Insolvency, trusts and unwinding transactions

Relevant authorities and suggested approaches

First Problem

Introduction

1. The protection of creditor interests in relation to 'asset protection' trusts designed to protect assets from claims by creditors broadly takes two forms:

   (1) protection under the sham and related doctrines; and

   (2) protection under insolvency (bankruptcy) laws.

'Sham' trusts

2. A relatively standard line of attack against trusts which appear to be under the settlor's control is an allegation that the trust is a 'sham' trust. Strictly speaking, there is in fact no such thing as a 'sham' trust. What may or not be shams are the documents which purport to set up the trust.

3. A sham "*means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties' legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create*" (per Lord Diplock in *Snook v London West Riding Investments* [1967] 2 QB 786 at 802).

4. For there to be a finding of sham:

   (1) There must be a common intention to create a sham. The unilateral intentions of the settlor are not enough.

   (2) Reckless indifference by a trustee will be taken to constitute common intention.

   (3) The trust must be a sham from the outset. A trust which is not initially a sham cannot subsequently become one.

(See *A v A [2007] EWHC 99 (Fam)* at [32] – [54] and *JSC Mezhdunarodniy Promyshlenniu Bank & anor v Pugachev & others* [2017] EWHC 2426 ("***Pugachev***") at [145] – 154])

5. Whether the documents pursuant to which the Orange Trust was set up are shams is a highly fact-specific question, but relevant facts pointing towards them being shams are:

   (1) The timing of the setting up of the trust;

   (2) The choice of trustees; and

   (3) The way in which the trust was operated.

6. There may be two other bases (related to, but distinct from, the sham doctrine) on which to attack the Orange Trust:

   (1) In *Pugachev*, Birss J appeared to reject the notion that there was a separate concept of "illusory trusts" under English law: see [155] to [169]. This concept had been adopted by the Supreme Court of New Zealand in *Clayton v Clayton* [2016] NZSC 29 (in which the Supreme Court described a finding of an illusory trust as one where the attempt to create a trust had failed, such that no valid trust had come into existence). However, Birss J was of the view that another way in which the Court could hold that assets have not been divested by a settlor is by construing the terms of the trust deed itself: the true effect of the terms of a trust may be that a settlor has not divested himself of the beneficial ownership of the assets transferred into it. This may be the case because of the scope of the powers reserved by the settlor.

   (2) In *Tasarruf Mevduati Sigorta Fonu v Merrill Lynch Bank and Trust Co (Cayman) Ltd and others* [2011] UKPC 17, the Privy Council held that powers of revocation very similar to the one in the Orange Trust deed of settlement were such that in equity they were tantamount to ownership; and that, accordingly, a settlor could be ordered to delegate his powers of revocation to receivers who were seeking to enforce a judgment.

Transactions defrauding creditors

7. Section 423 of the Insolvency Act 1986 may come in aid if it is not possible to establish that a trust is a sham trust. The relevant principles were summarised in *JSC BTA Bank v Ablyazov* [2016] EWHC 3071.

8. Section 423 can be invoked by a creditor whether the debtor is bankrupt or not.

9. The key question is likely to be that of the purpose of each transfer: a real and substantial purpose must have been to defeat creditors. The result merely being a by-product is not enough.

Transactions at an undervalue

10. See section 238 and 339 of the Insolvency Act 1986.

11. Section 339 (which applies to bankruptcies) establishes a procedure for the retrospective avoidance of transactions at an undervalue entered into by a person who is subsequently adjudged bankrupt. The procedure may be invoked by the trustee through an application to the court, whereupon the court at its discretion may make an order to restore the position to what it would have been if the transaction had not been entered into.

12. For the remedy under section 339 to be available two requirements must be satisfied: first, the transaction must have been entered into at an undervalue, within the meaning of section 339(3); and secondly it must have been entered into at a relevant time, within the meaning of section 341. Whether the transaction was entered into at a relevant time is unlikely to be an issue here.

Cayman Islands law

13. Several offshore jurisdictions have statutory regimes against fraudulent dispositions loosely modelled on old English law (i.e. the Statute of Elizabeth), but with modifications made to them which mean that they are fairly pro-asset protection.

14. The effect of the Cayman Islands Fraudulent Disposition Law 1989 is to render voidable any disposition with an intent to defraud and at an undervalue.

15. In summary, under the 1989 Law:

(1) A disposition made at an undervalue is safe unless the creditor can show an intent wilfully to defraud creditors.

(2) Even then, the disposition would only be set aside to the extent necessary to satisfy the prejudiced creditors.

(3) The burden is on the creditor seeking to set aside the disposition to show that there was an intent to defraud.

(4) There is a limitation period of six years after the disposition which prevents any action being taken to set aside the disposition after that time.

(5) If a trustee has not acted in bad faith in receiving property, it will be able to retain sufficient funds to pay its entire costs in defending the proceedings and also will be entitled to retain its proper fees and costs incurred in administering the trust.

(6) A beneficiary who has received a distribution properly from the trust fund will be entitled to retain it provided he has not acted in bad faith.

16. This seems significantly more settlor-friendly than section 423. Other jurisdictions have adopted laws similar to the 1989 Law: see, for example, the Bahamian Fraudulent Dispositions Act 1991 and section 36C of the Bermudian Conveyancing Act 1983.

17. In addition to the 1989 Law, Cayman Islands law has a provision in section 107 of the Bankruptcy Law rendering void a settlement of property (which means any conveyance, gift or transfer) as against a trustee in bankruptcy if made within 2 years prior to the date of the bankruptcy order. In addition, any settlement made within 10 years prior to a bankruptcy order is void as against the trustee in bankruptcy unless it can be established that at the time of making the settlement the settlor was solvent and able to pay his debts without the settled property. This is a more straightforward way of attacking the trust in the event that Donald goes bankrupt than under the Fraudulent Disposition Law.

18. Further, even if Donald was made bankrupt in England, rather than in the Cayman Islands, by reason of section 122 of the (English) Bankruptcy Act 1914, the Cayman Islands Court would recognise the English bankruptcy and be able to apply section 107 of the (Cayman) Bankruptcy Law to void the settlements. See *Al Sabah v Grupo Torras* [2005] AC 333.

Preferences

19. See sections 239 and 340 of the Insolvency Act 1986.

20. Under section 340 (which applies to bankruptcies), a preference arises if an individual does anything or suffers anything to be done which (in either case) has the effect of putting that person into a position which, in the event of the individual's bankruptcy, will be better than the position he would have been in if that thing had not been done.

21. See also definition of "relevant time" in sections 240 and 341. This is unlikely to be an issue here.

What should the beneficiaries do?

22. The beneficiaries of the Orange Trust are likely to have to undertake the burden of defending the claims against the trust (unless the trustees can obtain *Beddoe* relief permitting them to defend the claims – as to which see below).

What should the trustees do?

23. The general rule, at least in cases where the trust is being attacked (as may well be the case here), is that trustees should remain neutral.

24. However, there may well be circumstances in which a trustee could and should descend into the arena.

25. Trustees should almost invariably seek a *Beddoe* relief before taking any substantive steps in the litigation.

26. The relevant authorities were recently considered by Hellman J in *Trustee L and others v The Attorney General and others* [2015] SC (Bda) 41 Com (Bermuda). See also *Lewin on Trusts*, 19th ed. at 27-236 onwards.

27. Each case is fact specific but if the beneficiaries are infants or there are no other available sources for funding the defence, *Beddoe* relief might well be granted on the basis that the trustees are the proper persons to defend the trust / trust property.

Setting up of 'asset protection' trusts – some pointers

28. It may be worth considering the following factors when establishing an 'asset protection' trust:

    (1) The jurisdiction in which the trust is established. An offshore trust is more likely to survive an attack by creditors than an onshore trust because the offshore statutory regimes are comparatively pro-asset protection rather than pro-creditor.

    (2) Whether the trust is revocable or irrevocable. A trust that is revocable is more susceptible to attack on the grounds that it is a sham trust, that the beneficial ownership remains with the settlor or on *Tasarruf* grounds.

    (3) Whether the settlor's powers should be limited more generally. Consideration should be given to limiting the powers or terminating them on the settlor's bankruptcy.

    (4) Whether the trustees should be independent. It is obviously better to have independent trustees than trustees who can easily be shown to be in the habit of following the settlor's wishes.

    (5) The timing of the creation of the settlement. Precisely when a trust is set up may make any disposition of assets into it more susceptible to attack.

29. In our problem situation, had Donald set up an irrevocable Cayman Islands trust well before any claims had been intimated against him and had he appointed independent trustees who exercised their own judgment when making decisions in relation to the trust, that trust would have had a much better prospect of surviving a challenge from creditors.

Second Problem

Issues where English law applies

30. England, unlike, e.g. BVI, Jersey and Guernsey, has had no statutory interventions into the arena of trustee liability to third parties, trustees' indemnification rights or creditors' subrogation rights to trustees' indemnification rights when a trustee is personally insolvent.

31. Hence:

    (1) A creditor of a trustee can (indeed has to) sue the trustee personally in order to establish a personal liability of the trustee to him.

    (2) Where a trustee has incurred the liability in the course of acting as trustee, he has a right of indemnification from the trust fund in respect of that personal liability, so long as he has acted properly.

        - *Lewin on Trusts*, 19th ed. at 21-010

        - *Re Johnson* [1880] 15 Ch D 548

32. If the trustee's personal assets are insufficient to discharge his debts, including those incurred by him as trustee, the creditors to whom debts were incurred as trustee have a right of subrogation to the trustee's right of indemnification. It is the insolvency of the trustee which brings into operation the right of subrogation.

        - Mitchell and Watterson, *Subrogation – Law and Practice* (2007) at 12.24

        - *Owen v Delamere* (1872) LR15 Eq 134

33. Thus in our problem situation:

    (1) both the Bank and Marco can sue Donald personally on the liabilities he has incurred to them – and prove in his bankruptcy if he enters one.

    (2) *If* Donald incurred those liabilities in the course of acting as trustee, and did so acting properly, he has a right of indemnification from the trust fund in respect of them, which he is entitled to exercise without regard to beneficiaries' interests or

needs. On his bankruptcy, in that scenario, the Bank and Marco would be subrogated to that right.

34. The analysis above takes one as far as the two creditors' potential rights of subrogation. What happens where Donald owes each of them £1m but the trust fund is only £1.5m. In other words, what are the priorities rules as between them on their subrogated claims to the trust fund?

    (1) Surprising lack of English authorities directly in point (or those from other jurisdictions – see, e.g., *Re the Z Trusts* [2015] JRC 031 at [16] in Jersey).

    (2) One possibility is that the trustee is to be regarded as having a right of indemnification in relation to each liability as it arises, to which specific claim the relevant creditor is subrogated. It may then follow that, in line with the equitable priorities principle *prior est tempore, potior est iure*, the first incurred in time has priority over the second one.

    (3) The other is that the rights of subrogation place the creditors in an analogous position to unsecured creditors into a fund where the courts, borrowing from insolvency legislation, are minded to regard a *pari passu* approach as to most equitable.

        - See, e.g., *Re Suco Gold Pty Ltd (in liq.)* (1982) 33 SASR 99
        - Mitchell and Watterson at 12.28
        - *Lewin* at 22-047

35. If that is the common law background and the uncertain continuing English law position, significant and difficult issues then arise where, often rather terse, statutory interventions have been made elsewhere, such as the BVI, Jersey and Guernsey. Note e.g. in the case of the BVI provision, where applicable:

    (1) The distinction drawn between contractual situations where a counterparty knows it is dealing with a trustee (e.g. the Bank) and all other creditors (e.g. our caddy).

    (2) The removal of subrogation principles and their replacement with "direct" rights against the trust fund – apparently regardless of whether the trustee is personally

liable and, if it is, whether it is solvent, and, query, whether the trustee has or has not acted properly so as to have a right of indemnification itself.

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