

Z Trusts judgment: whose rights take priority when a trust is insolvent?

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Jersey's Court of Appeal has handed down its long awaited judgment in the Z Trusts case. The decision considers important questions regarding the equitable rights of a former trustee, and whether those rights have priority over the rights of other claimants to the assets of a trust (including successor trustees) whose liabilities exceed its assets.

Factual background

A settlor, C, had established eight trusts, of which the 'ZII Trust' and 'Z III Trust' (the "Trusts") were the focus of this case. Equity Trust (Jersey) Limited ("Equity") was appointed as the original trustee of the Trusts, but at the beneficiary's request it retired in 2006 and was replaced by new trustees. Upon retiring, Equity was provided with an indemnity by Deeds of appointment and resignation of trustees.

On 31 July 2012 one of the companies within the ZII Trust structure, Angelmist Properties Limited (in liquidation) ("Angelmist"), instituted a claim in the High Court of England and Wales against two of its former directors and against Equity (the "Angelmist Proceedings"). The claim alleged a breach of duty against the two directors who were employees of Equity, and claimed against Equity for vicarious liability and upon the basis that it acted as a de facto or shadow director of Angelmist. Equity notified the then-current trustee of the Z II Trust of its intention to rely on its indemnity.

The Angelmist Proceedings were settled by Equity on 22 December 2015. As a result of those proceedings, Equity incurred liabilities in excess of £18 million comprising both a payment to Angelmist and Equity's own costs. Equity claimed reimbursement of that sum out of the assets of the Z II Trust, arguing that its claim took priority over the other creditors of the Z II Trust.

The Z II Trust's liabilities exceeded its assets (and in that sense it is described in the judgments as 'insolvent'): the only asset of the Z II Trust was a loan due by the Z III Trust of £186 million, but the current value of this loan was about £6 million. As such, if Equity's claim for priority succeeded it

would recover all of the Z II Trust's assets. If not, it would rank *pari passu* with other creditors of the Z II Trust and so only recover around £330,000.

The Royal Court's judgments

The current appeal considered three judgments of the Royal Court, two of which are material for present purposes. These were the 'Priority Judgment' and the 'Recoverable Costs Judgment'.

In the Priority Judgment, the Court recognised that a trustee has an equitable lien (akin to an equitable charge) over the trust assets for its liabilities properly incurred. The Court addressed two key issues in relation to that lien, namely:

- whether the trustee's right of lien takes priority over the claims of creditors making claims to the trust assets; and
- whether the right of lien of a former trustee takes priority over the right of lien of a successor trustee.

On the first issue, the Court noted this question of competition between a trustee and creditor only arose as a result of Article 32(1)(a) of the Trusts (Jersey) Law 1984 (the "Trusts Law"), which in effect precludes creditors from claiming against a trustee personally where the latter knows the former is acting as trustee – thus limiting the trustee's liability to the value of the trust assets. The Court held Article 32 did not go so far as to give a trustee's claim priority over trust assets, reasoning that if a trustee's claim was to be given priority over the claims of its Article 32(1)(a) creditors, then that would have the result of the trustee "scooping the pot", and that went beyond what was intended by Article 32.

On the second issue, the Court considered the purpose of the equitable lien is to give a trustee priority over the interests of beneficiaries, who it noted no longer have an interest in the assets once the trust is 'insolvent'. As the lien arose out of the relationship between trustees and beneficiaries (and not between trustees), the Court considered that the usual rule that equitable interests rank according to the order of their creation did not apply. In holding that successive trustees' rights under their equitable liens rank *pari passu*, the Court was clearly influenced by concerns of fairness and ensuring the good administration of trusts (i.e. avoiding the risk a new trustee would otherwise face of a prior trustee 'scooping the pot').

In the Recoverable Costs Judgment, the Court found that Equity was not entitled to claim the costs which it had incurred in seeking to prove its claim against the assets of the Z III Trust. The Court considered that, as trustees are the only persons who can assume liabilities, then assuming a *pari passu* regime, each creditor should assume the costs of proving its claim subject to the discretion of the court in any particular case. The Court considered this should not discourage people becoming trustees, whereas the risk of a prior trustee 'scooping the pot' might do so.

The Court of Appeal's judgment

The Court of Appeal overturned both the Priority Judgment and Recoverable Costs Judgment.

The Court of Appeal's starting point was the Privy Council's judgment in *Investec Trust (Guernsey) Ltd v Glenella Properties Ltd* [2018] UKPC 7. That judgment recognised that, as a matter of Jersey trust law, a trustee has an equitable lien on the trust assets to secure its right of indemnity for liabilities properly incurred as trustee.

The Court of Appeal also noted the acknowledgment in *Investec* that "the law of trusts in Jersey is a comparatively recent import from England", and that it looked to the trust law of England save where inconsistent with Jersey's customary law and legislation. The Court of Appeal therefore considered that, to identify the appropriate priority of the rights of indemnification and lien possessed by trustees in Jersey, it was appropriate to consider the English law on that issue (as well as authorities in other common law jurisdictions that drew on that law). Having done so, the Court of Appeal reached the following conclusions:

- a trustee's priority over the trust assets arises by virtue of its office, and ranks ahead of beneficiaries and those deriving title from them. Each trustee therefore possesses its own equitable interest and right of lien enforceable as a first charge against the trust assets;
- the general rule that equitable interests rank according to the order of their creation applies between trustees, such that the right of lien of a former trustee ranks ahead of the right of lien of a successor trustee;
- the trustee's equitable lien has priority over the claims of its Article 32(1)(a) creditors;
- the ranking in priority exists whilst the trust 'remains solvent' and if it becomes 'insolvent'; and
- each trustee's rights of indemnity and lien are continuing rights that do not depend upon there being any actual liability at a given point in time. Their ranking depends solely upon the date when each trustee took up appointment as trustee.

Applying this reasoning, Equity was entitled to assert its equitable lien in priority to the rights of successor trustees (in this case there were no trust creditors). Equity's liability resulting from the *Angelmist* Proceedings was not a 'new' liability arising after its retirement, but a contingent liability existing at the time it retired.

The Court of Appeal also overturned the Recoverable Costs Judgment, finding no reason in principle why a trustee could not recover from the trust assets its costs in proving a claim incurred as trustee. The Court noted that the recoverable amount would be a matter for taxation, taking into account all of the relevant circumstances.

Comment

The Court of Appeal's judgment is welcome insofar as it confirms the trustee's equitable lien for costs properly incurred. However, trustees will need to consider the practical implications of this judgment and whether/how they should be mitigated.

Successor trustees clearly face the risk that a predecessor will unexpectedly 'scoop the pot' in connection with a past liability that has since crystallised – potentially in circumstances where the existence and/or extent of that liability was unknown to the successor trustee. The Court of Appeal considered this not to be a material risk: it noted that it is a successor trustee's choice whether to assume the role, and that before it does so it can "exercise such due diligence as it wishes on the state of the trust and the potential liabilities to which it might find itself subject in due course" and also consider the potential for the trust to become 'insolvent'. Potential successor trustees may question the extent to which they can realistically mitigate this risk through due diligence, especially given one of the Judges in this case recognised that "no reasonable investigation would have revealed the possibility of the Angelmist claim".

Trustees will also need to consider how to respond if some creditors seek greater protections from them before agreeing to enter into contractual arrangements. Trustees may also wish to consider how they ensure that third-parties know they are dealing with a trustee, so as to attract the protection in Article 32(1) (a) of the Trusts Law.

The Bailiff (sitting as part of the Court of Appeal in this case) recognised that the Court's decision followed logically from *Investec*. However, he queried whether the Privy Council in that case had received sufficient submissions on Jersey's customary law, and suggested that customary law might not actually recognise the 'equitable charge' afforded by way of the trustee's lien. Ultimately, however, this point of principle is settled unless and until reconsidered by the Privy Council. As such, trustees will need to consider the steps they should take to address the issues raised by the Court of Appeal's judgment.

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Meet the Author



Oliver Passmore

Partner

Jersey

E: oliver.passmore@ogier.com

T: [+44 1534 514247](tel:+441534514247)

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