PRIORITY OF CLAIMS TO THE ASSETS OF AN "INSOLVENT" TRUST[1]

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The Jersey Court of Appeal recently reversed a decision of the Royal Court in Re Z II Trust *in relation to the priority of claims to the assets of an insolvent trust. This article analyses the reasoning of the Court of Appeal and asks some questions as to the practical and legal consequences of the decision for trustees.*

1 In *In re Z II Trust*[2] the question raised was whether, in the case of a trust the assets of which are not sufficient to meet its liabilities, the creditors claiming through a former trustee took priority over creditors claiming through a successor trustee. Clyde-Smith, Commr held that they did not, and that all creditors ranked *pari passu*. In a judgment given on 28 June 2019, the Court of Appeal reversed that decision of the Commissioner.[3]

2 Their decision was expressly given on the basis that Jersey law on this issue is the same as English law and the case may therefore be of interest to English lawyers as well as to lawyers in offshore jurisdictions such as Jersey.

3 The make-up of the Court of Appeal was of some interest. It consisted of John Martin QC, one of the leading English chancery practitioners, who was therefore well placed to consider the position under English law, Roy Logan Martin QC, a leading Scottish silk (who very sadly died unexpectedly not long after the judgment was delivered),[4] and Sir William Bailhache who was Bailiff of Jersey until October 2019.

4 The Z II Trust was a discretionary trust governed by Jersey law. The former trustee, Equity Trust Ltd ("Equity Trust"), had retired in favour

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[1] This article is based upon a lecture delivered on 13 November 2019 at the second annual Lewin Conference organized by New Square Chambers.
[2] 2018 (2) JLR 81.
[3] [2019] JCA 106.
[4] Roy Logan Martin QC will be a considerable loss to the Court of Appeal; he delivered a number of important judgments and was an enthusiastic and learned member of the court.

of Volaw Trustees Ltd ("Volaw") in October 2008. Volaw had in turn retired in favour of the current trustee, Rawlinson & Hunter Trustees SA ("Rawlinson & Hunter"). The trust was found to be insolvent, in the sense that its liabilities exceeded its assets, in October 2015. In December 2015—and therefore long after its retirement—Equity Trust became liable for and paid out of its own resources a total of £18m in settlement of a claim. It was assumed for the purposes of the hearing that this was a properly incurred liability for which Equity Trust could seek reimbursement out of the trust assets. However, whether this was in fact so remains for determination when the matter comes to trial.

5 Equity Trust sought reimbursement of the £18m from Rawlinson & Hunter as trustee of the Z II Trust, and the matter which came before the Royal Court was a preliminary issue of law as to the priority between different creditors. Equity Trust argued that its claim took priority over the claims of the other creditors (who, it would seem, were all claiming through one or other of the successor trustees) and that it should therefore recover all of the assets of the trust, which were some £6m. Conversely, one of the other creditors (the estate of the settlor) argued that all the debts should rank *pari passu*, with the result that Equity Trust would only recover some £330,000. The court's decision was therefore of some significance.

6 The case was argued in the Royal Court on the basis that, as established by the Privy Council in the recent case of *Investec (Guernsey) Ltd v Glenalla Properties Ltd*,[5] Jersey law was in this respect the same as English law, in that a creditor has no direct access to trust assets to enforce his claim. His action lies against the trustee and his only recourse, in the event of the trustee not satisfying the claim, is by way of subrogation to the trustee's right of indemnity. The case was also argued on the basis that the former trustee has an equitable lien to secure his right of indemnity as set out by Lord Hodge in *Investec* in the following terms:

> "(v) A trustee is entitled to procure debts properly incurred as trustee to be paid out of the trust estate or, if he pays it in the first instance from his own pocket, to be indemnified out of the trust estate: *In re Blundell* . . . (40 Ch. D. at 376). To secure his right of indemnity, the trustee has an equitable lien on the trust assets: *Lewin on Trusts*, 19th ed., para. 21–043, at 854 (2017). Because an equitable lien does not depend on possession, it normally survives after he has ceased to be a trustee: *In re Johnson* . . . (15 Ch. D. at 552)."[6]

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[5] 2018 GLR 97, [2018] 2 WLR 1465, [2018] UKPC 7.
[6] *Ibid*, at para 59 (v).

7 Equity Trust relied upon the general principle of equity that competing equitable interests rank according to the date of their creation *i.e.* the first in time takes priority. The creditor, on the other hand, submitted that the principle did not apply, and that all the claims should rank *pari passu*.

8 Clyde-Smith, Commr held that the trustee's lien was intended to give a trustee's claim priority over the beneficiaries but it had nothing to do with the equities as between trustees. Furthermore, fairness together with some of the practical implications which would result from application of the first in time principle, suggested to him that it would be preferable for all the claims to rank *pari passu*. In the absence of any authority to the contrary from any jurisdiction, he took the view that the *pari passu* approach should be applied.

9 He added—

> "I see no unfairness in this to a former trustee. One assumes that a trustee will be aware from its administration what liabilities it may have incurred which could give rise to a claim being made against it, and it has the right under art. 34(2) of the Trusts Law to require 'reasonable security' for those liabilities before surrendering the trust property."[7]

10 As stated above, the Court of Appeal reversed the Commissioner's decision and held that the claim of Equity Trust had priority over any claim through the successor trustees. The leading judgment was given by Logan Martin, JA, with whom Martin, JA agreed. In a closely reasoned judgment Logan Martin, JA concluded that—

(i) A trustee has an equitable lien in order to secure his right of indemnity.

(ii) That lien comes into existence upon the trustee's appointment and continues after his retirement.

(iii) It is a single lien which is enforceable in respect of all the individual liabilities incurred by the trustee. It is in the nature of a floating charge; its value expands and contracts with the liabilities incurred by the trustee on behalf of the trust. The court therefore specifically rejected the view of the Commissioner that there were in fact a number of different liens which arose and then ceased as the trustee incurred and then discharged individual liabilities in the course of administering the trust.

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[7] 2018 (2) JLR 81, at para 144.

(iv) The lien of a former trustee is intended to give it some form of security for its right of indemnity. The effect of ordering *pari passu* payment of all liabilities in an insolvency is the practical extinguishment of the lien when its continued existence would be most critical, namely when there are insufficient assets of the trust to meet all the liabilities.

(v) The first in time principle applies generally to equitable interests. The equitable liens of both a former trustee and a current trustee are equitable interests in the trust property and therefore, on the face of it, should be subject to the principle.

(vi) The court was not aware of any authority which would justify disapplying the principle in the case of a trustee's equitable lien.

(vii) On the contrary, Logan Martin, JA considered that there was one case which, although not directly in point, lent support to the view he was taking. That was *Lemery Holdings v Reliance Financial Servs* in the Supreme Court of New South Wales.[8] He referred to the fact that in that case, Brereton J had set out nine principles concerning a trustee's right of indemnity against trust assets and had articulated the eighth of those principles as follows at para 21—

> "*Eighthly*, if the trust property is transferred to a new trustee, the lien survives and the *new trustee takes subject to the lien of the old trustee*—except perhaps in the exceptional case of a bona fide purchaser for value without notice . . ." [Emphasis added.]

Clyde-Smith, Commr had held that the emphasised wording meant no more than that the former trustee's right of lien continued to exist. But the Court of Appeal considered that it went further and meant that a successor trustee takes the trust assets subject to a former trustee's right of lien and this must mean that the former trustee's right of lien continues to exist and can be enforced against the trust assets in priority to the lien of the successor trustee.

11 The court went on to hold that, as it had reached its conclusion that a former trustee's lien took priority over that of a successor trustee as a matter of legal principle, issues of fairness and administrative convenience did not arise because they could not outweigh legal principle. The court did address very briefly a couple of the arguments on fairness but concluded that, as a matter of general impression, the fairness issue did not fall strongly one way or the other and the question of novation, which I shall mention in a moment, would have

[8] [2008] NSWSC 1344.

to be assessed once the trust industry had taken account of the court's decision.

12 It is interesting to contrast the different approaches of the two courts. Both were agreed that there was no authority directly in point in Jersey, England or anywhere else. Given this background, Clyde-Smith, Commr, approached the question of whether the first in time principle should apply by considering whether it was appropriate to apply it to a trustee's lien in view of the issues of fairness and administrative difficulty which he thought would follow from application of the principle. These considerations led him to conclude that the principle should not be applied. The Court of Appeal, on the other hand, started from the point that the first in time principle is one of general application to all equitable interests. As a trustee's lien was an equitable interest, the principle should apply unless there was authority to the contrary, which there was not. As can be seen therefore, the different starting point of each court partially explains why they came to different conclusions.

Consequences

13 The decision of the Court of Appeal is closely reasoned and helpful to the position of a former trustee. But what are the practical consequences of its decision? Practitioners with an obligation to advise trustees on a regular basis about issues which may arise on a change of trustee have much material on which to reflect. But at least three matters seem worthy of consideration.

(i) *Novation*

14 On a change of trustee, it is common for the obligations of the former trustee to be novated to the successor trustee. Thus, by a deed of novation, the creditor will accept the new trustee as debtor in place of the former trustee and will discharge the former trustee from the obligation. That makes sense. After all, it will be the successor trustee who has possession of the trust property, whereas the former trustee will no longer hold any trust assets, and will be reliant entirely upon its right of indemnity to meet any obligation to the creditor. Agreeing to a deed of novation does not prejudice the creditor in any way and simply recognises the reality of the situation following the change in trustee.

15 But will creditors be as willing in future to agree to novation? As was made clear by the Privy Council in *Investec*, a creditor can only have access to the trust property *via* the trustee's right of indemnity. If the current trustee's right of indemnity ranks behind that of a former trustee, a creditor who has agreed to novation may suffer prejudice in the event of there being insufficient trust assets to pay all creditors. He will now claim through the successor trustee and will therefore rank

behind any creditors claiming through the former trustee whereas, if he had refused to agree to novation, he would have continued to be able to claim through the former trustee's right of indemnity and would therefore have had priority over all creditors claiming through the successor trustee. Whilst, of course, all this will only matter in the event of an insolvency arising, one can foresee the possibility of a cautious creditor (or his cautious advisers) wishing to stay with the former trustee rather than agree to novation to the successor trustee. If this were to become widespread, it would seem to be rather unsatisfactory.

(ii) *Future security*

16 If the successor trustee purports to grant security over the movable trust property, whether by means of a security interest under the Security Interests (Jersey) Law 2012 or under foreign law, what is the effect in relation to the former trustee's lien? After all, the successor trustee will be purporting to grant security over property in which, to the knowledge of the successor trustee, the former trustee has an equitable interest which ranks in priority to the successor trustee's own lien. Will the security created by the successor trustee trump the former trustee's lien or will such security rank behind the lien? One might instinctively think that the new security would be effective because the former trustee's lien is in the nature of a floating charge, which presumably only takes effect when it crystallises. But, as stated by Sir William Bailhache, Bailiff, in his judgment,[9] the Court of Appeal's decision raises a question over who has priority and one can see the potential for argument.

(iii) *Uncertainty*

17 As Clyde-Smith, Commr pointed out at paras 128—129 of his judgment, quite apart from any question mark over future security, a successor trustee will face considerable uncertainty in administering the trust assets. He will know that any claim through the former trustee will take priority over creditors claiming through him. The successor trustee will not necessarily be aware of the full extent of the creditors claiming through the former trustee when he, the successor trustee, takes office. So, as in the case of the Z II Trust, claims may arise subsequently out of transactions entered into by the former trustee prior to the handover. The successor trustee will therefore have to administer the trust assets in the knowledge that even liabilities which he has incurred properly in the administration of the trust may end up

[9] [2019] JCA 106, at para 279.

being irrecoverable because one or more creditors claiming through the former trustee have, by virtue of their priority, "scooped the pot" and exhausted all the assets of the trust in the event of its becoming insolvent.

18 However, in fairness, it is not all in one direction. Given that a trustee's lien is in the form of a floating charge, if claims were settled *pari passu*, a former trustee or creditors claiming through a former trustee could find that the value of the former trustee's lien has been radically reduced by liabilities taken on by the successor trustee. Whilst the value of the former trustee's lien is always vulnerable to actions undertaken by the successor trustee (whether by incurring liabilities or poorly managing the trust investments) the effect would be much greater if claims were paid *pari passu* than if the former trustee's lien retained its priority.

Customary law point

19 I have dealt so far with those parts of the court's judgment which describe the position under English law just as much as under Jersey law. However, there is a specific point of Jersey customary law which was raised by Sir William Bailhache, Bailiff, in his judgment.

20 As I have already said, the foundation of the court's decision was the assertion of the Privy Council in *Investec* that Jersey law was to the same effect as English law, in that a former trustee has an equitable lien over the trust property in support of his right of indemnity. However, Bailhache JA queried whether the Privy Council had been correct in this assertion. He pointed out that there is a long standing rule of Jersey law encapsulated in the maxim "*meuble n'a point de suite par hypothéque*" *i.e.* movable property may not be subject to hypothecation. Thus, historically, it was not possible under Jersey law to create security over movable property except by way of pledge accompanied by delivery of possession of the relevant property. This was only changed following the introduction of the Security Interests (Jersey) Law 1983, which has in turn been superseded by the Security Interests (Jersey) Law 2012. But these two laws only apply to security specifically created pursuant to those laws.

21 The existence of this rule of Jersey customary law does not appear to have been drawn to the attention of the Privy Council in *Investec*, and Bailhache JA was of the view that its decision that a former trustee had an equitable lien over property of which he no longer had possession (because it was in the possession of the successor trustee) would appear to be inconsistent with this rule of Jersey customary law.

22 Of course, if the former trustee does not have an equitable lien over the trust property in the hands of a successor trustee, there can be

no question of competing equitable interests and therefore no question of any application of the first in time principle. Although he does not expressly say so, it appears that, were it not for the decision of the Privy Council, Bailhache, JA would have concluded that the *pari passu* principle was appropriate. However he felt bound by the decision of the Privy Council notwithstanding that he felt it had been given in ignorance of the rule of Jersey customary law to which reference has been made.

23 The case is expected to go to the Privy Council which will have an opportunity of considering all these matters—the Court of Appeal gave leave to the creditor to appeal to the Judicial Committee of the Privy Council. The Jersey trust industry and those who advise in relation to it, as well as English trust practitioners, will no doubt await the outcome with interest.

Other points in the decision

24 Two other matters decided by the Court of Appeal are of some interest—

(i) It is to be recalled that under art 32(i)(a) of the Trusts (Jersey) Law 1984 ("the Trusts Law"), where a creditor knows that he is dealing with a trustee, his claim is limited to the trust property and the trustee is not personally liable for any shortfall. Conversely, under art 32(i)(b), if a person who does not know that he is dealing with a trustee transacts with a Jersey trustee, the trustee remains personally liable as under English law. Clyde-Smith, Commr held that, in the case of insolvency, no distinction was to be drawn between art 32(i)(a) creditors and a trustee exercising his right of indemnity in respect of art 32(i)(b) creditors with whom he has settled. They all rank *pari passu* between themselves in so far as they have transacted with the same trustee and are therefore claiming through that trustee's right of indemnity. The Court of Appeal disagreed with this finding. They held that, if the intention of art 32 (which was to protect trustees at the expense of creditors) was to be fulfilled, a trustee seeking an indemnity in respect of an art 32(i)(b) creditor should rank ahead of art 32(i)(a) creditors. The court's reasoning on this aspect was fairly brief. On the face of it, this could have consequences which some might think to be unsatisfactory. A trustee who has neglected to tell a creditor that he is dealing with a trustee and who pays the creditor in full (assuming the trustee is solvent) will obtain recompense from the trust property ahead of those creditors to whom he has disclosed that he is a trustee. It is not clear why in those circumstances it is thought fair for the trustee to be reimbursed ahead of the art 32(i)(a) creditors rather than *pari passu* with them.

(ii) In a second judgment,[10] Clyde-Smith, Commr held that a creditor claiming against an insolvent trust may not claim for the costs incurred in connection with bringing his claim. He reached this conclusion by analogy with the position where there is a bankruptcy and accordingly refused to allow the former trustee to recover the costs incurred in connection with the present litigation. This was overturned by the Court of Appeal which held that the former trustee was entitled as a matter of principle to recover from the trust assets its costs in proving its claim as trustee.

Issues relating to the retirement of trustees

(i) *Retention of trust property*

25 Given that English trusts have been in existence for such a long time, it is rather surprising to find that there appears to be some uncertainty as to whether a retiring trustee can retain any trust property as against a new trustee in support of his right of indemnity.

26 The issue fell for decision fairly recently in the Bermuda case of *Meritus Trust Co Ltd v Butterfield Trust (Bermuda) Ltd*[11] where the case was argued on the basis that Bermuda law was the same as English law on this point. Both parties accepted that a trustee is entitled to retain trust property as against a beneficiary when a distribution is made because the trustee's equitable lien (which survives retirement) confers an equitable interest in the trust property which has priority over the interests of the beneficiaries. However Kawaley, CJ held that there was no right of retention as against a new trustee. He did so on two main grounds—

(i) Section 30 of the Trustee Act 1975 of Bermuda (which appears to be in similar terms to the English Trustee Act) provides that, save for certain assets such as stocks and shares, a deed of appointment of a new trustee operates to vest the trust property in the new trustee without the need for any further document, and s 27 of the same Act imposes a mandatory requirement upon a retiring trustee to execute any document which is necessary to transfer trust assets (*e.g.* shares in a company). The Chief Justice felt that these provisions were inconsistent with a right of retention by a retiring trustee.

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[10] [2018] JRC 164.

[11] [2017] SC (Bda) 82 Civ (13 October 2017); https://www.gov.bm/sites/default/files/Judgment-Meritus%20Trust%20Company%20Limited-v-Butterfield%20Trust%20%2528Bermuda%2529%20Limited.pdf (last accessed 10 January 2020).

(ii) The Chief Justice considered that, whilst there were *dicta* to the opposite effect, the preponderance of judicial authority was in favour of the new trustee's submission that there was no right of retention. He placed particular reliance upon the Australian case to which reference has been made, namely *Lemery Holdings Pty Ltd v Reliance Financial Servs Pty Ltd*.[12] That case had held that a former trustee did not have a right to retain, as against a new trustee, trust assets as security for its right of indemnity. Both the Australian case and the Bermuda case appeared to accept that there is a discretionary jurisdiction in the court to order retention of trust property if it thinks the circumstances justify it, but there is no *right* in a retiring trustee to retain trust property.

27 The position is different under Jersey law. First, there is no equivalent provision in the Trusts Law to s 30 of the Bermuda Act to the effect that the deed of appointment itself operates to transfer title to trust property subject only to certain exceptions, such as stocks and shares. Secondly, art 43A of the Trusts Law provides that before a trustee retires and surrenders trust property, he may require to be provided with reasonable security for liabilities, whether existing, future, contingent or otherwise. In the event of a dispute as to whether it is reasonable in a particular case to retain trust property and if so, how much, the matter would be resolved by the court which would undoubtedly sit promptly to resolve the matter. There are at least two cases where this has occurred. The first is *In re Carafe Trust*,[13] where the court directed payment into an escrow account to cover a claim for outstanding fees by the retiring trustee. The second is *In re Essel Trust*,[14] where the court made it clear that the retiring trustee was not entitled to retain the whole of the trust fund pending payment of its fees.

(ii) *Contractual indemnities*

28 In the past, it was comparatively rare for English trusts to be exported, with the consequence that the new trustee was subject to the jurisdiction of the English courts, which would of course apply, and be familiar with English law. Retiring trustees were therefore often content to rely upon the right of indemnity and equitable lien which the law gave them.

29 In the offshore world, a new trustee may often reside in a different jurisdiction and the proper law of the trust may be changed to the law of that jurisdiction. In those circumstances a retiring Jersey trustee may

[12] [2008] NSWSC 1344.
[13] 2005 JLR 159.
[14] 2008 JLR *N* [18].

well feel nervous about relying solely upon a point of Jersey law which would, in the event of the retiring trustee needing to enforce its equitable lien or right of indemnity, have to be proved to the satisfaction of the foreign court. For that reason, retiring Jersey trustees usually insist upon contractual indemnities in the deed of retirement, in the expectation that this will be much easier to establish in a foreign court even if that court is unfamiliar with the niceties of the Jersey law of trusts. The indemnity usually includes a personal covenant by the new trustee that, before distributing any trust property to a beneficiary or passing trust assets over to a successor trustee, he will in turn obtain an indemnity by the beneficiary or successor trustee in favour of the former trustee.

30 But of course, whether a retiring trustee is relying upon his indemnity at law or a contractual indemnity, its effectiveness will ultimately be dependent not only upon the ease of enforcement in a foreign court against any defaulting new trustee, but also on whether the new trustee is an entity of substance which can meet any obligation. Retirement in favour of Flybynight Trustees Ltd might well not be the best of ideas!

Sir Michael Birt was Bailiff of Jersey from 2009 to 2015. He now sits as a Commissioner, as an Ordinary Judge of the Courts of Appeal of Jersey and Guernsey, and as a Judge of the Cayman Islands Court of Appeal.