CHANCERY BAR ASSOCIATION'S

ISLE OF MAN CONFERENCE 2018

TRUSTEE LIABILITY AND INSOLVENT TRUSTS

Overview

"*To talk of an insolvent trust is of course a misnomer. A trust is not a separate legal entity and cannot, as a matter of law, be insolvent*." *Re the Z Trusts* [2015] JRC 031

1. The trust is in legal reality a relationship between trustees, who hold the trust assets, and the beneficiaries, who are entitled to them. That relationship is not directly connected to the relationship between the trustee and any other third parties, to whom the trustee may owe other obligations, e.g. under contract or tort. A trustee who contracts for the services of a cleaner is liable under that contract, notwithstanding that the property being cleaned is held by the trustee for one or more beneficiaries. Moreover, if the cleaner is injured in the course of their employment it is the trustee who is liable. Recourse for those liabilities from the trust assets is a matter between the trustee and the beneficiaries, and is of no concern to the cleaner.

2. This has the potential to go wrong where liabilities incurred by the trustee exceed the trust assets. In that case, the absence of sufficient assets becomes the trustee's problem and if they have other assets then the law provides (with exceptions) that the liabilities must be met from such assets. However, if the trustee is a corporate vehicle established for the sole purpose of being a trustee of that trust then some means must be found to divide the assets between those persons entitled to them.

3. It is remarkable that in the centuries over which the trust has existed very few authorities have had to grapple with these problems. Perhaps before the growth of offshore trusts the use of SPV trust companies was rare, and the possibility of liabilities exceeding assets limited. In any case, the growth of offshore trusts, highly leveraged property investment and the 2008 crisis look set to change all that. The Privy Council has recently had to grapple with the immensely complex case of *Investec v Glenalla* [2018] 2 WLR 1465

and the courts of Jersey have had to grapple with the *Z Trusts* litigation, see especially [2018] JRC 119. More litigation seems inevitable.

Trustee Liability for trust liabilities

4. The position of the trustee *vis a vis* the liabilities of the trust is established by two basic propositions. First, as the trust itself has no legal personality the trustee incurs any liabilities personally and, until recently, was not accurately described as having any other 'capacity'. Second, the ability of the trustee to recover those liabilities from trust assets depends upon those liabilities having been properly incurred by the trustee (using the language of section 31 Trustee Act 2000 and IOM Trustee Act 2001, contrast "*reasonably incurred*" in Article 26(2) of the Trusts (Jersey) Law 1984).

5. A debate can be had as to whether a liability was properly (or reasonably) incurred and indeed that is a commonplace dispute between trustees and their beneficiaries. In *Investec* it was asserted that the question had to be answered with hindsight and so could include a consideration of whether such liabilities were properly *retained*. That was, however, rejected. So the question relates solely to whether, at the time they were incurred, such expenses were incurred properly for the trust, which usually means for the benefit of its beneficiaries.

6. The entitlement to reimbursement for liabilities continues after a trusteeship ceases and after the assets have passed to new trustees or to the beneficiaries. The entitlement to reimbursement operates as an equitable lien and extends over the whole of the trust assets.

Limitations on Trustee Liability

7. A trustee, in contracting with third parties, may limit the extent to their liability to the trust assets. By doing so, they avoid the possibility of recourse being had to their own, personal, assets. Merely contracting as a trustee, or expressing the contract to be entered into 'as trustee' is unlikely to be sufficient. The contract needs to make it clear that the third parties rights as against the trustee are to be limited to the trust assets held in their

hands. Moreover, a contract may limit liability for one thing (e.g. breaches of contract) without limiting liability for others, including misrepresentation and breaches of tortious duty, see *First Tower Trustees Ltd v CDS* [2018] EWCA Civ 1396.

8. Article 32 of the Trusts (Jersey) Law 1984 is an attempt by the Jersey legislature to impose such limits on liability by statute. It provides:

> *"(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."*

The article throws up more issues than perhaps the legislature ever considered, especially where Guernsey trustees of a Jersey law trust incur liability under BVI law in respect of their international assets (the *Investec* case). Following the Privy Council decision, it appears that:

(i) The section defines a trustee's capacity, so that, for the first time in common law, a trustee has two capacities, that of trustee and personally. Moreover, the existence, or otherwise, of that capacity depends not on some aspect of the trustee or trusteeship but on the knowledge of the other party.

(ii) The issue is one of status, so that even when incurring liability under a contract governed by a different law, the trustee's liability can (depending upon the other party's knowledge) be limited by the provision. That is how a Guernsey trustee of a trust governed by Jersey law was able to limit their liability under BVI loan agreements.

(iii) The trustees' liability is not limited by the trust assets. Rather, the creditor has a claim against the trustee only in that capacity (and so no recourse to personal assets) and so, through that, will have a claim against the assets held by the trustee as trustee.

(iv) The section does not alter the means by which a creditor is entitled to have recourse against the trust assets, i.e. by means of subrogation of the trustees' own right to be indemnified from the trust assets (see next heading).

9. *Investec* has not answered all of the problems that such statutory limitations on liability will throw up. For example, in *First Tower Trustees* the English Court of Appeal suggested that it remained to be considered whether the limitation on liability could be contracted out of or otherwise altered, and whether it is sufficient to know that one party is a trustee, or whether it must also be known that they are trustees of a Jersey trust.

Creditors' rights of subrogation

10. The right of a trustee to be indemnified from trust assets for liabilities properly incurred exists as an equitable lien over the trust office and survives removal from office. It is a fundamental aspect of any trusteeship.

11. An insolvent trustee may be unable, or unwilling, to exert its rights to an indemnity. For that reason, the law confers a right upon creditors to be subrogated to the trustees' right of indemnity. In effect, the creditors stand in the shoes of the trustee in being entitled to recover from trust assets their liabilities.

Limitations on the rights of subrogation

12. In *Investec*:

> *"Because the creditor's recourse to the assets is derived from the trustee's right of indemnity, it is vulnerable. It is exercisable only to the extent that that right exists. It may be defeated if there are insufficient trust assets to satisfy his debt, or if the*

trustee's right of indemnity is defeated, for example because the debt was unreasonably or improperly incurred and the indemnity does not extend to such debts, or because the trust deed excludes it on account of the trustee's wilful default or gross negligence. More generally a breach of trust by the trustee, even in relation to a matter unconnected with the incurring of the relevant liability, will, to the extent that it creates a liability to account on the part of the trustee, stand in the way of the enforcement of the indemnity. As has frequently been observed, this can be hard on the creditor, who will usually have no knowledge of the state of account between the trustee and the beneficiaries. But the creditor can in principle protect his position, for example by taking a fixed charge over the trust assets, or, as in the present case, by stipulating for a personal guarantee from the principal beneficiary. It appears to the Board that all of these principles must be regarded as having been part of the law of Jersey before the enactment of the TJL or its statutory predecessors."

13. There are some significant practical problems with this, as the Privy Council observed above. A creditor who is owed £1m will be unable to rely upon their indemnity if the trustee is in breach to the trust for £100. More significantly, a creditor who is owed £100 cannot recover (or hope to recover anything) if the trustee is in breach of trust for £1m. Moreover, in cases where everything is collapsing around the trust, the temptation on the beneficiaries to allege a breach of trust against current or former trustees (so avoiding liabilities falling on the trust) is almost irresistible, as the *Investec* case shows.

Competing Interests: the priority of creditors

14. On the assumption that the trustee's indemnity is a good one then all the trust assets will be available to satisfy it. If, however, liabilities exceed trust assets then the trust will truly be insolvent and there will be a deficiency between the amount of the liabilities and the sums actually paid.

15. This is an area crying out for a formal insolvency regime. However, none exists. Until it does, creditors and trustees must rely upon the general power of the court to administer trusts, something that places a heavy burden upon the trust. The most recent (and largest) experience of this is in the *Z Trusts* litigation in Jersey. In that case, the courts seem to

have directed a scheme of administration with the assistance of an insolvency practitioner, permitting the court to then rule upon the more difficult issues of principle without becoming bogged down in the basic matters of administration.

16. The most important question of principle in *Z Trusts* and generally is the basis upon which liabilities are satisfied. There are essentially two choices: first in time and *pari passu*.

17. There is much to recommend a first in time approach. Creditors may have incurred liabilities with a trustee at a time when they were not insolvent and all reasonable enquiries would have revealed no prospect of their becoming so. To then require such creditors to share in the consequences of later indebtedness (if that is the cause of the insolvency) is potentially very unfair. That is the more so if those debts were incurred by a former trustee who may have personal liability for the debts and have incurred them without any reason to believe they could not be met from trust assets.

18. Having said that, equity tends to favour equality and, so far, so have the authorities. In *EC Investments Holdings Pte Ltd v Ridout Residence Pte Ltd* [2013] SGHC 139 division *pari passu* was assumed. More significantly, after a lengthy discussion of the arguments and principles, a division *pari passu* was ordered in *Re Z Trusts* [2018] JRC 119. It is understood that this decision is under appeal and the point may yet be considered by the Privy Council.

Trustees' remuneration and expenses in an insolvency

19. A further question concerns the priority of remuneration, and expenses, incurred in the course of an insolvency. In principle, these have no greater priority than do any other sums payable by reason of the trustees' right of indemnity. In practice, such costs must be met in priority to other debts if the administration of an insolvent trust is to have any success. It appears that it has so far been generally assumed or agreed that such costs and expenses should be paid in priority to all other debts.

Some thoughts on the future

20. It is unlikely that the courts will see sufficient of these cases, at a sufficiently high level, for a comprehensive regime to be established. That makes it likely that aspects of the applicable principles will remain vague. That is even more so where legislatures have added 'extras' to their trusts law to relieve trustees of personal or other liability in specific cases (as in Jersey). Add in the inevitable international aspect and uncertainty reigns – good for lawyers but bad for creditors. This is, therefore, an area where those legislatures who are inclined to introduce specific legislation regarding trusts on a reasonably regular basis could consider ripe for reform.

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