 27 E.R. 144; *Speight v. Gaunt supra* note 114.

Role of Beneficiaries in Trust Administration

Beneficiaries at common law play no role in the administration of the trust. The legal ownership of the trust property by the trustee entitles the trustee to make all decisions in regard to its administration. The beneficiaries' powers lie in their equitable remedies for breaches of trust.

Appointment and Discharge of Trustees

Most modern trust instruments contain a power in some person, often the remaining trustees, to appoint replacement trustees. In the absence of such a power in the trust instrument or in circumstances where the relevant provision is inadequate or silent, the court has a common law and statutory power to step into the breach. A general principle of trust law is that a trust will not fail for want of a trustee.

Accountability of Trustees

The trustee must account for his performance as trustee. He must present information and documentation.. His accounts may be falsified - to identify assets that should still appear in the accounts - or surcharged - to identify assets that but for the trustees breach of duty would be in the accounts.

The Trustee's Duty to Provide Documents to Beneficiaries

A trustee must supply to a beneficiary information as to the manner in which the trust property has been dealt with regardless of whether the beneficiary has vested, contingent or discretionary interest in the trust property.

The beneficiary is entitled to see all trust documents because they are his property.

A trustee is not required to disclose any aspect of the trustee's deliberations.[124]

8. TRUST LAW AND MUTUAL FUNDS - ACCESSORIAL LIABILITY OF TRUST STRANGERS

Accessorial Liability

Recapping the main ideas of the Sections 6 and 7, the trust is a contractual, or at least a consensual relationship in which the trustee undertakes an obligation to pursue the best interests of the trust beneficiary in a loyal and competent manner. The beneficiary is the real owner of the trust property; the trustee's powers over that property are powers that the trustee must exercise in the beneficiary's best interest.

Recall also the discussion in Section 4 dealing with fiduciary relationships. In Section 4 it was suggested that the obligations of a fiduciary are assumed voluntarily, although it was admitted that there is some dicta suggesting that courts can impose these obligations regardless of whether they have been assumed voluntarily. It was concluded in Section 4 that, insofar as the mutual fund industry is concerned, it is quite clear that any person with the power that a manager typically has will be at least a fiduciary, if not a trustee, for the benefit of unitholders in most cases.

In this Section I discuss another area of law which might be applied to managers (and others) rendering them liable for breaches of trust in which they participate or which they assist or from which they benefit in the case where they are not trustees or fiduciaries. These doctrines deal with the obligations of strangers to a trust - persons who have no direct contractual link to the beneficiaries (although they are usually

[124] *Re Londonderry's Settlement* [1965] Ch 918, [1964] 3 All E.R. 855 (C.A.).

linked contractually to the trustee) who become involved in a violation of a trust. These doctrines are labeled "trustee de son tort", "knowing assistance" and "knowing receipt". Given the development in the complexity of the services provided by financial intermediaries in recent years, the application of these three doctrines in the financial intermediary industries shows every sign of growing. These doctrines and related ideas are discussed in this section.[125]

Formulations

Lord Selborne's formulation in *Barnes* v. *Addy at p. 251*[126] is the starting point of the modern analysis for all three doctrines:

> Those who create a trust clothe the trustee with a legal power and control over the trust property, imposing on him a corresponding responsibility. That responsibility may no doubt be extended in equity to others who are not properly trustees, if they are found either making themselves trustees de son tort or actually participating in any fraudulent conduct of the trustee to the injury of the cestui que trust. But, on the other hand, strangers are not to be made constructive trustees merely because they act as agents of trustees in transactions within their legal powers, transactions, perhaps of which the Court of Equity may disapprove, unless those agents received and become chargeable with some part of the trust property, or unless they assist with knowledge in a dishonest and fraudulent design on the part of trustees.

It is not entirely clear what classification of liability Lord Selborne had in mind in this passage. How many categories of strangers are identified, and what, in particular, is the logical relationship between the concept "trustee de son tort" and "constructive trust"?

There are a variety of positions on these questions in the cases. Professor Sullivan identifies three. 1. Some say there are two categories of liability established here, (1) one for those who assist or induce a fraudulent design and thereby become constructive trustees, (2) another for those who wrongfully receive trust property, and thereby become trustees *de son tort.*[127] A second possibility is that trustees de son tort and constructive trustees identify the same thing and therefore only one category of liability is established.[128] 3. Others suggest, and this is the contemporary position, that there are three categories: (1) trustees de son tort, for those strangers who voluntarily take on the responsibilities of trusteeship, and (2) constructive trustees, for both (a) those who assist a fraudulent design and for (b) those who receive trust property pursuant to a fraudulent design.[129] In a leading article on these doctrines another author suggests a useful variation of this scheme: (1) trusteeship de son tort (2) acting inconsistently with the terms of a trust (a) by dealing inconsistently with trust property, (b) by knowingly inducing a breach of trust terms and (c) by knowingly assisting a breach of trust terms; and (3) knowing receipt.[130] Despite the fact that the second category deals with more than assistance liability, the contemporary usage, misleadingly, refers to the doctrine in (2) as "knowing assistance" and as in (3) as "knowing receipt".

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125 The Canadian writing on these doctrines includes: T. Allen, "Fraud, Unconscionability and Knowing Assistance", (1995) 74 Can. Bar Rev. 29; A.H. Osterhoff and E.E. Gillese, *Text, Commentary and Cases on Trusts*, 4th ed. (Toronto, Carswell, 1992) at 459-480; R. Sullivan, "Strangers to the Trust", (1986) 8 E. & T.Q. 217; D.W.M. Waters, *The Law of Trusts in Canada,* 2d ed. (Toronto: Carswell, 1984) at 399-403. The English writing includes: S. Gardner, "Knowing Assistance and Knowing Receipt: Taking Stock" (1996), 112 L.Q.R. 56; H. Norman, "Knowing Assistance)) a plea for help (1992) 12 Legal Studies 332; P.L. Loughlan, "Liability for Assistance in a Breach of Fiduciary Duty" (1989), 9 Oxf. J.L.S. 260; C. Harpum, "The Stranger as Constructive Trustee" (1986) 102 L.Q.R. 114, "The Basis of Equitable Liability" in P. Birks (ed.) *The Frontiers of Liability* (1994) 9 and "Accessory Liability for Procuring or Assisting a Breach of Trust" (1995) 111 L.Q.R. 545.

126 (1874), 9 Ch App. 244.

127 *Selangor United Rubber Estates Ltd. v. Cradock* (No. 3) [1968] 1 W.L.R. 1555, [1968] 2 All E.R. 1073 (Ch. D.).

128 *Mara v. Browne* [1896] 1 Ch. 199 (C.A.) at p. 209 "...a constructive trustee, ... so far as I know, is the same thing as a trustee *de son tort*."

129 *Soar v. Ashwell* [1893] 2 Q.B. 390, [1893] All E.R. Rep. 991 (C.A.). C. Harpum, "The Stranger as Constructive Trustee" *supra* note 125.

130 C. Harpun, "The Stranger as Constructive Trustee" *supra* note 125 at 114-18.

The contemporary emphasis, (helpfully), is moving away from attempting to define constructive trusteeship and trustee *de son tor*t, to identifying the ground of the court's intervention in the cases where these doctrines are implicated. Thus, it is fair to say that in the modern thinking the trustee de son tort doctrine deals with situations where a stranger to the trust voluntarily steps into the position of trustee and thereby assumes the liability of a trustee. Knowing assistance deals with situations where the stranger assists a breaching trustee and therefore identifies as a civil wrong[131] and knowing receipt deals with situations where the stranger actually receives trust property through a breach and therefore identifies a case of unjust enrichment.[132] Trustee de son tort is in a peculiar class of its own and is easiest to deal with first.

Trustee de Son Tort

The common law doctrine of trustee de son tort bears an affinity with the civilian doctrine of *negotiorum gestio.* It might fruitfully be grouped with other similar common law doctrines, such as certain instances of necessitous intervention. These doctrines solve a group of private law questions in situations where one person, the intervener, intervenes in the affairs of another without prior approval. The doctrines in various ways treat the intervener analogously to a mandatary or agent: (1) the intervener is immune in private law from suit in trespass or its equivalent, provided the intervention was opportune; (2) the intervener is held in his administration of the property to a standard of reasonableness;[133] and (3) the intervener is entitled to some sort of recompense for his expenditures and effort in the administration. The equitable doctrine adds a fourth, perhaps obvious, element to the analysis: (4) the property under administration remains the property of the owner.[134] Like many equitable doctrines, the doctrine's name is almost entirely misleading since the intervention can be made by mistake or out of a concern for the best interests of the beneficiaries, as well as wrongfully - "de son tort"-, and even when the intervention is wrongful, the fact of its being wrongful plays no role in the liability argument. What matters is that the stranger voluntarily assumed the duties of trustee and is therefore required to discharge them.

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131 The leading Canadian authorities on knowing assistance are: *Austin v. Habitat Development Ltd.* (1992), 94 D.L.R. (4th) 359 (N.S.C.A.); *Air Canada v. M. & L. Travel Ltd.* (1991), 77 D.L.R. (4th) 536, aff'd (1994), 108 D.L.R. (4th) 592 (S.C.C.); *Canadian Imperial Bank of Commerce v. Valley Credit Union* (1990), 63 D.L.R. (4th) 632 (Man. C.A.); *Winslow v. Richter* (1989), 61 D.L.R. (4th) 549 (B.C.S.C.); *Henry Electric Ltd. v. Farwell* (1986), 29 D.L.R. (4th) 481 (B.C.C.A.); *Trilec Installations Ltd. v. Bastion Construction Ltd.* (1982), 135 D.L.R. (3d) 766 (B.C.C.A.); *Andrea Schmidt Construction Ltd. v. Glatt* (1979), 104 D.L.R. (3d) 130 (Ont. H.C.J.), aff'd (1980) 112 D.L.R. (3d) 371 (Ont. C.A.); *MacDonald v. Hauer* (1977), 72 D.L.R. (3d) 110 (Sask. C.A.).

The leading English authorities on knowing assistance are: *Royal Brunei Airlines Sdn. Bhd. v. Tan,* [1995] 3 W.L.R. 64 ("*Brunei*"); *Eagle Trust plc. v. S.B.C. Securities Ltd*., [1993] 1 W.L.R. 484 (Ch.D.); *Polly Peck International. v. Nadir (No. 2)*, [1992] 4 All E.R. 769 (C.A.) *El Ajon v. Dollar Land Holdings PIC* [1993] 3 All E.R. 717. ("*Polly Pock"); Cowan de Groot Properties Ltd. v. Eagle Trust pcl,* [1992] 4 All E.R. 700 ("Cowan""); *Agip (Africa) Ltd. v. Jackson*, [1990] 1 Ch. 265, aff'd [1991] Ch. 547; ("*Agip*"); *Baden, Delvaux & Lecuit v. Société Générale pour Favoriser le Développement du Commerce et de l'Industrie en France S.A.*, [1983] B.C.L. 325; aff'd [1985] B.C.L. 258 (C.A.) ("*Baden*"); *Belmont Finance Corp. Ltd. v. William Furniture Ltd.* (No. 1), [1979] Ch. 250, 1 All E.R. 118 (C.A.); *Karak Rubber Co. v. Burden (No. 2)* [1972] 1 W.L.R. 602; *Selangor United Rubber Estates Ltd. v. Cradock (No. 3)* [1968] 1 W.L.R. 1555 ("Selangor").

132 The English authorities on knowing receipt are: *Re Montagu's Settlement Trusts* [1987] Ch. 264 (Ch.D.); *International Sales and Agencies Ltd. v. Marais,* [1982] 3 All E.R. 551; *Belmont Finance Corp. Ltd. v. Williams Furniture Ltd. (No. 2)* [1980] 1 All E.R. 393; *Carl Zeiss Stiftung v. Herbert Smith* (No. 2), [1969] 2 Ch. 276; *Nelson v. Larholf,* [1948] 1 K.B. 339; *Baden, supra*.

Leading Commonwealth decisions include: *Nimmo v. Westpac Banking Corp.,* [1993] 3 N.Z.L.R. 218 (H.C.); *Marshall Futures Ltd. v. Marshall*, [1992] 1 N.Z.L.R. 316 (H.C.); *Powell v. Thompson*, [1991] 1 N.Z.L.R. 597 (H.C.); *Equiticorp Industries Group Ltd. v. Hawkins*, [1991] 3 N.Z.L.R. 700 (H.C.).

133 In *Pearce v Pearce*, ((1856), 22 Beav. 248, 52 E.R. 1103) an improperly appointed trustee argued that she could not be liable for poorly administering the trust because she was not, technically a trustee. Her argument was met with the finding that she was, by her voluntary assumption of the duties of a trustee, a trustee de son tort. She was therefore held liable for the loss caused to the trust due to her poor administration.

134 A reasonable formulation of the doctrine is contained in the following passage from *Lyell v. Kennedy* (1884), 27 Ch.D. 1 (C.A.):

The principle... as stated by Turner L. J. in [Life Assurance of Scotland v Siddal] was, that a person who had assumed to be a trustee "could not be heard to say, for his own benefit, that he had no right to act as trustee." Mr. Lewin in his learned and accurate treatise on the Law of Trusts, thus puts it (7th ed. P. 191): "If a person, by mistake or otherwise, assume the character of trustee when it really does belong to him, and so becomes a trustee de son tort, he may be called to account by the cestui que trust for the monies he received under color of the trust."

Knowing Assistance and Knowing Receipt

Two Supreme Court of Canada decisions - *Citadel General Assurance Co. v. Lloyds Bank Canada*[135] and *Gold v. Rosenberg*[136] contribute to the development and clarification of these doctrines in the banking context. In both cases the stranger, a bank, was alleged to have knowingly assisted in a violation of trust terms and to have knowingly received trust property in violation of trust terms. In the first case, *Citade*l, the bank was held liable to the trust beneficiary for its knowing receipt of trust property transferred to it in breach of trust, but not for any assistance in the violation of the trust terms. The two doctrines were distinguished on the basis that assistance liability requires actual knowledge of the breach or wilful or reckless blindness to the fact that a breach is occurring, whereas receipt liability requires only "constructive knowledge", that is, knowledge of facts which would have put an honest and reasonable man on notice. In the second case, *Gol*d, the bank was held not liable in knowing assistance on the basis that there was, on the facts of the case, no actual knowledge of a breach and no wilful or reckless blindness that a breach was occurring. With respect to the bank's liability in knowing receipt, three of the justices in the majority of four, exonerated the bank on the basis, mainly, that it had discharged any duty it might have owed to the trust beneficiary, since an honest person in the same circumstances would not have made further enquiries, and even had the bank investigated further, it would not have discovered anything improper. They held, as well, that there had not been, in any event, any receipt of value at the expense of the trust. Gonthier J., the fourth judge constituting the majority, disposed of the appeal in the bank's favour solely on the basis that the bank had met the standard of reasonableness imposed on a stranger who knowingly receives. The remaining three justices in *Gol*d, held in dissent that the bank was liable for knowing receipt, on the basis that knowing receipt liability requires only "constructive knowledge" that a breach is occurring, which they held the bank had.

The facts in the first case, Citadel, briefly, were as follows. The plaintiff, Citadel, was an insurance company whose policies were sold on its behalf by one company, "Subco", which was a wholly-owned subsidiary of another, "Parentco". Subco collected premiums and remitted them monthly to Citadel. Subco deposited the premiums in the interim in its account with the defendant bank. The bank, on instructions from Parentco, transferred Subco’s account balance to Parentco's account. The issue was whether the bank could be held liable to Citadel for the amounts so paid, in breach of trust. As stated, the Supreme Court of Canada found the bank liable in knowing receipt.

The facts in Gold, briefly, were as follows. The case involved a testamentary trust. The testator’s son, the"uncle", and the testator's grandson, the "nephew" were executors and residual beneficiaries under the will. The nephew allowed the uncle to manage the assets of the estate two real estate companies) pursuant to a power of attorney. The uncle had his own commercial real estate ventures and all of his banking, as executor and for his own businesses, was conducted at the defendant bank. The uncle, with the nephew’s concurrence, caused one of the real estate companies to execute a guarantee and mortgage over one of its properties in favour of the bank for the benefit of the uncle’s own business. The nephew sought a declaration that the guarantee was invalid and unenforceable on the basis of knowing assistance and knowing receipt, and, for the reasons already stated, failed in the Supreme Court of Canada.

It is clear, without working through the analysis in detail, that any of these three doctrines could be applied in the mutual fund context to almost any of the usual actors: the trustee, the manager and perhaps even some of the service providers. Thus, even if these players are not technically fiduciaries or trustees, there always is a fiduciary or trustee in these structures, so there always will be a real possibility that any breach of duty by such fiduciary or trustee could lead to accessory liability in the other entities, depending on the facts.

135 [1997] 3 S.C.R. 805 (S.C.C.).

136 [1997] 3 S.C.R. 767 (S.C.C.).

9. TRUST LAW AND MUTUAL FUNDS - THE TRUST IN QUEBEC

The simple idea that the administration and management of property can be separated from its enjoyment, with the administration and management in one person and the enjoyment in another, is also native to the civil law tradition. The division of interests in property in this way responds to a basic social need that must be recognized by any legal system.

The trust is the most general case and the most flexible and efficient of instantiations of the fiduciary concept. Quebec civil law, like the common law, recognizes the trust as a facilitative institution governed only by a modest imperative law which provides its basic definition or logic and constrains its use in accordance with the principles of public order, good faith and doctrines such as abuse of rights.

The trust is governed by Articles 1260 and following in the Civil Code of Quebec ("CCQ"). Article 1260 defines the trust as resulting "from an act whereby a person, the settlor, transfers property from his patrimony to another patrimony constituted by him which he appropriates to a particular purpose and which a trustee undertakes, by his acceptance, to hold and administer."

Article 1261 states that the patrimony thus created by appropriation is "autonomous and distinct" from the patrimony of the settlor, the trustee and the beneficiary. None of these, therefore, has a real right in the trust patrimony.

Article 1262 provides that a trust is "established by contract whether by onerous title or gratuitously, by will or in certain cases, by operation of law."

It would seem that the common law doctrines of constructive trust or a trust imposed by law are not a possibility under Quebec law. However, there is the idea of a resulting trust in Article 1297 which requires the trust property to be returned to those who are entitled to it on the termination of the trust and, where there are no beneficiaries when the trust is terminated, the property is to be returned to the settlor or his heirs. That, in essence, is what the common law recognizes as a resulting trust. It is merely the idea that, since the entire trust interest has not been exhausted in the trust instrument, the trust property must, at the termination of the trust, revert to the original owner, the settlor.

Under Article 1265, once the trust is accepted the settlor is divested of the property and the trustee is charged with "seeing to the appropriation of the property and the administration of the trust patrimony" and the rights of the beneficiary are established. This article is the analogue of the doctrine of the three certainties.

In the way the trust is thus defined in the CCQ, it is not possible for the settlor to create a trust by declaration of trust as it is under common law. This is, however, a minor inconvenience. The requirement of a trustee distinct from the settlor reflects the civilian view that the trust is a type of contract.

Under the CCQ a trust can be created by onerous or gratuitous title. This is in contrast to the trust under the Civil Code of Lower Canada which permitted trusts only by gift inter vivos or by will.

Trusts are further divided into personal trusts, private trusts and trusts for social utility. A personal trust is constituted gratuitously for the purpose of securing a benefit for a determinate or determinable person. A private trust is a trust created for the object of erecting, maintaining or preserving a thing and, when constituted by onerous title, providing for retirement or procuring another benefit for the settlor or for persons the settlor designates. The social trust is the equivalent of the common law charitable trust with a broader definition of social purposes. A mutual fund in Quebec in the trust form, therefore, is a private trust.

The major difficulty that the civil law has had with accepting the common law institution of the trust is the common law idea that property rights can be bifurcated into legal and equitable ownership. The civil law does not accommodate the notion of bifurcated ownership. Under the civilian conception of property, there can only be one person who is owner. Just where ownership lies in the civil law version of the trust has been a problem for many years. It is an issue of perennial academic interest but little practical consequence.[137]

One solution to the fact that under the CCQ none of the settlor, trustee or beneficiary is thought of as the owner of the trust property, is to regard the trust as a legal person. However, the CCQ is just as clear on that issue and states that the trust is a patrimony without an owner, not a legal person.

As in the common law tradition, the settlor is the person who constitutes the trust. Additional property may be appropriated to the trust by the settlor or by third persons at a later date. The settlor determines the object of the trust, and the settlor may create a power of appointment in the trust to determine who the beneficiaries of the trust are at a later date and reserve that power to himself. The settlor typically nominates the trustee and provides for the succession of the trustee.

The positions of trustee and beneficiary are basically similar to the common law.

Unlike the common law, the settlor retains the right to supervise the trustees' administration. Under Article 1287 the administration of the trust is subject to the supervision of the settlor or his heirs, as well as of the beneficiary. Under Article 1290 the settlor and beneficiary or any other interested person may, notwithstanding a contrary stipulation in the trust instrument, take action against the trustee to compel the trustee to perform his obligations or to enjoin him to abstain from any action harmful to the trust or to have him removed. Further, under Article 1291, the court may authorize the settlor as well as the beneficiary or any other interested person to take legal action in the place and stead of the trustee. When the settlor or anyone else participates in the administration of the trust they become solidarily liable for acts performed in fraud of the rights of creditors or in fraud of the trust patrimony. This notion is similar to the accessory liability at common law except that it is restricted to settlors and beneficiaries who participate in such acts.

The CCQ provisions dealing with the position of the trustee are in Articles 1274 to 1278. Any natural person may serve as trustee and any legal person authorized by law may act as trustee. The settlor himself or herself may act as trustee but in that case they must act jointly with a trustee who is neither a settlor nor a beneficiary (Article 1275). The settlor has the power to appoint trustees and to provide for their succession (Article 1276) and the court may intervene to appoint trustees (Article 1277).

Rules governing the administration of trust property are set out in a separate title of the CCQ, Title VII Administration of the Property of Others, Articles 1299 to 1370. These rules are largely suppletive. They oblige the administrator, in carrying out his duties, to comply with the obligations imposed on him by law and by the constituting act. He is required to act within the powers conferred on him and he is obliged to act with prudence and diligence, honestly and faithfully in the best interest of the beneficiary. The CCQ provisions go on to articulate, particularly in articles 1308 to 1318, other general rules applicable to the administrator. These include a prohibition against the administrator acting in circumstances where his personal interest is in conflict with his duty as administrator. All of these rules are similar in tenor and scope to the common law rules discussed in Section 5.

The position of the beneficiary is described in Articles 1279 to 1286. These provisions provide that the settlor may himself or herself be a beneficiary and may reserve the power to appoint beneficiaries or determine their shares. The beneficiary has the right to require, according to the trust instrument, the provision of the benefits granted to him under that instrument. The CCQ contemplates, basically, three types of beneficial interests: revenue interests, capital interests and persons entitled to a specific payment.

There is no limit on the types of property that may be used to constitute a trust. There are no particular formalities for constituting the trust. There is no general publication requirement with respect to a trust.

Although there are important and interesting differences between the institution of the trust in the two traditions, there are no important differences insofar as the main question of this study is concerned.

[137] See *Royal Trust Company v Tucker* [1982] 1. S.C.R. 250.

There is no reason, as a matter of Quebec civil law why the regulation proposed in Part IVcannot work in Quebec.

10. ADAPTATIONS OF THE TRUST IN OTHER SETTINGS

The proposal described in Part IV is based on the notion that the trust is an extremely flexible institution which is capable of integrating innovative ideas that render it suitable for a variety of contexts. This Section sets out three such adaptations. The first is the office of protector which has been invented in relatively recent years. The second is the role of the trust and trustee under pension benefits legislation. The third is an example of an actual adaptation, in the mutual fund context.

Protectors

One author[138] defines the "protector" as follows:

> ... [P]rotector means a person other than the trustee who, as the holder of an office created under the terms of the trust, is authorized or required to play a part in the administration of the trust.

The institution of the protector of the trust has grown up in the last ten to twenty years. The protector is alternatively called "adviser", "appointer", "management committee", "beneficiary representative." The basic idea of the institution is to provide some control over the trustee by taking some of the trustee's or settlor's traditional powers and allocating them to the protector.

Protectors have been given the following powers:

- the power to appoint or remove trustees or to approve a trustee's remuneration;
- the power to approve administrative or investment decisions of the trustees;
- the power to initiate or approve amendments to the trust instrument or portions of the trust instrument;
- the power to name additions to or exclusions from the class of beneficiaries or to approve distribution decisions made by the trustee;
- the power to control the beneficiaries in the beneficiaries exercise of their rights, for example, by restricting access to trust documents;
- the power to approve trust accounts, nominate auditors, and oversee the financial administration of the trust;
- the power to change the governing law of the trust or to cause the trust to change jurisdictions; and,
- the power to terminate the trust by acquiring a final distribution of trust property.

[138] Antony Duckworth, "Protectors - Fish or Fowl?" (1995) J INT P 136 at 136. See also David Hayton "Letters of Wishes and Protectors as Devices to Further the Settlor's Purposes" in J.A. Schoenblum, ed. *A Guide to International Estate Planning*, Drafting Compliance and Adminstration Strategies (Chicago: ABA 2000)

In the context of family trusts, the protector might be the settlor, a close friend of the settlor or a professional adviser of the settlor. The basic idea in the family trust context is to have someone who will understand the settlor's situation and the settlor's intention and use the powers given to them to protect the trust from contrary intentions. Typically, the protector:

- will act when they feel that the trustee has become unsuitable or when the jurisdiction in which the trustee is operating has become, perhaps for tax reasons, unsuitable;

- will ensure that the trustee pays heed to the settlor's non-binding letter of wishes;

- will deal with disputes between beneficiaries and trustees; and

- will facilitate the participation of beneficiaries in trust decisions.

Sometimes, perhaps frequently, the purpose of having a protector is to allow the settlor to have control over the decisions of the trustee without constituting himself or herself as trustee. This can be a useful device to avoid taxation of off-shore trusts.

There is no default law governing the position of protector. There are no decisions which have dealt with or interpreted this office. Hence, the protector's precise legal position is unclear. This is not a serious concern since the role of the protector can be defined adequately and clearly in the trust instrument.

The role of the court in dealing with that the trust instrument is stated by the court in *Re: Gulbenkian's Settlement Trusts*:[139]

> It is then the duty of the Court by the exercise of its traditional knowledge and experience in a relevant matter, innate common sense and desire to make sense of the settlor's or party's expressed intentions, however obscure and ambiguous the language that may have been used, to give a reasonable meaning to that language if it can do so without doing complete violence to it.

Based on the notion that the trust is a contract, the settlor has almost complete freedom in designing the powers of the protector. The only restrictions would be in the imperative law of trusts. It is probable, therefore, that the protector could not be given the power to release the trustee from fundamental breaches of the trust or to detract from the basic rights of beneficiaries.

The relevance of this new institution for present purposes is that it shows that it is possible to carve-out some of the traditional powers of the trustee and to allocate them to a new player in the trust context.

Trust Law and the Pension Fund Structure

The pension trust, or the trusteed pension plan, is probably the first investment trust. Retirement and adequate financial provision for retirement has been a concern much longer than investment diversification. Under a trusteed pension plan the employer and employee who contribute to the plan are the settlors.

There are a wide variety of structures used in the design of pension plans in Canada. These structures respond to two main demands on pension plan designers: provincial or federal pension benefits legislation and the demands of the constituents of the relevant plan.

Perhaps the most common model in Canada is to have a trust company serve as trustee of the plan, pursuant to a trust instrument that limits the trustee’s responsibilities and powers, constituting it in essence, a custodial trustee of the plan assets. The custodial trustee would discharge all possessory

[139] [1968] 3 All.E.R 785 at 791

functions, such as actually holding the trust property, executing on instructions of investment advisors appointed by the plan administrator, keeping records, valuing trust assets in accordance with criteria established in the plan and producing reports, again in accordance with criteria established in the plan.

Pension benefits legislation in Canada imposes the lion's share of the traditional trust responsibilities on the plan administrator.

Section 19 of the *Pension Benefits Act* (Ontario), for example, requires the plan administrator to ensure that the pension plan and the pension fund are administered in accordance with the *Pension Benefits Act* (Ontario) and in accordance with the plan documents. The administrator, in discharge of these obligations, is required to file annual information returns with the Superintendent under the *Ac*t.

Under the *Pension Benefits Act* (Ontario) the administrator may be the employer, a pension committee composed of representatives of the employees and employer, or a pension committee composed of representatives of members of the plan.

Section 22 imposes a standard of care on plan administrators and their agents.

The Pension Benefits Act (Ontario), finally, states that only certain entities may act as trustees of the plan. Thus, in essence, the plan assets must be in the possession of a trustee, but the responsibility for the administration of the plan is on the plan administrators.

The relevance of this model for the purposes of the present study is to demonstrate that there are a variety of structures which have adapted the trust to new and different uses and new and different roles. In the pension context, there is a consequence, a growing body of pension trust law and growing literature which investigates the trust law implications of various aspects of this common structure. The most obvious examples of issues are the pension surplus question[140] and the custodial trustee's liability for breaches committed by the administrator or otherwise.[141] There is no need to examine this jurisprudence in this study since it is sufficient to note that this trust adaptation, like countless others, has been successful. Certainly, there are some difficulties, but these are being worked out on a satisfactory basis.

Royal Funds

The Royal Bank acquired Royal Trust in 1993 and immediately set about the task of combining the mutual fund businesses of the two entities. The structure of the mutual funds of the two entities was "dramatically different" and the Royal Bank therefore addressed the question as to the ideal structure for mutual funds. Implementing the ideal structure was not as difficult for the Royal as it would be for any other mutual funds since integrating the mutual funds of the two entities required significant amendments to the declarations of trusts of all of the funds in any event. Royal decided in this process to integrate into the mutual fund structure a board of governors.[142]

In an article describing this process Sandra Jorgenson describes the thinking with respect to the mandate of the independent board as follows:[143]

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140 For example, see *Supletro Ltd. Retirement Plan Fund (Trustee of) v. Sulpetro Ltd. Receiver Manager* (1990), 66 D.L.R. (4th) 271, [1990] 4 W.W.R. 173 (Alta C.A.); *Metropolitan Toronto Pension Plan v. Aetna Life Insurance* (1992), 98 D.L.R. (4th) 582 (O.C.G.D.); *Ford v. Laidlaw Carriers* (1994) 1 E.T.R. (2nd) 117 (O.C.G.D.) aff'd (O.C.A.); R. v. Blair et al (1993) 106 D.L.R. (4th) 1 (Ont. Ct. (Prov. Div.)) rev'd (1994), 129 D.L.R. (4th) 367 (O.C.G.D.);

141 *Schmidt v. Air Products of Canada Ltd.* [1994] 2 S.C.R. 611

142 Key elements of the Royal Funds Master Trust Declaration are set out in Appendix B

143 S.M. Jorgenson, "Mutual Fund Governance: The Experience of Royal Mutual Funds" in *Mutual Funds: Changing Structures, Changing Rules* (Toronto: Insight Press, 1997).

> in determining the mandate of an independent board, we have to ask ourselves why are we creating this entity in the first place? What are the costs involved? Do those costs outweigh any value which the board can bring to the funds and the unitholders? Unless we can demonstrate on cost/benefit analysis that the board has value, what is the point in creating this thing. As a unitholder myself I do not care to pay for something that provides little or no return. ...

The same author goes on to identify the following as ways in which the board of governors adopted in the Royal Trust mutual funds added value:[144]

> Since the Royal Bank financial group is such a large group there are a great many inherent conflicts of interest. Because of those conflicts there are many instances in which the mutual funds are prohibited by regulatory provisions from pursuing the best interests of the unitholders. With a board of governors in place Royal has been, on occasion, able to persuade regulatory authorities that certain exemptions from regulations ought to be provided.
>
> The board of governors reviews internal policies regarding the use of derivatives and internal policies dealing with personal trading practices of investment managers and increases in management fees and expenses and changes in the auditor. Arguably without a board of governors some of these changes might have required unitholder review or approval.

In her article Ms. Jorgenson goes on to describe a number of specific situations in which the existence of the board of governors aided in obtaining regulatory approval without the added expense of a unitholder meeting.

Again, the relevance of this example in the present context is that it demonstrates that it is possible to integrate into the traditional trust structure, a new institution - the board of governors - which has allocated to it some of fiduciary powers and responsibilities which are the traditional preserve of the trustee.

IV. PROPOSAL

11. Proposal - Structure

A good system of mutual fund governance aims to ensure that mutual funds are governed, and are seen to be governed, in the best interests of unitholders. In practice this means that the interests of unitholders are protected from the often conflicting interests of fund managers and other unitholders in other funds managed by the same fund manager and that mutual fund managers perform their investment duties to a certain standard of care. This objective is the central preoccupation of fiduciary law.

The discussion that follows continues to assume that some governance agency will be interposed between investors and the manager. It is also assumed that that agency will be independent of the fund manager and that it will have sufficient financial and legal resources to discharge its obligations to investors. The issue under discussion now is how as a matter of law this requirement should be formulated. There are, as stated in the introduction, two questions here: Where in the variety of legal structures ought this agency to be placed and what powers and duties should it have? The first question is discussed in this section. The second question is beyond the scope of this study. For ease of reference

[144] *Ibid.*

in this section, the set of powers and responsibilities constituting this content are referred to as the set of powers and responsibilities.[145]

It is worth noting that the two questions are transitional questions as much as questions about a preferred governance structure since the structural mechanism used should be one that is capable - politically, legally and commercially - of being implemented in a workable way.

Recall the definition of the new term "formally responsible agency." I coined this term in Section 3 to mean the *individuals* who are *ultimately* in charge of an entity. Recall also the classification from Section 3 of mutual fund structures and the nature of fiduciary conflicts in the case of each class of structure. These are as follows:

A The Manager-Trustee Trust where the conflict is structural because the same individuals occupy two conflicting positions: the formally responsible agents of the trust are the directors (the formally responsible agents) of the manager.

B1 The Captive-Trustee Trust where the conflict is situational (possibly structural) because the individuals in charge of the captive trustee are (at least) beholden to the individuals who are in charge of the manager or of the common entity that owns the captive trustee or the manager.

B2 The Captive-Trustee Trust where the conflict is situational (possibly structural) because the individual trustees owe their economic allegiance to the manager.

C The Compliant-Trustee Trust where the conflicts are situational because the board of the compliant trustee corporation owes some economic allegiance to the manager.

D The New Trust where the conflict is structural because the formally responsible agent of the new trust is the board of the manager.

E The Corporate Mutual Fund where the conflict is situational (possibly structural) because the formally responsible agents of the fund corporation are beholden to the board of the controlling shareholder which is or controls the manager. Recent innovations in this model give few of the traditional shareholder powers to investors, rendering the board of the fund corporation entirely dependent on the manager, which controls its election through ownership of controlling shares.

F The Mutualised Mutual Fund where, in its ideal form, there are no conflicts.

There are two main approaches to answering the first reform question. One approach is to simply require that every trust have as trustees individuals who are independent of the manager as trustees. This is the recommendation of *Making It Mutua*l. It works in every case because in every case there will be no question that there are no structural or situational divided loyalties. The implementation of such a proposal would require the modification of most trust instruments and entail a severe disruption of industry practices.

A more nuanced approach is to place an independent governance agency into each of the structures "between" the investor and the manager, in the appropriate place. The discussion that follows examines how this can be achieved for each type of fund structure. One important aspect of this more nuanced approach is that it does not mandate a single structure for all mutual funds. Each manager under this proposal can select and use any of the existing fund structures, provided an independent governance agency is integrated into the structure in the ways suggested below. For some fund structures, the integration of an independent governance agency into the structure will be as simple as ensuring that the existing formally responsible agent for the fund has the required independence from the manager. For others it will require the creation of a new governance agency and its integration into the structure.

145 The Concept Proposal will propose a set of powers and responsibilities similar to the powers and responsibilities exercised by a board of directors.

In the Type A Trustee Manager Trust, the governance agency would have to be created directly in the trust instrument. The manager could still be trustee but as trustee, the manager would have fewer powers and would be subject to the supervision of the independent governance agency.

That role would be reduced to the extent of the powers and responsibilities given to the governance agency. Imagining a continuum of types of trustees, from bare through custodial to “full”, this trustee role would probably be somewhat more substantial than the role of the typical custodial trustee.

In the Type B1 Captive-Trustee Trust the same solution could be adopted. The independent governance agency would be created directly in the trust instrument. Alternatively, if the board of the Captive Trustee met certain independence criteria (if the situational conflict is dealt with adequately), it could serve as the independent governance agency. The first approach would require an amendment to the trust instrument; the second approach would not. The Captive Trustee would have to implement procedures and business practices that comply with the independence and other criteria imposed by regulations.

In the case of the Type B2 Captive-Trustee Trust, where individuals act as trustees, the individuals could continue to serve as the governance agency provided the situational conflict is dealt with. This would require a rule to the effect that the individuals (or some of them) could not be fiduciaries or owners of the manager and possibly could not be employees of the manager.

In the case of the Type C Trust, the Compliant Trustee Trust, the conflict could be dealt with by ensuring that the compliant trustee meets certain independence requirements. Given the nature of the corporate trustee business in Canada, it probably would be sufficient to impose on corporate trustees the set of responsibilities and powers and ensure that there is nothing in the trust instrument that detracts from these. If those obligations were articulated, it would be in the corporate trustee's own best interest to abide by them, because its business of being a corporate trustee is to meet those obligations.

In the case of Type D, the New Trust, since the conflict is structural it can only be solved by creating an independent governance agency directly in the trust instrument that has the relevant powers of supervision over the New Trustee. This is the same solution adopted for the Type A Trust.

In the case of the Type E the Mutual Fund Corporation, the situational conflict created by the fact that the mutual fund corporation's board of directors is "elected" by the controlling shareholder can be solved by a rule which requires those directors or a majority of them to be independent.

The difference between the two main approaches (i.e. requiring independent individual trustees for all mutual funds versus imposing a governance agency on each type in the way proposed) is more than cosmetic. The second approach to the fiduciary conflicts permits mutual funds to be organized in exactly the way that they are organized today in every case. All that happens is that a certain set of powers and responsibilities is divested from the trustee and given over to the independent governance agency or a severe situational conflict is dealt with by requiring a certain level of independence in the formally responsible agent of the relevant entity. This technique of reform permits an evolutionary or incremental approach. The content of the independent governance agency's powers can be developed and formulated over time drawing on the current experience of the mutual fund industry with boards of governors and boards of advisors. This would allow the industry to determine whether or not there are individuals of sufficient ability to serve in the relevant positions and whether the costs of implementing such governance agencies are worth the benefits.

The drawback of this approach is that it is somewhat legally complex. Investors probably know and understand what a board of directors is. Possibly some of them understand what a trustee is. This reform approach would be creating, in some cases, a new agency which would not or may not be readily comprehended by most investors. This problem, however, could be solved by ensuring in the regulations that the governance agency be called one name, for example, "board of governors", and that it be given one set of powers and responsibilities in every case. Where trustees and boards of directors are merely rehabilitated to deal with situational conflicts, these old terms can still be used. If that is done, it should not be too difficult to communicate to investors that there is an independent governance agency that is acting in their best interests.

Civil liability under this approach would attach to all fiduciaries in the fund structure and be imposed on them as a matter of the general law governing of fiduciary responsibility in common law Canada and as a matter of contract law and the law governing the administration of the property of another in Quebec. The extent and scope of fiduciary/administrator responsibilities would be a question of fact in any particular case, but in general it is clear the fund manager and the members of the independent governance agency would share these responsibilities and therefore liability for their breach. Provided the regulatory instrument and the trust declarations clearly establish the duty of care and the standard of care for the members of the governance agency, these individuals will have no more difficulty than do the directors of a public corporation understanding and discharging their responsibilities.

Although there is no concept of fiduciary duty in Quebec law per se, as discussed in Section 9, the rules in the CCQ dealing with administrators of the property of another - articles 1299 to 1370 - will likely apply to impose on the members of the governance agency in the Type A and Type D structures the same level and types of duties they will have in common law Canada. Since, as discussed above in Section 9, these rules are suppletive, the trust instrument which creates the trust and establishes the governance agency will also apply to articulate the duties of the members of that agency and will over-ride the suppletive rules in the CCQ, to the extent desired. Thus, like their common law counterparts, the members of the governance agency in Quebec will have no greater and no lesser duties than required in the circumstances. The tenor and scope of their duties will be tied directly to the powers and responsibilities they are given under the trust instrument.

There may be some concern that the implementation of the proposal will somehow jeopardize the limited liability status of unitholders. It might be argued that the governance agency that is to be integrated into the Type A fund structures somehow enhances the arguments in favour of a principal/agent characterization of the unitholder/manager relationship. Since the governance agency in a Type A structure will owe its duties exclusively to the unitholders, it might be said that it is the agent of the unitholder. It is extremely unlikely that such an argument, without more, could prevail in court. All that the integration of the governance agency does, in effect, is to rehabilitate the trustee function in the structure by eliminating the fiduciary's conflicts of interests. It is difficult to see how this improvement in this relationship could lead to a collapse of the trust characterization of the structure.

Implementation of this reform should, at least for most if not all fund structures, be fairly straightforward and should not require a meeting of unitholders. Most declarations of trust permit the trustee to amend the trust declaration when required to do so to ensure compliance with applicable laws, regulations and policies, when it is in the unitholder interests to do so or when the amendment does not materially adversely affect the interests of unitholders. Any one of these types of powers to amend should be sufficient to facilitate the required amendments.

GLOSSARY OF TERMS

"Agent" is a legal and economic term of art. In economics it means any person who acts on behalf of or in the interests of another, no matter what the precise legal bond. In law, it means a person who is legally empowered to act in law to change the legal relationships of the principal.

"Definitional law" means the rules that state the essence of a legal institution. It is part of "imperative law".

"Fiduciary law" means the general law governing the fiduciary's obligation to act loyally and competently in the best interests of the creditor of the fiduciary obligation.

"Formally responsible agent" is a term invented for the purpose of this study. It means the individual or group of individuals who have the legal power and duty to manage or control an association, organization or pool of assets such as the board of directors of a corporation or the trustees of a trust. The power and duty may, as a matter of fact, be delegated to others who actually exercise it.

"Governance agency" is a neutral, non-technical term invented for the purpose of this study. It means the group of individuals who have ultimate power and ultimate responsibility in respect of the governance of an organization or association.

"Imperative law" means law which is not optional or default law. Its complement is "suppletive law" meaning optional or default rules. It comprises definitional law and public order rules.

"Private law" means the law that applies between individuals, in contrast to the law that applies between individuals and the State. In general, it means the law of property, torts, and contract, broadly defined.

"Public order rules" are rules imposed on behaviour on a mandatory basis by the legislator or the common law.

“Situational conflict” means a conflict of interest in which a fiduciary has divided loyalties because of some personal interest they may have in the matter.

“Structural conflict” means a conflict of interest in which a fiduciary has divided loyalties because of some other office that they hold.

"Suppletive law" means law which is provided by the legislator or common law to supplement explicit terms adopted by parties to a private law relationship. It is optional or default law in the sense that the parties are free to alter the suppletive law.

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