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BUSINESS TRUSTS

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WITH the rapid growth of the corporation as a business unit due to the limited liability of its stockholders, have also come the numerous statutory regulations and prohibitions of the same. Due to governmental inquisition, regulation, and special taxation "capital" has looked about for a new form of business unit which would have all the advantages of the corporation and yet not be hampered with the statutory exactions that have grown up along with the increase and popularity of the corporation.

This search has evolved the use of the business trust which in reality is a development of the common law trust. These trusts have been called at various times "Common Law Companies", "Common Law Corporations", "Massachusetts Trusts", "Voluntary Associations" and "Business Trusts". The business trust, which seems the more appropriate name, has had its growth and development mainly in the state of Massachusetts where such trusts were formed to deal in real estate because the legislature prohibited a corporation from so doing. Of late years its use has been increasing in other states, especially in Texas in the oil industry, where trusts were formed to purchase and develope oil properties.

As the name would imply, this method of doing business is simply a development of the common law trust, which rests upon an agreement between the trustees and the cestui que trust. In brief, it may be defined as "a combination of capital vested in trustees who issue transferable certificates for shares and execute a declaration of trust designed to provide for the shareholders all the immunities of corporate shareholders".[1] Under the trust agreement the trustees may be given varying degrees of control of the business they have agreed to carry on, but we shall see later on that this control cannot be too limited or the courts will declare the trust a partnership, and thus destroy the limited liability of the beneficiaries that is the moving factor in the formation of such trusts.

The liability of the shareholders is limited in the declaration of trust to the amount of capital each holder has contributed to the trust fund by the insertion therein of a provision to that effect, and also by inserting in all the contracts made between the trustees and third parties, that the latter will look only to the trust fund for any damages or enforcement of any contract made between them and the trustees.

[1] 21 Yale Journal 310.

The business trust seems to have many advantages over the corporate form of business unit. In Hussey vs. Arnold, 185 Mass. 202, 70 N.E. 87, the Massachusetts Supreme Court said that business enterprises could obtain (by the use of the business trust) "most of the advantages belonging to corporations, without the authority of any legislative act, and with freedom from the restrictions and regulations imposed by law upon corporations." Several advantages that the trust has over the corporate form of enterprise are that the trust insures a continuity of management which cannot be secured by the corporation with its changing officers and board of directors. The trustees of a trust are not so likely to be changed, and this produces a more flexible form of management. A few trustees can transact business more rapidly and easily than a cumbersome board of directors. These advantages will always remain in the trust, for they are inherent to its very life.

Other advantages of this form of business unit are briefly stated by Sears, in his work on "Trust Estates As Business Companies", page 17, and are as follows;

1. The doing of business upon the common law right of contract with freedom from all statutory exactions that may be imposed upon corporations, both foreign and domestic, as merely artificial persons.
2. The right of trustees to apply to courts for directions in the execution of their powers, whereby their acts are given legal certainty in advance of their commission.
3. The protection of the cestui que trustent, in their dealings with trustees, their right to accounting and full information, without the right, however, of securing information for improper purposes.
4. The protection of creditors in "following" the "trust fund" and their right against trustees individually in cases of fraud.
5. The freedom with which the terms of a trust instrument may be framed for the conduct of a particular business and according to the lawful preference of its equitable owners.
6. Latitude in amendment of provisions of management, as experience may show is desirable.
7. The winding up of a business expeditiously and without resort to proceedings at law, with their consequent burden of delay and expense, under provisions of the trust instrument, upon any termination of the trust.

In comparing the trust with the corporation, the courts are almost unanimous in holding that the business trust is not a corporation. The reasons are that a trust does not exist by virtue of legislative acts, but by virtue of the common law.[2] A corporation must secure a charter from the state, and can only exist by meeting the requirements as set forth by the legislature, while a trust may be created to carry on any legitimate business, unless such act is limited only to

[2] Gardiner vs. Gardiner, 212 Mass. 508, 99 N.E. 171 (1912).

corporations, or a trust is forbidden to carry on that certain business.[3] The trust is not organized under statutory regulations, such as corporations are.[4] In the case of Spotswood vs. Morris, supra, a trust was formed to purchase real estate, and was not organized under the incorporation laws of that state. The court said, "The association under consideration is not a corporation exercising any of the powers or privileges of corporations not possessed by individuals or partnerships. It is a voluntary association. To possess or exercise powers or privileges of corporations, requires a soverign grant, a franchise which said association has not, and does not profess to possess."

Such trusts are held not to be joint stock companies so as to be taxable as such under the Federal Income Tax Law.[5] The beneficiaries of the trust have no voice in the management of the business or control over the trustees. There is also lacking a relation of associates between the beneficiaries, which is found in the true association. In the case Crocker vs. Malley (supra) which declared that the fixing of an income tax on "every corporation, joint stock company or association—no matter how created or organized", did not include a Massachusetts trust. There the court said,

"If we assume that the words 'no matter how created or organized' apply to 'association',—still it would be a wide departure from normal usage, to call the beneficiaries here a joint stock association, when they are admitted not to be partners in any sense, and when they have no joint action or interest and no control over the fund. On the other hand, the trustees by themselves, cannot be a joint stock association within the meaning of the act, unless all trustees with discretionary powers are such."

While there are several characteristics which distinguish a trust from a partnership, there is one distinct difference which, by itself, seems to draw the line of distinction. This feature is that the trustees have unlimited control and legal title to the trust property, and the beneficiaries have only the right to see that the trustees conduct the business according to the terms of the trust agreement. Where the trustees have such an absolute control and are not subject to removal by the beneficiaries, no partnership relation exists.[6] However, a partnership was held to be created where "the certificate holders are associated together by the terms of the 'trust' and are the principals

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[3] Spotswood vs. Morris, 12 Idaho 360, 6 L.R.A. n.s. 665 (1906); Howe vs. Morse, 174 Mass. 491, 55 N.E. 123. (1899).

[4] Elliott vs. Freeman, 220 U.S. 178 (1911).

[5] Elliott vs. Freeman, 220 U.S. 178, (1911); Crocker vs. Malley, 249 U.S. 223, (1919).

[6] Mayo vs. Moritz, 151 Mass. 481 (1890); Williams vs. Milton, 215 Mass. 1 (1913).

whose instructions are to be obeyed by their agent, who for their convenience holds the legal title to their property. The property is their property. They are the masters."[7] In Wisconsin we have no case which has directly decided how much of a control the beneficiaries may be allowed before a partnership relation will be said to exist. The only case that even approached the subject was one in which the court did not go into a consideration of the terms of the trust agreement, but decided that the shareholders were liable as co-partners solely on the ground that they were not holding themselves out as doing business under a trust agreement.[8] For various forms of trust agreements that have either declared trust or partnership see note 40 and 41 pp. 10468-9 in Fletcher's Cyclopedia of Corporations Vol. IX.

The limited liability feature of the business trust is what the investor is primarily interested in, and so let us take up the liabilities of the trustees, the trust property, and the shareholders in a "pure" business trust.

The authorities are practically agreed that the trustees are personally liable on contract and tort liabilities incurred by them and their agents in carrying out the trust agreement.[9] The reason is that the trustees are not agents, but principals, and as such are bound, for the trust estate cannot make a promise. In the leading case of Faladreau vs. Boston Arts Association 181 Mass. 405, (1903) the trustees employed a janitor to care for a building of the trust estate. He negligently injured the plaintiff, while in the scope of his employment. The court held that the janitor was the servant of the trustees and not the cestui que trust, and so the latter were not liable for the injury. It would seem that third parties have no direct right against the beneficiaries, but must look to the trustees individually. A provision may be inserted in the contracts between third persons and the trustees for the benefit of the trust, that the creditor will look only to the trust property for the satisfaction of the debts of the trust estate. Such a provsion has been held binding upon both parties.[10] Neither is such an agreement contrary to law or public policy.[11] However, a provision in a declaration of trust exempting

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[7] Williams vs. Milton, 215 Mass. 1 (1913).

[8] Hayes Motor Truck Wheel Co., vs. Woelff, 175 Wis. 501 (1922).

[9] Taylor vs. Davis, 110 U.S. 330 (1883).
McGovern vs. Bennett, 146 Mich. 558, 109 N.W. 1055;
Sleeper vs. Park, 232 Mass. 292, 122 N.E. 315 (1919).

[10] Hussey vs. Arnold, 185 Mass. 202, 70 N.E. 87, (1904);
Rand vs Farquhar, 226 Mass. 913, 115 N.E. 286 (1917).

[11] American Smelting Co. vs Converse 175 Mass. 449, 56 N.E. 62.

the trustees from personal liability will not save them unless there is a special clause in the specific contract between the trustees and the third party exempting them from liability.[12]

Since the trustees are individually liable for obligations created for the benefit of the trust and within the scope of their duties, they have an inherent right to be reimbursed out of the trust fund for such expenses.[13] But where they have not been authorized to create a liability, they have no right to reimbursement,[14] and neither has the trustee such a right if he incurs a liability for a tort which was the result of his own negligence. Because of this it is best to provide in the trust agreement, that the trustees shall take out indemnity insurance to protect them, and that such expense be paid out of the trust fund.

Suppose however, that the trust fund is not sufficient to reimburse a trustee who has paid a liability properly incurred in carrying out the trust, might not the trustee obtain reimbursement from the beneficiaries personally? In the casé of Hardoon vs. Belilios, A. C. 118, (1901) it has been so held. In that case, the highest court in England said,

"The next step is to consider on what principles an absolute beneficial owner of trust property can throw upon his trustee the burdens incidental to his ownership. The plainest principles of justice require that the cestui que trust who gets all the benefit of the property should bear its burden unless he can show some good reason why his trustee should bear it himself. The obligation is equitable and not legal, and the legal decisions negativing it, unless there is some contract or custom imposing the obligation, are wholly irrelevant and beside the mark. Even where the trust property is settled on tenant for life and children, the right of their trustee to be indemnified out of the whole trust estate against any liabilties arising out of any part of it is clear and undisputable . . . Where the only cestui que trust is the person sui juris, the right of the trustee to indemnity by him against liabilities incurred by the trustee by his retention of the trust property has never been limited to the trust property; it extends further and imposes upon the cestui que trust a personal obligation enforceable in equity to indemnify his trustee. This is no new principle, but is as old as trusts themselves."

It would seem beyond question that there is an equitable principle which imposes upon the beneficiary of a trust the duty to reimburse the trustee for liability and expenses incurred in the proper execution of the trust when the trust estate is not sufficient. Therefore, so long as this liability exists, the beneficiaries of a business trust are exposed to unlimited liability, and this is true whether the court de-

[13] Pomeroy, Equity Jurisprudence 3rd ed. par. 1985.

[14] Land vs Winchester, 64 Mich. 23, 30 N.W. 896 (1897).

cides that there is a partnership or a trust relationship. The fact that the declaration of trusts is held to create a strict trust will not necessarily save the shareholders. To do that the declaration of trust must go farther and provide that the trustees will look only to the trust fund for reimbursement. The validity of such a provision has not been directly decided in this country, but it would seem valid from the language used in the English case of Hardoon vs. Belilios, supra. There Lord Lindley said:

"The obligation of such a person (cestui que trust) to indemnify his trustee against calls upon him appears to their Lordships indisputable in a court of equity, *unless of course, there is some contract or other circumstance which excludes such obligation.*"[15]

The insertion of such a provision cutting off the trustee's equitable right of reimbursement would not be invalid as against public policy, for this would be merely a contractual arrangement as to the right and correlative obligation of the parties, and as such are proper subjects for contractual control. The cestui is not contracting liability for wrongs he may do the trustee, but is only giving him notice, to which he (trustee) assents, that the cestui may not protect him against obligations for which the trustee alone and not the beneficiary, is liable to third parties.[16]

Again, would not such an insertion in the trust agreement be a remedial wrong against any trust creditors which might hinder, delay, and defraud them as creditors of the trustee, and therefore be declared invalid? It seems not, where the distruction of the trustees equitable right takes place before there are any creditors of the trustees in being, but otherwise if there are any already in existance. In the English Case of In re Johnson[17] which has been followed consistently by the English court and in some of our state decisions[18] the court held in effect, that the rights of the creditor are to be subrogated to the trustee's right of indemnity, and if he (trustee) had no right of indemnity the creditor would get nothing. Nevertheless would not the fact that the *settlor* in creating the trust, with such a provision destroying the trustees right of reimbursement, evidence a desire on the part of the settlor to hinder, delay, and defraud any creditors of the trustee? Should the cestui que trust, through the

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[15] Italics are the writer's.

[16] R. S. Stevens' Limited Liability in Business Trusts," 7 Cornell Law Quarterly 127 (1922).

[17] In re Johnson L. R., 15 Ch. D. 548, 552 (1880).

[18] Hewitt vs Phelps, 105 U.S. 393 (1881).
Wilson vs Fridenburg, 21 Fla. 386 (1885).
First National Bank of Freehold vs Thompson, 6 N.U. Eq. 188 (1901).

trustees, take all the profits of the trustee's contracts with creditors, and leave the creditors holding the "sack"?

The whole question of the liabilities of cestui, trustees, and trust estate is briefly summarized by Stevens as follows:

"The primary situation resulting from the creation of a business trust and without any contracts avoiding personal liabilities are:

1. The third party has a direct right against the trustee, but no direct right against the beneficiary.
2. The trustee has a right of reimbursement out of the trust estate, and if that is insufficient, against the beneficiary.
3. The third party has a derivative right through the trustee against a trust estate and against the beneficiary.

This primary situation may be changed by inserting the appropriate provisions in the trust agreement, so that the following will result:

(1) The trustee's right of reimbursement from the beneficiary, and hence the third party's derivative right against the cestui que trust, can be cut off.

(2) An agreement that all liabilities created by the trustee within the scope of his duties, whether in tort or contract, are to be satisfied out of the trust estate alone, and not out of the trustee's personal estate."

To have this last provision effective against third parties, it must be inserted in the contract relations between the trustee and the third party.

The business trust agreement must be drawn up so that it will not offend the rules against perpetuities, although some of the cases hold that such a trust does not come within such rule.[19] In this case, the trust was organized to deal in real estate for the sole benefit of the settlors and assignees. The court held in effect that since the time of sale was left to the discretion of the trustees, there were persons in being at the creation of the estate, and hence no invalid suspension of the power of alienation, and so no question as to perpetuities could arise. In a New York case[20] the court said:

"The mere creation of a trust does not ipso facto, suspend the power of alienation. It is only suspended by such a trust, when a trust term is created, either expressly or by implication, during the existence of which a sale by the trustee would be in contravention of the trust. Where the trustee is empowered to sell the land, without restriction as to time, the power of alienation is not suspended, although the alienation in fact may be postponed by the non-action of the trustt, or in consequence of a discretion reposed in him by the creator of the trust."

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[19] Hart vs Seymour, 147 Ill. 598, 35 N.E. 246 (1893).

[20] Robert vs Corning, 89 N.Y. 225 (1882).

In Wisconsin, a suspension of alienation for a period of twenty one years was upheld,[21] when the statute expressly prohibits a suspension for a longer period than two lives in being at the Creation of the estate and twenty-one years thereafter.[22]

In summarizing the question of perpetuities involved in a business trust, we may say that where the holders of the beneficial shares are the only ones who have an interest in the trust, such trust is revocable, and so there are at all times owners in being who may convey and destroy the absolute suspension of the power of alienation. In nearly all the states a suspension of twenty-one years not predicated on a life is valid, and that a period of time may be inserted in the trust agreement when it is to be measured by lives.

By the use of the business trust, certain taxes that are imposed upon companies organized under statutory regulations, may be escaped. Our Federal Supreme Court has held that a trust does not come within the provisions of the Federal Statutes placing a tax upon the income of corporations.[23] One reason for so holding, was the fact that the trust in question was not organized under any statute or derived any benefit from any statute which corporations or joint stock associations enjoyed. Thus, the organizer of a business trust must be careful not to form any trust under any such statute. This point is emphasized in the case of Roberts vs. Anderson,[24] where the court held that because the United States Express Company was enjoying privileges under the New York Statutes relative to joint stock companies, it was subject to the Federal Corporation excise tax of 1909.

In reviewing the cases on the subject of the taxability of the trustee, or beneficiary, or both, the weight of authority is that where there is a separation of the legal and equitable title, (as in a trust) in the same property, the tax must fall on either the holder of the legal or the beneficial title, and not upon both.[25] So where both trustee and cestui que trust reside in the same state, one tax only can validly be imposed. If they are separated, the tax is assessed in

[21] In re Will of Kopmeier, 113. 233 (1902).

[22] Wis. Stat. 1925, Sec. 230.15.

Note: Sec. 230.15 in 1929 ,was changed so that it now reads: two lives in being plus 30 years.—Ed.

[23] See note 5.

[24] Roberts vs Anderson, 226 Fed. 7, 144 C.C.A. 121 (1915).

[25] Robinson vs Dover, 59 N.H. 521 (1880); Latrobe vs Mayor, etc. of Baltimore, 19 Md. 13 (1862); People Ex Rel. Darrow vs Coleman, 119 N.Y. (1900); Lowry vs Los Angeles Co., 175 Pac. 702 (1918); Augusta vs Kimball, 40 Atl. 666 Me. (1898).

the state where the property is held. In Wisconsin, Section 226.14, Sub Sec. 10 of the statutes of 1929, provides that the business trust is to be subject to all the taxes that a corporation is liable for. This alters the situation in Wisconsin, so that as far as taxes are concerned, the business trust is treated on the same basis as the corporation.

This brings us to the question of what is the situation here in Wisconsin and what is the status of the business trust in this state. Before the passage of our so called "Blue Sky Law," and the statute relative to common law trusts, (Sec. 226.14 Wis. Stat. 1929) there seems to have been nothing to qualify the formation and activities of business trusts such as we have discussed in this article, and which seemed to have flourished in other jurisdictions, especially in Massachusetts. It may have been the Hayes Motor Truck Wheel Case (supra) that awoke the legislature to the possibilities of the business trust in this state, and because of the fraud involved in that case to add, in 1923, section 226.14 to our statutes. This section recognizes the business trust and virtually places it in the same status as a corporation in relation to its formation, its activities, and assessments of taxes. Then too, the "Blue Sky Law" also includes within its scope, the business trust; for by section 189.02 Sub. Sec. 5, Wis. Stat. 1929, the term "company" is defined to include "all domestic and foreign private corporations, associations, joint stock companies, partnerships, trusts, common-law companies, syndicates, pools, or any form of organization or association organized or proposed."

Thus it would appear that anyone desiring to organize a business trust in this state must be guided by the particular directions as set forth in the above cited sections, without which no such business trust could be validly formed and operated in the state of Wisconsin.

Of course this legislation practically annuls some of the features contained in the original purposes for which the common law business trust was formed, such as any exemption from corporate taxation, the exemptions of statutory restrictions and limitations, which necessarily limited the field of corporate activity, and other like features.

But regardless of the effect of the above mentioned statutes, there still remains in Wisconsin, those inherent advantages of the business trust which we have previously set forth; among them being the flexibility and continuity of management, and the personal responsibility in the trust management generally, as against the impersonal responsibility in management of the corporation by the continual changing of its directors and officers. Then too, there is the advantage of having a court of equity, in questionable matters, direct the course in the execution of the powers of the trustees, whereby their acts are given legal certainty in advance of their permission. There also remains the protection to the creditors in following the trust funds and of their right against trustees individually in case of fraud. I will not attempt to numerate all of these advantages that remain, even in Wisconsin's control over these trusts.[26]

[26] This article is printed primarily for the purpose of stimulating interest. Further discussion of the subject is invited.—Editor.