DOUBLE-EDGED SWORD

An overview of the UK Privy Council's landmark judgment on the 'insolvency' of trusts

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ABSTRACT

- *On 13 October 2022, the UK Privy Council handed down one of the most significant decisions of the past decade for the trusts industry in common-law jurisdictions. The decisions related to an appeal from the Jersey Court of Appeal and the Guernsey Court of Appeal, respectively. Both concerned trusts governed by Jersey law and so the two matters were heard together. This article focuses on the facts underlying the Jersey appeal and the practical considerations that trustees and their creditors might now usefully have regard to.*

- *The authors recognise that those who practice in or around the trusts industry are likely to have already heard about this matter. The various judgments are lengthy, complex and already the subject of considerable publication. However, a very brief summary of the salient background leading up to the Privy Council's decision is set out below, adopting the misnomer of 'insolvent trust' for convenience.*

BACKGROUND

The respondent to the Jersey appeal was Equity Trust (Jersey) Ltd (ETJL), which was the original sole trustee of the Ironzar II Trust (the ZII Trust) and the Ironzar III Trust. ETJL entered into a deed of removal and appointment (DORA) with its successor, Volaw Corporate Trustee Ltd (Volaw) as trustee of the ZII Trust.

The liquidators of Angelmist Ltd, a company within the ZII Trust structure, brought proceedings for breach of fiduciary duty against two of its former directors, who had been employees of ETJL at the relevant time. ETJL was made a defendant to the claim on the basis that it was vicariously liable (the Angelmist Claim). The Angelmist Claim, together with interest, totalled approximately GBP53 million.

ETJL gave notice to Volaw that it intended to rely upon the indemnities in the DORA. This prompted Volaw to apply to the Royal Court of Jersey (the Royal Court) to wind up the ZII Trust as its debts exceeded its assets. The ZII Trust was placed into a bespoke insolvency process (the first of its kind in Jersey). The Angelmist Claim was eventually settled for GBP16.5 million, with each party bearing their own costs; in ETJL's case, approximately

GBP2.4 million. This resulted in ETJL seeking to recover approximately GBP18.9 million from the assets of the ZII Trust, pursuant to its indemnity (the ETJL Claim).

FIRST INSTANCE

The Royal Court was asked to determine, *inter alia*, whether the payment of the ETJL Claim should be made in priority to ETJL's own creditors and subsequent trustees and their creditors (Volaw having retired and being replaced by Geneva Trust Company SA, GTC). The issue of priority was significant in that if ETJL had priority then it would recover all of the assets of the ZII Trust, which had been assessed at approximately GBP6 million, leaving ETJL with a loss of GBP12 million, against receiving approximately GBP330,000 if it had to share the assets of the ZII Trust *pari passu* with the claims of subsequent trustees and other trust creditors (being creditors with a claim to the trust assets by way of subrogation through a trustee).

A number of assumptions were made in order for the Royal Court to consider this important issue, not least of all that the ETJL Claim was the subject of indemnification from the assets of the ZII Trust; an issue that has yet to be determined.

The Royal Court held that, as between former and successor trustees (and their respective creditors claiming through them by way of subrogation), the claims against the trust assets ranked *pari passu* (i.e., rateably and on an equal footing), largely for reasons of fairness. The Royal Court also held that a former trustee claiming under its right of indemnity was not entitled to claim the costs of proving its claim in the winding up of an insolvent trust.

APPEAL

The outcome did not suit ETJL and it appealed.

The Jersey Court of Appeal (the Jersey Appeal Court) sided with ETJL by reversing the Royal Court's decision. It held that:

- a trustee has a single right of indemnity and lien that arises as an incident of it taking office and covers all liabilities that a trustee may properly incur in its office; and
- as between successive trustees, a former trustee's right of indemnity and lien ranks ahead of a successor trustee's right of indemnity and lien on a 'first-in-time' basis (i.e., the first trustee has priority over the second, if appointed later).

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The Jersey Appeal Court noted that the ranking of the claims of trust creditors *inter se* and the ranking of the claims of a trustee and its trust creditors were no longer live issues and, therefore, do not fall to be decided (although, some *obiter* conclusions were expressed by Logan Martin JA). The Privy Council did not pick up the baton on these issues.

The Jersey Appeal Court also reversed the recoverable costs point, holding that a former trustee claiming under its right of indemnity was entitled to claim the costs of proving its claim in the winding up of an insolvent trust.

THE PRIVY COUNCIL

Trust creditor Simon Halabi, in his capacity as executor of the estate of the late Intisar Nouri, appealed the Jersey Appeal Court's decision to the Privy Council (having been granted unconditional leave to do so in respect of the priority issue and the status of a trustee's lien in Jersey law).

Relevantly, prior to the Privy Council hearing the appeal, the Royal Court blessed a decision of GTC to enter into a compromise of breach of trust litigation against a former trustee. The Royal Court noted that the settlement had secured 'comfortably more' than enough funds for the trust to meet the ETJL Claim, on the assumption that the Jersey Appeal Court's decision on the priority issue was upheld. In contrast, if the Jersey Appeal Court's decision was overturned the distribution available to other claims to the trust assets would more than double.

Consequently, it remained firmly in the interests of those other than ETJL for the appeal to the Privy Council to be heard.

The Privy Council sat for three days to hear the appeal from the decisions from the Jersey Appeal Court and the Guernsey Court of Appeal, respectively, and distilled the issues to be decided as follows:

1. Does a trustee's right of indemnity confer on the trustee a proprietary interest in the trust assets?
2. If so, does the proprietary interest of a trustee survive the transfer of the trust assets to a successor trustee?
3. If so, does a former trustee's proprietary interest in the trust take priority over the equivalent interests of successor trustees?
4. Does a trustee's indemnity extend to the costs of proving its claim against the trust if the trust is 'insolvent', in the sense that the trustees' claims to indemnity exceed the value of the trust fund?

The decision (which spans 97 pages) was not quick to produce, with the Privy Council considering matters for over 15 months, which might have been contributed to by the tension between the Privy Council on the contentious and central issue 3. However, it was worth waiting for.

Before dealing with the conclusions reached in respect of these issues, it is worth noting that the Privy Council, against the submissions made in support of the appeal, concluded that the relevant principles of English and Welsh law[1] are fully applicable in the case of trusts governed by Jersey law and not inconsistent with, or modified by, Jersey customary law or legislation.

ISSUE 1

Answer: Yes (unanimous decision). The Privy Council noted that the English courts had not explicitly addressed this question. However, it concluded that the analysis in the authorities (many of which were Australian) that the right confers or constitutes a charge or lien over trust property, enforceable by a court of equity, leads 'inevitably to the conclusion that it does create a proprietary interest in favour of the trustee'.

It is clear that a trustee is entitled to apply, or to seek an order of the court to apply, trust assets in its possession in payment of amounts due under its right of indemnity and that a trustee is or may be entitled to retain sufficient assets or require security before a transfer to a new trustee. These rights are not inconsistent with the concept of a charge over, or proprietary interest in, the trust assets.

ISSUE 2

Answer: Yes (unanimous decision). The priority interest in the trust assets continues after the transfer of the trust assets to a successor trustee.

ISSUE 3

Answer: No (4:3 split). This issue resulted in three separate and carefully reasoned judgments. The majority view is set out in the judgment of Lord Briggs, with whom Lord Reed and Lady Rose agreed. Lady Arden was also in agreement, albeit for slightly different reasons. Lord Richards and Sir Nicholas Patten delivered the dissenting judgment of the minority, with Lord Stephens agreeing.

The starting point is Lord Briggs' observation that there was a dearth of authority on the point, 'anywhere in the common law world'. As set out above, if the first-in-time principle was upheld, a former trustee would have priority recourse to the trust assets over a successor trustee.

However, the unique nature of the trustee's lien, distinguishable from other types of equitable interest and not being deemed security per se for the payment of a debt enabled the majority to depart from the usual first-in-time rule. In coming to this conclusion, the Privy Council compared a number of other scenarios where competing claims are made to assets insufficient to meet them all in full. These alternative scenarios included directors in a company insolvency (who are treated as unsecured creditors and rank *pari passu* between themselves), and liquidators and administrators (who enjoy priority over other classes of creditors in a liquidation, but have no priority *inter se*).

From a practical perspective, ranking trustees' claims on a 'first in time' basis could cause unjustified prejudice (where one of two joint trustees was appointed moments after the other, for example) and subject creditors to settlement of their claims on the basis of the date of appointment of the trustee with whom they contracted.

1 Instances of English and Welsh will be referred to as 'English' for the remainder of this article.

Lord Briggs, originally in favour of the first in time outcome, concluded that 'the impressive arguments, coupled with lengthy ensuing debate and reflection, have caused me to change my mind', swinging the vote to 4:3 in favour of *pari passu*.

Ultimately, the majority decision rested, comfortingly, on considerations of justice, fairness, equity and common sense, while acknowledging that the *pari passu* rule will not always work perfectly in every case; the rule being described, in some cases, as doing no more than rough justice. However, the majority recognised that there is an inherent justice in equal division or equal sharing in common misfortune (if that is the outcome).

ISSUE 4

Answer: Yes (unanimous). The Privy Council held that the indemnity extends to the costs of proving the trustee's claim against the trust assets, there being no basis for suggesting otherwise given the survival of the indemnity after the retirement of the trustee.

The Privy Council, consistent with its stated position vis-à-vis the laws of Jersey, held that there was no analogy to be drawn from the bankruptcy process under regime in the *Bankruptcy (Désastre) (Jersey) Law 1990* as it does not apply to trusts and a former trustee is not proving a claim as a creditor but establishing the quantum of its proprietary interest in the fund.

PRACTICAL OBSERVATIONS

TRUSTEES

In light of the Privy Council's decision, trustees will or should now carefully consider their position when they are:

- being appointed as the first and original trustee of a structure where the structure will be what we call 'asset rich, cash poor';
- being asked to provide trustee services to an existing trust in place of a retiring trustee;
- retiring as trustee; and
- entering into transactions incurring a liability for the structure, whether as an original trustee or a successor trustee.

Liquidity should (if not already) be a particular focus and concern of trustees in all the scenarios above, but particularly because the duty of trustees switches in favour of the creditors of the trust when cash-flow insolvent. Difficulties also arise for trustees when charging fees for administering a trust that is cash-flow insolvent, unless with creditor or court agreement to do so.

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Trustees entering into a DORA should no longer expect a 'cheap' standard STEP '10/10' form of DORA.[2] DORAs are likely to become tailored to each trust and potentially heavily negotiated, given the risks on retiring trustees and incoming trustees.

Trustees will need to move away from the expectation that a DORA will cost GBP750. The costs will increase to reflect the bespoke and tailored advice that will be required to ensure adequate protection for the trustee (irrespective of whether it is an outgoing or an incoming trustee).

The authors anticipate a possible reversal on the now somewhat antiquated 'direct chain indemnities' on the change of trustees and there will inevitably be a much deeper and more thorough dive into the accounts of a structure prior to incoming trustees accepting new trusteeships, rather than that detailed review following acceptance of a trusteeship.

Trustees should now give proper consideration as to whether:

- liabilities can and/or should be paid in full before handing over the trusteeship;
- liabilities be novated to the incoming trustee;
- third-party lending agreements be terminated prior to handing over the trust or, in the absence of that as it may not always be in the best interests of the beneficiaries of the trust, the retiring trustee expressly being released by the third-party lender from all of its obligations under such agreement

2 This is in reference to STEP's jurisdiction-specific guidelines as set out in its 2017 publication, *A Practical Guide to the Transfer of Trusteeships*, by Richard Williams TEP, Arabella Saker and Toby Graham TEP.

and the incoming trustee stepping into its shoes in all respects;
- a retention be sought if there are anticipated liabilities and/or claims that can be quantified;
- in the absence of a retention being agreed on the resignation of a trustee, one might foresee trustees negotiating an undertaking that an incoming trustee ringfence an amount equal to the anticipated claim and any anticipated costs associated with such claim (if they can be met from the trust fund and do not arise from the former trustee's own fraud, gross negligence or wilful misconduct);
- restrictions be placed on an incoming trustee as to incurring any liability that it will not be able to repay in full, taking into account all existing liabilities of the trustee at the point of that new liability being incurred and any professional fees to be incurred, including the trustee fees; and
- an undertaking be provided by an incoming trustee that it will ringfence an amount equal to any liability or claim that a retired trustee notifies it of within any agreed period specified within a DORA and that the incoming trustee will not, once on notice, act in any way that would prejudice the retired trustee's ability to be able to enforce its indemnity under the DORA in full.

These are our initial observations of the potential considerations for trustees in light of the Privy Council's decision, but these may be expanded on in due course.

THOSE TAKING SECURITY

The Privy Council held that, as a matter of Jersey law, the lien conferred by the right of indemnity is not a form of security on the basis that there is no personal obligation to secure.[3]

It was further held that a trustee, in respect of its right of indemnity, is not a creditor because it has no personal claim against anyone but instead it has a proprietary interest in the trust assets.[4] As mentioned, the Privy Council unfortunately declined to consider the issue of priority between trustees and trust creditors; it not being an issue that was considered by or argued before the Jersey Appeal Court nor it being advanced as a ground of appeal. The Privy Council considered this question of priority to be potentially important, not straightforward and an issue that should only be considered by the Privy Council after full argument and, save in exceptional circumstances, only after it has been considered fully by the courts below.[5] However, it was made clear that the lien conferred by the right of indemnity gives the trustees 'clear priority over the beneficial interests of the beneficiaries'.

Lenders to Jersey trustees should ensure that any such rights afforded to trustees by reason of their appointment as fiduciaries are expressly waived in favour of the rights of the lenders generally and transaction security provided to secure that third-party debt. Such a waiver should continue to be made by the trustees both in their own personal capacity, given that the interest survives the transfer of trust assets to a successor trustee, and in their capacity as trustee of the relevant trust. Careful consideration should be given to any such language to ensure that such a waiver is clear and unambiguous.

CONCLUSION

The Privy Council's decision goes to the heart of trust administration not only in Jersey but also in common-law jurisdictions across the world; a trustee's ability to legitimately and adequately recover under its indemnity from trust assets while *in situ* and after retirement being a key consideration.

The result is, in some ways, double-edged. Trustees now have clarity that they do have a proprietary interest in the trust property, irrespective of whether they have retired in favour of another trustee. However, given that this interest ranks *pari passu* with former and successor trustees in an insolvent situation, there is a clear emphasis on a detailed exploration of the trustee's potential exposure upon retirement in tandem with ensuring that adequate assets are suitably ringfenced to provide for the same.[6]

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3 at para.216
4 at para.185
5 at para.44
6 Collas Crill, together with leading counsel Shân Warnock-Smith KC TEP and Clare Stanley KC, acted for the successful appellant in the Jersey Appeal, Simon Halabi (in his capacity as executor of the estate of the late Intisar Nouri).