The Z Trusts equation — Z2 + Z3 = 1T + IP

August 2020

The below article was first published on Lexis PSL, provides an update on the latest developments in the Z Trusts insolvency case, which has so far this year led to three ground-breaking judgments from the Royal Court of Jersey in the developing and controversial area of 'insolvent' trusts.

Private Client analysis: The Royal Court of Jersey has released three judgments in the first half of 2020 which continue to break new ground in the developing and controversial area of 'insolvent' trusts, culminating in the appointment of an insolvency practitioner to conduct a winding up of the two trusts in question. The Royal Court was also asked to consider a pre-emptive costs application by the appellant in the forthcoming Privy Council appeal on the issue of priority ranking and the equitable lien of a former trustee. Sam Williams, of counsel at Collas Crill LLP (Jersey), provides an update on the latest developments in the Z Trusts insolvency saga.

What was the background?

The two trusts at the centre of the litigation are the ZII Trust and the ZIII Trust. The trusts were part of a series of connected trusts established by a common settlor, Mrs C, now deceased.

In 2015, the Royal Court had decided that the ZII and ZIII Trusts should be deemed 'insolvent' and administered for the benefit of creditors, albeit that is a misnomer in the context of a trust. Insolvency was to be assessed on the basis of the cashflow insolvency test. In other words, the trust funds were unable to meet their liabilities as they fell due. The Royal Court clarified that in such circumstances the trustee ceased to owe duties to the beneficiaries of the trust in the administration of the trust assets but owed a duty to act in the best interests of the trust's creditors as a whole. It therefore set aside the appointment of new trustees of the ZII Trust installed in the interest of beneficiaries for the express purpose of avoiding a winding up of the trusts (*In the matter of the ZII Trust: Volaw Trustee Ltd v Chiddicks (for the minor beneficiary of the Z II Trust)* 2015 (2) JLR 108). A decision earlier in 2015 recognised as a matter of Jersey law the concept of a former trustee's continuing equitable lien over the trust assets in the hands of its successors for reasonably incurred liabilities (*In re Z Trusts* [2015] JRC 031).

The next question for the Royal Court to consider was how best to conduct the winding up of such a trust (In the case of *In re Z Trusts* [2015] JRC 214). Should this be left to the incumbent trustees, on the basis that they were familiar with the assets and likely to be relatively cost effective, or should an independent insolvency practitioner (IP) with greater expertise in winding up procedures and no risk of conflict of interest be appointed? The Royal Court emphatically preferred to leave matters in the hands of the trustees. The issue of winding up the trusts was avoided and the assets were to be administered for the benefit of creditors under the supervision of the Court. The ZIII Trust was in fact then restored to cash flow solvency for a period.

In 2018, the former trustee of the ZII Trust, Equity Trust, sought to argue that it had a priority over the other creditors, including successor trustees, for its incurred liabilities on the basis of its continuing equitable lien on the trust assets (*Representation of Rawlinson & Hunter Trustees SA re Z Trusts v Chiddicks* 2018 (2) JLR 81). The Royal Court considered that the equitable lien did not afford a priority when the trust became insolvent and the former trustee should share in the assets on a winding up pari passu with other creditors and trustees, largely for reasons of fairness. In a related decision, the Royal Court also rejected Equity Trust's argument that the costs of proving its claim against the ZIII Trust should come out of the trust fund as a result of its lien (*Representation of Rawlinson & Hunter Trustees SA re Z Trusts* [2018] JRC 164).

This note is a summary of the subject and is provided for information only. It does not purport to give specific legal advice, and before acting, further advice should always be sought. Whilst every care has been taken in producing this note neither the author nor Collas Crill shall be liable for any errors, misprint or misinterpretation of any of the matters set out in it. All copyright in this material belongs to Collas Crill.

In the ensuing costs decision, (*Representation of Rawlinson & Hunter Trustees SA re Z Trusts* [2018] JRC 203), the Royal Court also determined that the proceedings in which Equity Trust put forward these arguments should not be characterized as an administrative application and were effectively fully contentious and brought for personal benefit. On that basis, costs would not come out of the trust fund and the costs of the other parties would, according to the usual litigation principles, fall on Equity Trust as the unsuccessful party.

However, the substantive decision on priority was subsequently overturned by the Jersey Court of Appeal in *Representation of Rawlinson & Hunter Trustees SA re Z Trusts* 2019 (1) JLR 87 which determined that a former trustee did have a continuing equitable lien and priority as creditor over the trust assets on a winding up. Recognising the seminal importance of this decision, the Court of Appeal in *Equity Trust (Jersey) Ltd v E* [2019] JCA 188 very unusually granted leave to appeal to the Judicial Committee of the Privy Council.

In the interim, the ZIII Trust had become cash flow insolvent again. All interested parties agreed that it should be wound up. Again, the Royal Court preferred to leave the winding up to the incumbent trustee, rather than an IP or a new trustee, in order to avoid delay and additional cost. The Royal Court also decided that it was appropriate to establish a formal procedure for the winding up involving advertising for creditors, proofs of debt, admission or rejection of claims, court review and submission of final accounts (*In re ZIII Trust* [2019] JRC 069 and News Analysis: The final chapter? Winding up the Z III Trust).

The first decision of 2020—Zedra Trust Company (Jersey) Ltd v Chiddicks and Others

Zedra Trust Company (Jersey) Ltd v Chiddicks and Others [2020] JRC 044 (10 March 2020)

By the start of 2020, the trustee of the ZIII Trust, Zedra, had been conducting an orderly winding up process for that trust which was well advanced. It had experienced some difficulties in valuing the trust assets due to a perceived lack of cooperation from the other principal protagonist in the story, 'Mr E', who was the settlor's son and the executor of her estate, which was another creditor. However, proofs of debt had been submitted, assets and been liquidated and the trustee was close to making an announcement as to which claims were admitted.

Despite this progress, it was proposed that a new trustee, GTC, be appointed. GTC was already the current trustee of the ZII Trust. The driver for this proposal was that it had emerged that there may be a possible claim against Zedra for alleged breach of trust. The potential claim needed to be investigated and Zedra was in an obvious position of conflict as the incumbent. A further reason for the change was that GTC appeared to enjoy a better relationship with Mr E, which meant that the winding up might progress more smoothly.

The counter-arguments were raised by Equity Trust which had standing both as a direct priority creditor as former trustee and on the basis that it was the priority creditor of the ZII Trust, and the main asset of the ZII Trust was an inter-trust debt owed by the ZIII Trust. Equity Trust argued that the change of trustee at this stage in the winding up would be disruptive, costly and would lead to delay. GTC was also an unsuitable candidate because Mr E, it was said, had too much influence over GTC. As GTC was the trustee of the ZII Trust, it would also be in a position of conflict in having to adjudicate on its own claim as creditor. If Zedra could not continue in office, then the appropriate thing to do was to appoint an independent IP with the necessary expertise to oversee and complete the process.

Against this, GTC argued that it was independent from Mr E and that any conflicts could be managed through the taking of directions from and the surrender of any discretion to the court. An IP would add an unnecessary layer of cost to the winding up process.

The court analysed the options available, discounting the possibility of a receiver, which none of the parties was advocating. It determined that Zedra had to stand down so that the allegations of breach of trust could be investigated expeditiously. However, there was no alternative proposed to GTC as new trustee. The court expressed concern about GTC's actual and potential conflicts and noted that there were strong reasons in favour of appointing an IP.

This note is a summary of the subject and is provided for information only. It does not purport to give specific legal advice, and before acting, further advice should always be sought. Whilst every care has been taken in producing this note neither the author nor Collas Crill shall be liable for any errors, misprint or misinterpretation of any of the matters set out in it. All copyright in this material belongs to Collas Crill.

The court concluded, however, that it was essential to take a holistic approach to the affairs of both the ZII and ZIII Trusts in order to ensure, in the interests of the creditors of each trust as a body, that the winding up was consistent and proportionate. The court adjourned the matter so that both trusts could be dealt with together.

The second decision of 2020—In re ZII Trust

Geneva Trust Company (GTC) SA re ZII Trust [2020] JRC 053 (26 March 2020)

On 26 March 2020, the Royal Court issued a judgment in respect of the ZII Trust. This dealt with applications following its blessing of GTC's decision as trustee to enter into a compromise of breach of trust litigation against a former trustee. The settlement had secured 'comfortably more' than enough funds for the trust to meet Equity Trust's priority claim of £18m, assuming the Privy Council were to uphold the Court of Appeal's decision.

In addition, the ZII Trust had a claim against the ZIII Trust worth on its face £186m but thought to be worth only £6m. Other than Equity Trust, there were unproven creditor claims valued at £211m. The Royal Court described these as the 'connected creditors' as they included Mr E personally, the estate of Mrs C, GTC as trustee of the ZI Trust and other connected companies and parties.

Now that there were funds available in the trust, Mr E, as executor of the estate of Mrs C, applied for funding out of the ZII Trust's assets to reimburse his costs incurred in the priority litigation, as well as for his prospective costs of the appeal to the Privy Council, totalling nearly £650,000. This was in essence a pre-emptive costs application.

As an initial point, the Royal Court observed that it was inequitable as between the connected creditors that the estate of Mrs C should litigate the priority issue for their benefit without the other connected creditors contributing to the costs of doing so. However, the same principle of commonality of interest meant that it would be inequitable for the connected creditors to have their costs out of the fund when their arguments were made solely in their own interests and expressly contrary to those of Equity Trust as rival creditor.

The Royal Court noted that the estate had previously argued successfully that Equity Trust should not have its costs out of the trust fund (see above). In addition, while a payment from the ZIII Trust to the estate as an advance had been made in January 2019 in order to fund the costs of the appeal on the priority issue, that trust had not been insolvent at that point, so it did not set a precedent.

The estate of Mrs C sought to argue that sufficient assets could be ring-fenced within the trust fund to meet the priority claim of Equity Trust so as in effect to deny Equity Trust any interest in the balance of the funds and allow the payment to the estate. However, the Royal Court rejected that suggestion on the basis that Equity Trust had an equitable lien extending to the totality of the trust assets for current and future liabilities and had not consented to that proposal in any event.

The Royal Court concluded that the starting point was that neither party in the priority litigation should have recourse to the trust assets and that the estate of Mrs C had entered into that litigation with its eyes open to the need for funding and to costs risk. While it might be possible to have access if funding were otherwise unavailable, particularly given the importance of the appeal to the Privy Council being heard, the Royal Court was critical of the state of the evidence of the estate and Mr E personally as to their asset positions and noted that none of the other connected creditors had filed evidence of means.

The Royal Court therefore adjourned the application so that further evidence of means could be provided on behalf of the connected creditors. The Royal Court also adjourned the question of how to approach the winding up of the ZII Trust to be considered alongside that of the ZIII Trust.

The third decision of 2020—In re ZII and ZIII Trusts

Representations of Geneva Trust Co (GTC) SA and Zedra Trust Co (Jersey) Ltd re ZII and ZIII Trusts [2020] JRC 072 (29 April 2020)

This note is a summary of the subject and is provided for information only. It does not purport to give specific legal advice, and before acting, further advice should always be sought. Whilst every care has been taken in producing this note neither the author nor Collas Crill shall be liable for any errors, misprint or misinterpretation of any of the matters set out in it. All copyright in this material belongs to Collas Crill.

In its latest decision, the Royal Court considered the adjourned applications in relation to the appointment of GTC as trustee of the ZIII Trust and for the winding up of the two trusts. The Judgment records that it was an application on the papers in light of the unprecedented situation which had arisen due to coronavirus (COVID-19).

As before, GTC expressed its willingness to accept appointment to the trusteeship of the ZIII Trust and to undertake the winding up of both trusts at the same time. It proposed to refer any matter subject to a conflict of interest to the Royal Court. This position was supported by the estate of Mrs C. By contrast, Equity Trust argued that while GTC could become the trustee of both trusts in the sense of being the custodian of the assets, it should delegate the process of winding up to an independent IP.

The Royal Court confirmed the appointment of GTC, which would investigate the allegations of breach of trust on the part of the former trustee, but decided that in the final analysis that the sheer extent of the conflicts of interest on the part of GTC were unmanageable in the context of the winding up of the trusts. Equity Trust was entitled to have someone independent evaluate its claims.

The Royal Court therefore concluded that the appropriate course was to appoint an independent IP as the delegate of GTC, observing that it did not have power to appoint an IP directly. The same IP would be appointed for both trusts and the additional costs were deemed to be proportionate in the circumstances.

Conclusion

It is clear that the Royal Court of Jersey has evolved and adapted its position throughout the Z Trusts proceedings. While it has naturally sought to maintain control over the trusts by leaving matters so far as possible in the hands of the trustee subject to the court's direction, it has also rightly recognised the need to be flexible and to take account of possible conflicts of interest and practical considerations. The touchstone throughout has been to ensure that any decision is taken in the best interests of the creditors as a whole. It remains to be seen whether the Privy Council restores the Royal Court's original decision on the priority issue or upholds the Court of Appeal.

This note is a summary of the subject and is provided for information only. It does not purport to give specific legal advice, and before acting, further advice should always be sought. Whilst every care has been taken in producing this note neither the author nor Collas Crill shall be liable for any errors, misprint or misinterpretation of any of the matters set out in it. All copyright in this material belongs to Collas Crill.