TAB 12

The Exercise of Trustee Discretion – Discretion – Still the Better Part of Valour

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The Exercise of a Trustee's Discretion

Discretion – Still the Better Part of Valour

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In Shakespeare's *Henry IV*, Part One (1596), Falstaff proclaims: "The better part of valour is discretion, in the which better part I have saved my life." While a less than prudent exercise of a trustee's discretion is unlikely to cost him his life, it can certainly invite unwanted grief from beneficiaries, contentious proceedings and possibly reputation damaging litigation. A failure to exercise discretion at all can result in equally serious consequences that could threaten the constitution of the trust or influence the determination of where the trust is resident for tax purposes. Care, diligence, prudence and action, therefore, in exercising discretion as a trustee, no matter how "uncontrolled" or "absolute" the discretion may be, has become the standard. While historically, at least in the United Kingdom, courts were disinclined, absent *mala fides*, to interfere with the exercise of a trustee's discretion, both the United Kingdom and Canada seem to be trending toward more judicial intervention.

Judicial Intervention

A trustee's discretion to act is derived from the governing instrument, usually a trust deed or a will. Where the trustee has acted in good faith and within the bounds of his/her authority, a court will rarely interfere with the exercise of a trustee's discretion, and will not replace the trustee's judgement with its own pronouncement. This is so even if the court would have exercised the power differently. Further, in the absence of bad faith behaviour, historically, trustees have also

been protected from disclosure of the reasoning behind the exercise of a discretionary power.[1] All of this is based on the theory that for a trust administration to proceed in an orderly manner, the trustees must be free to properly consider the interests of competing claims in a proper and discreet manner without fear that "at any moment there is likely to be an investigation for the purpose of seeing whether they have exercised their discretion in the best possible manner".[2]

While it is true that courts will not interfere with a trustee's exercise of discretion based on mere dissatisfaction of the beneficiaries, in common law countries, the "court's supervisory jurisdiction over the discretions of trustees has been recognized since the seventeenth century".[3]

The seminal case of *Gisborne v. Gisborne*[4] established that, absent fraud or *mala fides*, a trustee's discretion was not controllable by the court and that "the court would neither interfere nor express its agreement or disagreement with a decision of the trustees".[5] In that case, a trust fund was established for the care of the principal beneficiary, being the testator's wife. The trustees were granted uncontrolled authority over the application of the trust fund. The principal beneficiary owned property and was eventually declared incapable, requiring full time care. She argued that the trust fund should be treated as the primary source of funds for her care, but the trustees disagreed. The trustees decided to pay her income from the fund as required only once her own resources had been exhausted. The court held that it would not interfere with the

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[1] *Re: Beloved Wilkes' Charity* (1851) 3 Mac & G 440 (Ch.D.).
[2] *Re: Londonderry's Settlement*, [1965] Ch. 918, at 935 ("*Londonderry's Settlement*").
[3] M.C. Cullity, "Judicial Control of Trustees' Discretion", (1975) 25 U.T.L.J. 99 at 99 ("Cullity"). See also *Boe v. Alexander* (1985), 21 E.T.R. 246 (B.S.S.C.), affirmed (1987), 28 E.T.R. 228 (B.C.C.A.) in which it was held that the jurisdiction of the Court to review the exercise of the trustee's discretion cannot be displaced by even the broadest language creating the discretion.
[4] (1877), 2 App. Cas. 300 (HL).
[5] *Supra*, note 3 at 100. See also *Re Blow* (1977), 83 D.L.R. (3d) 721, in which the court declined to intervene on the basis that there was no manifest prejudice to the beneficiary.

trustees' discretion in circumstances where the trustee's power is absolute, uncontrolled and final, and there is no *mala fides*.

This principle has been applied inconsistently over the years, particularly in cases in which judges have attempted to define the extent of their supervisory jurisdiction or the scope of a specific discretionary power. In many instances, judicial interference depends on the context of a particular case. In his article, Cullity summarizes the issues arising out of the later cases as follows:

> 1) whether the broad rule of non-interference applies to administrative discretions in the same way and to the same extent as it applies to dispositive discretion;
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> 2) whether, as some judges have suggested, the principle applies only to discretions which are declared to be absolute or uncontrollable or which are described in similar emphatic terms; and
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> 3) the precise meaning which is to be attributed to the concept of *mala fides*.[6]

Accordingly, in Cullity's view, the courts will interfere with the exercise of a trustee's discretion in five types of cases, namely, where:

> 1) the trustee seeks to achieve some "improper purpose" (a pursuit foreign to that for which the power was conferred);
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> 2) the trustee fails to turn his mind to the exercise of the discretion;
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> 3) the trustee's decision is arbitrary, as opposed to reasoned;

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[6] Cullity, *supra*, note 3 at 106.

4) the trustee takes irrelevant circumstances into account;

5) a decision made by the trustee is so capricious or unreasonable that no reasonable person could have arrived at it;

6) the trustee acts imprudently or carelessly; and

7) the trustee improperly or unfairly ignores the rights of certain classes of or individual beneficiaries.[7]

- ***The United Kingdom Experience***

A review of the jurisprudence reveals that in the United Kingdom more discretionary leeway is afforded to trustees. In the decision of *Edge and Others v. Pensions Ombudsman and Another*[8], the Court of Appeal confirmed that if trustees exercise their discretion for the purpose for which it is given, taking into account relevant matters and excluding matters which are irrelevant, then the result will be a proper exercise of the discretionary power, whether or not the judge agrees with the result; the judge cannot interfere with the trustees' exercise of discretion.[9] In *Edge and Others*, the Court of Appeal quotes Lord Greene M.R. in the 1948 case of *Associated Provincial Picture Houses Ltd. v. Wednesbury Corporation*, regarding discretionary power granted by statute:

> When discretion of this kind is granted the law recognises certain principles upon which that discretion must be exercised, but within the four corners of those principles the discretion, in my opinion, is an absolute one and cannot be questioned in any court of law. What then are those principles? They are well understood. They are principles which the court looks to in considering any

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[7] Cullity, *supra*, note 3, at 114-119.
[8] [2000] Ch. 602, 1999 W.L. 808969 (C.A. (Civ Div)), [1999] 4 All E.R. 546, [2000] Ch. 602, [2000] I.C.R. 748 ("*Edge and Others*").
[9] *Ibid*, at 627.

> question of discretion of this kind. The exercise of such discretion must be a real exercise of the discretion. If, in the statute conferring the discretion, there is to be found expressly or by implication matters which the authority exercising the discretion ought to have regard to, then in exercising the discretion it must have regard to those matters. Conversely, if the nature of the subject matter and the general interpretation of the Act make it clear that certain matters would not be germane to the matter in question, the authority must disregard those irrelevant collateral matters .... It has been perhaps a little bit confusing to find a series of grounds set out. Bad faith, dishonesty – those of course, stand by themselves – unreasonableness, attention given to extraneous circumstances, disregard of public policy and things like that have all been referred to, according to the facts of individual cases, as being matters which are relevant to the question.[10]

However, exceptions to the principle of non-intervention can be found in the United Kingdom jurisprudence. For example, with respect to trusts of land, under the *Trusts of Land and Appointment of Trustees Act 1996*, the court has an overriding discretion to control the exercise of the trustees' functions.[11]

Another exception to the principle of non-intervention is the court's statutory jurisdiction, under the (United Kingdom) *Trustee Act 1925*, to appoint a new trustee where it is expedient, difficult or impractical to do so without the assistance of the court.[12]

The recent and significant case of *Schmidt v. Rosewood Trust Limited*[13] established the court's jurisdiction to order the disclosure of information relating to the trust to the beneficiaries. This authority has been held to be part of the court's jurisdiction to supervise trustees.[14] As the Honourable Mr. Justice David Hayton writes: "An open and frank relationship between trustees

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[10] *Ibid*, at 628.
[11] J. Mowbray, L. Tucker N. Le Poidevin, E. Simpson, J. Brightwell, *Lewin on Trusts*, 18th ed. (London: Sweet & Maxwell, 2008) at 1109 ("Mowbray").
[12] *Supra*, Mowbray, note 11 at 1110.
[13] [2003] YJPC 26, [2003] A.C. 709, [2003] UKPC 26 ("*Schmidt v. Rosenwood*").
[14] *Supra*, Mowbray, note 11 at 1109.

and beneficiaries should be the normal one because secrecy is a breeding ground for suspicion and antagonistic action".[15]

In addition, the courts in England have set aside trustees' discretionary decisions which are dishonest, or reached by considering irrelevant factors, and have intervened when trustees have not exercised their discretion. Since *Gisborne*, there have been a number of cases that have expanded the circumstances in which the court might find *mala fides* behaviour and therefore intervene. As an example, in *Dunlop v. Ellis*[16], the trustee was given absolute and uncontrolled "discretion" to advance money for the benefit of the testatrix's daughter. The court intervened when the trustee refused to make any payments for the benefit of the daughter who was being cared for in an institution. In this case, the court stated that:

> Where there is, as here, a trust coupled with a discretionary power, the Court is entitled and bound to interfere where there is no attempt to exercise the discretion for the purpose of which it was given, but an attempt to accomplish a purpose quite alien from the intention of the testatrix, the author of the power.[17]

In a more recent decision, *NBPF Pension Trustees Ltd. v. Warnock-Smith*[18], the High Court agreed with the trustees' proposal to distribute the remaining assets on the winding-up of two occupational schemes. The trustees had applied to obtain the endorsement of the court on certain issues including their purchase of insurance to preclude the need for the further retention of reserves. The beneficiaries objected to the proposal on the ground that it was unnecessary and only protected the trustees. The beneficiaries claimed it was not justified under the scheme's rules or under the (United Kingdom) *Trustee Act, 1925*. The court applied the test from

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[15] D. Hayton, P. Matthews, C. Mitchell, *Underhill and Hayton: Law of Trusts and Trustees*, 17th ed. (UK: Lexis Nexis Butterworths, 2007) at vi.
[16] (1917), 41 O.L.R. 303 (HC).
[17] *Ibid*, at 307.
[18] [2008] EWHC 455 (Ch).

Merchant Navy Ratings Pension Fund Trustees Ltd. v. Chambers[19], where Justice Blackburne stated that:

> The test is whether it can be said that in reaching its decision to implement the proposal, the trustee has taken into account irrelevant, improper or irrational factors, or whether it has reached a decision that no reasonable body of trustees properly directing themselves could have reached.[20]

Based on these considerations, the court did not intervene and found that the trustees had made accurate considerations.

- ***The Canadian Experience***

In Canada, the courts have shown a greater willingness to interfere with a trustee's exercise of discretion. Generally, a court will interfere where it must be ascertained as a matter of construction to what task the discretion is attached[21]; and the court will not intervene just because it does not agree with the result of the exercise of the trustee's discretion.

Waters notes that the court will intervene if:

1) the decision is so unreasonable that no honest or fair-dealing trustee could have come to that decision;

2) the trustees have taken into account considerations which are irrelevant to the discretionary decision they had to make; or

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[19] [2001] Pensions LR 137.
[20] *Ibid*, at 5.
[21] D.W.M. Waters, M.R. Gillen, L.D. Smith, *Waters' Law of Trusts in Canada*, (3d. ed.) Toronto: Thomson Carswell, 2005 at 933 ("Waters").

3) the trustees, in having done nothing, cannot show that they gave proper consideration to whether they ought to exercise the discretion.[22]

Despite debate about whether the use of adjectives such as "uncontrolled", "absolute", and "unfettered" give trustees greater discretion than they would ordinarily have without those adjectives, Canadian courts have found ground on which to interfere with a trustee's discretion. A compelling argument is that despite the trustee's power of discretion, a trustee is in a fiduciary position and bound by the duties of this office to:

1) act in good faith;

2) direct his/her mind to the exercise of discretion;

3) maintain and even-hand amongst the beneficiaries; and

4) not delegate his/her discretion.[23]

The courts will intervene if they conclude that there has been a breach of any of these duties.

The courts will also intervene on the basis of *mala fides*, the interpretation of which has not been limited to just honesty, but has been expanded to include improper purpose and unreasonableness.[24] In *Re Carley Estate*[25], the court interfered because the trustees had not fulfilled the wishes of the testatrix. They ignored the principle of even-handedness and improperly encroached on capital.

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[22] *Ibid.*
[23] C.S. Theriault, *Widdifield on Executors and Trustees*. 6th ed. (Toronto: Thomson Carswell, 2008), at 8-5.
[24] *Ibid*, at 8-9. See also Cullity, *supra*, note 3.
[25] (1994), 2 E.T.R. (2d) 142 (Ont. Gen. Div.).

The Ontario Court of Appeal in the *Fox v. Fox Estate*[26] found that the trustee's exercise of discretion to encroach on the trust capital was for an improper purpose. It stemmed from her unhappiness with her son's marriage to a non-Jewish woman. In this case, the court's interference was justified because the discretion had been exercised in bad faith and for extraneous purposes. Specifically, the court found that the "extraneous consideration demonstrated sufficient *mala fides* to bring her conduct within any reasonable interpretation of that term."[27] Religion was an irrelevant consideration to the exercise of the discretion.

In contrast, in the case of *Edell v. Sitzer*[28], the Ontario Court of Appeal confirmed that the trustee was entitled to exercise his discretion in accordance with the principles on which the trust planning was based, which permitted distribution of shares to the settlor's son to the exclusion of the daughter, who was also a beneficiary. The court found that the trustee's motivation was not improper, although he was unhappy with his daughter's behaviour. The settlor/trustee had a concern that it would be detrimental to his descendants if his daughter continued to have beneficial rights to receive the shares.[29]

In the case of *Walterson v. Herriman Estate*[30], the same-sex partner of the deceased applied for the removal of the trustees of the estate when the trustees refused to encroach on the entire capital of the testamentary trust for his benefit. The applicant had been offered an allowance of $500 every month. The court held that the trustee's decision was not based on extraneous considerations and was not considered improper, despite the fact that one of the trustees outwardly disapproved of homosexual relationships.

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[26] 1966 Can LII 799 (Ont. C.A.), (1996), 28 O.R. (3d) 496 (C.A.).
[27] *Ibid*, at para. 11.
[28] (2001), 55 O.R. (3d) 198 (Can LII) (Ont. S.C.J.), affirmed (2004) 9 E.T.R. (3d) 1 (Ont. C.A.), Leave to appeal refused (2005) 2005 Carswell Ont. 96 (S.C.C.).
[29] *Ibid*, at 247.
[30] (1997), 20 E.T.R. (2d) 76 (Ont. Gen. Div.).

In *Martin v. Banting*[31], the plaintiff was a potential beneficiary of two *inter vivos* trusts created to effect an estate freeze. The trustees, who were the plaintiff's uncle and mother, used their discretion to distribute the trust assets and wind up the trusts. The plaintiff alleged that insufficient funds had been distributed to him and he brought an action alleging that the trustees had a legal obligation to distribute one-half of one of the trusts to him and one-third of the other of the trusts to him. The trustees brought an action for summary judgement dismissing the action. The motion was granted. The court found that the trust documents gave a discretionary power of appointment to the trustees. There were no limiting criteria in the documents, and the trustees took into account relevant considerations. The plaintiff failed to demonstrate *mala fides* on the part of the trustees.

Ascertaining the Settlor's Intention

A discretionary trust does not, by its very nature, define the interests of the beneficiaries in specific or fractional terms. Generally, the trust fund is held for a pool of beneficiaries and the trustees have discretion respecting distributions of income and/or capital, including the timing of such distributions and the allocation as among the potential beneficiaries. The trustees may also be given discretion respecting the making of tax elections, the winding up of the trust and adding or removing trustees, among other things.

In most cases, trustees would benefit from some guidance in relation to these decisions. It would be helpful if they could readily access the settlor's intention. However, ascertaining the settlor's intention, often decades after the trust was settled, can be an elusive exercise. Many trusts are drafted with little to no concrete evidence of the settlor's intention, no guidance as to the scope

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[31] [2002] O.J. No. 381 (C.A.).

of the trustee's broad discretionary power and no guidance respecting the factors to be considered in exercising that discretion.

To assist in solving the mystery of the settlor's intention, guidelines or letters of wishes prepared by the settlor can be extremely useful. Letters of wishes in the estate planning context would appear to be the exception, not the rule, yet such guidance would improve the chances of the trusts being administered in a way that the settlor would have administered them him/herself. As a practical matter, perhaps advisors should be strongly encouraging settlors and testators to provide a non-binding written expressions of the manner in which they would like to see the appointed trustees exercise discretion. That said, the interpretation and disclosure of letters of wishes have not necessarily made the process simpler for trustees and these letters too have been the subject of judicial consideration. The few cases that deal with letters of wishes tend to focus on the disclosure of the letter of wishes as opposed to the content or efficacy of such letters in assisting the trustees in the exercise of their discretion.

- ***Letters of Wishes***

A letter of wishes typically takes the form of a private letter written to the trustees by the settlor of a discretionary trust. Generally, it is intended as guidance to the trustees respecting the exercise of their discretionary powers. It could also extend to the settlor's personal philosophy or ideals and goals respecting the succession of a family business, the shares of which are held by the trustees. It may be amended at any subsequent time and generally is not subject to any formalities.

The advantage of updating the letter of wishes regularly is that by doing so, the letter of wishes keeps pace with changing family circumstances. Where the letter of wishes is confidential

between the settlor and the trustees, the settlor may include in the letter of wishes or supplemental letters of guidance a formula for how the trustees might deal with family disputes. Also, if the settlor has favoured one beneficiary or a group of beneficiaries over others in the letter of wishes, he or she may set out the reasons in some detail so that the trustees will be able to exercise their discretion fully apprised of all of the relevant issues.

However, if the letter of wishes is to remain confidential as between the settlor and the trustees, this feature can lead to unrest and suspicion among beneficiaries.[32] Further, unless it is ordered to be disclosed, it can be of no assistance to the court in determining whether the exercise of the power was properly exercised. For this reason, it may be important in some cases for the letter of wishes to be disclosed to one or both of the beneficiaries and the court. Where disclosure is likely, it would be important for the settlor to be judicious and careful respecting the contents of the letter. The letter should be informed, carefully considered and clear. A wise settlor would be cautious to avoid using inflammatory language about a beneficiary's character or lifestyle, which could cause psychological harm. If it is important that the trustees have a better understanding of a particular beneficiary's character, it would be better to include that information in a separate confidential letter to the trustees with a specific instruction that that letter not be disclosed to the beneficiaries. Thought should also be given to a discussion about the letter of wishes between the settlor and the beneficiaries. This openness could well reduce suspicion in the minds of the beneficiaries.

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[32] Morren McMillan, "*Friend or Foe*" Step Journal 2009 Vol. 17, issue 8 ("McMillan").

Notwithstanding the settlor's intentions respecting disclosure, in *Schmidt v. Rosewood*[33], the court concluded that the court has jurisdiction to determine whether the letter of wishes be disclosed to the beneficiary where the trustees have declined to make that disclosure.

As McMillan notes, citing *Londonderry's Settlement*[34], preservation of family harmony has long been accepted by the courts as a legitimate reason for refusal to disclose trust documents. This principle has been extended to letters of wishes on the basis of their confidentiality between the settlor and the trustees.[35] However, in the case of *Breakspear v. Ackland*[36], the court acknowledged the need for a balance between the settlor's desire for confidentiality and the beneficiaries' desire for accountability. The court found that the disclosure of the letters of wishes to an inquisitive beneficiary falls within the "balancing exercise"[37], to be undertaken by trustees in their administration of the trust, and is ultimately subject to the inherent jurisdiction of the court. It was held in *Breakspear* that "there are no fixed rules and the trustees need not approach the question [of confidentiality] with any predisposition towards disclosure or non-disclosure.[38] For greater certainty, and to minimize suspicion, the settlor might articulate the circumstances under which the letter of wishes may be disclosed to the beneficiaries or others.

Because the letter of wishes is designed to provide guidance to the trustees in the exercise of their powers and discretions and to give them a better understanding of the settlor's intentions, it must be general and not legally binding. When and as appropriate, the trustees should consider the settlor's stated views in the exercise of their powers and discretions by taking into account all of the relevant considerations. Slavishly following the letters of wishes without the benefit of

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[33] *Supra*, note 12.
[34] *Supra*, note 2, at 936, 937.
[35] *Hartigan Nominees Pty Ltd. v. Rydge* (1992), 29 NSWLR 405 and *Re Rabaiotti*, [2000] WTLR, 953.
[36] [2008] 3 W.L.R. 698.
[37] *Supra*, note 12.
[38] *Supra*, note 36 at para. 73.

independent thought could expose the trustees to the risk that the court would find that the letter of wishes forms part of the trust, or in a worst case scenario, that the trust should be set aside as a sham. For this reason, the settlor should not express his/her wishes too precisely, or in an imperative or mandatory manner. The result could create uncertainty as to how their powers of discretion ought to be exercised and could result in a court application for advice and direction respecting the proper interpretation of the letter of wishes. More troubling would be a letter of wishes that conflicts with terms of the trust.

Removing and Replacing Trustees and other Controls on Discretion

It is not unusual for a trust instrument to include among those powers granted to a trustee or those reserved by the settlor a power to remove and replace trustees. Absent such a power in the trust instrument, resort must be had to statutory non-judicial powers of appointment and discharge[39] or the inherent jurisdiction of the courts to ensure that no trust is without satisfactory trustees. Not surprisingly, settlors are often attracted to the power to remove and replace trustees as a means of retaining some measure of control over how the trust property is administered. However, in light of two recent much publicized tax cases, the consequences of reserving this power, or a variation of it, to the settlor are potentially problematic.

Under Canadian law, the power to dismiss trustees is a valid power. Express provisions to remove or replace trustees offer the ultimate check and balance tool, which facilitates the dismissal of a trustee that is more flexible and less costly than recourse to the courts. The power to dismiss and appoint trustees can be given to a variety of individuals[40] to address a wide variety

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[39] *Trustee Act*, R.S.O. 1990, c.T.23, ss. 2 and 3 ("Trustee Act").

[40] For example, beneficiaries may be given a power to remove and replace trustees by way of majority or some other formula. In the United Kingdom, if beneficiaries act unanimously, they can direct the retirement and

of circumstances and situations, including death, incapacitation or resignation. In Ontario, such events are contemplated in the *Trustee Act*, which provides, at s.3(1), that the surviving or continuing trustee or trustees may appoint a new trustee or trustees in writing. In circumstances in which this arrangement would be undesirable, it would be appropriate to insert an alternative mechanism in the trust instrument itself. Such mechanisms can be useful for the purposes of breaking a deadlock between two trustees when a temporary third person is required to decide a single issue.

Including an ability to remove a trustee in circumstances beyond those identified by the statute could also be useful. The courts can remove a trustee if he or she refuses or is unfit to act, or if the welfare of the beneficiaries justifies such removal. However, mere friction or hostility between trustees is not enough to justify removal by the court.[41] Express powers in the trust instrument may provide additional flexibility in situations of tension between trustees. This increased flexibility can be useful in circumstances that amount to less than legal cause, and would facilitate the retirement of a trustee without publicity, especially in cases where a trustee might otherwise contest his removal to protect his/her reputation.

An unresolved issue concerns the overlap between the mechanisms for removal provided in the trust instrument and the statutory provisions. The Ontario Law Reform Commission has highlighted various issues that can arise when powers conferred under a trust instrument differ

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appointment of trustees. Specifically, they may direct that a trustee retire without a new trustee being appointed or may appoint an additional trustee without any trustee retiring. This action on the part of the beneficiaries is permissible under sections 19 and 20 of the *English Trusts of Land and Appointment of Trustees Act, 1996*. Ontario does not have equivalent legislative provisions. Under Ontario law, it would be possible for all of the beneficiaries of the trust, assuming all are *sui juris*, to use the rule in *Saunders v. Vautier* to act together to terminate the trust, and re-settle the trust property on new trusts with new trustees.

[41] Waters, *supra*, note 21 at 844-845.

from statutory powers. These contradictions are especially difficult where the powers provided under the trust agreement are narrower in scope than those provided for in the legislation.[42]

For example, since statutory powers are "subject to the terms" of the trust instrument,[43] it could be argued that the existence of an express power to appoint trustees, even if not as extensive as the powers conferred under the *Trustee Act*, effectively ousts the statutory power. The current jurisprudence in England favours the line of reasoning which would oust the statutory powers in these circumstances, while legislation in Australia and New Zealand has adopted the opposite approach.[44]

In the United Kingdom, the settlor is often given the power to appoint new trustees under the trust instrument.[45] In reserving this power to the settlor, it is important that he/she has the ability to delegate the power if required; for example, if the settlor relocates to another jurisdiction. Since the power to appoint and remove trustees is a fiduciary power, it must be released by way of express provision in the trust instrument.

Over the years, there has been debate in the United States about whether the settlor (also referred to as the "grantor") can retain the power to dismiss and appoint trustees in the trust instrument.[46] Ackers provides a detailed analysis of the issues surrounding this debate, including numerous technical tax implications. The debate essentially revolves around the power of the settlor/grantor to remove trustees and the argument that this power results in *de facto* power on

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[42] Ontario Law Reform Commission, *Report on the Law of Trusts*, Vol. I (Toronto: Ministry of the Attorney General, 1984) at 96.
[43] *Trustee Act*, *supra*, note 39, at ss. 67-68.
[44] New Zealand *Trustee Act 1956*, s.43(8); Western Australia *Trustees Act*, 1962, s. 7(8).
[45] Richard Williams, Arabella Saker & Toby Graham (eds.), *A Practical Guide to the Transfer of Trusteeships* (London: STEP, 2007) at 4 ("Practical Guide").
[46] Steve R. Akers, *Trust Powers and Tax Liabilities: "But I Just Wanted a Few Strings Over Trust Assets" – Effects of Trustee Powers of Grantors and Beneficiaries* (Dallas, Texas: Bessemer Trust Company, 2005), online, ABA: http://www.abanet.org/rppt/meetings_cle/2005/spring/pt/TrustPowersandTaxLiabilities/AKERS_PT_SRI_HAND.pdf ("Akers").

the part of the settlor/grantor over trustees. It has been argued in the United States, and in particular by the Internal Revenue Service, that the trustees will be compelled to "follow the bidding of a Settlor who has the power to remove the trustee".[47] U.S. courts have generally not followed this reasoning. Instead, they rely on the fiduciary duty of any trustee to administer the trust in the best interests of the beneficiary and to act impartially. This duty, in the court's view, is weighty enough to balance the power of the settlor/grantor to hire and fire trustees.[48]

A similar debate has just begun to heat up in Canada, fuelled by the recent Tax Court of Canada decision re *Garron Family Trust et al*[49]. This case afforded the tax court the opportunity to consider an administrative power reserved to the settlor (and his spouse) to remove and replace a protector, who had the power to remove and replace the trustee.

By way of background, the case involved, in the main, the residency of two trusts (the "Fundy Settlement" and the "Summersby Settlement"). The court found that the trusts, notwithstanding that the trustee was resident in the Barbados, were in fact residents of Canada under legal principles. Woods, J. held that the residency test for trusts is "where the central management and control actually abides". The decision was based on the following reasons:

1) The case of *Thibodeau*[50] does not purport to state a general test regarding the residency of a trust, and the test that was applied in that case is not based solely on the residence of the trustees; and

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[47] *Ibid*, at 25, citing *Estate of Wall v. Comm'r,* 101 T.C. 300 (1993).
[48] Langdon T. Owen, Jr., "Some Thoughts Concerning Trustee Selection" (2005) Utah Bar Journal, online: UBJ http://www.webster.utahbar.org/barjournal/2005/06/some_thoughts_concerning_trust.html.
[49] 2009 TCC 450 (TCC), which decision is being appealed as *St. Michael Trust Corp., as Trustee of the Fundy Settlement v. R.* and *St. Michael Trust Corp., as Trustee of the Summersby Settlement v. R.* ("*Garron*").
[50] *Thibodeau Family Trust v. The Queen*, 78 DTC 6376 (FCTD) ("*Thibodeau*").

2) The central management and control test used in a corporate context is equally applicable in a trust context.

Specifically, Woods J. observed that: "Although there are significant differences between the legal nature of a trust and corporation, from the point of view of determining tax residence, the characteristics are quite similar. The function of each is, at a basic level, the management of property."[51] Accordingly, Woods, J. ruled that adopting a similar test for determining the residency of trusts and corporations promotes the principles of consistency, predictability and fairness.

Woods, J. concluded that the trusts were resident in Canada because the respective settlors of the trust made substantive decisions with respect to each respective trust with the result that the management and control of both trusts took place in Canada. Among the factors considered by the court was whether the trustee had *de facto* control of the trust. Reference was made to *Robson Leather Company Ltd. v. MNR*[52] (a case about whether a person had control for the purposes of the arm's length rules), in which the judge refused to accept that it would not be assumed that the trustees would not carry out their duties as trustees in accordance with the legal obligations imposed on trustees to formulate their own judgements affecting the trusts, but would follow the settlor's instructions merely because he had the power to cause the retirement of either or both of the other trustees if they did not do so.

Instead, the court reasoned:

> By demanding retirement of trustees, or even threat of such demand, or the knowledge in the co-trustees that the ultimate power was always in Mr. Robson, I

[51] *Supra*, note 49, para. 159.
[52] 77 DTC 5106 (FCA).

> have no doubt that Mr. Robson, for practical and legal purposes, controlled the trust and, therefore, controlled Robson Leather. I add the *caveat* here, that share control alone, (or absence of it), is not necessarily conclusive; it is a factor to be considered in determining questions of arm's length.[53]

While a contrary view was expressed in *Thibodeau* (the facts of which were strikingly similar to *Garron*), Woods J. concluded that it does not make sense that in every case trustees will comply with their fiduciary obligations and that the particular facts and circumstances must be considered.[54]

Woods, J. also noted that although the arrangement with respect to the trustee's role was likely unwritten, it was effectively enforceable through the ability of the protector to replace the trustee through the protector mechanism. That mechanism included the ability of respective settlors, with their spouses, to replace the protector.[55]

The fact that the Barbados trustee was found to have little independent decision-making authority and that other persons exercised considerable influence over the management of the trusts was critical to the conclusion in *Garron*. Woods, J. found that the trustee had no demonstrated expertise in managing trust assets and there was no evidence that it took an active role in the trusts' management. There was little evidence that the trustee had any involvement in the trusts' affairs beyond the execution of agreements and administrative matters. Woods, J.

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[53] *Ibid*, at 5112.

[54] *Supra*, note 48, at para. 150. For other contrary views, see *Rostal Sales Agency Ltd. v. R.*, 1982 CarswellNat 381, [1983] C.T.C. 5, [1983] 1 F.C. 447, 83 D.T.C. 5036, [1983] 1 F.C. 447 (FCTD), in which Collier, J. notes, in obiter, at para. 23: "The mere fact that, at some time the settlor might be in a position to remove trustees at will, does not necessarily mean that incumbent trustees are mere nominees for the voting rights of any shares held by the trust", citing *CIR v. Silverts Ltd.* (1951), 29 TC 491; and see *Lusita Holdings Ltd. v. R.*, 1984 CarswellNat 226, [1984] C.T.C. 335, 55 N.R. 122, 84 D.T.C. 6346 (FCA), in which the Court of Appeal concluded that the right of one trustee to require the resignation of his co-trustee and appoint a successor did not give the former control of the voting power of shares held by the trust. The Court of Appeal noted that the trust indentures required both co-trustees to decide how the votes attaching to the shares should be cast and that the trustees were required "to exercise their duties and powers in a fiduciary capacity" (para. 4). Both of these cases concerned whether parties were "associated" under the *Income Tax Act*, R.S.C. 1985 ("*Income Tax Act* (Canada)").

[55] *Ibid*, at para. 191.

found that it was more likely than not that the trustee had agreed from the outset that it would defer to the recommendations of the Canadian resident beneficiaries respecting the sale of the shares, the investment of the share proceeds, distributions to the beneficiaries and appropriate steps to minimize tax. Query whether the result would have been different if the trustee had been more involved in the management of the trust property, namely, the investment of the sale proceeds. Would this activity have been enough to satisfy the "central management and control" test?

In light of *Garron*, careful attention must be paid to whether a settlor should be given power to remove and replace trustees, or to replace a protector who has been given the power to remove and replace trustees. Query whether this power, in and of itself, will be considered sufficient to amount to control and management the trust such that the trust may be found to be resident where the settlor is resident. Query whether the same concerns arise if the settlor is a co-trustee in whom the power to remove and replace trustees has been invested.

Also decided recently by the Tax Court of Canada is another international trust case called *Antle v. R.*[56]. The case involved a purported "capital property step up strategy" (also known as a Barbados spousal trust freeze). The plan involved a transfer of appreciated property to a Barbados spousal trust relying on subsection 73(1) of the *Income Tax Act* (Canada) to avoid a capital gain in Canada. The trust sold the capital property to the spouse for a promissory note. The capital gain was recognized in Barbados but exempt from Canadian tax under the *Agreement Between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital* (commonly known as the "Canada-

[56] 2009 CarswellNet 2792, 2009 TCC 466, which decision is also being appealed as *Paul Antle v. R.* and *Renee Marquis – Antle Spousal Trust v. R.* ("*Antle*").

Barbados Treaty"). The spouse sold the property to a third party and used the sale proceeds to repay the promissory note to the trust. The trustee then made a capital distribution of the proceeds to the beneficiary and terminated the trust.

The Minister reassessed Mr. Antle to include in his income the taxable capital gain arising from the sale of the shares arguing that the trust was not validly constituted, or if it was, it was a sham, that the requirements of subsection 73(1) of the *Income Tax Act* (Canada) were not met, and that the general anti-avoidance rule applied. In the alternative, the Minister argued that the taxable capital gain should be included in the trust's income, on the basis that it was resident in Canada.

On the validity of the trust, the court found the certainty of intention to be lacking. In doing so, it looked beyond the trust instrument to take into account all relevant facts, including the actions of the parties. Miller, J. came to the "inevitable conclusion" that Mr. Antle "did not truly intend to settle shares in the trust . . . he never intended to lose control of the shares or the money resulting from the sale. . . . He simply signed documents on the advice of his professional advisors with the expectation that the result would avoid tax in Canada. . . . This is not indicative of an intention to settle a discretionary trust."[57] The court was not convinced that Mr. Antle fully appreciated the significance of settling a discretionary trust, beyond an appreciation of the tax result it might provide, and found that the trustee never intended to have real control over the trust property or real discretion respecting management of the trust property.

Certainty of subject matter was also found to be absent on the basis that Mr. Antle retained a right to receive value in respect of the shares from a third party shareholder. As such, it was found that an element of ownership of the shares did not pass to the trustee.

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[57] *Ibid*, at para. 49.

The court also noted many problematic inconsistencies and inaccuracies in the documentation and mechanics of the transaction. Without certainty of intention and subject matter, the court concluded that the trust never validly came into existence.

The court's conclusion underscores the importance of proper execution:

> This conclusion emphasizes how important it is, in implementing strategies with no purpose other than avoidance of tax, that meticulous and scrupulous regard be had to timing and execution. Backdating of documents, fuzzy intentions, lack of transfer documents, lack of discretion, lack of commercial purpose, delivery of signed documents distributing capital from the trust prior to its purported settlement, all frankly miss the mark – by a long shot. They leave an impression of elaborate window dressing. In short, if you are going to play the avoidance game, it is not enough to have brilliant strategy, you must have brilliant execution.[58]

The *Antle* case stands for the proposition that the degree of control exercised by the beneficiary or settlor, and the lack of discretionary power afforded to and actually exercised by the trustee are factors that may threaten the very existence of a trust. The court describes the trustee (an individual) as a "young pawn in a masterful game of chess by some experienced trust masters."[59]

In light of *Antle*, it is critically important that a trustee of a discretionary trust fully appreciate the scope of the power that he/she has been given and that he/she exercise that power judiciously and independently. Just how "active" a trustee must be as a consequence of the *Garron* and *Antle* decisions remains to be seen. However, it would seem that taking an active role in the sale of the trust property and the investment of the proceeds of sale of the trust property are essential to proving that the trustee exercised his/her discretion. To ensure that the trust has been properly constituted and the trustee is exercising his/her discretionary power sufficiently to demonstrate

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[58] *Ibid*, at para. 58.
[59] *Ibid*.

central management and control, the trustee function cannot be reduced to mere administrative tasks.

Where the power to remove and appoint trustees has been reserved to a trust protector, the protector's powers, as well as his/her obligations and liabilities, flow from the trust instrument. These powers can be minor or sweeping, depending on the degree of flexibility necessary and appropriate in the circumstances of the trust.[60] The protector could serve a useful purpose by monitoring and policing the trustee or trustees, especially if given the ability to remove and replace trustees. However, bearing in mind the *Garron* decision, care must be taken in determining who can remove and replace the protector who, in turn, has the power to remove and replace trustees.

The power to appoint and remove trustees can be exercised under any circumstances provided for in the trust instrument. As noted, the trust agreement can specify much broader grounds for removal than the strict guidelines that must be followed by the courts pursuant to legislation. However, fiduciary obligations may restrict which actions an individual may take. In the United Kingdom, a power of appointment of trustees is a fiduciary power[61] and must be exercised in accordance with the holder's fiduciary duty. It is possible, however, for the trust instrument to specify that the power is to be conferred (on persons other than trustees) in a personal, non-fiduciary capacity.[62] Trustees, however, must always act in the best interests of the beneficiaries, so their powers would be inherently limited in scope by their fiduciary duty.

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[60] Philip J. Renaud, Q.C., "*Protectors and Domestic Trusts*" (2008) E.T.P.J. 241 ("Renaud").
[61] Practical Guide, *supra*, note 45 at 4.
[62] *Ibid.*

It is less clear whether protectors owe a fiduciary duty to the beneficiaries of a trust under Canadian law. Their ensuing obligations to beneficiaries are not entirely clear, and nor are the limits that any such obligations would have on their powers to remove and replace trustees clear. There is currently no certainty in Canada as to whether a protector should be treated as a fiduciary.[63] So far, in Canada, there has been no judicial consideration of protectors in breach of their duties.[64] That said, since the 1973 decision in *Canadian Aero Service Ltd. v. O'Malley*[65], the Supreme Court of Canada has recognized that fiduciary relationships may arise in non-traditional situations. One such instance might be a grantee of the power to remove a trustee who receives his or her power in a fiduciary capacity. In such a case, the grantee-beneficiary relationship will be governed by the principles of "loyalty, good faith, and avoidance of a conflict of duty and self-interest".[66]

It is widely recognized in both Canada and abroad[67] that where a grantee of an express power to remove a trustee holds that power in a fiduciary capacity, his or her actions must be guided by the welfare of the beneficiaries. This principle, enunciated in the seminal judgement of Lord Blackburne in *Letterstedt v. Broers*[68] implies that a grantee will be in violation of his or her fiduciary obligations if he or she chooses to exercise the power for his or her own benefit.

It follows then that a trustee who is influenced by the settlor or protector to take a decision favourable to the settlor, which could ensure that the trustee will not be removed, is a breach of the trustee's fiduciary duty. More significantly, it could, in the wake of *Antle* and *Garron* also

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[63] Renaud, *supra*, note 60 at 248.
[64] *Ibid*, at 252.
[65] [1974] 1 S.C.R. 592.
[66] Renaud, *supra*, note 60 at 250, citing *Canadian Aero Service Ltd. v. O'Malley*.
[67] See, for example, Waters, *supra*, note 21, at 845 and Practical Guide, *supra*, note 45, at 6, 38, 66, 75 and 97 for a recognition of this principle in England, the Bahamas, Cayman Islands, Guernsey and Jersey, respectively.
[68] [1884] UKPC 1 (BaiL II).

compromise the very constitution of the trust or cause the trust to be resident where the settlor resides if that is where central management and control of the trust abides.

The common law rules governing fiduciary obligations have expanded over time to encompass not only those situations where the fiduciary has reaped a benefit from his or her actions, but also to ambiguous situations in which there is a potential that the grantee's self-interest may conflict with that of the beneficiaries. It is therefore essential that the grantee exercise extreme caution in deciding to remove a trustee.

The doctrine of fraud on a power applies to persons who are granted special or limited powers of appointment under a trust instrument. Its application is not limited to fiduciaries, but includes both trustees and those who hold their power in a non-fiduciary capacity.[69] As such, it is likely to apply to a grantee of the express power to remove a trustee, whatever the nature of his/her appointment.

The purpose of the doctrine, which has been adopted by the courts of Ontario,[70] is to prevent the exercise of a power of special appointment for an unjustified purpose or with an unjustified intention.[71] As emphasized by Lord Hatterly in *Duke of Portland v. Topham*[72], this implies that a donee:

> . . . must act with good faith and sincerity, and with an entire and single view to the real purpose and object of the power, and not for the purpose of

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[69] Geraint Thomas, *Thomas on Powers*, First Edition (London: Sweet & Maxwell, 1998), at 455 ("Thomas on Powers").
[70] See, for example, *Edell v. Sitzer*, *supra*, note 28, (Can LII), at para. 164.
[71] *Walker v. Stones*, [2001] Q.B. 902, at 934H, cited in John McGhee, Q.C. (Ed.), *Snell's Principles of Equity*, 31st ed. (London: Sweet & Maxwell, 2005), at 243 ("Snell").
[72] (1864) 11 H.L.C. 32.

> accomplishing or carrying into effect any bye or sinister object (sinister in the sense of being beyond the purpose and intent of the power).[73]

Cullity suggests that this standard is less stringent than that imposed on trustees and thus it enjoys a "greater immunity from judicial interference which, for the most part is limited to annulling attempts to exercise a power that is considered to be fraudulent . . .".[74] Supporting this lower standard is the English decision is *Vatcher v. Paull*[75] in which Lord Parker distinguished a fraud on a power from others wrongs, stating:

> The term fraud in connection with fraud on a power does not necessarily denote any conduct on the part of the appointor amounting to fraud in the common law meaning of the term or any conduct which could be properly termed dishonest or immoral. It merely means that the power has been exercised for a purpose or with an intention, beyond the scope of or not justified by the instrument creating the power.[76]

It thus appears that a lack of fraudulent intention on the part of the donee is immaterial. Rather, the settlor's intention is paramount. Courts will consider a power to have been fraudulently exercised wherever the donee departs from the intentions voiced in the trust instrument, even if he/she honestly believes that the power is being exercised in a more beneficial way than that contemplated by the donor.[77] In general, the exercise of a power may be fraudulent under one of three circumstances:

1) The power is exercised pursuant to an antecedent agreement to benefit a non-object between the donee and an object of the power;

2) The power is exercised for a corrupt purpose; or

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[73] *Ibid*, at 54, cited in *Thomas on Powers*, *supra*, note 69, at 453.
[74] *Supra*, note 72.
[75] [1915] A.C. 372 (H.L.).
[76] *Ibid*, at 378.
[77] *Topham v. Duke of Portland* (1869), [1869] 5 Ch. App. 40 at 59.

3) The power is exercised for purposes foreign to the power.[78]

Where the actions of a donee of a special power of appointment deliberately defeat the intentions of the donor, the appointment is "said to be a fraud on the power, and equity holds it bad".[79] However, such a finding will not invalidate the power itself; it will simply invalidate the particular exercise of that power leaving the grantee free to make future appointments. Nonetheless, where a trustee commits a fraud on a power, that action will also constitute a breach of fiduciary duty.[80] For example, it is possible that a donee of an express power to remove a trustee who holds that power in a fiduciary capacity may be held to have breached his/her fiduciary obligations if he/she removes the trustee in circumstances beyond those contemplated by the settlor in the trust instrument.

In making a decision to remove a trustee from office, a grantee of an express power must first have accepted his/her powers in good faith and with the intention to exercise them in accordance with the wishes of the settlor. Second, he/she must have exercised those powers in accordance with those wishes. Finally, the power must be exercised in a way that does not benefit the grantee on either a pecuniary or non-pecuniary basis. Failing this, any appointment or removal of a trustee will be void[81] and the parties will be returned to the positions they would have held had the power not been exercised.

The fact that the provisions of a trust instrument take precedence over a statute does not imply that they are beyond challenge. A trustee who has been deemed unfit to act, unless removed

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[78] *Thomas on Powers*, *supra*, note 69 at 460.
[79] *Snell*, *supra*, note 71 at paras. 9 through 12.
[80] *Thomas on Powers*, *supra*, note 69 at 455.
[81] Note: As noted in *Snell*, *ibid*, note 79, a distinction must be drawn between an exercise of power that is void and one that is illegal. In the context of a fraud on a power, the void decision is not illegal and the grantee of the power is not precluded from exercising the power again.

from office pursuant to an express power granted in the trust instrument, is entitled to contest the grantee's conclusion as to his/her fitness. Therefore, in exercising his or her power to remove a trustee, the grantee's judgement will ultimately be subject to the scrutiny of the court. In determining whether a trustee who is removed pursuant to an express power is unfit or incapable to act, the courts will consider the same criteria as are applied in the exercise of their inherent jurisdiction to remove a trustee. As the court emphasized in *Letterstedt v. Broers*[82], foremost amongst these factors is the welfare of the beneficiaries.

Conclusion

The role of trustee of a discretionary trust is an onerous one and not one that should be assumed lightly. Irrespective of efforts by a settlor to insulate the trustee from judicial intervention and potential liability by granting "absolute" and "uncontrolled" or "unfettered" discretion, courts will exercise their supervisory jurisdiction over trustees' discretion in a variety of situations. Trustees must therefore take great care in exercising their discretion and use their best efforts to carry out the intention of the settlor, as difficult as it may be to ascertain that intention in many cases. In light of very recent tax case law, the consequences of a trustee of a discretionary trust failing to exercise discretion can be very serious indeed. Inaction by such a trustee may call into question the settlor's intention to settle the trust and thereby cause the trust to fail for this lack of certainty. An undermining or stripping away of the trustee's discretion by the settlor or others (including a power to remove and replace the trustee) will be a factor in determining where the central mind and management of the trust abides and thus where it is resident for tax purposes.

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[82] *Supra*, note 68.