

First in time, first in line?

Adam Carvalho and Joseph de Lacey examine the priority of trustee indemnities



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'The original trustee argued that a *pari passu* approach was wrong in law, and that its claim had priority over the other creditors of the Z II Trust.'

Readers will of course know that trustees have a right to be indemnified for costs that they have incurred properly in relation to their trusteeships from their trust funds. In the majority of instances, this 'bundle' of rights can be invoked without issue, but sometimes cases come along which demonstrate the significant and potentially serious problems that can arise.

A recent Jersey case – *Representation of Rawlinson & Hunter Trustees SA re Z Trusts* [2019] – concerned a retired trustee which faced a liability for which it was entitled to be indemnified but which exceeded the value of trust assets (and where the successor trustee had also incurred further liabilities). The Jersey Court of Appeal conducted a thorough review of judgments from England and Wales and other common law jurisdictions in reaching its conclusions.

The case will therefore be of interest to contentious and non-contentious private client solicitors as it provides an illustration of the types of issues that can arise in relation to indemnities, and how they may be viewed by the court. These issues will need to be borne in mind when arrangements for the retirement and appointment of new trustees are being negotiated.

We set out, first, a summary of the factual and legal background before turning to our reflections in relation to the judgment.

Introduction: trustee indemnities

A trustee's indemnity for costs properly incurred in connection with the trust is 'one of the fundamental rights of an honest express trustee': see *Meritus Trust v Butterfield Trust Ltd* [2018], at paras 20-21. It is also fundamental to the relationship

between the trustee on the one hand, and the beneficiaries, trust creditors, and successor trustees on the other. Absent an understanding of the mechanics of, and privileges afforded by, the indemnity and the equitable lien by which it is secured, the rights of each of the above as against each other cannot be understood. A trust has no legal personality. Liabilities in respect of trust expenses are incurred by the trustee personally; see *Investec Trust (Guernsey) Ltd v Glenalla Properties Ltd* [2017] at para 59. Except where expressly agreed in the case of contractual liabilities, or where statutory protections apply (see Trusts (Jersey) Law 1984, Art 32; Trusts (Guernsey) Law 2007, s42), a trustee's liability for such is not limited to the trust assets, but also extends to their personal assets: see *Lewin on Trusts*, 19th ed, at 22-048.

Where costs are incurred properly, the trustee is entitled to an indemnity from the trust fund. This indemnity plays two crucial roles: first, it provides a right of reimbursement for costs paid, and a right of exoneration for liabilities incurred but undischarged; secondly, while trust creditors have no claim against the trust assets (the trustee debtor has no beneficial interest in them), but against the trustee only, the trustee may claim the benefit of that indemnity and satisfy its claims by way of subrogation to it: see *Re Frith* [1902].

The indemnity is secured against trust assets by equitable lien. When replaced, the trustee has no right of retention of trust assets, but the lien survives and the new trustee takes subject to it. As the indemnity covers present and future liabilities, the trustee can call on its indemnity

when a claim is made against it after its replacement: see *X v A* [2000]. Where assets held by the successor trustee are sufficient to cover all liabilities, no issues should arise. But what if, after the trustee's replacement, a liability arises which exceeds the value of trust assets? Assuming that the successor trustee has also incurred liabilities, how should each trustee's claim be treated? Should a *pari passu* approach be adopted or should the former trustee's indemnity and lien rank in priority to the later trustee, even though that may cause the later trustee's indemnity to become worthless, and even when, on the assumption of office, it had no notice of the liability in question? These were the questions facing the Jersey Court of Appeal in *Re Z Trusts*.

Facts

The dispute related to two trusts: the Z II Trust, established in 2004, and the Z III Trust, established in 2005. The original trustee of both was replaced in 2006, with the benefit of contractual indemnities. Some six years after its replacement a claim was brought by an English company within the Z II Trust (Angelmist Properties Ltd) against two of its former directors for breach of duty, and against the original trustee for vicarious liability.

The Angelmist proceedings were compromised in December 2015, on terms which provided that the original trustee:

- pay £16.5m to the liquidators of Angelmist; and
- accept liability for its own costs of over £2m.

The original trustee notified its successor trustee of the Z II Trust of its intention to rely upon its contractual indemnity in respect of this liability and asserted that its equitable rights as a former trustee took priority over those of the new trustee.

The original trustee's indemnity in respect of the Angelmist proceedings

It was agreed that the original trustee was entitled to an indemnity

in relation to the Angelmist liabilities: see *Representation of Rawlinson & Hunter Trustees SA re Z Trusts* [2018]. However, it was also agreed that the original trustee did not enjoy the protection of Art 32(1)(a) of the Trusts (Jersey) Law 1984. This provides that where a party to a transaction affecting the trust knows that the trustee is acting as trustee, any claim by that

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party shall extend only to the trust property. In other words, the claims of the original trustee's creditors were not limited to the trust property but could extend to its own assets. (Many modern precedents for deeds of retirement and appointment limit the indemnity given to the retiring trustee by the incoming trustee to the value of the trust fund in the possession or under the control of the incoming trustee, from time to time.)

The original trustee also enjoyed the protection of its equitable lien. However, the Z II Trust assets amounted to around £6m, whereas total liabilities amounted to some £211m. The Court of Appeal would describe such a trust as 'insolvent', despite the term being a 'misnomer' as a trust has no legal personality and cannot hold assets or incur liabilities. The Court of Appeal used this term to describe a situation where the assets held by the trustee on trust were exceeded by the liabilities incurred in relation to the trust. If this £6m was shared between all creditors on a *pari passu* basis, the original trustee's recovery would amount to around £330,000, leaving it substantially out of pocket. The original trustee therefore argued that a *pari passu* approach was wrong in law, and that its claim had priority over the other creditors of the Z II Trust.

The original trustee's claim and the decision at first instance

The matter first came before the Jersey Royal Court in March 2018. The Commissioner determined that

the claims against all trustees and the liabilities of all trustees ranked *pari passu*. The purpose of the equitable lien, he said, was to secure the rights of the trustee against the beneficiaries, not the rights of the trustees as against each other (para 126):

As it does not arise out of the relationship between trustees, there

is no reason for the general rule that equitable interests rank according to the order of their creation to apply as between trustees.

He also found that the claims of trust creditors would rank *pari passu* as against the trust assets (para 107), and (para 138):

... it would be inconsistent to then establish a ranking in time regime as between a former and successor trustee, allowing the former trustee and its creditors 'to scoop the pot'. Both trustees would have been involved in the due administration of the trust and one has no better right to be indemnified than the other.

Decision of the Court of Appeal

The original trustee's appeal was heard on 28 June 2019.

The original trustee's submissions

The original trustee's position was that:

- as a trustee, it had a right to an indemnity, secured by an equitable lien – a form of equitable charge upon the trust property;
- because it attaches to the trust assets, the successor trustee takes the trust assets subject to the subsisting equitable interest: See *Lemery Holdings Pty Ltd v Reliance Financial Services Pty Ltd* [2008]. This position was reflected in Art 34(2)

of the Trusts (Jersey) Law, which provided that an outgoing trustee:

... may require to be provided with reasonable security for liabilities whether existing, future, contingent or otherwise before surrendering trust property...

and

over movables was a concept less recognised in the *customary law* than in the common law of England, that was not material – the Privy Council had declared that the concept of a trustee’s lien was part of the law of Jersey (para 134).

Logan Martin QC, delivering the leading judgment of the court, found that the following principles

whether in Jersey, Guernsey or England.

Priority between former and successor trustee’s equitable liens

As a starting point, the court noted that the trustee’s lien did have a recognised element of priority, being over the claims of beneficiaries (para 155). Further, the general position – according to *Snell’s Equity*, 33rd ed, at 4-002 – regarding the ranking of equitable liens was that equitable interests take priority according to the order in which they are created. There are exceptions, including where the holder of a right created later in time has not received actual or deemed notice of the prior right, or where there has been some alienation of property held under an equitable interest – but these did not apply where a successor trustee takes office in the knowledge of the former trustee’s continuing equitable interest.

Logan Martin QC found therefore that there was (para 167):

... nothing to suggest that the basic rule of priority in time is subject to an exception where a trust has more than one trustee, and where the trustees have assumed office and incurred liabilities in succession.

That being so, and there being no authority displacing that rule in relation to a trustee’s indemnity, the original trustee’s appeal on this point succeeded.

As a further point, the court noted that the Commissioner, in explaining his decision, had relied upon his belief that the purpose of the equitable lien was to give trustees priority over the interests of beneficiaries. However, that could not be the only purpose. The court found that the equitable lien existed as a right which the trustee has and may exercise in order to protect itself (para 173). It was a right exercisable against the trust assets, and based upon the trustee’s proprietary charge or interest which was freely disposable by a trustee for its own benefit.

Support in Australian authorities

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- since a successor trustee obtains a ‘subsequent charge’ in the form of its own lien, there is no reason in principle why the equitable principles of priority as regarding equitable interests should not apply to a trustee’s interest (at para 62).

The Court of Appeal agreed.

Law of trusts in Jersey

The starting point, the court said, was to ascertain the relevant features of the law of trusts in Jersey. These features were set out in the majority judgment of the Privy Council in *Investec*. That case provided a ‘definitive statement of the law of trusts in Jersey’ (para 133), from which the following guidance could be taken:

A trustee is entitled to procure payment out of the trust estate or to be indemnified out of the trust estate in respect of debts properly incurred as trustee. This means that a trustee has a claim on the trust assets for the debts which it has incurred as trustee. In order to satisfy such a claim, the trustee has a right of indemnity which is secured by an equitable lien on the trust assets. That equitable lien does not depend on possession, and it normally survives after it has ceased to be a trustee.

These were, the court noted, English law principles. And, while in particular a right of security

of Jersey trusts law could be identified:

- a trustee possesses by virtue of its office an equitable right of indemnification, which arises by operation of law upon its appointment;
- this was an equitable interest secured over the trust property, and could be vindicated by the exercise of the trustee’s lien which secures the right of indemnification;
- each and every trustee possesses its own equitable interest and right of lien which was enforceable as a first charge against the trust assets;
- that equitable lien took priority ahead of the beneficiaries and those deriving title from them; and
- the trustee need not wait until the trust property has been realised, but may by itself or by court application bring about a sale of assets so as to satisfy its charge, even where the interests of the beneficiaries are affected (paras 145-147).

These principles do not, however, say anything about the ranking of a former and successor trustee’s equitable liens. Indeed, the court noted that this was a question on which there was no direct authority,

the principle that a trustee's right of indemnity and lien existed as a definitive, individual and continuing right. In *Lemery*, Brereton J had considered in detail the principles regarding a trustee's indemnity, finding that on the transfer of trust property to a new trustee, the lien survives and the new trustee takes subject to the lien of the old trustee. In fact, he went further, holding that the right of possession of the old trustee, until its right of indemnity is exercised, 'is superior to those of a new trustee or the [beneficiary]' (para 182). A successor trustee takes the trust assets subject to a former trustee's right of lien, and that (para 184):

... 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 right of lien of the successor trustee.

Practicalities

Having concluded on the principal issue, Logan Martin QC dealt with the concerns that if a former trustee's lien ranked in priority to a successor, it might 'scoop the pot' to the disadvantage of the successor trustees and its creditors. The court rejected this as a concern. First, the successor trustee was not imposed with obligations against its will – acceptance of office was a choice, and it could exercise such due diligence as it saw fit. Secondly, in accepting the appointment, the successor trustee would know that there had been a former trustee, with creditors with claims against the assets of the trust. Thirdly, the 'critical' effect of the priority of a predecessor trustee's right of lien only arises if a trust fund becomes insolvent (para 192).

Priority among trust creditors

Some commentary – see *Lewin* at 22-047 – has suggested that the claims of creditors will rank *pari passu* as against the trust assets – but the Court of Appeal found no difficulty with having one rule for trust creditors claiming through a particular trustee's lien and one rule for trustees claiming under their own (para 202):

The fact that creditors claiming under the right of lien of an earlier trustee may rank *pari passu* inter se is compatible in my opinion with the fact that the right of lien itself may rank in priority of time over the separate right of lien of a later trustee and its creditors. That does not involve a 'mixing' of the two

regimes; rather the regimes are being applied to two separate categories of claim, the one being the claims of trustees (and their creditors) under the trustee's right of lien and the other being the claims of the creditors of a single trustee amongst themselves.

Conclusion for practitioners

There may well be elements of the judgment that require further consideration:

- Is it right, for example, that a trustee's equitable lien is treated the same as other equitable security interests, or should a different rule apply which provides former and successor trustees with equal protection?
- Does the Commissioner's suggestion, that a first-in-time approach between former and successor trustee should be dismissed as the lien arises out of the relationship between the trustee and beneficiaries, downplay the role that the lien plays as between each of the other interested parties? The lien and indemnity do not exist only to determine rights between trustee and beneficiary. They provide creditors with the ability to satisfy their claims from the assets of the trust, and not just the personal assets of the trustee: see *Re Frith*. If the indemnity and lien therefore are not seen and understood simply as rights as against beneficiaries, should their

operation be restricted where the rights of beneficiaries, in the case of an 'insolvent trust', become secondary to the interests of the creditors?

- While it is true that equity tends to favour equality, an obvious unfairness arises if claims of

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former and successor trustees are treated *pari passu* when the liabilities of the former trustee were likely incurred at a time when the trust was 'solvent', and where it was under the supervision and management of the successor trustee that the trust became 'insolvent'.

The Court of Appeal's judgment in the Z Trust case provides a useful and important exploration of the principles relating to trustees' liens, and retiring trustees will need to consider carefully the arrangements they negotiate in the light of this judgment. And, as the Court of Appeal drew heavily from English case law in its decision, its influence is likely to extend far beyond Jersey, and may well indicate how a court of another common law jurisdiction might approach the question. ■

Re Frith

[1902] 1 Ch 342

Investec Trust (Guernsey) Ltd & anor v Glenalla Properties Ltd & ors
[2017] WTLR 205

Lemery Holdings Pty Ltd v Reliance Financial Services Pty Ltd
[2008] NSWSC 1344

Meritus Trust Co v Butterfield Trust Ltd
[2018] WTLR 545

Representation of Rawlinson & Hunter Trustees SA re Z Trusts
[2018] JRC 119;
[2019] JCA 106

X v A
[2000] WTLR 11