Too many hats, not enough time and the wrong people – the difficulties of Smith v Michelmores Trust Corporation

COMMENTARY BY LEMUEL LUCAN-WILSON, 2ND DECEMBER 2021

The recent case of *Smith v Michelmores Trust Corporation* [2021] EWHC 1425 (Ch) is a timely reminder for trustees of the need to critically evaluate the intended uses of powers of appointment, how beneficiaries may be interested in their usage, and the importance of actively managing conflicts of interest between different offices or trusts.

Facts

Mrs Crawshay died on 3 November 2010. She had four children, and the residuary estate was split into four equal parts – 3 of the children took a portion absolutely, but the remaining quarter was left on discretionary trust for her son John, his children and remoter issue. At the date of the hearing, John had 3 children and one grandchild. That trust contained a power of appointment exercisable in favour of any of the beneficiaries.

After the death of Mrs Crawshay, the executors brought proceedings against John relating to his actions whilst in partnership with the deceased. The executors were successful at trial, and were awarded £391,417 plus costs. John failed to pay this sum, and the executors subsequently presented a petition for his bankruptcy, based on a statutory demand for £505,815. John was adjudged bankrupt on 15 May 2020 (and would, without an application for suspension, be discharged on 15 May 2021) and trustees in bankruptcy were appointed on 9 June 2020. The surviving executor and discretionary trustee was appointed as one of John's trustees in bankruptcy.

John's debt formed a large part of the deceased's estate, the only other asset was £233,836 held in a bank account. As a result, the trustees in bankruptcy suggested that a distribution be made to John from the discretionary trust during his bankruptcy, so that it would instead vest in his trustees and reduce the debt.

The executors made a distribution of £220,000 to the residuary beneficiaries under the deceased's will, and the discretionary trustees then brought *Public Trustee v Cooper* proceedings to bless the momentous decision that they appoint the £55,000 which had been received from the deceased's estate to John whilst he was an undischarged bankrupt.

The proceedings

Unhelpfully for the trustees, the decision to make the appointment was only reached on 7 May 2021. The hearing took place on 14 May 2021; 1 day before John's discharge from bankruptcy.

The Decision

HHJ Paul Matthews refused to sanction the trustee's decision, for four reasons:

First, the claim had been improperly constituted. John's children and grandchild had not been joined to the proceedings. Although an application had been made for the representation of unborn and unascertained beneficiaries, the already existing beneficiaries were in a different situation; by appointing to John at this point, the trustee would be actively deciding against appointing to any of the existing beneficiaries. Whilst the trustees accepted that these beneficiaries could challenge the decision later since they were not joined, the Court considered that this would still be inappropriate where the purpose of the *Public Trustee v Cooper* jurisdiction as to give certainty, and the CPR required that the beneficiaries had a chance to make representations. It was also not clear why the residuary beneficiaries under the will had been joined when they had no interest in the proceedings, and their views could not be taken into account by the discretionary trustees.

Second, that in any event it could not be said that the appointment would be for John's benefit. The judge considered that there could be no direct benefit accruing to John from the clearing of 11% of the judgment debt. Nor would there be any indirect benefit for John. In fact, the next day, the same decision would have given him a direct

financial benefit. It was therefore "*impossible*" to say that the proposed arrangement was for his benefit.

Third, that the appointment would be fraud on a power. As the judge noted, whilst the trustee must normally be alive to the possibility that an appointment would benefit non-objects, in this case it was obvious that non-objects would be benefited because of the effect of insolvency law. Further, the entire purpose of the appointment was to benefit non-objects; i.e the deceased's estate, and it was therefore an "*irrational*" decision.

Fourth, there was a stark conflict of interest. The judge gave short shrift to suggestions made by the executor about the need to maximise the deceased's estate; whilst that duty existed, it did not override her duty as a discretionary trustee to act in the best interests of the discretionary beneficiaries. As discretionary trustee, it was not permissible for her to take into account the interests of the residuary beneficiaries. The judge noted that different trustees could have been appointed or the trustees could have surrendered their discretion to the court, but neither of these steps was taken. *Public Trustee v Cooper* jurisprudence made it clear that the failure to acknowledge and manage a conflict of interest could be fatal to an application, and the judge considered that here, it was. Similarly, the judge was unpersuaded by evidence given by the executor about the unfairness of the situation for John's siblings; that was a result of the deceased's choice to set up a trust, the decision of the executor to petition for bankruptcy and the dual positions held by the executor (in conflict of interest) which had made an appointment seem possible.

Lessons for practitioners

The main lesson to draw from Smith is the need to ensure full compliance with the procedural rules. Here, the primary reason the application failed was the failure to join the other living beneficiaries (which could not be rectified given the limited time before John's discharge from bankruptcy). It is therefore worth undertaking a critical analysis as to which beneficiaries need to be joined when contemplating proceedings; whilst as the judge noted some beneficiaries may have their interests align in such a way that only one of them needs to be joined, that is not always the case. John's bankruptcy meant that he was in a different category to the other beneficiaries, and his interests would not be the same as theirs.

The decision also highlights the need for trustees to fully think about the capacities in which they act; as the judgment makes clear, where there is a conflict of duties between different capacities, the trustee cannot decide that one overrides the other – they are separate. Moreover, trustees may need to consider more carefully the enforcement remedies available to them; John's bankruptcy meant that without an application for suspension of discharge, his debts would be discharged after one year. It is difficult to see how an appointment to John during his bankruptcy (and where there was no application for suspension) could be to his benefit, or for the benefit of the objects of the discretionary trust.

Finally, there is the all important reminder to be aware of the time limits involved; the decision to appoint to John was made one week before the discharge of the bankruptcy, and it seems likely that this will have naturally reduced the time available to cure any defects, but also to set out the evidence in the most extensive way.

Hopefully, by following these lessons practitioners will be able to avoid the substantial cost consequences suffered by the trustees in this case; as set out at [2021] EWHC 1521 (Ch). The trustees agreed to pay John's costs and to not take their costs out of the discretionary trust, but asked to take them out of the remaining residuary estate. As might be anticipated, the Court was not sympathetic to this – the trustees had only been able to bring the claim as discretionary trustees, not as personal representatives, and it was not the business of the estate generally. The capacities had, once again, been confused.

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