Winding up insolvent Trusts

Andrew Shaw considers some of the issues facing a trustee where the trust property is insufficient to meet the demands upon it

A trust is not a discrete legal entity and therefore cannot, formally, be insolvent. The liabilities of a trust are in fact personal liabilities of the trustees and it is to them that creditors must have recourse, unless security has been granted over the trust assets.

If the trustees are unable to meet their liabilities to creditors, then they can be made bankrupt or, in the case of corporate trustees, wound up. In these circumstances, the creditors in respect of liabilities incurred by the trustees in that capacity might, in certain circumstances, have recourse to the trust assets. Where those assets are insufficient to meet the liabilities of the (now insolvent) trustees, then the trust might colloquially be described as insolvent.

A similar situation can arise where any recourse the unsecured creditors have against the trustees is limited to the extent of the trust assets, but those assets are insufficient to meet the liabilities incurred by the trustees.

This article examines the approaches which trustees might take to winding up such an ‘insolvent’ trust.

Limiting the Trustee’s Liability

In some jurisdictions, the liability of the trustee is limited to the extent of the trust assets by statute. For example, Article 32 of the Trusts (Jersey) Law 1984 provides that:

1. Where a trustee is a party to any transaction or matter affecting the trust –
   (a) if the other party knows that the trustee is acting as trustee, any claim by the other party shall be against the trustee as trustee and shall extend only to the trust property; 
   (b) if the other party does not know that the trustee is acting as trustee, any claim by the other party may be made against the trustee personally (though, without prejudice to his or her personal liability, the trustee shall have a right of recourse to the trust property by way of indemnity).

2. Paragraph (1) shall not affect any liability the trustee may have for breach of trust.

Similar provisions apply in Guernsey and the British Virgin Islands.1

This is not the case in England, however, where the trustee’s liability may only be limited to the extent of the trust assets by agreement. Whether a trustee has succeeded in so limiting his liability will depend upon whether, on the true construction of the contract by which the liability is incurred, the

1. Section 42 of the Trusts Law (Guernsey) 2007 and the BVI Trustee Act 1961, sections 94 – 104 respectively.
intention of the parties was that the trustee's liability would be limited. It would not be generally be enough though, for the trustee simply to state that he contracts "as trustee".\

**Trustee’s Lien**
A trustee is generally entitled to be indemnified out of the trust assets in relation to those costs and expenses incurred by him while acting on behalf of the trust. In England this indemnity is now statutory, being conferred by section 31(1) of the Trustee Act 2000:

- A trustee
  - (a) is entitled to be reimbursed from the trust funds, or
  - (b) may pay out of the trust funds, expenses properly incurred by him when acting on behalf of the trust.

In jurisdictions where there is no such statutory provision, the scope of the indemnity will depend upon the terms of the trust instrument. In England too, it is possible for the scope of the indemnity to be increased beyond that specified in the Trustee Act. So, for example, the trust instrument may indemnify the trustee against any liability arising from his own negligence.

In consequence, a trustee acquires a first charge or lien over the trust property for the purpose of enforcing his right of indemnity. This right takes priority over the rights of beneficiaries and, indeed, creditors who hold a debenture over the trust assets.\

**Creditor’s Right of Subrogation**
Where a trustee is able to satisfy his liabilities to creditors then no difficulties arise. The trustee will either pay the creditor directly and recoup his expenditure from the trust property, or will discharge the liability directly from the trust property.

If the trustee is unable to satisfy his liabilities either personally, or directly from the trust property, a creditor will generally be limited to enforcing his rights against the trustee, as, in the absence of the specific grant of security over the trust property, a creditor of the trustee has no right to levy execution against trust assets.\

In certain circumstances, a creditor may be unable to enforce the personal liability of the trustee. An obvious example is where the trustee is insolvent. Another is the scenario described above, where the liability of the trustee is limited to the trust property. In such a situation, the creditor is likely to be subrogated to the trustee’s rights under his lien. Provided that the trustee would have been indemnified by the trust for his liabilities to a given creditor, then the right of subrogation will enable the creditor to satisfy the liability from trust assets. Further, in the case of an insolvent trustee, the right of indemnity from the trust property does not form part of the insolvent trustee’s estate. Where there is more than one creditor subrogated to a trustee’s lien and the assets of the trust are insufficient to

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2/. Muir v City of Glasgow Bank (1879) 4 App Cas 337, 368.
3/. Re Exhall Coal Company (1866) 55 ER 970.
4/. Jennings v Mather [1902] 1 KB 1.
5/. Re Pumfrey(1882) 22 Ch D 255, 263.
6/. Re Richardson [1911] 2 KB 705.
Where there is more than one creditor subrogated to a trustee’s lien and the assets of the trust are insufficient to meet all claims in full, then the question arises as to how the claims should be treated

meet all claims in full, then the question arises as to how the claims should be treated. There are essentially two options: (i) the creditors rank in the order of time in which the personal liability of the trustee to them arose; or (ii) the creditors rank pari passu between themselves. There is no direct authority on this point but there are good reasons for preferring a pari passu distribution. As a matter of principle this is the fairest approach and is common practice in insolvencies. As a matter of practice, this approach removes any requirement to investigate the precise timing of creditors’ dealings with the trustee. The pari passu approach is also supported by the dicta of King CJ in *Re Suco Gold Pty Ltd* (1982) 33 SASR 99, 109.7

**Practical Considerations**

The preceding paragraphs set out the basis on which unsecured creditors might be satisfied pari passu from the trust assets in circumstances where they have no recourse against the trustee, either by reason of the trustee’s insolvency or because the trustee’s liability is limited to the trust assets. There remains the practical matter of how a trustee can implement the winding up of a trust. Factors which will need to be taken into account include how the expenses of winding up the trust should be treated and what should be done about creditors who claim to have preferential claims.

The safest course for a trustee would be to apply to the court for directions under Part 64 of the Civil Procedure Rules, or the equivalent provisions in jurisdictions outside England. The question then becomes what directions should the trustee seek?

One possible solution is provided by the decision of the Jersey Royal Court in *Re Hickman* [2009] JRC 040, which concerned an application by an executor for ratification of the procedure adopted for dealing with the insolvent estate of a deceased person. No provisions for this eventuality were provided in Jersey’s probate laws, so the executor had devised a procedure based on the relevant provisions of the Bankruptcy (Désastre) (Jersey) Law 1990. *Inter alia*, the procedure provided for:

1. publication of a notice requiring creditors to submit claims by a specified date;
2. forfeiture of claims not submitted by the specified time;
3. preferential claims;
4. the inspection of all claims by creditors and the ability to file oppositions to other claims;
5. the admission or rejection of creditors’ claims by the executor;
6. an appeal procedure for rejected claims;
7. the executor’s fees to be paid out of the insolvent estate.

The Jersey Royal Court ratified this procedure. It provides a useful template for the directions which might be sought in relation to an insolvent trust; although, clearly any analogous procedure devised for approval by an English court under CPR Pt 64 should be based as closely as possible on the provisions of the Insolvency Act 1986 and related legislation.

Where an insolvent trust has a limited number of creditors whose debts are known and undisputed, there is the possibility of the trustee avoiding a potentially expensive and time consuming application to the court under CPR Pt 64 and for a streamlined version of the procedure described in *Re Hickman* to be implemented.

As a matter of English law, the payment of a

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7. See Lewin on Trusts (19th Edn, Sweet & Maxwell, 2014) at paragraph 22-047 for other common law cases which indicate a preference for a pari passu distribution in this situation.
lesser sum does not provide good consideration for the release from a debt.⁸ There is an exception to this rule though, where a creditor can reach a composition with all of his creditors.⁹ It would therefore be open to the trustee to propose a pari passu distribution of all of the trust assets to the creditors; if the creditors unanimously agreed then a binding composition could be reached without the need for a court application.

There are a number of considerations for the trustee if he opted to pursue such a course of action. First, it would be necessary to confirm that the terms of the trust instrument permitted the trustee to reach a compromise with creditors and conduct a winding up of the trust without reference to the court. Second, if the trustee wanted any expenses incurred in winding up the trust to be paid in full, this could only be achieved with the agreement of all the creditors and the payment of such expenses from trust property would also have to be permitted by the trust instrument. Finally, there is the matter of the treatment of preferential claims.

In practical terms, the most likely reason for any preferential debt is that other creditors had contractually agreed to subordinate their debt. In this situation, it might well be very difficult to obtain the consent of the subordinated creditors to any composition based upon a pari passu distribution to ordinary unsecured creditors, because the subordinated creditors would be unlikely to receive anything. If unanimous agreement cannot be reached with all the creditors, the prudent course for the trustee would be to make an application for directions to the court.

Conclusion

Despite the fact that English insolvency legislation does not apply to trusts whose liabilities outstrip their assets, it does provide a useful template for the winding up of such trusts, and one which it would be possible for a trustee to implement through an application under CPR Pt 64 or, if the circumstances permit, unilaterally.

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⁸. Pinnell’s Case (1602) 5 Co Rep 117a, affirmed by the House of Lords in Foakes v Beer (1884) 9 App Cas 605.
⁹. Good v Cheesman (1831) 2 B&Ad 328.