

Insolvent Trusts and Trustees In The Isle of Man



Commercial transactions involving trusts and trustees are commonplace. As well as the commercial dealings of the trustees of family trusts, which take place in the proper exercise of their investment powers, in the business arena unit trusts have proved a popular vehicle for the acquisition of valuable land and property portfolios, and substantial assets are held by pension trustees and by security trustees in banking transactions.

When a trustee deals with third parties in a commercial transaction relating to the trust, he does so as principal, because a trust has no legal personality and cannot be party to a contract. As a result, the trustee's liabilities are personal to him, and they will be unlimited in the absence of express terms in the contract which limit the trustee's liability to the trust assets.

A trustee has a statutory right to be indemnified out of the assets of the trust for expenses properly incurred by him when exercising the trusteeship. This indemnity extends to contractual liabilities which are incurred in the administration of the trust. The right to an indemnity will be lost if the expenses were not properly incurred, or if the transaction creating the trustee's liability was outside its powers in the trust instrument. In those circumstances, the trustee would remain personally liable to a third party with whom it had entered into a contract in breach of trust, but the trustee would be unable to seek reimbursement from the trust assets.

A trustee who loses the right of indemnity risks bankruptcy or insolvency if it cannot meet the contractual liabilities from its own assets. Even if the right of indemnity remains, there is a risk in the current economic climate that the trust assets may

have fallen in value and are insufficient to indemnify the trustee, leading to the potential bankruptcy or insolvency of the trustee. In the absence of an express provision to the contrary in the trust instrument, a corporate trustee who becomes insolvent and an individual trustee who is adjudged bankrupt may remain as trustee. Neither the trusteeship nor the trust assets vest in the individual trustee's trustee in bankruptcy, and the corporate trustee remains a trustee, but exercises its duties via the company's liquidator.

A trust can be considered as insolvent if it has insufficient assets to cover its liabilities, including its liability to indemnify the trustee. The statutory provisions which apply to insolvent companies and to bankrupt individuals do not apply to an insolvent trust, because it is neither a company nor a person. The trustee of an insolvent trust may make an application to the Isle of Man High Court for an administration order under the Rules of the High Court of Justice. This is a procedure under which a trustee may ask the Court to determine any question arising in the management, administration or execution of a trust. A court application on the insolvency of a trust should deal with matters such as how the creditors should be ascertained, and what rights the creditors have against the assets of the trust. It would also be appropriate for the trustee to ask the Court to direct that the priority in which creditors are paid should reflect the practice which is followed on the liquidation of a company, namely:

- secured creditors holding a fixed charge;
- the costs of realising the trust assets;
- preferential creditors having preferred debts;
- secured creditors holding a floating charge;

- unsecured creditors; and
- beneficiaries.

The court application should also be made with reference to Section 61 of the Trustee Act 1961, which empowers a trustee to apply to Court for directions on any question concerning the administration or management of a trust. Acting in accordance with the Court's directions operates as a statutory indemnity to protect the trustee against any subsequent action by the beneficiaries, provided that the directions were not obtained fraudulently or by the concealment of material information.

The insolvency of the trust is not the same as the insolvency of the trustee. Each may occur independently of the other, and the former may result in the latter. The assets of the trust may not be used to pay the personal creditors of the trustee nor the costs of winding up a corporate trustee. However, trust creditors may have recourse against the personal assets of the trustee if the trustee's contractual liabilities are not expressed to be limited to the trust assets.

Practical steps to help trustees avoid either form of insolvency include: ensuring that any liabilities are properly incurred by the trustee, so that the right of indemnity from the trust assets is not lost; checking that loan agreements and security documents covering the trustee's obligations to the lender contain provisions limiting the recourse of the lender to the trust assets; keeping the trust accounts up to date; and obtaining an express undertaking from the settlor or beneficiaries to indemnify the trustee when entering into a transaction in fulfilment of their wishes.

Should you have any questions or requests for further information please contact:

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