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Insolvency in trusts: Representation of the Z Trusts

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In Representation of the Z Trusts [2015] JRC 196C, the Royal Court has provided guidance on the underlying principles relevant to “insolvent” trusts. This is a novel area of the law. It represents, therefore, an important development not only within Jersey but also to the broader international trust industry.

The Facts

The facts can be briefly stated. “Madame C” had established a series of Jersey trusts. Two of the trusts were “insolvent” - the "Z II Trust" and the "Z III Trust". The Royal Court accepted that "insolvent" was a misnomer on the basis that trusts do not have sufficient legal identity to render them formally capable of either solvency or insolvency. Nevertheless, it saw it as a convenient shorthand description for trusts where the trustee is unable to discharge liabilities as they fall due out of trust assets. In this regard, it confirmed that the “cash flow” test was the appropriate test for establishing such insolvency in the context of a trust.

The Z II Trust had a number of creditors including:

- the current trustees, for substantial unpaid fees;
- the former trustees, in relation to liabilities arising from litigation commenced against them by a third party regarding events connected with their former trusteeship. The former trustees' creditor claim arose pursuant to their trustee indemnity and equitable lien, which existed to protect them from the financial impact of such liabilities (in relation to which see our previous briefing).

The Z III Trust also had a number of creditors including, in particular, the Z II Trust for a substantial sum of money. Thus, the respective solvency of the two trusts was interlinked, with the fate of the Z III Trust ultimately dependent on the fate of the Z II Trust (the winding-up of the Z II Trust potentially

triggering the winding-up of the Z III Trust).

The trusts were being administered under direction of the Court. In this context, discussions had commenced about a proposed Court-sanctioned “insolvency regime” in relation to the Z II Trust, which would involve the ascertainment of claims and priorities and the realisation of assets. This was with a view to the matter coming back before the Court for the regime to be approved. However, the beneficiaries of the two trusts (Madame C and her family) were agreed that the imposition of such an insolvency regime would be calamitous, for example because of the potential forced sale of important family assets.

As a result, Madame C wished to replace the current trustees of both trusts with new trustees, which she had the power to do under the respective Trust Deeds. Once appointed, it was envisaged that a wide ranging review and restructuring would take place for both trusts “with a view to a more stable administration of their affairs” (i.e. potentially negating the cash flow insolvency). Accordingly, in June 2015 she executed a Deed of Retirement and Appointment to that effect in relation to the Z II Trust. However, the former trustees (in their capacity as creditors) raised concerns over Madame C exercising this power, which was a fiduciary power, in circumstances where the former trustees claimed she had a conflict of interests.

The Law

The Court confirmed as follows:

- the power to appoint trustees is a fiduciary power;
- an exercise of a fiduciary power to appoint a new trustee which is a “fraud on a power” is void;
- a “fraud on a power” arises where “the power has been exercised for a purpose, or with an intention, beyond the scope of or not justified by the instrument creating the power”;
- a fiduciary is under a duty to act in the best interests of the person to whom the fiduciary obligation is owed;
- trust powers must be exercised in the interests of the trust to which the powers relate. They cannot be exercised for the benefit of another trust in the structure, even though it may be convenient to do so.

These points reflect existing principles of Jersey law. What had not been determined is how they should be applied in the context of an insolvent trust. In this regard, the Court held that insolvency in a trust brings about a shift towards the interests of the creditors analogous to that seen in company law. Thus, the trusts should be administered by the trustees on the basis that the creditors, and not the beneficiaries, have the economic interest. The same principle applied to third parties, such as Madame C, who held fiduciary powers in relation to the trust. They were to be exercised for the benefit of the creditors and not the beneficiaries.

Accordingly, the Court concluded that, in circumstances of insolvency, the trustee or fiduciary should exercise its powers either with the consent of all the creditors or under direction of the Court. The trust should also be administered for the benefit of the creditors as a class, and not simply for a majority of them (regardless of how big the majority is).

The Decision

The Court held that the appointment of the new trustees of the Z II Trust should be set aside. It held that, at the time the appointment of new trustees was made, the Z II Trust was insolvent and under the direction of the Court. No notice had been given of the proposed appointment to the former trustees (as creditors). Madame C did not, therefore, have the consent of all the creditors or the approval of the Court.

The Court also held that Madame C had taken her decision in the interests of the beneficiaries, with a view to trying to avoid the insolvency, and not in the interests of the creditors. The fact that some of the creditors (notably those connected with the family) approved, was not enough. The decision had not been taken for the benefit of the creditors as a class.

Comment

This case provides welcome guidance, and something of a warning, to trustees who find themselves administering trusts which are in a parlous financial condition. Other trust-related fiduciaries should also take note. It comprises further confirmation of the duties owed to creditors, and not beneficiaries, where a trust is “insolvent”. This may be instinctively uncomfortable for trustees who normally administer trusts on behalf of the beneficiaries to the exclusion of all others. However, being able to adopt a shift in approach, and recognising when it is right to do so, is now unquestionably a necessary skill for Jersey’s professional trustee community.

We await to see what insolvency regime the Court may approve in relation to these trusts. In particular, it remains to be seen whether the regime will involve the appointment of insolvency practitioners to undertake the asset realisation process. Whilst such a step would be consistent with broad insolvency principles, the appointment of receivers over trusts is a rarely used concept.

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