Application of the *Bankruptcy and Insolvency Act* to the Trust of the *Civil Code of Québec*[*]

Albert BOHÉMIER[**]

This study addresses the advisability of rendering the Bankruptcy and Insolvency Act *applicable to a trust (*fiducie*) or a trust patrimony (*patrimoine fiduciaire*) within the meaning of the* Civil Code of Quebec.

In the 1994 Civil Code reform, the provincial legislator considerably expanded the scope of the trust in civil law. Relying on the notion of patrimony by appropriation, the provincial legislature wanted to create a trust based on the model of English law that could be consistent with civil law concepts. The Quebec trust became a private law institution of which the primary mechanisms have been codified.

It would be imprudent to attempt to anticipate the manner in which this renewed institution might develop in future, especially on commercial matters. In any event, if such an institution were used more widely in the field of business, the problem of the insolvency of a trust that carries on an enterprise would take on a new light.

Thus far members of the legal profession in Quebec have mainly been interested in the creation of the trust and in the rules governing its administration. To our knowledge, there has been no in-depth analysis of the conflicts that could result from the insolvency or bankruptcy of a trust.

The author of this study has attempted to draw the reader's attention to the potential legislative policy issues of such a legal situation as well as offering a number of possible solutions.

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[**] Senior Counsel with Joli-Cœur, Lacasse, Geoffrion, Jetté, St-Pierre and professor emeritus of the Faculty of Law of the Université de Montréal.

Outline

Advisability of Establishing Provisions Relating to the Bankruptcy of a Trust Within the Meaning of the *Civil Code of Québec*

Trusts were already recognized in the 1866 Civil Code, but in a very limited way. It was not until the special statute of 1879, which was integrated into the Civil Code in 1888, that Quebec adopted its first overall scheme with regard to gratuitous trusts.[1]

During the Civil Code reform in 1994, the legislator wanted to make the rules governing Quebec trusts more flexible, thereby fostering greater use of them. It is still too soon to know the extent to which that desire to broaden the scope of the trust will meet its objectives.

A variety of factors may impede the development of that institution. Various groups have shown some reluctance towards the idea of incorporating such a notion into the system of civil law. There may also be fears concerning the potential reaction of the courts.[2]

> *I think that the use of Quebec trusts as commercial vehicles outside of the province of Quebec will likely be something that will take time to evolve. The new C.C.Q. provisions that came into force on January 1, 1994 have, to a very large extent, no precursors in the Quebec or other civil law systems. This means that it will take some time before a canon of jurisprudence (and practice) evolves to the point that practitioners and business people are comfortable with the new rules. Uncertainty of that sort is, generally speaking, unattractive in a commercial context.*[3]

Notwithstanding such reluctance, the 1994 reform may well foster an increased development of the trust in Quebec in a context of

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1 J.E.C. Brierley, "De certains patrimoines d'affectation: Les articles 1256-1298" in *La réforme du Code civil*, vol. 1 (Sainte-Foy, Qc.: Presses de l'Université Laval, 1993) 735 at para. 6.

2 R.A. Macdonald, "The Security Trust: Origins, Principles and Perspectives" in *Meredith ConferenceLectures* (Montréal: McGill University, Faculty of Law, 1997) 155 at paras. 27-32.

3 W.I. Innes, "Advantages and Disadvantages in Using a Quebec Trust or an Ontario Trust in Commercial Matter: A Comparative Analysis" in *Meredith Conference Lectures*, *supra* note 2, 389 at 416.

commercial relations.[4] For example, it is easy to imagine a testator assigning his commercial enterprise to a trustee charged with administering it and operating it for the benefit of an heir[5] or using it as security for the performance of an obligation.[6]

It is obvious that such forms of trusts established for commercial purposes entail insolvency risks. The enterprise behind them may incur debts that exceed the value of the property held in trust. This would be an example of a situation in which the question would arise as to whether the trust should be subject to the *Bankruptcy and Insolvency Act* in order to ensure a more equitable distribution of the property of the trust among the various categories of creditors.

It should be noted that it is not our intention to analyze in this study the fate of how the trust should be treated in the common law provinces. Our sole focus will be Quebec trusts. However, it may be useful to observe that there are those who would like to revisit the question of the trust in common law:

> *However, let me be frank, and say that this – the personification of the common law trust – is not necessarily an unthinkable development. As we shall see in the final chapter, the idea is abroad and the twentieth century may not be over before we hear the serious suggestion made that the common law trust itself be recognized, as so many common law practitioners appear incorrectly to see it, as* a persona.[7]

Irrespective of the fate reserved to the common law trust, our analysis will be confined to the Quebec trust and its treatment from the standpoint of harmonization of the federal legislation with the *Civil Code of Québec*.

The question we are asking here is the following: to what extent would it be advisable to amend the *Bankruptcy and Insolvency Act* (hereinafter *B.I.A.*) to enable a trust within the meaning of the *Civil Code of Québec* to take advantage of the provisions

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4 C. Bouchard, "L'exploitation d'une entreprise par une fiducie : Une alternative intéressante?", (2000) 102 R. du N. 87.

5 This strategy has long been used in English law. See *e.g. Re Evans*, [1887] 34 Ch.D. 597 (C.A.); *Dowse* v. *Gorton*, [1891] A.C. 190.

6 The name of "security trust" is generally given to this form of security.

7 D.W.M. Waters, "The Institution of the Trust in Civil and Common Law" (The Hague: Academy of International Law, Collected Courses, vol. 252) at 406, cited by Innes, *supra* note 3 at 416, n. 86.

of that federal statute in similar fashion to any other person or organization? If it would be, what would be the consequences of such a legislative amendment on the rights and obligations of the settlor, the trustee and the beneficiary of the property held in trust and the various creditors?

It appears obvious at the outset that the fundamental objection that one might be tempted to make against any such proposed reform relates to the current law and the English tradition. English and Canadian law do not contain any provisions that address the possibility of the bankruptcy of a set of property held in trust, based on that argument that such property would form a trust of a particular nature. The English bankruptcy statute includes the "trust" in its application. Paragraph 283(3)(a) of the *Insolvency Act* of 1986 provides, as does the Canadian statute, that property held in trust is excluded from bankruptcy:

> *... that property held by the bankrupt on trust for any other person is not included in the bankrupt's estate.*[8]

As well, subsection 281(3) of the English statute provides that an order of discharge does not release the bankrupt of debts incurred as a trustee in connection with "any fraud or fraudulent breach of trust to which he was a party."[9]

Aside from that, the English legislation on bankruptcy does not contain any other significant rules on "trusts". In other words, all of the legal problems relating to property and to the rights of the parties arising out of the fact that bankruptcy has been declared against a person acting as a trustee or involves property or rights associated with a trust must be resolved under the rules of common law and in particular the rules of equity that apply in that area.

The question is therefore whether or not, despite the harmonization objectives that are being pursued, we should adopt the approach used under English law and avoid making any reform. Might it not be considered strange that the trust of the C.C.Q., modeled on the trust of English law, be subject to specific rules in the event of bankruptcy when the common law trust on which it is based is not?

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8 I.F. Fletcher, *The Law of Insolvency*, 2d ed. (London: Sweet & Maxwell, 1996) at 209.

9 *Ibid.* at 318.

On the other hand, given that the manner in which certain disputes are settled is based on the law of equity, one might be encouraged on the contrary, if only for harmonization purposes, to take steps to ensure where applicable that the supplementary law in effect in that regard is constituted by the rules of the C.C.Q. and not those of equity law.

A second objection to the idea of a proposed reform relates to whether the federal Parliament should treat the trust of the *Civil Code of Québec* as a "person" when the Code itself does not recognize it as having any juridical personality.

In our view, such an objection is not valid. The fact that an organization or group becomes a "person" within the meaning of the *B.I.A.* does not necessarily confer juridical personality on it.

In reality, an organization or group would be deemed a "person" for the purposes of application of the federal legislation only. Accordingly, the organization or group in question could become a "debtor" or a "creditor" within the meaning of that statute and its acts prior to the bankruptcy could henceforth be contested as "preferential payments" or "reviewable transactions". This is the advantage of considering an organization or a group to be a "person" within the meaning of the *B.I.A.*

The procedure is not new. Under section 2 *B.I.A.*, ""person" includes a partnership,[10] an unincorporated association ..." Along the same lines, section 44 *B.I.A.* provides that "a petition for a receiving order may be filed against the estate of a deceased debtor."[11]

Accordingly, to determine the advisability of making the *B.I.A.* applicable to Quebec trusts, the following questions must be asked instead.

Is the trust of the *Civil Code of Québec* similar to the English trust? Are there on the contrary sufficient differences between the two institutions to warrant legislative intervention in the interest of harmonization? The first part of this text will compare the trust

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10 See *e.g. Langille* v. *Toronto Dominion Bank* (1982), 40 C.B.R. (N.S.) 113 at 114 (S.C.C.); *Re Kingsberry Properties Ltd.* (1998), 3 C.B.R. (4th) 135 (Ont. C.A.).

11 A. Bohémier, *Faillite et insolvabilité*, t. 1 (Montréal: Thémis, 1992) at 134-35.

in English law with that of the C.C.Q. Second, if it has been determined that reform is desirable, we will then examine the impact that such changes could have on the application of the law.

I. Comparison between the English Trust and the Quebec Trust

In this first part we will endeavour to establish the similarities and differences between those two institutions. The comparison will address the nature of those institutions and the rights and obligations of their various components and of their creditors.

A. Nature of the Institution

We will be focusing on two questions. From a legal standpoint, is there any difference between the nature of the English trust and the Quebec trust? Since there are distinctions among various types of trusts, are the categories used in English law and Quebec law the same?

1. The Trust in English Law

It has been through the system of equity[12] that the trust has been able to develop in English law:

> *The key to the trust and its direct ancestor, the use, is this: they are creatures of equity. That is, they were enforced in the courts of chancery on the basis of conscience.*[13]

The basic idea behind the "trust" is to consider the trustee to be the nominal owner or the person who holds title to the property held in trust, whereas the true owner – the party who is to benefit from it – is the beneficiary under the trust, often called the "*cestui*

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12 P.H. Pettit, *Equity and the Law of Trusts*, 5th ed. (London: Butterworths, 1984) at 10-11.

13 A.H. Oostherhoff, *Cases and Materials on the Law of Trusts*, 2d ed. (Toronto: Carswell, 1983) at 1.

que trust". In other words, "the trustee is the legal owner, the cestui que trust the equitable owner."[14]

The trust therefore effects a type of division of the right of ownership. The trustee has legal title to the property while the beneficiary holds a "beneficial interest" (beneficial title) to it. It is that split in the title with regard to right of ownership that makes the integration of the trust into the system of civil law so difficult.

2. The Trust in Quebec Law

It is important here to distinguish between the scheme prior to the 1994 reform and the scheme established by it.

a. Scheme of the *Civil Code of Lower Canada* (C.C.L.C.)

Notwithstanding a number of special statutes, under the scheme of the former Code (C.C.L.C.), the trust, modeled on the English trust, had only a very limited role. Introduced in 1879 through a special statute,[15] it was integrated into the *Civil Code of Lower Canada* in 1888. In the C.C.L.C. only the trust established by donation or by will was recognized:

> *Limited in its application to the area of donations, the trust did not apply to business relations.*[16]

This incorporation of the trust into the *Civil Code of Lower Canada* gave rise to doctrinal and precedential controversies on the nature of the right held by the trustee over the property in the trust.[17] It seems to us that the dominant opinion was to consider that the trustee held a *sui generis* right of ownership.[18]

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14 Petit, *supra* note 12 at 22.

15 *An Act respecting Trusts*, S.Q. 1879, c. 29.

16 R. Godin, "Utilisation de la fiducie dans le domaine commercial au Québec", in M. Cantin Cumyn (ed.), *La fiducie face au trust dans les rapports d'affaires*, XV[e] Congrès International de Droit Comparé (Bruxelles: Bruylant, 1999) at 156 [translated].

17 On such controversies, see J. Beaulne, *Droit des fiducies* (Montréal: Wilson & Lafleur, 1998) at paras. 12-33.

18 See *Curran* v. *Davis*, [1933] S.C.R. 283; *Royal Trust Co.* v. *Tucker*, [1982] 1 S.C.R. 250; Brierley, *supra* note 1 at para. 7.

b. 1994 Reform and Scheme of *Civil Code of Québec*

The new *Civil Code of Québec* (C.C.Q.) has adopted the notion of *patrimony by appropriation* as the basis for the trust and considerably broadens its scope. A trust can henceforth be established by onerous title or gratuitously, by contract, by operation of law or even by judgment, where the law provides (art. 1262 C.C.Q.). The purpose of the reform was two-fold: to make the trust in the Code more attractive and more commonly used, and to make it more consistent with the concepts of civil law:

> *The new Quebec law governing the trust is largely modeled on the trust of the common law. The challenge for this reform is precisely to integrate into the Quebec civil law some of the important features of the common law trust, without violating the fundamental principles of civil law.*[19]

Under the C.C.L.C. it was legitimate to refer to the common law to interpret the Quebec trust without, however, introducing the whole of English law.[20]

In the new Civil Code, the trust has become a patrimony by appropriation. Unlike with the trust, neither the trustee nor the beneficiary possesses the right of ownership over the property in the trust. Under article 1261 C.C.Q.:

> *The trust patrimony, consisting of the property transferred in trust, constitutes a patrimony by appropriation, autonomous and distinct from that of the settlor, trustee or beneficiary and in which none of them has any real right.*

However, to ensure that the property in the trust does not become property without an owner, article 1278 C.C.Q. provides that the trustee has the control and the exclusive administration of the trust patrimony.

c. Conclusion

Although this has ultimately few consequences in concrete terms, the Quebec trust has a great deal of inherent similarities with the trust of English law. However, the Quebec trust is an entirely

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19 A. Morrissette, "Réforme du Code civil : Fiducie" (1993) 15:3 R.P.F.S., 737 at 739 [translated].

20 Beaulne, *supra* note 17 at para. 63. See *Royal Trust Co.* v. *Tucker*, *supra* note 18 at 261.

autonomous patrimony which has no owner. The English trust, on the contrary, effects a division in ownership: the trustee holds a "legal right" to the property in the trust while the beneficiary acquires a "beneficial interest" in the property.

This English conception may explain why it was considered appropriate to stipulate in the bankruptcy statutes, both English and Canadian (s. 67 *B.I.A.*), that "the property of a bankrupt … shall not comprise … property held by the bankrupt in trust for any other person."[21] Since the trustee holds a right of ownership (legal title) to the property in the trust, that wording was based on the idea that the beneficiary could not be deprived of his rights associated with his beneficial interest. Such wording is not equally useful for Quebec trusts. Since the trustee does not own the property in the trust, in the event of bankruptcy he cannot transfer any real rights over the property to the trustee in bankruptcy. Section 67 *B.I.A.* nonetheless has the advantage of confirming the idea that the trustee in a trustee's bankruptcy does not acquire the rights of control and exclusive administration the latter held over the property in trust. Under article 1355(1) C.C.Q., the duties of the trustee, who is an administrator of the property of others (art. 1278, para. 2 C.C.Q.), terminate upon his becoming bankrupt.

B. Types of Trusts

The English law recognizes various types of trust. This study will not enter into a detailed analysis of this question; however, the following major categories of trust have generally been identified:

1. **Express Trust**: The settlor clearly expresses his intention to create a trust. This category covers the "declaration of

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21 *Insolvency Act 1986* (U.K.), 1986, c. 45, s. 283(3). We note that section 67 *B.I.A.* raises certain problems of interpretation. Does that provision apply solely to the common law trust, which requires that property be able to be traced? See *British Columbia* v. *Henfrey Samson Belair Ltd.*, [1989] 2 S.C.R. 24. It would appear that section 67 is sufficiently broad to cover all cases in which a trust is created. See Honourable L.W. Houlden & Morawetz, *The 2001 Annotated Bankruptcy and Insolvency Act* (Scarborough, Ont.: Carswell, 2000) at 262, F§5. However, section 67 would not cover situations in which a simple fiduciary relationship is created between the parties affecting the amounts held by the bankrupt of a trust in favour of persons towards whom the bankrupt is responsible in the capacity of fiduciary. See on this subject: Fletcher, *supra* note 8 at 209.

trust", whereby the settlor, through his unilateral declaration, creates a trust.

2. **Implied Trust**: In this case the settlor's intention to establish a trust has not been clearly expressed but can be deduced from the words he has used or by his acts.[22]

3. **Resulting Trust**: A resulting trust is created when, for example, a person purchases property with another person's money, transfers it to the name of another person or registers the property in his own and another person's name.

4. **Constructive Trust**: This type of trust is created by order of a court of equity, irrespective of the settlor's intention.

5. **Statutory Trust**: A statutory trust is created by a provision of the law.

6. **Discretionary Trust**: With this type of trust, the trustee has the discretion of paying certain beneficiaries of the trust to the exclusion of others.

7. **Protective Trust**: A beneficiary can take advantage of a protective trust throughout his lifetime. It terminates upon a specific event, such as bankruptcy, and enables the trustee to exercise his discretion on behalf of other beneficiaries.

The *Civil Code of Québec* recognizes only a limited number of types of trust. The express trust is the only one recognized. With the exception of the implied trust, which is open to discussion, there cannot be a resulting trust or a constructive trust.[23] As well, a trust cannot be established simply by unilateral declaration.[24]

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22 Pettit, *supra* note 12 at 54. This work discusses the existence of the implied trust in Quebec law: see Beaulne, *supra* note 17 at paras. 172-177.

23 D. Bruneau, "La fiducie et le droit civil", (1996) 18:4 R.P.F.S. 755 at 762, n. 19; L. Morency, "La fiducie (Trust) : Une institution de Common Law dans un contexte de droit civil" in *Conférences sur le nouveau Code civil du Québec : Actes des Journées louisianaises de l'Institut canadien d'études juridiques supérieures,1991* (Cowansville, Qc.: Yvon Blais, 1992) 1 at 7: "The scope of the proposed provisions is limited to express trusts and does not cover resulting trusts or constructive trusts" [translated].

24 Beaulne, *supra* note 17 at paras. 178-181.

In reality, the Civil Code characterizes trusts according to the manner in which they are established (art. 1262 C.C.Q.): by contract, by will, by operation of law or by judgment, where authorized by law (see, for example, article 591 C.C.Q.). This classification of Quebec trusts is of little significance since the rules by which trusts are established are generally the same in all cases. Regardless of the legal source, the trust itself can exist only if the settlor transfers property to the patrimony that has been created.[25]

In this context, it seems easier to contemplate a trust declaring bankruptcy. Since a trust has an express nature regardless of its source, the proof of its existence and the determination of the property that comprises it raise relatively fewer difficulties.

II. The Parties' Rights and Obligations

Introduction

Aside from the legal nature of each of the two institutions (at 121, above), it is undoubtedly here that the most fundamental differences between the English and Quebec trusts arise. The final outcome of each of the two systems is quite similar but the method used and the procedure that applies are rather different. As we will see, the English trustee is, in principle, personally liable for the debts incurred, even when he is acting in the context of the trust, whereas the trustee of a Quebec trust, as an administrator of the property of others, assumes no personal responsibility. It is the trust itself that is engaged. Like any other patrimony, a trust has assets that serve as security for its liabilities.

In light of this situation, it is easier to understand why English law has not contemplated the bankruptcy of a trust devoid of all juridical personality, while the Quebec trust, as an autonomous and distinct patrimony, lends itself more readily to this. That is why in the following lines we will be analyzing the rights and obligations of the parties under the system of the English trust and that of the Quebec trust.

It is not our intent here to analyze in detail the rights and obligations of each party in the trust (settlor, trustee, beneficiary, and

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25 *Ibid.* at para. 130.

their respective creditors). Such an undertaking would require an in-depth analysis of English case law and doctrine and would not be of a great use here.

The English trust is different from the Quebec trust. The latter is regulated fairly closely by the provisions of the new Code pertaining to trusts (art. 1260 C.C.Q.) and the administration of the property of others (art. 1299 C.C.Q.). It is true that English law, like the law in the Canadian common law provinces, has enacted legislation to clarify certain rights of the trustee.[26] Those statutes have added to the previous law without really changing its substance.

Our analysis centres on the Quebec trust. It seems to us that the fundamental question is to determine which persons would have claims against a trust patrimony declared to be in bankruptcy and in what capacity. It will then be necessary to establish the remedies that the trust patrimony, represented by the trustee in bankruptcy, could itself exercise. The other remedies that could be exercised among the various other parties to the trust or even against third parties should continue in principle to be governed by the rules of *jus commune*.

If a trust patrimony were declared to be in bankruptcy, this would mean that its indebtedness was higher than the realizable value of its assets. In such a scenario there would no longer be any trust property that could be transferred by the trustee to the beneficiaries or, failing this, to the settlor of the trust.[27]

A. The Rights of the Settlor, the Beneficiary and their Creditors

In creating a trust, the settlor abandons ownership of the property transferred in the trust patrimony. This means that the settlor's personal creditors no longer hold any rights over the trust

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26 See in English law: *Trustee Act 1925* (U.K.), 1925, 15 Geo. V, c. 19 and the amendments of 1893, c. 20, now the *Trustee Act 2000* (U.K.), 2000, c. 29; see also, for example: *Trustee Act*, R.S.O. 1990, c. T-23.

27 The nature of this right to return the property to the settlor (art. 1297 C.C.Q.) is open to discussion; see Macdonald, *supra* note 2 at para. 159, which speaks of a "reversionary right", without going into greater detail. Beaulne, *supra* note 17 at para. 475, is of the view that this could not involve a "resulting trust" within the meaning of the common law.

property itself. If applicable, they could seize only the settlor's residuary right.[28]

At best, the settlor will have a right of oversight over the trustee's administration. By inserting the appropriate clauses in the constituting act, he could thereby play a more active role during the life of the trust:[29] designation or replacement of the trustee, power to appoint the beneficiaries, etc.

As for the beneficiary of the trust, his rights are no more extensive. The beneficiary is the person who is to receive the benefits of the trust. While the trust is in effect, the beneficiary holds only a personal right against the trust (art. 1284 C.C.Q.). However, as the holder of that right, he can transfer it to a third party (art. 1285 C.C.Q.), unless the constituting act contains inalienability or exempt of seizure clauses. Moreover, unless there is such a limitation clause, the beneficiary's creditors can seize that right to benefit from the trust but they have no remedy against the trust property itself.

Finally, if the trust patrimony enters into a deficit position, the rights of the settlor and the beneficiary are subordinate to those of the trustee and the creditors of the trust.

> *Should the trust become bankrupt, the residuary rights of the settlor and the rights of the beneficiary will, in principle, be similar to those of a shareholder of a corporation. The beneficiary will take only after all creditors of the trust – secured, privileged and unsecured – have been fully paid. Some suggest that the beneficiary is an ordinary, unsecured creditor of the trust who should rank pari passu with other unsecured creditors, but this would be to mischaracterize the relationship of the beneficiary to the trust patrimony. The beneficiary does not have a personal right as a creditor against the trust since the trust is not a legal person.*[30]

If the trust patrimony were to be considered a "person" for the purposes of the application of the bankruptcy statute (see at 137, above), it would be necessary to ensure that the granting of such status did not have the effect of enhancing the beneficiary's rights.

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28 D.-C. Lamontagne, *Biens et propriété*, 2d ed. (Cowansville, Qc.: Yvon Blais, 1995) at para. 186.

29 Beaulne, *supra* note 17 at para. 189. If this role is too broad, it could be claimed that there is contract of mandate between the settlor and the trustee, which could be such as to engage the responsibility of the settlor.

30 Macdonald, *supra* note 2 at para. 160.

B. The Rights of the Trustee and of the Creditors of the Trust

Here the rules of English law and those of the *Civil Code of Québec* are quite different. We provide a summary of those differences below. This will serve to explain why there might be a stronger inclination to establish provisions relating to the bankruptcy of a Quebec trust patrimony as compared with the English tradition.

1. English Law

In principle, the trustee under English law is personally responsible towards third parties for debts incurred in the administration of a trust:

> *A trustee is personally liable on the contracts into which he enters, unless he excludes personal liability by express stipulation, and the knowledge of those who deal with him that he is contracting in his capacity as trustee is immaterial... Accordingly, where a trustee trades or otherwise deals with trust property, he is deemed, as against all persons other than the beneficiaries, to do so on his own account, and is consequently personally liable for all debts incurred in the course of the trade or dealing and may be made bankrupt in respect of it.*[31]

In consideration of the above, the trustee is entitled to seek compensation from the trust property itself, against which he has a lien so as to ensure he is reimbursed.[32] If necessary, the trustee may seek compensation from the beneficiary *sui juris and solely* for his duly incurred expenses and obligations.[33]

In principle, those creditors who have contracted with the trustee have no direct remedy against the trust property as such. However, given that the trustee is entitled to claim compensation

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31 *Halsbury's Laws of England*, vol. 48, 4th ed. (reissue) (London: Butterworths, 2000) at 652, para. 976; Pettit, *supra* note 12 at 404; A. Tettenborn, "The Trust in Business: Property and Obligation in England", in Cantin Cumyn (ed.), *supra* note 16 at 48; see also Innes, *supra* note 3 at 412.

32 *Halsbury's Laws of England*, *supra* note 31, n. 4; Underhill & Hayton, *Law Relating to Trusts and Trustees*, 14th ed. (London: Butterworths, 1987) at 699ff.; *Re Evans*, *supra* note 5; *Dowse* v. *Gorton*, *supra* note 5.

33 *Hardoon* v. *Belilios*, [1901] A.C. 118 at 124 (P.C.): "... a cestui que trust ought to save his trustee harmless as to all damages relating to the trust". *Halsbury's Laws of England, supra* note 31 at 524-25, para. 785, n. 3; Tettenborn, *supra* note 31; Pettit, *supra* note 12 at 404-06.

for duly incurred obligations, the creditors may then exercise their rights over the property in the estate by invoking a form of subrogation.[34]

Moreover, if the trustee becomes insolvent, his right to compensation from the trust property is transferred by operation of law (subrogation) to the creditors as a whole.[35]

The author of these lines has found relatively few developments in connection with the trustee's right to receive compensation for his services. The reason for this may be that, under common law, a trustee was required in principle to perform his duties free of charge. However, in North America, the practice of professional trustees being paid for their services has always been recognized.[36]

When a trustee is entitled to compensation, he may be paid from the property held in trust but he generally has no remedy against the beneficiary. There are, however, two exceptions to that rule:

> *... where they [trustees] undertook the trust at the request of a settlor who is also a beneficiary... and except where the beneficiary or beneficiaries are sui juris and solely entitled to the trust property.*[37]

Those are the rights and remedies generally conferred on creditors and on the trustee under English law. However, our limited

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34 Underhill & Hayton, *supra* note 32; *Re Johnson*, [1880] 15 Ch.D. 548; *Re Raybould*, [1900] 1 Ch. 199. In English law, subrogation normally requires that payment be made: *Coursolles* v. *Fookes*, (1889) 16 O.R. 691. However, it would appear that subrogation is also a more commonly used remedy for avoiding unjust enrichment. See *Orapko* v. *Manson Investments Ltd.*, [1977] 3 All E.R. 1, [1978] A.C. 95 at 104: "My Lords, there is no general doctrine of unjust enrichment recognised in English law. What it does is to provide specific remedies in particular cases of what might be classified as unjust enrichment in a legal system that is based on the civil law. There are some circumstances in which the remedy takes the form of "subrogation", but this expression embraces more than a single concept in English Law.

> *It is a convenient way of describing a transfer of rights from one person to another, without assignment or assent of the person from whom the rights are transferred and which takes place by operation of law in a whole variety of widely different circumstances."*

See also *Re TH Knitwear (Wholesale) Ltd.*, [1988] 1 All E.R. 860 at 865: "However, though there are many reported cases relating to subrogation, the limits of the principle are ill-defined and obscure."

35 Tettenborn, *supra* note 31.

36 Oostherhoff, *supra* note 13 at 865.

37 *Ibid.* at 872-73.

research did not reveal how the trust property was allocated among them when the trustee was insolvent and the trust showed a deficit.

2. Quebec Civil Law

It is evident that the rules that apply in civil law are quite different from those of English law. Articles 1260 to 1298 C.C.Q. deal with trusts. Those provisions simply provide, at article 1278, para. 2, that the trustee "acts as the administrator of the property of others charged with full administration." To establish the rights and obligations of the parties, it is necessary to refer to articles 1299 to 1370 C.C.Q. relating to the administration of the property of others.

Having the control and the exclusive administration of the trust patrimony (art. 1278 C.C.Q.), the trustee may exercise all rights pertaining to the patrimony and take any proper measure to secure its appropriation:

> *He may proceed to sell or exchange the property under his control without any problem; he is also authorized to make the property subject to any security ...*[38]

a. Determination of Liability in the Bankruptcy of a Trust Patrimony

With respect to the trustee's obligations and the creditors' rights, the fundamental rule is found in article 1319 C.C.Q.:

> *Where an administrator binds himself, within the limits of his powers, in the name of the beneficiary or the trust patrimony, he is not personally liable towards third persons with whom he contracts.*
>
> *He is liable towards them if he binds himself in his own name, subject to any rights they have against the beneficiary or the trust patrimony.*

In principle, a Quebec trustee who acts on behalf of a trust patrimony does not assume his liability in any way, unlike the English trustee. The creditors thus acquire a direct remedy against the trust property. The same holds true when a trustee has acted in his own name. In that case, third parties have a remedy against the trustee

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38 Beaulne, *supra* note 17 at para. 298 [translated].

personally or against the trust patrimony by bringing an action against the trustee in his capacity as administrator.[39]

If the trust patrimony is showing a deficit, the result will be a *pari passu* ranking among the creditors themselves on the one hand and between the creditors and the trustee for his legitimate claims. In that type of situation, since the trust patrimony is insolvent, we do not see why the *Bankruptcy and Insolvency Act* would not apply as is the case for any insolvent debtor. Why would a creditor holding a prior claim be paid before a hypothecary creditor when normally, in the event of bankruptcy, the situation would be different? In other words, it would seem legitimate for the distribution of the property in an insolvent trust patrimony to be subject to the same rules as any other insolvent person who carries on an enterprise in Canada.

Under the Civil Code, a trustee's duties terminate upon his becoming bankrupt (art. 1355 C.C.Q.) but not when the beneficiary of that administration becomes bankrupt.[40]

As for the end of the trust itself, it is governed by articles 1296 to 1298 C.C.Q. It goes without saying that, at the time, the provincial legislature could not consider bankruptcy to be the cause of a trust's extinguishment. However, under article 1296, para. 2 C.C.Q., the trust is terminated by "the impossibility, confirmed by the court, of attaining" the purpose of the trust.

Turning to *In re : La succession de feu Pierre des Marais,*[41] the bankruptcy of a trust can be considered to lead to its extinguishment:

> *Under the* Civil Code of Quebec, *the trust also terminates by the impossibility, confirmed by the court, of attaining the purpose of the trust.* ***Such would be the case here if there were no longer any property to administer***.[42]

If provisions relating to the bankruptcy of the trust patrimony were to be established, would it be useful for the federal legislator

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39 See art. 59, para. 3 *Code of Civil Procedure*.

40 Brierley, *supra* note 1 at para. 96: "the bankruptcy of the beneficiary terminates the administration of the property only if it has an effect on the property administered" [translated].

41 [1997] R.J.Q. 2662 (C.Q.).

42 *Ibid.* at 2666-2667 [emphasis added] [translated].

to provide that the latter automatically terminates the trust? In our view, it would be neither necessary nor really useful to adopt such a provision. It seems to us that it could give rise to some constitutional difficulties.

If the trust patrimony becomes a "person" who can be declared bankrupt under federal legislation, all of its property will be vested in the trustee pursuant to subsection 71(2) *B.I.A.* The trust would thereby be emptied of its content and the trustee of the patrimony would no longer have any property to administer. The trustee in the bankruptcy of the trust patrimony could henceforth administer it and wind it up.

The only difficulty lies in the fact that, as long as the trust has not terminated, there are no provisions requiring the trustee to render an account.[43] Would terminating the trust necessitate a judgment from a *jus commune* court? Would the bankruptcy court have the authority to rule on such a matter? The simplest solution, in our view, would be for the federal legislation to provide that the trustee shall, as the case may be, render an account of his administration, at the request of the trustee in the bankruptcy of the trust patrimony, or provide the latter with a copy of the account made by the trustee to the beneficiary of the trust (art. 1363 C.C.Q.).

In the event of the bankruptcy of the trust patrimony, the trustee in the bankruptcy acquires seisin thereof and the trustee of the patrimony must hand the trust property over to the latter. A difficulty could arise here by virtue of the fact that article 1369, para. 2 C.C.Q. provides that a trustee may "retain the administered property until payment of what is owed to him" (expenses and remuneration). In addition, if that right of retention pertains to movables, the trustee's claim would become a prior claim (art. 2651(3) C.C.Q.).

The fact that such a claim is deemed to be a prior claim can be explained by the fact that the trustee of the patrimony's expenses are generally incurred in the common interest or, at the very least, in the interest of others. However, in the event of a bankruptcy, such a priority disappears.

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43 See art. 1363 C.C.Q.

The trustee of the patrimony's right of retention could have a more detrimental effect on the effective administration of the bankruptcy. A right of retention is effective against the trustee in the bankruptcy of the trust patrimony and confers the status of secured creditor.[44] In our view, the federal legislation should provide that the trustee of the patrimony cannot exercise his right of retention against the trustee in the bankruptcy. At the same time, the law should also provide that the trustee of the patrimony's claim is a preferred claim.

Regarding the distribution of the property in a bankrupt trust patrimony, it should follow the order set out by the federal legislation. The rights of secured creditors would be protected and unsecured creditors would be paid on an equal footing subject to the priorities of section 136 *B.I.A.*

Only the trustee's claims could raise certain special difficulties. Such claims can be placed in three categories:

1. Remuneration that is set by the constituting act or, failing this, by usage or according to the value of the services rendered (art. 1300 C.C.Q.).

2. Expenses incurred by the trustee in the performance of his duties to attain the purpose of the trust. With regard to administration of the property of others, article 1367, para. 1 C.C.Q. provides as follows:

   > *Administration expenses, including the cost of rendering account and delivering the property, are borne by the beneficiary or the trust patrimony.*
   >
   > *The resignation or replacement of the administrator binds the beneficiary or the trust patrimony to pay him, apart from the administration expenses, any remuneration he has earned.*[45]

3. Obligations which were assumed by the trustee in his own name and which benefited the trust patrimony. In that case, as we have seen, the third party has a remedy against the trustee personally and also against the trust patrimony (art. 1319, para. 2). If the third party brings an action against the

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44 *Federal Law – Civil Law Harmonization Act, No. 1*, S.C. 2001, c. 4, s. 25 (modifying s. 2(1) "secured creditor" *B.I.A.*).

45 M. Cantin Cumyn, *Traité de droit civil : L'administration du bien d'autrui* (Cowansville, Qc.: Yvon Blais, 2000) at para. 391 [translated].

trustee personally, the latter should then be able to initiate a claim against the trust patrimony as a subrogate.

To ensure that the amounts owing to him are paid, the trustee of the patrimony may assert compensation. Under article 1369, "An administrator is entitled to deduct from the sums he is required to remit anything ... the trust patrimony owes him by reason of the administration."

The exercise by the trustee of the patrimony of such a right to compensation presupposes that there is sufficient liquidity in the trust patrimony. If the latter is declared bankrupt, as has been suggested, there is no reason to deprive the trustee of the exercise of that right. The *Bankruptcy and Insolvency Act* itself provides in subsection 97(3) that any creditor may invoke the rules of set-off against the trustee in bankruptcy.

If this does not enable the trustee of the patrimony to be paid in full, article 1369, para. 2 C.C.Q. confers on him a right to retain the administered property. That right is exercised effectively against movables since it is associated at the same time with preferred status. We discussed earlier how that right of retention should be addressed.

With regard to unpaid claims of the trustee in the bankruptcy of the trust patrimony, we would be inclined to grant them a level of preferred status in the bankruptcy, at least in relation to the trustee's compensation, expenses associated with rendering account, and administrative expenses duly incurred by the trustee in attaining the purposes of the trust. Such expenses are incurred not in the interest of the trustee himself but rather for the benefit of the beneficiary and the creditors. As for claims based on obligations contracted by the trustee in his own name but on behalf of the trust, in our view they should not receive any special treatment. The trustee should come to the bankruptcy as subrogated to the rights of a creditor whose claim has been paid by the trustee.

b. Determination of the Property in the Bankruptcy of a Trust Patrimony

The determination of the property in the bankruptcy of a trust patrimony should not be the source of any difficulties. Through divestment, all property in the trust patrimony is to be vested in the

trustee in the bankruptcy, who will then claim payment of all amounts owing to the trust patrimony, including damages against a trustee whose administration was reckless or faulty.

> *The sources of civil liability are numerous. Damages compensate the beneficiary or the trust administered for any harm that arises as a result of the administrator's failures in exercising his powers. Failure to perform an obligation without justification may consist of reckless or negligent administration, the performance of a contract of which the cancellation is excluded by the effect of appearance, an inappropriate delegation, an untimely resignation, or the deterioration and destruction of the property administered.*[46]

Moreover, the trustee in the bankruptcy of the trust patrimony, as the creditor's representative, should be able to exercise the appropriate remedies against the trustee when an act has been fraudulently executed in connection with the rights of the trust patrimony. Depending on the circumstances, such remedies may be directed against the settlor or the beneficiary to the extent that the latter participated in the fraudulent act.[47]

The use of the above-mentioned remedies by the trustee in bankruptcy does not require special legislative intervention. The current rules of *jus commune* and the federal legislation appear to be sufficient.

Conclusion

In general, creditors who contract with a trustee have no remedy against the latter. Their rights must be exercised instead against the trust patrimony itself. There is always a possibility that the trust patrimony may show a deficit, especially when the trust is carrying on an enterprise. If this were to occur there would inevitably be competition among the creditors themselves as well as between them and the trustee. It would thus seem more appropriate to apply the rules of the *Bankruptcy and Insolvency Act.*

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46 *Ibid.* at para. 358 [translated].
47 Art. 1292 C.C.Q.

III. Proposed Reforms

It seemed useful to us to try to present the content of this report in the form of proposals for specific reforms. Obviously, these are mere suggestions. However, drafting them in the form of legislative provisions should give the reader a better understanding of the proposed changes and their relevance.

A. Application of the Bankruptcy and Insolvency Act to the Quebec Trust

Proposed provision 1 (amendment to section 2 *B.I.A.*)

***Also deemed to be a person is a trust or a trust patrimony within the meaning of the* Civil Code of Québec.**

OR

Proposed provision 1A

Also deemed to be a person is a trust or a trust patrimony within the meaning of the* Civil Code of Quebec *of which the purpose is to carry on an enterprise.

Although of more limited application, we prefer the wording in provision 1A. It is when a trust carries on an enterprise that its creditors may be greater in number and the risk of insolvency higher. It will be recalled that all organized economic activity constitutes an enterprise within the meaning of the Civil Code (art. 1525, para. 3). That notion may therefore, depending on the circumstances, go so far as to include administration and investment in immovables. To simplify the drafting of the various texts, in our view it would be useful to refer to a "trust patrimony".

The *Civil Code of Québec* distinguishes among three (3) types of trust (art. 1266 C.C.Q.):

1. **The personal trust (art. 1267 C.C.Q.)** "is constituted gratuitously for the purpose of securing a benefit for a determinate or determinable person."

2. **A private trust (art. 1268 and 1269 C.C.Q.)** is a trust created gratuitously or by onerous title "for the object of erecting, maintaining or preserving a thing or of using a property ... , whether for the indirect benefit of a person or in his memory, or for some other private purpose."

Depending on the situation, this type of trust may or may not be of a commercial nature.[48]

3. **A social trust (art. 1270 C.C.Q.)** "is a trust constituted for a purpose of general interest, such as a cultural, educational, philanthropic, religious or scientific purpose. It does not have the making of profit or the operation of an enterprise as its main object."[49] Accordingly, the social trust would generally not be covered by the *Bankruptcy and Insolvency Act*.

B. Acts of the Trust Patrimony

In civil law, the trust patrimony has no juridical personality. It is the trustee that has the control and administration of the patrimony. The trustee acts on behalf of the trust patrimony within the limits of the powers conferred on him (art. 1308 C.C.Q.). The obligations he contracts and the payments made by the trustee in that capacity are binding on the trust patrimony.

In civil law, the consequences that could arise from the fact that the trust patrimony constitutes a patrimony by appropriation are still not clear. There are those who maintain that the trust patrimony cannot contract directly and is neither a debtor nor a creditor because it has no juridical personality.[50] For others, the trust patrimony as a patrimony by appropriation has a true existence in law. Although it does not have a juridical personality, it has assets and liabilities and there is accordingly nothing to prevent it from acquiring the status of creditor or debtor.

That is why, to avoid entering into such a discussion, which does not appear to have been definitively resolved thus far, it might facilitate the application of the federal provisions to stipulate that acts duly performed by a trustee are binding on the trust patrimony, which is deemed to be a person. Preferential payments and reviewable transactions made by the trustee for the trust patrimony could thus be considered acts and payments of the "person" constituted by the trust patrimony for the purposes of the application of the federal legislation.

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48 Beaulne, *supra* note 17 at paras. 88-115.
49 *Ibid.* at para. 117.
50 See Macdonald, *supra* note 2.

Proposed provision 2

For the purposes of the application of the present statute, any act and any payment made by the trustee in good faith within the limits of his powers shall be deemed to be an act or a payment made by the trust patrimony.

C. Institution of Bankruptcy Proceedings

Like a company, the trust patrimony must be represented in order to act. That is the role of the trustee. Since the bankruptcy of the trust patrimony does not *ipso facto* terminate the trust, the initial proceedings should be exercised against the trustee in his official capacity.

Proposed provision 3

A petition for a receiving order against a trust patrimony is served on the trustee in his official capacity.

The trustee in his official capacity may make an assignment for the trust patrimony or file a proposal for it within the meaning of Section I of Part III.

Comments: This rule is not absolutely necessary since Rule 3 refers to the provisions of the *Code of Civil Procedure.* Article 59 of the Code provides that an administrator of the property of others pleads in his own name and in his official capacity in respect of anything concerned with his administration. Moreover, under article 1316 C.C.Q., "An administrator [of the property of others] may sue and be sued in respect of anything connected with his administration; he may also intervene in any action respecting the administered property."

Once bankruptcy has been declared, the entire trust patrimony is vested in the trustee in bankruptcy, who will then exercise his powers over the property of the patrimony.

D. Fraudulent or Preferential Acts

Several situations must be contemplated here: (1) a trust may be established in fraud of the rights of the creditors; (2) the trust patrimony may have made preferential payments or fraudulent acts; (3) the trustee alone or with the complicity of others may have performed acts in fraud of the trust patrimony. The rules of current positive law seem sufficient to us for all of those questions.

1. Establishment of a Trust in Fraud of the Rights of the Creditors

Let us imagine an insolvent person who transfers property in a trust patrimony in order to defraud his creditors. That type of situation has nothing to do with the possible bankruptcy of the trustee patrimony. It is rather the creditors of the settlor himself or the trustee in the settlor's bankruptcy who will be affected in such a transfer of property to a trust. The current law has sufficient rules to address that type of situation.

When bankruptcy has not been declared, article 1292 C.C.Q. provides that the settlor is responsible for acts performed in fraud of the rights of his creditors. The creditors may then institute proceedings against the settlor to seek compensation from him for the harm suffered. In addition, creditors are able to recover assets transferred fraudulently to a trust patrimony through a Paulian action (art. 1631ff. C.C.Q.).[51]

If there has been a bankruptcy, the trustee in the settlor's bankruptcy may, as the creditors' representative, exercise a paulian action under section 72(1) *B.I.A.*

2. Preferential Payments or Fraudulent Acts Made by the Trustee in his Official Capacity from the Trust Property

Here also the rules of positive law cover the situation sufficiently. Aside from a paulian action, the specific remedies provided for in the federal legislation may be applied. If, on behalf of the trust, the trustee in his official capacity has paid a creditor in order to give him priority over the others, section 95 *B.I.A.* comes into effect. Under that provision, "[E]very payment made … by any insolvent person in favour of any creditor or of any person in trust for any creditor … is … deemed fraudulent and void as against the trustee in the bankruptcy."

As well, if a transaction takes place between the trustee and the trust patrimony – which becomes a person – there should be

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51 É. Prud'homme, *Caractéristiques de la fiducie québécoise comme instrument de protection d'actifs* (Master's thesis, University of Montréal, Faculty of Graduate Studies 1999) at 75-77 [unpublished].

no hesitation in considering that the two are not in fact dealing at arm's length and that the transaction is reviewable (s. 100 *B.I.A.*). Section 4 *B.I.A.* could clearly be amended to provide that the trustee and the trust patrimony are related persons. It can be seen that considering the trust patrimony to be a "person" within the meaning of the *Bankruptcy and Insolvency Act* greatly facilitates the application of the rules of that statute.

3. Acts Made in Fraud of the Trust Patrimony

As the creditors' representative, the trustee in bankruptcy should be able to take advantage of article 1292 C.C.Q. Under that provision, "The trustee, the settlor and the beneficiary are solidarily liable for acts in which they participate that are performed in fraud of the rights of the creditors of the settlor **or of the trust patrimony**."[52]

It is for that reason that we believe that, with regard to the various fraudulent acts relating to the creditors of the settlor and the trust patrimony, the rules of the current positive law seem sufficient in themselves.

E. Determination of the Property in the Bankruptcy of the Trust Patrimony

If the trust patrimony constitutes a person who can be declared to be bankrupt, all of its property shall "forthwith pass to and vest in the trustee" in the bankruptcy (s. 71(2) *B.I.A.*). So as not to impede the administration of the bankruptcy, the trustee of the patrimony should not be able to exercise his right of retention against the trustee in bankruptcy (see at 15, above) and should immediately transfer to him all of the property that comprises the trust patrimony.

Proposed provision 4

When a receiving order is made against a trust patrimony, or an assignment takes place with an official receiver for such a patrimony, the trustee of the patrimony must immediately transfer all of the property in the trust patrimony to the trustee in bankruptcy.

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52 [emphasis added].

Notwithstanding any rules of provincial law, the trustee of the patrimony shall not retain, as against the trustee, possession of the trust property nor exercise any right of retention.

Comments: The effectiveness of the administration of the bankruptcy requires that the trustee in bankruptcy take immediate possession of all of the property in the trust patrimony. At that point, the trustee of the patrimony should not be able to exercise his right of retention against the latter.

Proposed provision 5

At the request of the trustee in bankruptcy, the trustee of the patrimony shall render account of his administration. If there is no agreement, the rendering of account is made judicially.

Comments: This wording is based on article 1364 C.C.Q. Since the bankruptcy of the trust patrimony is not a cause of the termination of the administration of the trust, this provision seems necessary. The trustee in bankruptcy and the trustee of the patrimony can agree on the form and content of this rendering of account. The trustee in bankruptcy can then be satisfied on such points as the rendering of account in favour of the beneficiary (art. 1363 C.C.Q.). If there is no agreement, the trustee in bankruptcy should be able to demand that the rendering of account be made judicially.

F. Payment of Amounts Owing to the Trustee of the Patrimony

As we have seen, the trustee of the patrimony may have three types of claims against the trust patrimony. One pertains to his remuneration and the other relates to expenses incurred on behalf of the trust. The third applies to obligations contracted by the trustee in his own name but that benefited the trust (see at 16, above). For the first two, as a minimum, the trustee enjoys a right of retention and compensation under the Civil Code. Moreover, by virtue of his right of retention over movables, his claim constitutes a prior claim.

In our view, when the trustee of the patrimony has contracted in his own name and is asked to pay amounts to a creditor in that capacity, he should be able to come to the bankruptcy as a simple subrogate to the creditor's rights.

With respect to his remuneration and the administration expenses, including the costs of rendering account, it is our view the trustee should have a preferred claim in the bankruptcy under section 136 *B.I.A.* The trustee's claim should be subject to the rights of secured creditors. If the trustee has not already been fully compensated through his right to compensation, his claim should be satisfied on a priority basis immediately after the costs of administration (s. 136(1)(b) *B.I.A.*). That rule would confer on the trustee a status similar to that recognized by the Civil Code.

G. Release of Debts

Article 169(4) *B.I.A.* should be amended as follows:

Proposed provision 6

A bankrupt corporation or a trust patrimony may not apply for a discharge unless it has satisfied the claims of its creditors in full.

If a trust patrimony carries on an enterprise and shows a deficit, the purpose of the trust can no longer be attained. Any interested party may cover the deficit (s. 1293 C.C.Q.). Failing this, however, the trust should not be able to be discharged of its debts unless it pays all its creditors or submits a proposal to them under Section I of Part III of the *Bankruptcy and Insolvency Act.*