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CAN I ENCROACH AND, IF SO, HOW? TRUST ISSUES IN AN ESTATES CONTEXT

Suzana Popovic-Montag

Introduction and Basic Principles

A trust is created when there is a transfer of property to one or more trustees for the benefit of someone else, who is known as a beneficiary. There are various types of trusts that can be created. For example, the trust document can restrict the beneficiary to a fixed amount of money, such as only the income on the capital assets of the trust. For more flexibility, the trustees may be given the right to pay to the beneficiaries a combination of both income and a portion of the capital, over a period of time.

There are significant tax consequences to the creation and administration of a trust, and these should be considered when creating this type of estate plan. For example, creating a trust and a Will can, in the right circumstances, reduce the taxes that will be paid on the income that is earned on an inheritance each year. The treatment of capital gains can also be beneficial in the trust context. Any capital gains realized on the trust funds can be paid to the beneficiaries, and this is taxed in their hands, at their marginal rate, and used for their expenses. In many circumstances, proper estate planning can significantly reduce, or even eliminate, tax paid on investment income and capital gains.

Proper estate planning can also assist you in avoiding the payment of probate fees on death, by creating a trust transferring property to a living spouse, through your Will.

When you die, you are treated as having sold all of your property at fair market value for income tax purposes. This, of course, means that gains may be realized on your property and tax may be owing. By transferring your assets to a spousal trust, you can maintain control of the property and possibly obtain tax-free rollover benefits.

Another benefit of creating a trust is that you can leave assets in trust for your beneficiaries, and it may also protect that inheritance from the beneficiaries' creditors.

If there are no creditors looking to the beneficiaries' assets, it still may be important to control the flow of money to the individual beneficiary. For instance, if a child inherits a large sum of money at a young and impressionable age, he or she may not be able to properly handle the money. If it is controlled by an adult trustee, however, the money can be spent properly until the child reaches a stage in life when he or she can look after the money in a responsible way.

A further benefit of creating a trust is the fact that it can be drawn in a way that allows the estate plan to be extremely flexible. Therefore, in circumstances where you want to protect a young person from receiving too much money at too early a stage in life, a trust could provide that a portion of the money would be released to him or her at, say, age 25, and then the final portion, for example, at age 35.

For a valid trust to be created, there are three elements, the so-called "three certainties" that must be established:

- (1) certainty of beneficiaries;
- (2) certainty of property given in the trust; and
- (3) certainty of intention to create a trust.

If any one of these elements is not present, the trust may be invalid.

While trusts have always been one of the most important and flexible tools of any estate planner, the law has become more complicated and tax minimization is more and more difficult to achieve.

There are specific rules in the *Income Tax Act* designed to prevent taxpayers from diverting income to other related taxpayers with lower marginal rates.

For example, in the *Income Tax Act* there are attribution rules that are intended to prevent the taxpayer from income-splitting with family members to reduce the tax payable by the taxpayer.

Essential to avoiding these attribution rules is planning, with the result that beneficiaries of a trust who could cause income attribution to the settlor (*i.e.* a spouse, children, grandchildren, nieces and nephews under the age of majority) do not receive any income or capital gain, as the case may be.

Family Trusts

An important consideration in any Family Trust case is that the terms of the trust are always governed by the trust deed itself, and a careful read of the trust is therefore essential.

Typically, a Family Trust will involve the following steps:¹

- A lawyer will first set out certain property to the trustee to be held in trust for the beneficiaries.
- A lawyer will also execute the trust deed.
- The duration of the trust will be set out, typically using a maximum period of 21 years from the death of the last born of the adult children beneficiaries.
- The conditions of the trust will be set out in the trust deed, including gifting provisions, the payment of income and the fact that the distributions will typically be made in a tax-efficient way, such as annual distributions and provisions to avoid any accumulations.

¹ N.D. Renton, *Family Trust*, (3d), Wright Books for Lawyers, Sydney, Australia, 2006, at p. 12

A number of problems, however, can arise in a Family Trust scenario.

For instance, there is often inability for the trustees to pay out some or all of the capital of the trust on the basis of a capital encroachment. In addition, the terms of the termination of the trust are often set out, including the fact that, in many cases, the trustees can agree to simply wind-up the trust prior to the expiration date or the date of division, as it is often called.

In most cases, the Family Trust will create a set of beneficiaries including the parents, the adult children and the adult children's children (namely, grandchildren). Once the trust is established, the financial interests of each of these groups are fixed, and any changes to the terms of the trust cannot be made without collective and unanimous agreement.

Having said that, an important objective of any Family Trust is to establish a gifting scheme that allows for adult children and younger children to enjoy the benefits of the assets, including children with disabilities. Given that, control over the wealth itself is not entirely lost if the legal framework is properly established. As a consequence, there is usually useful protection against potential creditors of the beneficiaries of the trust.

It is often a tax-efficient structure, which allows for the passing of wealth from generation to generation and provides for discretionary power in the context of the gifting scheme itself. For instance, discretionary powers found in many trusts are related to the ages of the potential beneficiaries and the educational needs of the adult children or their children. Income and capital flow can be amended to also accommodate the need for working capital or "seed money" by a beneficiary who may want to start a business. It can also allow for payment of extraordinary medical expenses and help for a long-term retirement scheme to be established, with regard to the continuity and assurance of income throughout one's lifetime.

Duties of a Trustee

An important aspect of advising a client on the administration of a trust or an estate is the nature and extent of a trustee's duties and responsibilities. Often included in such advice is the need to consider the question of capital encroachments. In particular, a trustee will ask a solicitor whether or not the trustee has the power to encroach and, if so, what considerations must be addressed in determining the quantum of the encroachment.

In considering this issue, one should first look to the specific wording of the Will or trust and consider the trustee's role in such a decision in the context of the language of the document.² Typically, a testator's Will establishes trusts providing for the income to be paid to a life tenant (usually a surviving spouse), with the capital to be distributed on the death of the life tenant to capital beneficiaries. It is also typical to give the trustee the ability to encroach upon the capital for the benefit of the life tenant.

The language of the capital encroachment clause is critical. Sometimes it is specific and restricted; most of the time, however, it is a generic "precedent" type clause with broad flexibility.

An example of a wide power to encroach would be as follows:

... to my said trustees to pay to my wife for the benefit of my said wife, such part or parts or the whole of the capital of the residue of my estate as, in their uncontrolled discretion, my said trustees consider advisable.

In this instance, the testator has signaled that the interests of the wife are paramount, for the following reasons:

² For a comprehensive review of the issue of capital encroachments see *Fox v. Fox Estate* (1994), 5 E.T.R. (2d) 174 (Gen. Div.); reversed on other grounds (1996), 10 E.T.R. (2d) 229; 28 O.R. (3d) 496 (Ont. C.A.); leave to appeal to the Supreme Court of Canada dismissed

1. The testator has considered that the whole of the capital might be consumed in the encroachment;
2. The testator has used the word "benefit", which imparts a very broad use for the wife and does not restrict it to her maintenance, well-being, or other such concepts, which might import a more restricted use or specific use; and
3. The trustees are given an uncontrolled discretion.

Does the Will Allow the Trustee to Encroach Upon Capital?

● Rules of Construction – The Armchair Rule

The central principle of construction which applies to Wills is that the testator's intention is collected from a consideration of the whole Will, taken in connection with any evidence properly admissible, and the meaning of the Will and every part of it is determined according to that intention.

This examination of "any evidence properly admissible" has been commonly referred to as the "armchair rule", which allows the Court to take into account surrounding facts and circumstances when ascertaining and giving effect to a testator's intention.³

After having regard to all of the relevant factors and the tenor of the Will as a whole, the Court will then interpret the specific capital encroachment provision.⁴ From a practical standpoint, if the language is unclear, then the executor should bring an Application for advice and direction to the Court to determine the extent of the power to encroach, generally.

³ See *National Co. v. Fleury* (1965), 53 D.L.R. (2d) 700 (S.C.C.), p. 710

⁴ *Feeney's Canadian Law of Wills* at 11.43-11.79

In interpreting a Will, a Court must endeavor to give effect to the testator's intentions as ascertained from the express language of the Will and the surrounding circumstances.⁵ In *Feeney's Canadian Law of Wills*,⁶ the author suggests that there are two approaches in regard to the admissibility of the extrinsic evidence in interpretation cases. The first is the more restrictive English approach. The second is the Canadian approach, which seems to be more flexible. In the latter case, the Courts seem to be more comfortable in relying on and admitting extrinsic evidence of the surrounding circumstances.

Assuming that there is evidence of the surrounding circumstances that is relevant to introduce the concept of ambiguity, all such evidence ought to be received under the armchair rule to assist the Court in resolving an ambiguity.⁷ However, if the subject matter of the gift is not in existence at the date of the Will, it is unlikely that such evidence will be admitted.⁸

The surrounding facts and circumstances which a Court should consider are: the character and occupation of the testator; the amount, extent and condition of his or her property; the number, identity and general relationship to the testator of immediate family and other relatives; the persons who comprised his or her circle of friends; and any other natural objects of his or her bounty.⁹ Therefore, with one possible exception, all evidence should be admissible under the armchair rule except for direct evidence of the testator's intention, which is generally inadmissible. Unless there is an equivocation, the Court will be careful to attempt to exclude any direct evidence of the testator's intention.¹⁰

⁵ See *Edell v. Sitzer* (2001), 55 O.R. (3d) 198 (Ont. S.C.J.) Cullity J. at para. 106, where the Court describes the Armchair Rule referred to in *Perrin v. Morgan*, [1943] A.C. 399 (U.K. H.L.) at p. 420

⁶ *Feeney's Canadian Law of Wills* at 11.43-11.79

⁷ *Ibid.* at para. 11.54

⁸ *Ibid.*

⁹ *Ibid.* at para. 10.57

¹⁰ *Ibid.* at para. 11.55

- **The Even-Hand Principle**

When considering the question of capital encroachments after reviewing the provisions of the Will, the trustee must also have regard to his/her fiduciary duties. In particular, trustees have a duty to act impartially as between beneficiaries.

Part of the duty to act impartially is the application of the even-hand rule. In the *Law of Trusts in Canada*,¹¹ Waters states the even-hand principle as follows:

It is a primary duty upon trustees that in all their dealings with trust affairs they act in such a way that if there are two or more beneficiaries each beneficiary receives exactly what the terms of the trust confer upon him and, otherwise, receives no advantage, and suffers no burden which other beneficiaries do not share. In this way, the trustees act impartially; they hold an even-hand. The settlor or testator may choose to give disproportionate interests to various beneficiaries and he, very often, does so in practice, but that is his privilege. It is still the duty of the trustees to carry out the terms of the trust as they find them and to ensure that in the administration of the trust they do not give advantage or impose burden when that advantage or burden is not so found in the terms of the trust.

The balanced and even-handed approach to the beneficiaries, as between income and capital, has been described by Waters at page 788 as follows:

It is the distinction between income and capital that is so important in the context of this rule; there are two classes of beneficiaries, for income and capital beneficiaries are interested in different things. With regard to the trust fund, the income beneficiary is looking for the best yield obtainable, while traditionally, the capital beneficiary is concerned with the safety of the fund ... it is the duty of the trustees to manage the fund so that they

¹¹ D.M.W.M. Waters, *The Law of Trusts in Canada*, 2nd Edition (Toronto: Carswell, 1984), p. 787

do the best possible for both, and this means holding an even balance between yield and risk.

This reference deals with the application of the even-hand rule to the investment powers of trustees. The same rule applies with respect to a number of other aspects of the administration of the estate, such as the duty to allocate expenses equitably between and among the income and capital beneficiaries.

If a Will contains no power to encroach on capital, the even-handed principles apply without modification. However, the addition of a power to encroach on capital for the benefit of an income beneficiary means that the testator has in some way changed the rules and already given an indication to the trustees that the income beneficiary is to be preferred in some measure over the capital beneficiary.

The requirement to uphold the even-hand rule is something that cannot be easily avoided. Even if the Will gives the executors the power to ignore this even-hand principle, there are always limits imposed by the Court.

As was stated by Maurice Cullity¹² (as he then was), there is a danger that a trustee's decision, which seems to be reasonable when it was made, will acquire a very different appearance when judged with the benefit of hindsight. This is something of which all trustees must be aware when exercising their discretion. The Author goes on to state that, however wide the terms in which a trustee's discretionary powers are conferred, the Court's discretion to fix the limits of the trustee's freedom of choice may appear to be far greater. Therefore, trustees must be cautious in presuming that the testamentary powers set out in the Will are unlimited and must be conscious of the fact that the Court will, if necessary, restrict those powers.

¹² Trustees' Duties, Powers and Discretion - Exercise of Discretionary Powers, Special Lectures of the Law Society of Upper Canada 1980 at pp. 13-14; and see M.C. Cullity, "Judicial Control of Trustees' Discretions", (1975) 25 U of T Law Journal 99

The Scope and Extent of the Power to Encroach

When considering the scope and extent of an executor's power to encroach, the leading case is *Gisborne v. Gisborne*.¹³ Although not strictly speaking a "capital encroachment case", it dealt with the underlying issue of the scope of an executor's discretion, particularly in circumstances where the beneficiary has resources of his own.

In *Gisborne v. Gisborne*, the Will provided for a trust fund for the care of the principle beneficiary, the widow of the deceased. The trustees were allowed "uncontrolled authority" to apply the whole or part of the income of the fund. The principle beneficiary had economic resources of her own; however, she was incapable and required full-time care. The trustees proposed to apply only so much of the income from the trust as was necessary after the widow's other income had been completely exhausted.

In his Will, the testator gave his estate to his executors and trustees to invest and:

... in their discretion, and of their uncontrollable authority, pay and apply the whole, or such portion only, of the annual income ... as they think expedient, to or for the clothing, board, lodging, maintenance, ease, and support, or otherwise for the personal and peculiar benefit and comfort of my dear wife ...

The testator made certain specific legacies and bequeathed the residue of the estate to other persons. One of the trustees was also a residuary legatee. The wife had been adjudged a lunatic and had in her own right property out of which she could be maintained. By her Next Friend, she sought a declaration that she was entitled to have a provision made for her maintenance out of the income of the testator's estate.

In *Gisborne v. Gisborne*, Lord Cairns, the Lord Chancellor, wrote:

The question, however much it may be discussed, must really come back

¹³ (1877), 2 App. Cas, 300 (H.L.)

to and turn upon the construction of the will ...

My Lord's larger words than those, it appears to me, it would be impossible to introduce into a will. The trustees are not merely to have discretion, but they are to have "uncontrollable" that is uncontrolled "authority". Their discretion and authority always supposing that there is no *mala fides* with regard to its exercise, is to be without any check or control from any superior tribunal. What is the subject-matter with regards to which they are to exercise this discretion and this authority? The subject-matter is the payment, or the application, not merely of the whole of the income of his real and personal estate, but of such portion only as they deem it proper to expend. It is for them to say whether they will apply the whole, or only a part, and if so what part. And how are they to decide, if they do not apply the whole; what is the part which they are to apply? They are to decide upon this principle, that is to be such part as they shall think expedient, not such part as shall be sufficient, not such part as shall be demanded by or for the person to be benefited, but such part as they think expedient; and upon the question of what is expedient, it is their discretion which is to decide and that discretion according to which they are to decide is to be uncontrolled.

Therefore, the question continues to turn on whether the plaintiff can show the presence of *mala fides*.

The Court considered the general question of the scope of an executor's power to encroach in such circumstances and, at page 305, stated the following:

The trustee's discretion and authority always supposing that there is no *mala fides* with regard to discretion is to be without any check or control from any superior tribunal.

The widow's solicitors appealed the decision of the lower Court but the Appeal Court stated that, in the absence of fraud or "*mala fides*", the discretion of the trustees was not subject to the control of the Court. Consequently, the trustees' decision to apply only part of the income after the widow had exhausted her resources was upheld.

The decision in *Gisborne v. Gisborne* was considered and confirmed by the Ontario Court of Appeal in *Fox v. Fox Estate*.¹⁴ However, in this case, the Court interfered with the discretion of the trustee. Here, the widow of the testator was the sole trustee of the estate. It was to be held in trust with the widow/trustee receiving 75% of the income during her lifetime; the other 25% was to be paid to her son. On the widow's death, the son was to receive the residue of the estate. The widow/trustee was also given the power to encroach on capital for her son and/or her son's issue, in such amounts as she in her "absolute discretion" considered "advisable".

The son had married, had two children and was divorced. Shortly after his divorce, he sought to re-marry. The mother did not approve of her son's choice. As trustee, she exercised her discretion over the portion of the estate held in trust for the son and encroached upon the fund to the extent of the whole for the benefit of her grandchildren. The effect of this encroachment was that the son would receive nothing from the 25% of the estate held in trust out of which he was to receive the income. He would only be entitled to receive the 75% of the estate in which his mother had a life interest, after her death.

The son brought an Application to have the Court set aside the exercise of discretion in favour of his children, on the basis that it was improper exercise of his mother's discretion as a trustee. Her Honour Judge Haley found that the principle motivating factor in exercising her discretion was the trustee's objection to her son's impending marriage. Her Honour was satisfied that the trustee, though exercising her discretion because of the impending marriage, was permitted to do so because the testator had given her uncontrolled discretion. On appeal, the Court of Appeal emphasized the central limit on discretion as being a consideration of whether or not there exists in the

¹⁴ (1996), 10 E.T.R. (2d) 229, 28 O.R. (3d) 496 (*sub nom. Fox v. Fox*), 88 O.A.C. 201 (Ont. C.A.). See also *Martin v. Banting* (2001), 37 E.T.R. (2d) 270; Appeal dismissed (2002), 46 E.T.R. (2d) 94 (Ont. C.A.)

mind of the trustee an element of "*mala fides*" and stated:¹⁵

The entire question of the degree of control which the Courts can and should exercise over a trustee, who holds an absolute discretion, is filled with difficulty. The leading case, or at least the case to which reference is almost always made, is *Gisborne v. Gisborne*. It stands for the proposition that, so long as there is no "*mala fides*" on the part of the trustee, the exercise of an absolute discretion is to be without any check or control by the Courts.

In essence, the principle governing the review of an exercise of discretion by a trustee under a discretionary trust is that the Court will not interfere with the exercise of the discretion in the absence of *mala fides*.

In *Fox v. Fox Estate*, Galligan J. considered the concept of *mala fides* and emphasized the fact that the term should be interpreted with some flexibility, and that *mala fides* itself is more than just a category of fraud. Rather, it includes any act by an executor which is based on "extraneous" matters, namely considerations, which are in fact extraneous to the purposes of the testator as set out in the Will. Galligan J.A. in *Fox v. Fox Estate* concluded that the fact that her son intended to marry a gentile was entirely extraneous to the duty which the mother held as trustee and this extraneous consideration demonstrated sufficient *mala fides* to bring her conduct within any reasonable interpretation of that term.

Does It Matter If a Beneficiary Has Financial Resources of Her Own?

Generally, the only limit set by the Courts in *Gisborne v. Gisborne* and *Fox v. Fox Estate* is whether or not the trustee displayed *mala fides* in the decision making-process. Therefore, the question as to the extent of the beneficiary's personal resources should, at first instance, be irrelevant.

Having said that, the term *mala fides* itself can be broadly interpreted, as demonstrated

¹⁵ Galligan J. noted at paragraph 11

by the Court of Appeal's reference to the use of "extraneous" considerations.

In coming to this conclusion, Galligan J.A. relied on *Hunter Estate v. Holton*.¹⁶ In *Hunter Estate v. Holton*, Steele J. outlined the scope of a trustee's discretion as follows:¹⁷

Trustees must act in good faith and be fair as between beneficiaries in the exercise of their powers. There is no allegation of bad faith in the present case. Courts should be reluctant to interfere with the exercise of the power of discretion by a trustee. I adopt the following criteria in *Re: Hastings – Bass* ... as being applicable to the Courts review process of the exercise of such power.

. . . .

To sum up the preceding observations, in our judgment, whereby the terms of a trust ... a trustee is given a discretion as to some matter under which he acts in good faith, the courts should not interfere with his action notwithstanding that it does not have the full effect which he intended unless (1) what he has achieved is unauthorized by the power conferred upon him, or (2) it is clear that he would not have acted as he did (a) had he not taken into account considerations which he should not have taken into account, or (b) had he not failed to take into account considerations which he ought to have taken into account.

It appears that the Canadian Courts have placed a gloss on the *Gisborne* principle by defining *mala fides* as something less than active bad faith. By stating that the trustees took into account matters "extraneous" to the issues, the Court has gone a long way in reserving a right to review the actions of a trustee. Nevertheless, it seems from a review of the cases that the overwhelming view is to allow for the broad exercise of discretion on an unfettered basis (presuming the Will provides for such) and that the Courts will only reluctantly limit that discretion.

¹⁶ (1992), 7 O.R. (3d); 46 E.T.R. 178 (Ont. G.D.)

¹⁷ *Ibid.*, p. 379

For example, in *Re: Luke*,¹⁸ the Court considered a case whereby the testator appointed his wife as executor and life tenant. The Will provided for her to use the income and so much of the corpus thereof as she may have need for her comfort, maintenance and support during her lifetime. The Court considered the question as to whether or not the wife should first use her own financial resources before she could exercise her power to encroach on the capital.

The Court held that the widow did not have to exhaust her own resources and stated:¹⁹

Had the testator here intended that his widow should first exhaust her own funds before encroaching on the corpus of his estate he could have used appropriate language to express that intention. His failure to do so must surely indicate that her right of encroachment was an absolute right and not regulated by reference to other means of her own which she might have.

The Court again supported the principle that the surviving widow did not have to look to her own financial resources before she could enjoy the capital by way of encroachment.

In considering the exercise of discretion in the context of financial resources, the issue was dealt with directly in *Hinton v. Canada Permanent Trust Company*.²⁰ In this case, the testatrix provided a trust for her son. The executors were her son and a corporate trustee.

The Will provided that the trustees were to encroach on the capital if the interest income proved "insufficient" for the son's support. For many years the executors paid the interest income to the son and an additional amount in the form of a capital

¹⁸ [1939] O.W.N. 25

¹⁹ *Ibid.*, p. 29. See also *Re: Mattick* (1969), 62 D.L.R. (2d) 539 at 543-4 (Co. Ct.); and see *Re: King*, [1940] O.W.N. 57 (H.C.)

²⁰ (1979), 5 E.T.R. 117 (H.C.); *aff'd* [1980] O.J. No. 1720 (Ont. C.A.)

encroachment. Some years later, the corporate trustee requested that the son provide information as to his own resources to determine whether the encroachment was appropriate given the provisions of the Will. The son refused. The Court found that the lack of reference in the Will to the son's income as a factor in determining any capital encroachments was intentional on the part of the testatrix and the son's personal resources were not relevant.

Recent Developments

In *O'Donnell v. Canada Trust*,²¹ the Court, relying upon *Hinton v. Canada Permanent Trust Company*,²² found that the decision of the trustees to deny a capital encroachment based on the financial resources of the beneficiary was improper. The Court again confirmed the principle that if a testator intended the trustees to have regard to the private means of a beneficiary, derived from sources outside the trust fund, the testator would have used appropriate language to express that intention.

Similarly, in *Re Atwell Estate*,²³ the Court agreed that there was no need for trustees to "factor in" other sources of income before exercising a power of encroachment and relied on *Hinton v. Canada Permanent Trust Company*.

In *Paterson v. Paterson Estate*,²⁴ the Manitoba Court of Queen's Bench came to a different conclusion, but relied on the earlier premise established in *Gisborne* that the Court should not interfere in the absence of *mala fides*. In that case, an elderly son left his estate in trust and gave the trustee an uncontrolled discretion to use the income "for the care of my mother" The testator gave directions to his lawyer that the trust fund was to maintain his mother "if it became necessary". Both the income and the capital were available for his mother's care as the executrix "in her uncontrolled discretion considered advisable". The executrix was also a beneficiary of the estate, and would

²¹ [1996] O.J. 05-0026 Ferrier J. (Ont. S.C.)

²² *Supra*, note 12

²³ (1997), 19 E.T.R. (2d) 234 (Ont. Gen. Div.)

²⁴ (1996), 13 E.T.R. (2d) 86. (Man. Q.B.)

receive 60% of the residue upon the death of the mother. The remaining 40% was to be paid to a cousin. There were contingent charitable beneficiaries if the executrix or the cousin predeceased the mother.

On the death of the testator, the mother had sufficient income to meet her needs. After consultation with the other capital beneficiary and a solicitor, the trustee declined to use any part of the estate for the mother's care. The mother's attorney applied for a monthly allowance out of the estate. The Court held that there was no positive duty on the trustees to encroach on capital. The Court found that the testator intended to confer a broad and uncontrolled discretion, as the trustee deemed advisable. The Court also found that the trustee properly exercised her discretion, based partially on her knowledge of the mother's own income - which was more than sufficient to meet her needs.

Curiously, the Court noted that the trustee was in a conflict of interest but said that "she had engaged in a careful balancing of the needs of the income and capital beneficiaries". The Court distinguished *Hinton* because, in that case, it was the clear intention of the testator that the beneficiary's private means should be disregarded. In this instance, the testator had given instructions to his solicitor that the funds should be used "if it became necessary".

It also distinguished *Schipper v. Guaranty Trust Company*,²⁵ an Ontario Court of Appeal case, where the Court held that the terms of the trust showed that the testator's intention, first and foremost, was to provide for the beneficiaries' care out of the trust fund, including capital. In *Paterson*, the Court confirmed that once the Court ascertained the true intention of the testator, that intention ruled the day. It also reiterated that the Court will not lightly interfere with the exercise of discretion on behalf of the executor.

²⁵ (1989), 33 E.T.R. 149 (Ont. C.A.)

In the decision of the Alberta Court of Appeal in *Re Passmore Knox United Church v. MacLeod*,²⁶ the Court held that a Will which provided that the testator “did not anticipate it will be necessary to expend substantial amounts” because of the beneficiaries’ “comfortable circumstances”, was sufficient to require the trustees to consider the financial resources of a beneficiary.

In summary, therefore, it appears that the principle enunciated in *Hinton v. Canada Permanent Trust Company* continues to apply. That is, unless the testator specifically requires the trustee to consider the financial resources of the beneficiary, the trustees may ignore such factors in exercising their discretion.

Clearly, then, a careful balancing act must be undertaken by a trustee when administering a trust that includes broad powers to encroach. While the limits on the trustee appear to be focused on the question of *mala fides*, the principle that the trustee may exercise his power to encroach, regardless of the financial resources of the beneficiary, of course has limits. The limit that an executor must not encroach for “extraneous” purposes is a fundamental consideration.

As to what are “extraneous” considerations, it appears that the Courts will continue to struggle with this term and will continue to attempt to define it in the context of the facts and circumstances of the case before it.

Mutual Wills: *Hall v. McLaughlin*²⁷

The background in respect of this case was that Emily and John McLaughlin were married later in life. John was 78 years of age when they were married. This was a second marriage for both of them, and each had children from previous relationships.

As is often the case, after they were married, they executed mutual Wills on June 12, 1992. The 1992 Wills provided that their respective estates would pass to each other

²⁶ (1965), 49 D.L.R. (2d) 176 (Alta. C.A.)

²⁷ [2006] O.J. No. 2848 (Ont. S.C.J.)

and the last spouse to die would benefit the families of both spouses. Identical Codicils were also signed on February 4, 1994, dealing only with the change of executors.

In 1997, Emily became incapable and was no longer able to change her Will. More importantly, she was not able to consent to her husband, John, changing his Will. Notwithstanding this, subsequent to Emily's incapacity, her husband made two further Wills, one in 1998 and an additional one in 2000. Both his new Wills left his entire estate to his own family.

The evidence at the hearing suggested that the two sets of children had limited contact with each other and that, in fact, Emily appeared to dislike John's children.

Emily predeceased John and, pursuant to the terms of her 1992 Will, her assets (in the amount of approximately \$320,000.00) passed to her husband John. As a result, when John passed away, his estate was valued at approximately \$700,000.00 and went entirely to his own children, pursuant to the terms of his subsequent Wills. In other words, the combined assets of the estate passed to John's family to the exclusion of Emily's children.

Not surprisingly, litigation ensued and Emily's family commenced an action for a determination as to the validity of the agreement that Emily and John had entered into in their marriage. It was alleged by Emily's children that the combined assets would be split equally amongst the two families. Emily's children argued that the 1992 Wills evidenced the contract entered into by Emily and John to accommodate such an estate plan.

Justice Pierce, in her decision, carefully considered the doctrine of mutual Wills and referred to the leading case of *Edell v. Sitzer*.²⁸ In *Edell v. Sitzer*, Justice Cullity held that an agreement, proven upon clear and satisfactory evidence, is a prerequisite for finding a binding contract, and that the existence of mutual Wills themselves was not enough to

²⁸ [2001] O.J. No. 2909 (Ont. S.C.J.)

prove such an agreement. Cullity, J. went on to find that the contract had to include an agreement not to revoke the mutual Wills.

Justice Pierce reviewed the evidence in respect of Emily and John McLaughlin's estates and held that there was clear and satisfactory evidence that the two spouses intended to enter into an agreement and had, in fact, entered into a binding agreement that the survivor of them would divide his or her estate into two equal shares to be divided amongst the two sets of children.

Justice Pierce held that the deceased, John McLaughlin, mentioned their agreement in discussions with Emily's family and repeatedly assured Emily's children that they would be looked after and that their mother's estate would pass to them.

Justice Pierce struggled with the evidentiary reality that, notwithstanding John's assurances to Emily's family, he did indeed make two new Wills in 1998 and 2000. Her Honour communicated that there were two possible explanations for John's behaviour. One was that John expected to die first, and the second was that he intended to make an *inter vivos* gift to Emily's children.

In summary, Justice Pierce held that there was a breach by John and that there was indeed a contract entered into between John and Emily to share their combined assets equally among their families. Consequently, she imposed a constructive trust on one-half of John's estate to the benefit of Emily's children and, given that most of the assets have been distributed, issued a tracing order with respect to the proceeds of the assets of the estate.

The decision of Justice Pierce is an important reminder that, notwithstanding the potentially onerous evidentiary difficulties associated with proving an agreement, referred to in *Edell v. Sitzer*, the beneficiaries of mutual Wills must indeed look carefully at the facts and surrounding circumstances to determine whether or not a binding contract was created, and to determine if there is sufficient evidence to prove that agreement. Furthermore, one must not forget that, even if the agreement can be

proven, there must be clear and satisfactory evidence that the contract included an agreement not to revoke the mutual Wills.

Family Law Act Elections: lasenza v. lasenza Estate²⁹

Mrs. lasenza came to Canada from the Philippines in 1990. Mr. and Mrs. lasenza met and dated each other for one year before commencing to live together in 1995. Mrs. lasenza had never been married, and Mr. lasenza was divorced and had two adult children from that marriage. The couple eventually married on May 5, 2000.

By 2003, Mr. lasenza was terminally ill; he ultimately died on November 12, 2003. Mr. lasenza left a Will, which divided his estate into three equal shares for Mrs. lasenza and his two adult children, namely Michael and Paul. Pursuant to the terms of the Will, Michael was appointed as the Executor of his father's estate. Mrs. lasenza's ability to converse in the English language was limited; as a result, she retained a lawyer to assist her with the estate. The lawyer acted diligently in investigating what assets were in the estate.

It turned out that, during his lifetime, Mr. lasenza executed a Power of Attorney for property in favour of Michael. Subsequently, Michael transferred \$202,603.36 out of Mr. lasenza's RBC Securities Account (the "**RBC Account**") and into a joint account between Mr. lasenza and himself. There was evidence that indicated that the transfer was an estate planning transaction.

The estate solicitor wrote to the lawyer listing the estate assets, which totaled \$310,292.00. In addition, the estate solicitor listed the assets that were not included in the estate, specifically referencing the proceeds held in the RBC Account and an RRSP totaling \$67,218.34 (the "**RRSP**"). The lawyer advised the estate solicitor that he would recommend to his client that she elect for an equalization of the net family property under the *Family Law Act* (the "**FLA**"), unless the estate solicitor provided assurances

²⁹ [2007] O.J. No. 2475 (Ont. S.C.J.)

that his client would distribute the proceeds in the RBC Account and the RRSP as estate assets.

Assurances never came. The six month limitation period to file the equalization election was rapidly approaching and Mrs. lasenza understood the assets available for distribution were about half (\$310,292.00) of what the actual estate was worth. No assurances were forthcoming that the RBC Account and the RRSP would be available for distribution pursuant to the terms of the Will. In addition, the lawyer expected Mr. lasenza's former wife to bring a support claim against the estate.

Accordingly, on August 21, 2004, Mrs. lasenza elected to take under section 6(1) of the *FLA*.

At trial, it was held that the RBC Account and the RRSP would be included as estate assets and would, therefore, pass under the Will. At the time of Mr. lasenza's death, the estate was worth about \$612,000.00.

Having made the election, Mrs. lasenza was not entitled to receive the one-third she would otherwise have received under the Will. In fact, since her net family property was actually greater than Mr. lasenza's, she received nothing.

As a result, Mrs. lasenza sought an order setting aside, or declaring of no force and effect, her election. The issue for the Court, then, was whether or not it had the discretion to set aside an election made under section 6 of *FLA*.

It was ultimately held that the Court does have a residual discretion to set aside an election made under section 6(1) of the *FLA*; however, such discretion should only be exercised in restrictive circumstances where the interests of justice require it, and where the balance of the interests of effected parties clearly warrants it.

In exercising its discretion, it was held that a Court should refer to the following factors:

1. Was the election filed as a result of a **material mistake of fact or law** made in good faith?
2. Was there any **responsibility or culpability** on the part of effected parties in relation to the election?
3. Was the notice of intent to seek revocation of the election given in a **timely** way and, in particular, how long after the 6 month filing period was such notice given?
4. Has the estate been distributed or would **interested parties** otherwise be **adversely effected** by a revocation of the election?
5. Does the election result in an **injustice to the surviving spouse** in all of the circumstances?

In the end, the Court held that this was an appropriate case to declare that Mrs. lasenza' election under section 6(1) of the *FLA* was of no force and effect. It reasoned that there was a material misunderstanding, or lack of knowledge, as to what assets formed part of the estate, and that the estate should bear some responsibility for that misunderstanding – after all, it refused to provide assurances to Mrs. lasenza that significant assets would be included in the estate.

Furthermore, the beneficiaries of the estate would not be prejudiced by the revocation of the election as Mrs. lasenza's intention to challenge her decision was given within a sufficient time. The *FLA*, it was noted, is remedial in nature. Section 6 was designed to enlarge the rights of a surviving spouse upon the death of the other spouse, rather than to restrict the rights of spouses. According to the Court, the election that was made, based on a mistake of fact and what appears to be a mistake of law as to its operation of section 6 of the *FLA*, would have draconian consequences if Mrs. lasenza was required

to adhere by the election. She would completely lose the intended benefits of the election, compared to a one-third bequest in an estate with a current gross value of \$650,000.00.

As a consequence, Mrs. Iasenza's election was set aside. A very novel result indeed.

Conclusion

In practice, the use of trusts can be an essential planning tool. Trust lawyers, however, tend to look at trust agreements somewhat differently than family law lawyers might. Whereas some focus on things like rights, duties and obligations, others might be more concerned with the view of a trust as simply another piece of property – something to be valued and eventually divided.

From a trusts perspective, the trust deed itself can't be ignored – nor can the fiduciary obligations of a trustee be disregarded. Unfortunately, though, planning intentions can be frustrated – and we want to be sure that we advise our clients about this possibility, and then try to protect against it, as best as we can.