

# The Approach in Jersey to ‘Insolvent’ Trusts: The Z Trusts

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Much has been written in recent years regarding the somewhat vexed question of what happens when a trust becomes ‘insolvent’. That bald question of itself begs closer analysis, particularly in view of the fundamental principle that a trust has no legal personality and therefore cannot technically be insolvent. The position in Jersey is further complicated by the presence of the statutory protection afforded to trustees whereby their liability, when contracting as trustee with another party who knows them to be so acting, is limited to the trust assets.<sup>[1]</sup> The traditional (English law) position differs in that (absent a contractual limitation) a trustee is personally liable for all debts it incurs in its capacity as trustee, and must rely on its right of indemnity to recover those liabilities from the trust estate.

Whilst the statutory protection provision in Jersey is a very relevant consideration in this area and will be touched upon, this article will consider the recent decisions of the Royal Court of Jersey in the cases concerning the Z Trusts.<sup>[2]</sup> These entailed a scenario in which trustees of related trusts were unable to meet liabilities incurred as trustees of the trusts as they fell due. Directions were sought from the Royal Court. The Royal Court, therefore, was called upon to provide guidance on the underlying principles that apply to ‘insolvent’ trusts and, in the context of the parties’ positions, provide a framework for tackling the situation that had arisen.

### Factual background

There were eight Z Trusts, all of which had been established by a Mrs C and of which Equity Trust (Jersey) Limited (‘Equity’) was the original trustee. Equity retired as trustee of all of the Trusts in 2006 with Volaw Trustee Limited (‘Volaw’) becoming trustee of the Z Trust and Z II Trust and Barclays Private Bank and Trust Limited (‘Barclays’) trustee of the remaining six trusts. Under the

terms of the deeds by which it retired in 2006, Equity handed over the assets of the Trusts in return for standard indemnities.

After retiring, Equity had been put on notice of certain claims for which it said it was entitled to be indemnified both contractually and in law from the assets of the Z II Trust. However, the Z II Trust, as well as the Z III Trust were 'insolvent', in that the trustees of those Trusts could not meet out of trust assets the liabilities incurred in respect of those Trusts when they fell due. The remaining Trusts, whilst solvent, faced a number of financial difficulties. Mrs C was critical of the conduct of Equity as trustee and, with others, had brought breach of trust proceedings against Equity in which counterclaims were also raised by Equity. In short, there was a general background of hostility.

### ***Court administration: insolvency regime and change of trustee considered***

The Trusts were being administered pursuant to directions of the Royal 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. The beneficiaries of the Z II and Z III Trusts (Mrs C and her family) took the view that the imposition of such a regime would be calamitous, not least as it would likely lead to the forced sale of assets considered to be of importance to the family. Mrs C and her family had been pressing for new trustees to be appointed in respect of the Z II and Z III Trusts and considered that resolving the difficulties and hostility affecting the Trusts would be facilitated by the appointment of a single new trustee to replace Volaw and Barclays. Rawlinson & Hunter Trustees SA ('R&H'), based in Switzerland, had agreed to take on that role. Mrs C envisaged that, once R&H were appointed, a wide ranging review and restructuring would take place for both the Z II and Z III Trusts with the anticipation of a more stable administration, which might potentially thereby overcome the cash flow insolvency.

Accordingly, in June 2015 Mrs C executed a Deed of Retirement and Appointment to appoint R&H as trustee of the Z II Trust. Equity had concerns about Mrs C's actions, both in its capacity as a creditor (in respect of its indemnity claims) and in circumstances where Equity considered Mrs C to have a conflict of interest. In protection of its indemnity claim, Equity claimed an equitable lien over the assets of the Z II Trust and was concerned to ensure that these assets and the lien were not destroyed, diminished or jeopardised. In particular,

Equity was concerned that the appointment of a nonresident trustee could make enforcement of its rights under the indemnities and the lien more difficult. As a consequence, the change of Trustee was effected for all but the Z II and Z III Trusts.

### ***Financial status***

The Z II Trust had only one asset, namely a loan due from the Z III Trust of GBP 186m, albeit written down by Volaw to GBP 6m to reflect likely recovery. The Z II Trust had a number of

creditors including, in particular, Volaw for substantial unpaid fees (exceeding GBP 1m) and Equity in respect of claims under its indemnity and equitable lien. The claims against Equity giving rise to its claims were for potentially substantial sums in relation to liabilities arising from litigation commenced by a third party. That litigation concerned events connected with equity's former trusteeship. Equity had, at one stage, agreed to limit its claims to GBP 2m if ring-fencing of that value of trust assets could be agreed. Equity also had claims in respect of legal costs connected to other proceedings.

The Z III Trust had assets valued at GBP 15.9m, including cash of more than GBP 4m. It also faced substantial creditor claims of GBP 279m, including a loan due to Mrs C of GBP 86m and the loan due to the Z II Trust as described above.

From an insolvency perspective, therefore, it was clear that the Z II Trust could not meet its liabilities as they fell due - at the very least the Volaw fees were presently due. Furthermore, 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 on the basis that the winding-up of the Z II Trust would potentially trigger the winding-up of the Z III Trust should the claims to the loan due to the Z II Trust by the Z III Trust be pursued.

### **Issues for the Royal Court of Jersey**

The Royal Court delivered three judgments in 2015 concerning the Z Trusts, addressing the key issues arising from the facts summarised above, as follows:

1. To determine whether or not Equity did in fact have an equitable lien as a matter of Jersey law and, if so, what priority (if any) that claim enjoyed;[3]
2. To determine the validity of the appointments of R&H by Mrs C in the context of the insolvency of the Z II and Z III Trusts:[4] and
3. To determine what insolvency regime would be appropriate for an insolvent trust and whether insolvency practitioners should be appointed to realise the trust assets.[5]

### **Important elements of the Court's Decisions**

The Royal Court accepted that the expression *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.

### ***Priority of a former trustee's indemnity claim***

In its first decision, the Royal Court concluded that a former trustee does have an equitable lien, following the decision of the Guernsey Court of Appeal in *Investec Trust (Guernsey) Limited v*

*Glenalla Properties Limited*,<sup>[6]</sup> in which Guernsey based former trustees of a Jersey law trust are being pursued for loan repayments by liquidators of certain BVI companies. As regards priority, the Court had no hesitation in confirming that a claim by a former trustee pursuant to its right of indemnity or equitable lien (which in this case, in the absence of any ring-fencing was held to extend to all of the assets of the Z II and Z III Trusts) had priority over claims by beneficiaries. As regards creditors, the Court noted that, strictly, a trust does not have creditors (rather, the trustee does) and indicated that further submissions would be required, but noting that where a deficiency of assets arose a question remained whether a former trustee would have priority over claims of a current trustee for liabilities they incur in that capacity.

### *Insolvency test for trusts and acting in the interests of creditors*

In its second decision, the Royal Court had to consider the status of Mrs C's attempted change of Trustee of the Z II and Z III Trusts to R&H and in whose interests that decision should be taken. Interestingly, from the point of view of insolvency principles, the Court confirmed that the cash flow test was the appropriate test for establishing insolvency in the context of a trust, referring to the approach adopted in insolvent estates<sup>[7]</sup> but noting that a trust is more akin to a company or an individual given the ongoing conduct of its affairs, as opposed to an estate where there is a final winding up of the deceased's affairs.

The Court confirmed the well-established Jersey law principle that the power of appointment of trustees exercised by Mrs C was fiduciary and, accordingly, she was required to act in the best interests of the person to whom such fiduciary obligation is owed and in the interests of the trust to which the powers relate. However, the interesting and novel point was how those principles would apply where the trust in question is insolvent. Significantly, 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, an insolvent trust should be administered by the trustees on the basis that the creditors, and not the beneficiaries, have the economic interest. The Court also confirmed that the same principles apply to those exercising fiduciary powers in relation to the trust and, therefore, such powers 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 Court held that the appointment of the new trustees of the Z II Trust should be set aside on the basis that, at the time the appointment, the Z II Trust was insolvent and under the direction of the Court, no notice had been given to the former trustees (as creditors) and their consent was not given. The Court also considered that Mrs 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 the appointments, was not enough. The decision had not been taken for the benefit of the creditors as a class.

### *What insolvency regime should apply*

In its third judgment, the Royal Court considered what insolvency regime should be applied to the Z II and Z III Trusts. The current trustees proposed a regime based on that previously adopted in a Jersey case involving an insolvent estate<sup>[8]</sup> (and which was itself based on the Jersey *désastre* (bankruptcy) provisions that exist for insolvent companies and individuals). This approach would entail creditor claims being examined and either admitted or rejected, and for there to be an orderly realisation of assets for the benefit of the creditors.

The current trustees argued that they could examine creditor claims, ascertain priorities and realise assets and, accordingly, there was no need for an insolvency practitioner to be appointed. They contended that Article 32 of the Trusts (Jersey) Law 1984 (which as noted above provides that, where a creditor knows that a trustee is acting as trustee, creditor claims will only extend to the trust property) removed any issue of a conflict of interest that would otherwise arise if the trustees were personally liable for assessing and admitting creditors' claims.

Equity, as former trustee, argued that the Royal Court (exercising its supervisory jurisdiction) should appoint an insolvency practitioner to wind up the trusts as would be the case in insolvency scenarios involving companies and individuals. Equity proposed that different insolvency practitioners should be appointed for each trust, and, as officers of the Court, they should conduct an investigation into the circumstances in which the trusts had become insolvent. This stance was resisted by Mrs C, who pointed amongst other things to the potential expense of such a step.

As already determined, the Royal Court's starting point for an insolvent trust is that the Court should supervise the administration of that trust in the interests of the creditors. The Court will look to whether there is a power within the trust deed (as there was in the case of the Z II and Z III Trusts) for the trustees to appoint insolvency practitioners voluntarily to assist them in the administration of the trusts, and to delegate tasks to them. In terms of precedent, whilst the Court recognised that it had, on rare occasions, appointed receivers over Jersey trusts, that had not been done in relation to insolvent trusts, although the Court confirmed that it has the power to make such an order given the breadth of its inherent supervisory jurisdiction.<sup>[9]</sup> The Court emphasised the need for it to retain discretion and flexibility to address the circumstances of an insolvent trust on its own merits. In this case, the Royal Court saw little point in engaging a formal process of examining, admitting or rejecting claims in relation to the Z II Trust or the Z III Trust as, with the exception of the claim of Equity as former trustee, all of the creditor claims were accepted.

### **Conclusions**

The saga of the Z Trusts has provided, through the judgments handed down in 2015, some welcome guidance with regard to the approach to the administration of trusts facing financial difficulties. There is a clear statement that when insolvency arises, the interests of creditors, and not beneficiaries, are paramount. The confirmation that the cash flow insolvency test is applicable is also a useful clarification.

Where matters are perhaps left in the air is in respect of the regime to be imposed, if any. In refusing to appoint an insolvency practitioner over the Z II and Z III Trusts, and concluding that an insolvent estate of a deceased is not a useful analogy, delivers something of a blow to those in that line of professional practice who might have seen the winding up of trusts in the wake of the financial crisis as a rich seam of work. However, the Court has left the door open to the possibility that such an appointment could be made in the right circumstances. The advantages of an independent and impartial liquidator might well be attractive to a Court in other circumstances such as where the affairs of the trust and, perhaps, the actions of the trustees and the status of liabilities and creditors' claims need to be carefully reviewed and possibly adjudicated upon. What is clear is that the interests of the creditors will be treated as paramount in an insolvent trust and if there is sufficient creditor support for the appointment of an insolvency practitioner that may be hard to resist, especially if that is the unanimous view of the creditor body.

As matters stand, those who are advising trustees or creditors in circumstances where a Jersey trust is insolvent are still left with little option but to seek a Court ordered solution. Whether this is something that the legislature will address its mind to will remain to be seen. Whether also there is a prospect of this issue taxing the Courts in other jurisdictions where there is no equivalent of Article 32 is also questionable. A trustee that is personally liable could be wound up/made bankrupt and the liquidator/trustee in bankruptcy would no doubt look to recover under the trustee's indemnity against the trust assets to the extent available. The limited liability that Article 32 has granted to trustees by reference to the assets of the trust has not only given rise to an abundance of issues of construction and practical application (which are still being argued out before the Guernsey Courts in *Glenalla*), but would appear to have created a situation where creditors will be looking for dividends by reference to the trust fund. Importantly for the professionals involved there will also be a tension with regard to the ongoing decision making regarding a trust, particularly in what might be a lengthy period before a decision as to the way forward is made by the Court, and the payment of trustee fees and expenses during that period. This is an area of law that will undoubtedly continue to develop.

## Notes

1 Article 32 of the Trusts (Jersey) Law 1984.

2 *Representation of the Z Trusts* [2015] JRC 031; [2015] JRC 214; and [2015] JRC 196C.

3 *Representation of the Z Trusts* [2015] JRC 031 (12 February 2015).



4 *Representation of the Z Trusts* [2015] JRC 196C (23 September 2015).

5 *Representation of the Z Trusts* [2015] JRC 214 (20 October 2015).

6 *Investec Trust (Guernsey) Limited-v-Glenalla Properties Limited and Ors* [2014] (29 October 2014).

7 The Court cited *Del Amo v Viberts, Collas Crill and Others* [2012] JLR 180.

8 *Re Hickman* [2009] JRC 040.

9 Circumstances where the appointment of a receiver has been considered appropriate include where there are non-professional trustees without the requisite training or resources or where the trustee found itself in a position of real conflict.

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