'Insolvent trust': A misnomer?

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Legally, yes. However the Royal Court of Jersey has noted that the phrase is useful shorthand for a situation that may have been encountered by many trust practitioners.

In '*In the matter of the representation of Volaw Trustee Limited in its capacity as trustee of the Z II trust*', the Royal Court considered the appropriate test to determine whether a trust can be said to be insolvent and the consequences if the answer to that question is 'yes'.

The Court confirmed that, in the context of a trust, the cash-flow test (whether a debtor is able to meet its debts as they fall due) was the correct test to apply.

Specifically, the test was confirmed as being whether a trustee is unable to meet his, her or its debts – as trustee – as they fall due, out of the trust property. To this end, the Court drew strong correlation between the insolvency of a trust and the insolvency of a company or individual with ongoing business activities.

The parallels did not end there, though.

When a company becomes insolvent its directors' duties should shift to focus on the interests of the company's creditors. Significantly, the Court noted that a trust that fails the cash-flow test, also, "*should thereafter be administered on the basis that it is insolvent, treating the creditors, rather than the beneficiaries, as the persons with the economic interest in the trust*".

That is an enormously important fact for trustees to take into consideration in the exercise of their fiduciary powers, and raises a number of practical issues.

Most pressingly, the fact that in an insolvent trust situation the trustees and others (such as protectors) who owe fiduciary duties would have to exercise those duties for the benefit of the creditors as a whole raises the prospect of direct claims from creditors arising from a trustee's dealings with trust assets.

So what can a trustee do when it thinks that a trust may be insolvent?

Companies have a number of 'safe harbour' procedures to deal with insolvency situations (administration or liquidation, for example) but a trust, not being a legal entity, cannot take advantage of these. Instead, a practical option would be for trustees to make a *Public Trustee v Cooper* application to invoke the Court's supervision, as the trustee of the *Z II* trust did.

In that way, a trustee can try to limit their liability in the face of uncertainty over whether they should continue to look to the interests of beneficiaries, or whether that focus should shift full-circle to creditors.

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