Private Client eBriefing

What next for "insolvent trusts" after ETJL v Halabi; ITGL v Fort Trustees [2022] UKPC 36?

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Technically, a trust cannot be insolvent: trusts are not legal persons. However, the term "insolvent trust" is a useful shorthand for the situation which arises where the trustee of a trust has incurred liabilities in their capacity as such (in this paper, such liabilities will be referred to as "trust liabilities") which exceed the amount or value of the trust fund—or, perhaps, where there is insufficient liquidity to meet such liabilities as they arise.

Insolvent trusts have been the subject of two significant Privy Council decisions in the last five years, both involving trusts governed by Jersey law. On 23 April 2018, the Privy Council handed down its decision in *Investec Trust (Guernsey) Ltd v Glenalla Properties Ltd* [2018] UKPC 7. And on 13 October 2022, the Privy Council handed down its decision in *Equity Trust (Jersey) Ltd v Halabi* and *ITG Ltd v Fort Trustees Limited* [2022] UKPC 36.

This short paper is intended to provide a summary for English private client advisors of where the law now stands, to identify some of the questions which remain unanswered, and to explore some of the practical consequences.

Insolvent trusts in English law

The starting point where there is an insolvent trust has historically been that the trustee's liability is unlimited. By default, English law (unlike, for example, Jersey law) does not distinguish between a trustee's personal and fiduciary capacities. It is therefore the trustee's responsibility to meet any shortfall in the trust liabilities out of the trustee's personal assets—if there is to be an insolvency process, it will be the trustee's own insolvency.

However, that starting point may be contractually modified as part of the trustee's dealings with third parties. It is now relatively common for trustees to make clear that third parties' recourse is limited to the trust fund (in this paper, such liabilities will be referred to as "limited liabilities". Where the trust fund is insufficient to meet those limited liabilities, the shortfall is not (or not necessarily, at least) the responsibility of the trustee, and so the fund itself is – in practical terms – insolvent.

There are no English law authorities dealing directly with how the fund should be administered in that scenario. Some limited guidance may be drawn from cases concerning the statutory trusts arising in respect of client money held by companies defined as "investment banks" under the Banking Act 2009 – for example *Re MF Global UK Ltd* [2013] EWHC 1655 (Ch) – and from *National Westminster Bank Plc v Lucas* [2014] EWCA Civ 1632 which concerned a potentially insolvent estate.

However, for more detailed guidance we must look to the Privy Council decisions.

The Privy Council decisions

The majority in the *Investec* decision (at [59]) drew together a number of "well-established principles of English trust law" which are relevant to insolvent trusts. Most importantly for present purposes, it recognised the longstanding principle that a trustee is entitled to be indemnified from the trust fund in respect of properly incurred trust liabilities, and that the trustee's right of indemnity is secured by an equitable lien over the trust fund which normally survives the trustee's retirement. In addition, the recourse of third-party creditors against the trust fund is only by way of subrogation to that equitable lien.

The nature of that equitable lien – and the outcome where there are multiple former and current trustees, each with equitable liens – was considered in detail in the *Equity Trust* decision. There, the majority – departing from the decision of the Jersey Court of Appeal that the trustees' liens ranked according to their order of creation, i.e. according to the date each trustee was appointed – held that all of the former and current trustees' claims ranked equally, sharing *pari passu* in the insolvent trust fund. This was for two main reasons:

(i) there is not necessarily any connection between the appointment dates of the trustees and the appropriate order of priority; and

(ii) the purpose of the lien – which is to give priority over the beneficiaries and to give at least some security to trust creditors – does not require or support a first in time approach.

So, the majority held, there were "sufficiently powerful reasons, of justice, equity, fairness and common sense" for preferring a *pari passu* rule of priority.

The three judges who were in the minority preferred a first-in-time approach, in line with the general rule applicable to competing equitable interests: priority is determined by the order of creation.

However, as Lady Arden pointed out in her concurring judgment, the minority's reasoning presupposed that the trustees' liens were in competition. In her view, they were not, and that was why *pari passu* was the appropriate rule.

Unanswered questions

The overarching unanswered question is the extent to which the Privy Council decisions – and other recent decisions of the Jersey and Guernsey courts in this area – represent the position in England and Wales, as well as in other common law jurisdictions.

In particular:

(a) is the test for insolvency in an English trust the "balance sheet" or "cash flow" test – both of which have been applied in Jersey law – and is the test the same for all purposes?

(b) must the trustees of an insolvent English trust have regard to the interests of the trust's creditors – as has been held in Jersey by analogy with English company law – and if so are those interests determinative or merely a relevant consideration?

(c) how will the English courts approach applications for directions concerning insolvent English trusts—will they take the context-sensitive, flexible approach they have taken in Jersey and Guernsey?

(d) do English trustee liens rank *pari passu* – as held by the majority in the Privy Council – or first in time?

Although the Privy Council cases were decided as a matter of Jersey law, they were – importantly – decided expressly on the basis that there was no relevant difference from the underlying principles under English law. They are therefore likely to be treated as

persuasive by the English courts. However, the trustees of English law trusts will nevertheless need to be cautious before assuming that the Privy Council and Channel Islands cases apply, and – if in any doubt – seek directions from the English courts.

Moreover, certain questions were expressly left open by the Privy Council in *Equity Trust.*

First, Lord Briggs left open the possibility that exceptional circumstances might arise in which the strict application of a *pari passu* rule of priority might work such obvious inequity that an exceptional discretion to depart from it might be justified.

What might those exceptional circumstances be, given that the law already caters for breaches of duty by trustees by depriving them of their indemnity in the first place?

Second, Lord Briggs noted that the priority of claims as between trustees and creditors had not been considered and would have to be resolved on another occasion.

This was the subject of conflicting decisions in the Jersey courts in the lead-up to *Equity Trust*. So:

(i) the Royal Court's decision was that creditors with limited liabilities would rank *pari passu* with the trustee's claims (both in its own right and in respect of its unlimited liabilities), with the result that the trustee would be left to meet any shortfall owing to the unlimited creditors;
(ii) the Jersey Court of Appeal, *obiter*, held that the trustee's claims (both in its own right and in respect of its unlimited liabilities) would rank ahead of the claims of creditors with limited liabilities, with the result that they – rather than the trustee – would bear the brunt of any shortfall.

That leaves us without much sense of how the English courts (or indeed other common law courts) will approach this question in future.

Third, Lord Briggs acknowledged that the procedure for distributing funds *pari passu* – once the fund becomes inadequate to satisfy the liens in full – had not been determined and may require the intervention of the court in some cases.

The Jersey and Guernsey cases suggest that the courts will take a context-sensitive, flexible approach. Depending on the circumstances, this might range from a formal claims process administered by an insolvency practitioner and supervised to the court, to a straightforward distribution exercised administered by the current trustee.

Fourth, Lord Briggs floated the possibility that the general rule of *pari passu* priority might be displaced, in a particular case, by express provision in the relevant trust instrument.

This gives rise to a more general point. It is not only the governing instrument of the trust which might displace the general rule of *pari passu* priority. That could also be achieved by subsequent trust instruments – like deeds of trustee retirement and appointment – or in the terms of the trustees' dealings with third parties: for example, lenders to trusts are often advised to seek an express subordination of the trustees' right of indemnity.

Practical consequences

For English private client advisors, the developing law concerning insolvent trusts presents a challenge: there is now considerable authority, but none of it is of direct application to English law trusts, and that means there are significant unanswered questions.

For current trustees, the key takeaway – given the current state of the law – is that they need to be vigilant in identifying when an insolvent trust situation might arise, and cautious in considering how to act in response. So they should seek advice if at any point it looks as if the trust liabilities exceed the amount or value of the trust fund, or as if there is insufficient liquidity to meet such liabilities as they arise. And they should seek directions from the court if there is any doubt concerning how to proceed.

For incoming trustees, rising awareness of the problems posed by insolvent trusts is likely to increase the intensity with which deeds of retirement and appointment are negotiated, and to increase the due diligence required before taking office.

For outgoing trustees, care should be taken to avoid leaving hostages to fortune once the trust fund is in the hands of a new trustee. So they should do their best to pay trust liabilities in full before they retire, or to obtain express releases from third party creditors. And they may wish to seek a "ring-fenced" retention from the trust fund to cater for any anticipated (or unanticipated) future liabilities, or to negotiate a time-limited form of priority over the incoming trustee's indemnity.

In all of this, it will be vital to keep up to date. *Equity Trust* will surely not be the last word on insolvent trusts. So keep an eye on the *eBriefing* for more news, when we have it!

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