

Articles

Insolvency and trusts

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Rights of trust creditors

Rights against trustee

Unlike a director, personal representative or agent, a trustee acts as principal in connection with the administration of a trust and is personally liable whether or not he is acting in accordance with the powers and duties conferred on him.

Rights to trust assets

Subrogation

A trust creditor has the right to look to the trustee's right of indemnity and associated lien over trust assets and is entitled to be subrogated to those rights (see *Re Johnson*¹ and *Jennings v Mather*²). The trustee's rights take priority over the rights of beneficiaries and even creditors who have been granted security over the trust assets (see *Re Exhall Coal Co*³).

If subrogation applies, the right of indemnity survives the trustee's bankruptcy. Indeed, the trust creditor does not have to compete with the trustee's other creditors. Because the creditor has to be a trust creditor in order to qualify for subrogation to the trustee's indemnity and lien, those rights are of benefit only to those trust creditors and not to general creditors of

the insolvent trustee (see *Re Richardson*⁴). That position was also recognized for insolvent corporate trustees in *Re Suco Gold Pty Ltd.*⁵ Similarly, the right survives if the trustee absconds or dies.

Trust creditors

Not all of the trustee's creditors can be subrogated, and the creditor's rights of subrogation are not necessarily co-extensive with the right of indemnity. In order to be subrogated, the creditor must be a 'trust creditor'. The right exists to the extent that the trustee has exercised trust powers. In other words, the trustee must have incurred liability to the creditor as a result of an exercise of trust powers.

A right of subrogation has been recognized when the trustee has incurred a contractual liability (see *Re Pumfrey*⁶) and when, in the exercise of a power, the Trustee has incurred a non-contractual liability (see, eg for costs *Re Blundell*⁷ and in tort *Re Raybould*⁸).

Loss of right of indemnity

A creditor can only be subrogated if he proves that the trustee has a right of indemnity. That right may have been lost, for example, because the trustee lacked capacity under the trust instrument to incur a liability (see, eg *Ecclesiastical Commissioners v Pinney*).⁹ The

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1. [1880] 15 Ch D 548.

2. [1902] 1 KB 1.

3. (1866) 55 ER 970.

4. [1911] 2 KB 205.

5. (1982) 33 SASR 99.

6. (1882) 22 Ch D 255, 259.

7. [1890] 44 Ch 1.

8. [1900] 1 Ch 199.

9. [1900] 2 Ch 736. The Court retains a discretion to allow an indemnity nevertheless (see *Vye v Foster* (1872) 8 Ch AC 309, 366–37). Whether and how a creditor would invoke this discretion is unclear.

indemnity may also be lost if the trustee failed to follow a necessary procedural requirement or acted in breach of a fiduciary duty. This is no more than a corollary of the requirement that the creditor's rights must be derived from the exercise of a trust power.

The right of indemnity may also be suspended if the trustee has committed a separate breach of trust, either before or after the transaction in question. In most cases, no amount of due diligence will tell the creditor whether this has happened. The Trustee first has to make good his default before the indemnity revives (see Jessel MR in *Re Johnson*¹⁰). The creditor is subrogated to the indemnity on the same terms: he must make good the default before he can have access to trust assets.

Limiting trustee's liability

Contractual limitation

At common law, it is only possible to limit liability to the trust assets if the trustee and the creditor have expressly agreed. A trustee will not have done enough if all that is done is for the trustee to state that he contracts 'as trustee' (see *Muir v City of Glasgow Bank*¹¹). A trustee may be able to persuade a third-party to agree that liability should be limited or excluded or that the creditor can only have recourse to the trust assets pursuant to the trustee's right of indemnity.

Structural limitation

A trustee cannot suppose that all personal liability can be avoided as a matter of contract. The real concern must be the potential for unpredictable, non-contractual liabilities in tort or restitution. The most effective way for a trustee to distance himself from trust creditors is to transfer assets to a special purpose vehicle, which can then be supervised or left to run more or

less independently with the aid of an anti-Bartlett clause. Nevertheless, cases do fall through the net, especially when they concern structuring of the trust.

Statutory limitation in offshore jurisdictions: *Glenalla*

General liability may be limited to the trust assets by statute as it is in a number of offshore jurisdictions. To take a paradigm example of such a provision, Article 32 of the Trusts (Jersey) Law 1984 provides that:

1. Where a trustee is a party to any transaction or matter affecting the trust –
 - a. if the other party knows that the trustee is acting as trustee, any claim by the other party shall be against the trustee as trustee and shall extend only to the trust property;
 - b. if the other party does not know that the trustee is acting as trustee, any claim by the other party may be made against the trustee personally (though, without prejudice to his or her personal liability, the trustee shall have a right of recourse to the trust property by way of indemnity).
2. Paragraph (1) shall not affect any liability the trustee may have for breach of trust.

There is substantially identical protection in Guernsey (see section 42 of the Trusts Law (Guernsey) 2007, which depends on the trustee 'informing' the creditor that he is acting as such) and in the BVI (see sections 94–104 of the Trustee Act 1961).

Article 32 does not extend the right of creditors but provides protection to a trustee. Thus, it confers no new proprietary right to the trust assets. Equally, Article 32(1) does not deprive the creditor of the right to be subrogated to the trustee's indemnity and lien.¹²

10. *Re Johnson* (n 1) 855.

11. (1879) 4 AC 337, 368.

12. As was made clear by the Guernsey Court of Appeal in *Investec Trust (Guernsey) Ltd v Glenalla Properties Ltd* 29 October 2014 §12.

What is significant about Article 32 is that it does not depend on persuading a counterparty to agree to limit the trustee's liability. Instead, it applies whenever the counterparty 'knows' that the trustee is acting as such and not his own account.¹³ This is a very significant move away from the common law, which put the onus on the trustee. The onus is reversed and it is assumed that, since sub-paragraph (1)(a) operates when a counterparty knows that he is transacting with a trustee, he has the opportunity of taking security over trust assets if he wants.¹⁴

Moreover, Article 32 also attempts to take this concept beyond mere contract by applying it to 'any transaction or matter affecting the trust'. This wording might extend to liability for restitution or tort where there would have been no opportunity for agreement.

Investec v Glenalla (29.10.14)

The issues

In 2014, the Court of Appeal of Guernsey considered Article 32(1)(a) of the Jersey Law in two separate decisions on preliminary issues in *Investec Trust (Guernsey) Ltd v Glenalla Properties Ltd*. In the first of the decisions (27 June 2014), the Court dealt with the conflict of law principles governing the applicability of this provision. In the second (29 October 2014), the Court of Appeal was concerned with the extent of the Trustee's liability in circumstances when Article 32(1)(a) was engaged.¹⁵

The Tchenguiz Discretionary Trust (TDT) was a Jersey trust established in 2007, principally for Robert Tchenguiz, to take over his interest in the Tchenguiz Family Trust (TFT). The original TDT Trustees, Investec Trust (Guernsey) Ltd (Investec), took over TFT's borrowing with Kaupthing Bank hf (Kaupthing) pursuant to a novation and made a payment to TFT. The result was that the TDT trust assets comprised shares in a very heavily leveraged

investment portfolio held by BVI companies, which included Glenalla and Oscatello.

Pursuant to a refinancing arrangement, the Framework Transaction, the TDT Trustees assumed personal responsibility for monies becoming due from Eliza or Oscatello, two of the BVI Companies. Kaupthing had given an overdraft facility to Oscatello, which was itself guaranteed by Eliza. By 2008, the overdraft had risen to sum in excess of £600 million. Kaupthing collapsed in early 2008, and, as everywhere, credit dried up and the debts were called in. The BVI Companies were placed into liquidation on various dates in 2009 and 2010.

Hostile proceedings were commenced by Kaupthing and the BVI liquidators in the BVI and in the UK in 2009 and 2010. It was obvious that if the loans to the BVI Companies and the TDT Trustees' guarantees were valid, the trust was insolvent and unable to meet its liabilities. This prompted Investec in March 2010 to institute proceedings in Guernsey 2010, seeking a determination as to the extent of its liability. In April 2010, the receivers of the BVI Companies made a formal demand of the TDT Trustees for payment of £183 million pursuant to the guarantees. Investec was replaced by Rawlinson & Hunter as TDT Trustees in July 2010.

The former TDT Trustees argued that they had a continuing right of indemnity secured by a lien over the TDT assets and that, pursuant to Article 32(1)(a) of the Jersey Trust Law, they should only be liable to the extent of those trust assets. There was no dispute that the BVI Companies knew that the TDT Trustee was contracting as trustee, but it was nevertheless argued by them that Investec's liability was unlimited and not restricted to the TDT Trust assets. The new TDT Trustee argued that the loans and guarantees were not enforceable as having been unreasonably concluded and, in the alternative, that Investec had no right of indemnity against the assets. A further claim was made on the basis of breach of trust.

13. Under its previous incarnation (art 28(1)), it had to be shown that the counterparty had been informed that the trustee was acting as such.

14. In this respect, it also differs from art 42 of the Guernsey Trust law, which requires the trustee to inform the creditor that he is acting in that capacity.

15. The third decision dealt with the issues of unreasonableness, gross negligence, and delay in delivering judgment.

Is there liability when the right to indemnification has been lost?

The Lieutenant Bailiff (Sir John Chadwick) held that the loans were due and that Investec were not entitled to limit their own liability by reference to Article 32(1)(a). He also held that the liabilities incurred by the former TDT Trustees had not been unreasonably incurred and were liabilities properly incurred for the purposes of the statutory right of indemnification and recoupment in Article 26(2) of the Jersey Trust Law. The Lieutenant Bailiff held that he would not apply Article 32 and that the liability of the trustees was in principle unlimited. All these findings were challenged on appeal.

Having held that as a matter of private international law it would apply Article 32(1)(a) of the Jersey Trust Law as the proper law of the TDT (see §106 of its decision of 27 June 2014), in its October 2014 decision the Guernsey Court of Appeal dealt with the effect under Article 32 of the hypothetical loss of the right of indemnification under Article 26. The issue was whether a Trustee would have any personal liability if he had lost the right of indemnity. The answer to that question was not entirely easy to follow.

On one view, the wording of Article 32(1)(a) suggests that the Trustee may be liable, irrespective of any ability on his part to reach the trust assets through his indemnity or lien. The claim of the third party against the Trustee 'shall extend only to the trust assets' could be understood as setting a cap on the Trustee's liability. So construed Article 32(1)(a) operates to fix from the outset the ceiling of the Trustee's liability.

However, the Guernsey Court of Appeal apparently concluded (see §29) that there was no personal liability whenever the counterparty knew that the Trustee was acting as such so that Article 32(1)(a) applied:

The final words of sub-paragraph (1)(a) provide that any claim 'shall extend only to the trust property'. The plain reading of these words is that such a claim cannot extend beyond the trust property and in our opinion the logical consequence is that such a claim cannot extend to the personal property of the trustee.

Later on the Court again made an observation, which suggested that it was immaterial whether there was an allegation that would result in a loss of an indemnity (see § 45):

In so far as trustees are concerned, there is an improvement at least in accordance with paragraph (1)(a) because where that paragraph is engaged, a trustee is entitled to settle the liability from the trust fund and obtain his discharge in respect of that liability whether or not there remains any allegation of default against him.

If that is correct, Article 32(1)(a) means that the creditor's sole recourse is to the trust assets. There is nothing inherently wrong with this as a conclusion. It is perfectly competent at common law for a trustee to enter into a contractual engagement to limit the creditor's recourse to the trustee's right of indemnity against trust assets, whatever that right may turn out to be. The creditor takes the risk that the indemnity is worthless.

What happens if the Trustee has lost the indemnity because of his own default? The Court of Appeal's interpretation provides a somewhat unsatisfactory answer to this question. Is the trustee discharged even if he is unable to use the trust assets to pay the creditor?

Investec as the retiring trustee

The difficulty was seemingly ignored when dealing with the argument about Investec's ongoing rights as the retiring Trustee. The Court of Appeal concluded that there was 'an inevitable inference' that a retired trustee is entitled to be indemnified out of the trust assets (see §33) by the new trustee. This inference was said to arise because the Trustee *had* to satisfy the claim from trust assets at the date the claim is made. If by virtue of Article 32(1)(a) the trustee is not personally liable if he has lost the right of indemnity, then it is difficult to see why an *entitlement* on the part of the trustee to an indemnity is a necessary inference. In short, why should he care about this if he is not personally liable?

The Court of Appeal held that the on-going indemnity in favour of an outgoing trustee was supported by a passage in Lewin. There is in fact also Australian authority (see *Rothmore Farms Pty Ltd v Belgravia Pty Ltd*¹⁶), referred to in Underhill,¹⁷ more directly in point which holds that the old trustee retains his right of indemnification with the attendant lien. In Guernsey itself, Article 43 of the Trust Law entitles an outgoing trustee to security.

Nevertheless, if the Trustee has lost his right of indemnity before he retired, how is it relevant to the operation of Article 32(1)(a) that he then does not have the further indemnity upon his retirement? If Article 32(1)(a) exonerates the outgoing trustee from having to meet the claim out of his personal assets even when he has no recourse to the assets why does he care what happens to him upon his retirement? Why is it said to be an inference of necessity that the incoming trustee must indemnify him?

What is the ‘trust property’ to which the claim extends under Article 32(1)(a)?

The Court of Appeal also held that what is represented by the ‘trust assets’ for the purposes of satisfying claims under Article 32(1)(a) is to be ascertained at the date when the claim has to be satisfied and not at that date when the transaction is concluded (see §32–33). The *obligation* of the trustee, it was held, extends to what *is* trust property when the claim is made and not to what *was* once trust property. Where does the trustee have an obligation if he is not personally liable?

The conclusion that trust assets must be ascertained at the date when a claim is to be satisfied is also inconsistent with the proposition that it is immaterial that the right of indemnity is lost. If he is insulated from personal liability, the trustee would pay the creditor with such trust assets as remain subject to the trust at the time he chooses to discharge the liability. The creditor can recover what is in the trust at the time he asserts his claim and in that way his claim

‘extends to the trust property’ and only to the trust property. Why should the property be ascertained at an earlier time if it really is the case that the trustee could not be liable for any depletion in the interval? Indeed, if the trustee chooses to dissipate or distribute the trust assets before the creditor can have recourse to them what personal liability would be incurred?

Indemnity when creditor does not know of trusteeship

Another curious implication of the decision in Glenalla is the difference between the right of indemnification under Articles 32(1)(a) and 32(1)(b). Article 32(1)(b) applies and imposes personal liability on the trustee when the counterparty cannot be shown to have known that the trustee was transacting only in the capacity of trustee. In those circumstances, the Court of Appeal held (see §44) that the trustee is always entitled to his indemnity even if he has been in default or breach of trust because the words in brackets suggest that the right of recourse always exists.

This, the Court of Appeal recognized, represented a change in general trust law. In a case where the trust creditor did not know that the trustee was acting as such he can, of course, claim both from personal assets as well as trust assets and be subrogated to the trustee’s right. However, why should there be a right of recourse against trust assets as well personal assets when the trustee has lost his right of indemnity? Another perhaps more logical interpretation of Article 32(1)(b) would be that the trustee’s right of recourse against assets only exists when the right of indemnity also exists on the facts.

Otherwise, the comparison with the creditor who knows nothing under Article 32(1)(b) and the creditor who does know that the trustee is acting as such in Article 32(1)(a) seems difficult to justify. In cases where the creditor knows that the trustee is acting in that capacity, he has no comfort that the trustee will in

16. (1999) 2 ITELR 159.

17. *Law Relating to Trusts and Trustees* (18th edn) §81–33.

fact be able to have recourse to the trust assets and he has no recourse against the personal assets of the trustee if the above interpretation is correct. He is treated in a manner that is inexplicably harsh.

Third party on notice of breach of trust?

The position becomes even more bizarre when the third party is aware that the trustee is in default and not entitled to claim on his indemnity. Of course, the assumption under Article 32(1)(b) is that the third party did not even know the trustee was acting as such so that he is hardly likely to know of a breach of duty.

However, under Article 32(1)(a), it is unclear whether it makes any difference if the creditor knew that the transaction was somehow affected by breach of trust. The third party has no right against the trustee's personal assets irrespective of whether the trustee is in breach of duty. Under Article 32(1)(a), does it matter that the creditor knows that the trustee is in default? Does he lose his rights to the trust assets if he is not involved beyond that in the default? If the trustee has no right of indemnity, is the innocent creditor who nothing of the breach any better off than one who does.

Liability for breach of trust

The Court of Appeal said that the conclusion on Article 32 did not affect the rights of beneficiaries to pursue the trustee. The suggestion seemed that this somehow mitigated the impact of allowing a third party to take trust assets even when there had been a breach of trust. Nevertheless, in their subsequent decision, the Court of Appeal upheld the Lieutenant Bailliff's decision that there had been no gross negligence on the part of the former trustees.

Liquidation process for trust property

Procedure

Where more than one creditor is subrogated to a trustee's lien and the assets of the trust are insufficient to meet all claims in full, then the question arises as to

how the claims should be treated. No jurisdiction appears to have a statutory scheme to enable a trustee to work out what to do. In England, the safest course for a trustee would be to apply to the court for directions under Part 64 of the Civil Procedure Rules. The question is what directions should be sought.

An example of a scheme of liquidation being proposed by a trustee was followed in the unreported limb of *Re Biddencare*. In that case liquidators, holding a small insolvent trust fund for a large number of claimants, applied to the Court for approval of a scheme of distribution. It was part of that scheme that there should be a notification procedure, a bar date for late claims, a process for adjudicating claims and allowing appeals. There also had to be provision for the expenses of conducting the exercise. In truth, in any case where there is a body of creditors, the problems that need to be addressed are likely to be the same.

Who should conduct a winding up?

The case of *Re Z Trust* [2015] deserves a little more discussion not only because it is the first pure trust case to discuss the jurisdiction. Mrs C, the settlor, had established a series of Jersey trusts for herself and her family, two of which were 'insolvent', the Z II Trust and the Z III Trust. The Z II Trust had a number of creditors including the former trustees who sought indemnification in respect of liabilities arising from litigation commenced against them by a third party regarding events connected with their former trusteeship. The current trustees were also creditors in relation to their unpaid fees. The main asset of Z II Trust was a claim against Z III Trust and that was the principal liability of the Z II Trust. In other words, the solvency of ZII and ZIII was interlinked.

As a result of ongoing hostility between the former trustees and Mrs C and her family, she purported to appoint new trustees over the Z II Trust and the Z III Trust. The appointment was later set aside by the Royal Court. That left the question how the insolvent trusts should be administered. The current trustees proposed a regime which was a variation on *Re*

*Hickman*¹⁸ (see further below). They would themselves examine the claims rather than delegate this.

The current trustees indicated that they felt able to undertake the examination of creditor claims themselves, rather than delegating this task to an insolvency practitioner. They argued that they were better placed to do this by virtue of Article 32(1)(a) of the Trusts (Jersey) Law 1984 because that would restrict the creditor claims to the trust assets.

The Court held that in the case of an insolvent trust the estate should be administered in the best interests of creditors. It was their interests that were paramount. In practice, the Court is very likely to rely heavily on views from independent creditors just as it does in determining questions in liquidation.

The Court accepted it had power to appoint an insolvency practitioner as a delegate of trustees in an appropriate case given the breadth of its inherent supervisory jurisdiction. It might, for example, be appropriate to entrust the winding up to someone independent when there were only lay trustees without the necessary skills to conduct an orderly winding up, or where the trustee found itself in a position of real conflict. Where there was no unmanageable conflict then it may be more cost effective for the regime to be operated by the trustee under the supervision of the Court.

Although the former trustees argued that there should be an independent investigation of each trust, there was little point in engaging a formal process of examining, admitting, or rejecting claims in relation to the Z II Trust and the Z III Trust as, with the exception of the claim of the former trustees all the creditors' claims were uncontroversial and were admitted. It would clearly have been an expensive waste of time to have appointed another layer of professionals.

The Court permitted the current trustees to retire in favour of new trustees and then set a number of conditions. The new trustees were required to pre-

serve the creditor claim of the Z II Trust against the Z III Trust, had to agree not themselves to charge any fees or expenses, and had to procure the agreement of other creditors not to demand repayment until the position of the now former trustees had been established.

The Royal Court showed that a nuanced approach needs to be adopted. Whether a full liquidation scheme is necessary will depend on the circumstances. The Court will be particularly mindful of factors such as costs, delay, and the need for the process to be managed by an objective and independent person.

Priority of claims

Claims are paid out either on a *pari passu* basis as favoured by most insolvency practitioners or on the basis of first come first serve, which is liable to create an unseemly competition between creditors. The *pari passu* approach removes any requirement to investigate the precise timing of creditors' dealings with the trustee. There is support for it in observations of King CJ in *Re Suco Gold Pty Ltd.*¹⁹ Less clear is how other aspects well understood in an insolvency context should be implemented.

Expenses of the winding up

Should the expenses of winding up the trust be given priority and what costs should be included? The logic of giving priority to these exemplified by Berkeley Applegate [1989] Ch 32 is that they represent a cost of distributing the assets without which nothing could be returned to the creditors. Indeed, creditors would be unjustly enriched if they did not have to meet these expenses on a quantum meruit basis. On this basis, the reasonable remuneration of the person winding up the trust fund ought to be recoverable in priority to the claims of creditors. In the unreported decision of *Re Caledonian Securities* (2016) the Chief Justice of the Cayman Islands held that the Court had power to

18. [2009] JRC 040.

19. *Re Suco Gold* (n 5) 109.

apportion expenses of liquidators amongst several trusts on a basis other than quantum meruit.

Similarly, expenses would include the costs of ascertaining the claims and collecting in available assets. Those assets might include choses in action and claims possibly against trustees and other service providers, but more obviously claims would exist further down the chain of ownership against directors and others. The question would arise whether the cost of funding litigation by trust companies should be an expense of the winding up. Since such funding has as its object increasing the value of trust companies, the costs should fall within the general principle.

Processing claims

The Jersey Royal Court in *Re Hickman* involved an application by an executor to approve the procedure adopted for dealing with the insolvent estate of a deceased person. The executor had devised a procedure based on the relevant provisions of the Bankruptcy (Désastre) (Jersey) Law 1990. The procedure proposed by the executor and approved by the court provided for publication of a notice requiring claims to be submitted by specified date, inspection of all claims by creditors and the ability to file opposition to the claims of others, appeals and distribution.

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