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UPDATE

No scooping the pot: Z Trusts and the order of priority of creditors of an insolvent Jersey trust

On 3 July 2018, the Royal Court handed down its much anticipated judgment in the latest instalment of the Z Trusts case on the question of the order of priority of creditors of an insolvent Jersey trust. Justin Harvey-Hills (Partner, Jersey), Luke Olivier (Counsel, Jersey) and Bethan Watts (Associate, Jersey), who act for a major creditor, successfully argued that such creditors should rank pari passu.

In 2015, the Royal Court began establishing an insolvency regime for trusts by supervising their administration in the interests of the creditors as a body and giving directions accordingly. The latest judgment (which has been handed down and will be published soon) deals with the question of the order of priority of creditors.

The classic English position is that a trustee has unlimited personal liability and that, where a trustee is insolvent, the creditors are subrogated to the trustee's right of indemnity. However, Jersey (along with Guernsey and BVI) has the additional factor of Article 32 of the Trusts (Jersey) Law 1984 (or equivalent in Guernsey and BVI).

Article 32 distinguishes between counterparties who know that they are dealing with a trustee in its capacity as trustee and a party who does not. The former (Article 32(1)(a) creditors) can only claim against the trustee in its capacity as trustee and the claim extends only to the trust property. In *Investec –v- Glenalla*, the Judicial Committee of the Privy Council held that an Article 32(1)(a) creditor can have recourse to the trust assets by way of subrogation to the trustee's right of indemnity and subject to the limits of that indemnity. The latter (Article 32(1)(b) creditors) may claim against the trustee personally but the trustee may have a right of recourse to the trust fund. Thus, Article 32(1)(a) goes some way to introducing the concept of limited liability into the law of trusts.

Issues before the Court

A former trustee (which had also been the original trustee) had, some years after leaving office, settled a claim brought against the directors (which it had supplied) of a company within the structure. The directors had been found liable in England for breach of fiduciary duty (the recent hearing before the Jersey Court proceeded without prejudice to any argument that this liability was not one for which the former trustee had a right to be indemnified). The former trustee's claimed right of indemnity therefore arose in respect of a liability arising under Article 32(1)(b).

There were two main issues before the Court:

1. The first related to the issue of priority between the former trustee and its own trust creditors. In other words, between the Article 32(1)(a) creditors of the former trustee who were claiming through the former trustees' right of indemnity and the former trustee itself claiming through its right of indemnity in respect of its personal Article 32(1)(b) liability; and
2. The second related to the issue of priority as between the former trustee and any successor trustee, in respect of their respective Article 32(1)(a) creditors and any Article 32(1)(b) personal liabilities.

The former trustee argued that it had priority over its own Article 32(1)(a) creditors (on the basis that it had the better equity) and over any successor trustee on the basis that its lien was akin to an all monies floating charge over the trust fund.

Trustee versus Article 32(1)(a) creditors

The Court considered that, prior to the introduction of Article 32, the creditors would have sued the trustee personally. If the trustee was insolvent, they would have been subrogated to the trustee's right of indemnity and their claims would rank *pari passu*.

As regards the impact of Article 32, the Court disagreed with the former trustee's argument that, because the creditors only had a right of recourse to the trust fund by subrogation, the trustee had the better equity. It found that subrogation put the creditor in the place of the trustee and therefore the creditor by subrogation and the trustee were exercising the same right of indemnity. Thus, there was no principled basis for claiming any inequality between the two.

The Court also found that Article 32 went no further in altering the pre-existing law than allowing the trustee to incur a liability as trustee and not personally if the counterparty knew that the trustee was acting as trustee. Article 32 did not give the trustee the added protection of priority for its Article 32(1)(b) liability over the subrogated claims of an Article 32(1)(a) creditor.

In summary, therefore:

1. The claims of Article 32(1)(a) creditors to the trust assets rank *pari passu* between themselves;
2. In the case of a solvent trustee, the claims of its Article 32(1)(a) creditors to the trust assets rank *pari passu* with the trustee's claims for its Article 32(1)(b) liabilities; and
3. In the case of an insolvent trustee, the claims of Article 32(1)(a) and (b) creditors to the trust assets rank *pari passu*.

Former trustee versus successor trustee

It was not contentious that a trustee is entitled to an indemnity in respect of liabilities reasonably incurred and that this gives rise to a lien in favour of the trustee which in turn takes priority over the interests of beneficiaries.

The Court found that such an equitable lien arose by operation of equity from the relationship between the parties and was in this case intended to secure the rights of the trustee against the beneficiaries. It did not arise out of the relationship between trustee and successor trustee and so there was no reason for the first in time rule to apply.

Furthermore, there were good reasons as to why such a rule should not apply. The Court considered that operation of a "first in time" rule between trustees would be arbitrary, unfair and inimical to the good administration of trusts. It would not be appropriate to establish a regime that allowed a former trustee and its creditors "to scoop the pot". Such a regime could give rise to increased claims for security on a transfer of trusteeship and make trust creditors reluctant to agree novation documents upon a transfer of trusteeship for fear of losing rank. The Court concluded that the principled and fair way forwards was to extend the *pari passu* regime as between trustees.

And in the alternative....

The Court also held that if it was wrong about *pari passu* and liens were ranked on a first in time basis, liens arose on a liability by liability basis and were extinguished following reimbursement. It rejected the concept of there being a single lien operating as an all-monies floating charge.

Conclusion and comment

In our view, the Court has taken the logical step of establishing a regime which is practical and fair both for trustees and for counterparties dealing with trustees. It reflects a direction in which the Court has been moving in the area of insolvent estates (see *Re Hickman* [2009] JRC 040) and is consistent with the development of personal and corporate insolvency legislation. It should help to bring fairness and order to trust insolvencies.

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