Principles applicable to an 'insolvent' trust

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It is important that trustees understand their obligations if their trust structure comes under financial stress. Helpfully, the Jersey courts have provided guidance on the principles applicable to 'insolvent' trusts, which is likely to be highly persuasive in other jurisdictions.

When is a trust insolvent?

As the Royal Court noted in Re Z Trusts [2015] JRC 196C, "[t] *o 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.*" Nonetheless, the Court described the term as a useful shorthand.

Whether a trust is insolvent is determined using the cash-flow test: is the trustee unable to meet its debts as trustee as they fall due out of the trust property?

Why does it matter?

Insolvency in a trust brings about a shift towards the interests of creditors (analogous to that seen in company law). This means the trust should be administered by the trustee on the basis that the creditors, not the beneficiaries, have the economic interest. Importantly, the trust is to be administered for the benefit of the creditors as a class, not simply a majority of them.

Trustees may find administering a trust for the benefit of creditors to be an unusual and uncomfortable experience. The Royal Court has cautioned that "[t] *he trustee or fiduciary of* [an insolvent] *trust would be wise ... to exercise their powers either with the consent of all of the creditors or under directions given by the Court*".

What insolvency regime applies?

In Re Z Trusts [2015] JRC 214 the Royal Court concluded it has a discretion as to the appropriate insolvency regime to implement, reasoning as follows:

- The starting point for the Court is to supervise the administration of an insolvent trust in the interests of the creditors.
- On the facts, the trustees had the power to appoint insolvency practitioners (**IP**) voluntarily to assist them in the administration of the trusts and to delegate tasks to them (whether this is the case in other trusts will depend on the terms of the relevant trust deed and the circumstances of the trust and its creditors).
- There is precedent for the Court appointing receivers over trusts, but this power has been exercised rarely and there was no obvious example of this being done in relation to insolvent trusts.
- However, the Court does in principle have the power to make such an order given the breadth of its inherent supervisory jurisdiction.
- Non-exhaustive examples of where it may be appropriate to make such an order include where there are lay trustees without the necessary skills to conduct an orderly winding-up, or where the trustee found itself in a position of real conflict.
- However, where there was no unmanageable conflict it may be more cost effective for the trustee to operate the regime under the Court's supervision.
- There is no "*one size fits all*" solution: the Court retains a discretion as to the appropriate regime to implement, and "*should be flexible in its approach, having regard always to the best interests of the creditors as a body*".

On the facts, the Court saw "*little point*" in a formal claims process when, with one exception, the creditor claims were all accepted. In contrast (and demonstrating the Court's 'flexible approach'):

- In Re Z III Trust [2019] JRC 069, the Court imposed an insolvency regime similar to that for personal and corporate insolvencies, but with the trustee (not an IP) conducting it. The Court considered that, on the facts, this would ensure fair treatment of creditors and resolve the matter without undue delay.
- In Re Z II and Z III Trusts [2020] JRC 072, given the "*sheer extent*" of the conflicts faced by the trustee the Court ordered the trustee to exercise its power to appoint an IP.

Priority of a trustee's equitable lien

Jersey's Court of Appeal in Re Z II Trust [2019] JCA 106 considered important questions as to whether a former trustee's equitable rights have priority over the rights of other claimants to the assets of an insolvent trust (including successor trustees).

The starting point was the Privy Council's judgment in Investec Trust (Guernsey) Ltd v Glenella Properties Ltd [2018] UKPC 7, which recognised that (under Jersey law) a trustee has an

equitable lien on trust assets to secure its right of indemnity for liabilities properly incurred as trustee.

The Court went on to conclude that:

- A trustee's priority over 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 their order of creation applies between trustees, such that a former trustee's right of lien ranks ahead of that of a successor trustee.
- The trustee's equitable lien has priority over the claims of creditors falling within the scope of Article 32(1)(a) of the *Trusts (Jersey) Law 1984* (which provides that, where a creditor knows a trustee is acting as trustee, its claims will only extend to the trust property).
- The ranking in priority exists whilst the trust 'remains solvent' and if it becomes 'insolvent'.
- Each trustee's rights of indemnity and lien are continuing rights that do not depend upon there being any actual liability at a given time. Their ranking depends solely upon the date each trustee took up appointment as trustee.

Conclusion

The above cases give rise to various practical considerations for trustees. Importantly, they must ensure they give due regard to creditors' interests where the trust comes under financial stress. Further, before being appointed they should consider how to mitigate the risk that a predecessor 'scoops the pot' in connection with a past liability.

Ultimately, trustees should remember that they are subject to the Court's supervision, and are therefore entitled to expect the Court's assistance in cases of genuine difficulty – including when administering an insolvent trust.

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