THE INTERACTION BETWEEN TRUSTS IN REAL PROPERTY AND INSOLVENCY: RECENT DEVELOPMENTS

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1. Many personal and corporate insolvent estates include real property that the office holder has to realise for the benefit of creditors and there will often be a dispute with the legal owner or occupier of the property as to whether it can be so realised.

2. Most of the authorities in this area arise in the context of bankruptcy proceedings and it is these proceedings on which this paper will focus. Often, disputes concern the existence and extent of common intention constructive trusts, the legal framework for which is relatively settled and which has been considered in depth elsewhere.

3. However, recent case law has served to demonstrate that the potential issues relating to real property which office-holders, creditors and associates of a bankrupt person may encounter are more wide-ranging. I consider below four discrete trust law issues which have arisen in recent case law, namely:

    a. The extent to which a trustee in bankruptcy ("TIB") or creditors can challenge the effectiveness of a trust deed;

b. When express trusts can be challenged using statutory mechanisms;

c. The possibility of a TIB establishing a resulting trust in property held legally by another;

d. The relevance of equitable accounting principles and the possibility of the TIB obtaining occupation rent.

Challenging the validity of trust deeds

4. When confronted with a trust deed apparently transferring property away from a bankrupt individual, if the facts allow, the TIB may consider relying on the following arguments for the benefit of the creditors.

a. It may be alleged that, on construction, the trust deed gives so much power over the trust to the settlor that the trust did not have the effect of divesting from the settlor the beneficial interest in the property.

b. It may be alleged that the trust deed is a sham. In *Raja v Nicholas Van Hoogstraten* [2018] 2 WLUK 607 Mr Justice Morgan summarised the relevant principles to be applied as follows.

"*1. A sham involves 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.*

2. The persons whose intentions are relevant in this context are the persons who did the acts, or who were the relevant parties to the documents which were executed.

3. The concept of a sham can apply to a settlement by way of trust.

4. An allegation of sham is an allegation of deliberately misleading conduct which involves a degree of dishonesty.

5. There is a presumption that a duly executed legal document is intended to have legal effect in accordance with its terms.

6. It follows from (5) above that the person who alleges that a legal document is a sham has the burden of establishing that contention.

7. The conduct of the parties to the alleged sham after they have entered into the transaction is admissible on the question whether the transaction was intended to be genuine or a sham.

8. A trust which is not initially a sham cannot subsequently become a sham.

9. The fact that a trustee under a genuine trust subsequently commits a breach of trust does not show that the trust was not originally genuine.

10. A trust which was initially a sham could conceivably subsequently lose that character and become a genuine trust, but that was not argued in this case."

5. Whilst the statutory mechanisms considered below may appear the most obvious starting point when seeking to unravel a deed of trust in an insolvency setting, the relatively controversial case of *JSC Mezhdunarodniy Proyshlenniy Bank v Pugachev* [2017] EWHC 2426 (Ch) demonstrates that there are other options available.

6. In *Pugachev* Mr Justice Birss considered whether five trust deeds could be impugned either because they were a sham, because the trust did not have the effect of divesting the settlor of beneficial ownership of the relevant property, or because the trust was a transaction defrauding creditors. In this case, the settlor (who was not subject to a bankruptcy order) had settled trusts of certain assets, including real property, in favour of discretionary beneficiaries. However, the settlor retained certain powers as "protector" of the trust.

7. Mr Justice Birss considered the position of an "unscrupulous" person attempting to protect their real property from creditors as follows:

174. Consider an unscrupulous person is trying to "protect" one of their assets from creditors when the asset is a house. Since the asset is real property, it can be seen, identified and there is likely to be a public register of ownership, as there is in the UK. The simpler kind of trust achieves a significant goal for the person because it allows the public information to name the trustee as the owner of the house instead of the person. The trustee can be an anonymous "special purpose vehicle", in other words a company with no assets whose directors and shareholders are professionals. All the better if the trusts and the trustees are in a jurisdiction a long way away; that just makes the task of searching a little bit harder.

175. However there is still a significant disadvantage inherent in the simpler kind of trust. Imagine the unscrupulous person fears or is advised that they might be ordered by a court, on pain of contempt, to identify any assets they hold. Crucially the order will or may make clear that this includes any assets of which they are the beneficial owner even if they do not hold the bare legal title. To comply with that order honestly they would have to identify the asset held in the simpler kind of trust because in that arrangement the person is still the beneficial owner. Now they might decide to lie by falsely not revealing the asset but there is always a risk that the lie would be discovered. Particularly if the asset is a house which the unscrupulous person has an obvious connection with because they or their family lives in it. In addition once the beneficial ownership has been identified, a creditor may well be able to get their hands on the property beneficially held by the person.

176. This is where the discretionary trust can come in. In a discretionary trust over a piece of property the beneficiaries are themselves discretionary (cf Clayton v Clayton above). The trustees may exercise their powers to advance property to a discretionary beneficiary, but then again they may not. The trustees are fiduciaries but that does not compel them to advance property to any given beneficiary. So the

analysis is that none of the discretionary beneficiaries have a proprietary interest in the property.

[…]

180. The problem for the unscrupulous person is that in the kind of discretionary trust discussed so far, all the power is in the hands of the trustees. Now while it is not the reason the concept was invented, this is where the concept of a protector may come in. It was common ground before me that whatever its origins, the concept of "protector" is not a term of art, in that different trusts may provide for different rights and obligations on a protector. I gather that trust deeds which include a protector often provide for one or both of the following: a power to remove and appoint trustees and a power of negative consent, in that various powers of the trustees are only exercisable with the protector's consent. In the trust deeds in this case the protector has both powers and some others.

8. The issue then to be considered, according to Mr Justice Birss, was whether the powers held by the "protector" of the trust were fiduciary, in that the protector is required to exercise them for the benefit of the beneficiaries as a whole, or whether they were personal and did not have to be exercised for the benefit of beneficiaries. This is a matter of construction of the relevant trust deed. Mr Justice Birss noted that the settlor had the following rights/powers in addition to his being a discretionary beneficiary:

   a. The right to information from the trustees;

   b. The power to veto all major decisions a trustee might make;

   c. The right to appoint new discretionary beneficiaries;

   d. The power to appoint his successor.

9. The above circumstances led Mr Justice Birss to conclude that the powers were personal and that on construction of the trusts, the settlor had not parted with the beneficial interest in the relevant property. Mr Justice Birss

also concluded that the trusts were a sham, and that the trust deeds were transactions defrauding creditors.

10. The decision in *Pugachev*, in particular in relation to the finding that the trusts were "illusory" trusts, has been criticised by commentators. It has been pointed out that the terms of the trust in *Pugachev* were not unusual and that the settlor would only be the effective beneficial owner of the relevant property if he could direct a trustee to divert it to him in breach of fiduciary duty (see *Lewin on Trusts* (20th edition 2020 5-035 n. 147). The decision in *Pugachev* was followed in the decision of *Webb v Webb* [2017] CKCA 4 (a decision of the Court of Appeal of the Cook Islands) and an appeal of that decision was heard by the Privy Council in January 2020. Accordingly, further guidance on the points below is likely to be forthcoming.

Using statutory mechanisms to unwind express trusts

11. In addition to the above methods of challenging the effectiveness of trust deeds at common law, the Insolvency Act 1986 ("IA 1986") contains provisions allowing a TIB and, sometimes, a creditor, to unwind a transition (including an express trust).

    a. If the transaction was entered into in the five years before presentation of the bankruptcy petition and at a time when the individual was insolvent it may be alleged that the trust deed (or in the two years prior to the petition regardless of insolvency), to the extent that it donates property to a third party, is a transaction at an undervalue pursuant to section 339 of the Insolvency Act 1986 ("IA 1986").

    b. It may be alleged that the trust deed is a transaction defrauding creditors pursuant to section 423 IA 1986. For a transaction defrauding creditors to be established, (in short) it must be established that (i) the transaction was entered into at an undervalue, and (ii) the transaction was entered into by him for the purpose of putting assets beyond the reach of creditors or otherwise prejudicing the interests of creditors ("the statutory purpose"). Section 423 is often used where it is not possible to

use section 339, as section 423 applies to any transaction, whenever it occurred.

12. When a declaration of trust will constitute a transaction defrauding creditors was considered recently in *Fox v Mohammed* [2019] EWHC 3409 (Ch). In that case, the court heard an appeal by a TIB in respect of a finding that a deed of trust in relation to a property was not a transaction defrauding creditors. The TIB argued that the lower court's finding in respect of the transaction was not consistent with the judge's finding that the trust declared in respect of a different property the day before was a sham and a transaction defrauding creditors.

13. Roth J, following the Court of Appeal decision in *IRC v Hashmi* [2002] EWCA Civ 981, acknowledged that there is no need to establish that the sole or even the dominant purpose of entering into the transaction was to defraud creditors. However, dismissing the appellant's argument that the statutory purpose must have applied by inference to the transaction even if there was a different, separate purpose in making the transaction, he stated that:

> *"It is one thing to infer the purpose of a transaction when there is no other possible explanation. It is quite another, in my view, to draw that inference when also finding that a distinct and different purpose for the transaction has been established. It comes down, in my view, to an evaluation of the evidence."*

14. The Judge held it was not appropriate to interfere with the lower court's conclusion on the evidence.

Establishing a resulting trust in favour of the insolvent estate

15. The ability of a TIB to establish that property is held by a third party on resulting trust for them was considered by ICC Judge Barber in the recent case of *Wood v Watkin* [2019] EWHC 1311 (Ch). In this case a TIB argued that the bankrupt's daughter held three properties on trust for the bankrupt on resulting trust principles, on the basis of (i) the bankrupt's

advancement of purchase money and (ii) the bankrupt acting as guarantor or party to the mortgages of the properties.

16. The respondent father argued, inter alia, that the presumption of advancement applied and the TIB had not rebutted the presumption in the present case. The presumption of advancement as between a parent and child is summarised by *Lewin on Trusts* at 10-025 as follows:

> *"Where a parent purchases real or personal property in the name of his legitimate child, the purchase is presumed to be by way of advancement. The presumption of resulting trust which could have arisen if the purchase had been made in the name of a stranger does not apply and the property is presumed to be a gift. The presumption will now apply to a purchase by a mother in the same way as to that by a father if, indeed, it has not always done so."*

17. In response, the TIB argued that the presumption of advancement:

    a. Applied only to minors, relying on the Canadian case of *Percore v Percore* [2007] 1 WTLR 1591;

    b. Alternatively, was relevant only to financially dependent children;

    c. Was a "very weak" presumption in the modern age (relying on dicta in *Close Invoice Finance v Abaowa* [2010] EWHC 1920 and *Lavelle v Lavelle* [2004] EWCA Civ 223); and

    d. Was rebutted by evidence in the present case. The TIB pointed to, inter alia, the fact that purchase ledgers had been opened in the name of the bankrupt, that purchase monies were contributed from a joint account held by the bankrupt and his wife, that the bankrupt had been a party to or guarantor of the mortgages of the properties and that the bulk of the monies received from sale of two of the properties had been paid to the bankrupt.

18. The presumption of advancement had, prior to the above decision, been judicially criticised as outdated and arbitrary, and only to be relied on in the absence of other evidence (see in particular *Pettitt v Pettitt* [1970] AC

777). The presumption of advancement is also due to be repealed by section 199 of the Equality Act 2010, which is not yet in force. However, ICC Judge Barber held that the presumption of advancement applied to the present case, and held as follows:

a. The decision in *Percone* was "ultimately obiter" and "does not represent English law";

b. The dicta in *Laskar v Laskar* [2008] EWCA Civ 347 support the view that a presumption of advancement can exist in relation to a child who is not a minor;

c. It was not necessary for a child to be financially dependent on their parent for the presumption to apply, although the degree of financial dependence is a factor relevant to the strength of the presumption;

d. The dicta criticising the presumption of advancement in *Pettitt v Pettitt*, in a matrimonial context, could not readily be applied to parent-child cases;

e. Dicta stating that the presumption of advancement was weak was obiter;

f. In all the circumstances, the TIB had failed to discharge the burden of the presumption.

19. It could be argued that the above decision is surprising as it constitutes a break from previous (albeit obiter) dicta. As recently as 2018, Lord Briggs, sitting in the Privy Council, stated in *Gany Holdings (PTC) SA v Khan* [2018] UKPC 21 that:

> "*[R]ecourse may be had to time-honoured presumptions, such as the presumption of advancement or the presumed resulting trust, where there really is no evidence from which an inference as to common intention may properly be drawn. But these are, in modern times, a last resort, now that historic restrictions on the admissibility of evidence have*

been removed, and the forensic tools for the ascertainment and weighing of evidence are more readily available to the court."

20. However, *Wood v Watkin* was followed by Freedman J in *Farrell v Burden* [2019] EWHC 3671 (QB) and it may be that a decision of a higher court is needed before this matter is fully resolved.

Equitable accounting

21. Where it is established or agreed that a TIB holds a beneficial interest in property jointly with another party, the further question arises (usually upon an order for sale pursuant to section 14 of the Trusts of Land and Appointment of Trustees Act 1996 ("TOLATA")) as to whether any equitable accounting is to be done between the parties. The purpose of an equitable account was explained by Mr Justice Lightman in *Murphy v Gooch* [2007] BPIR 1123 as follows:

"To resolve questions between co-owners of the character raised in this case Equity developed the doctrine of 'equitable accounting' to facilitate the striking of the balance between the co-owners. This consisted of a body of (non-binding) guidelines or rules of convenience aimed at achieving justice between the co-owners. The thrust of these guidelines was that, where it is just to do so, co-owners may be given credit for moneys paid and expenditure incurred on the jointly owned property, a co-owner in sole occupation of property may be charged with or required to give credit to his co-owner for an occupation rent and these credits may be offset against each other."

22. Where an order for sale is made in respect of a property, the court must take an equitable account: *Re Pavlou* [1993] 3 All ER 955. In *Re Pavlou* an equitable account was made where the bankrupt owned a property jointly with his wife and TIB applied for an order for sale. It was held that:

    a. Where the property was a matrimonial home and the marriage had broken down the party who left the property would in most

cases be regarded as excluded from the property and thus be entitled to occupation rent;

b. Any claim for reimbursement for expenditure on improvements to the property had to be justified by an increase in value to the property;

c. The wife was prima facie entitled to reimbursement for the interest element in the mortgage payments which she had made.

23. In *French v Barcham* [2009] 1 WLR 1124 it was suggested by Blackburne J that a TIB would usually be entitled to an occupation rent as against an equitable co-owner following bankruptcy, given that it would not be appropriate for the trustee in bankruptcy to occupy the relevant property:

"When a trustee in bankruptcy has been appointed of the estate of a co-owner so that that co-owner's interest vests in the trustee, but the other co-owner remains in occupation of the property, application of the principle will ordinarily, if not invariably, result in the occupying co-owner having to account to the trustee of the beneficial interest to which the bankrupt co-owner was formally entitled for an occupation rent. This is because it is not reasonable to expect — even if it were otherwise practicable for him to do so — the trustee in bankruptcy to exercise the right of occupation attaching to the interest in the property that vested in him on his appointment as trustee of the bankrupt co-owner. If it could be shown that the occupying co-owner was given by the trustee to understand that no occupation rent would be charged or was unaware of, and had no reasonable means of discovering, the other co-owner's bankruptcy, the court might take the view that it would not be just to require the occupying co-owner to pay an occupation rent. But short of such circumstances it is difficult to see why the occupying co-owner should not be charged an occupation rent."

24. In *Davis v Jackson* [2017] EWHC 698 (Ch) Snowden J explained the principles to be applied where a TIB applies for an equitable account and, in particular, an occupation rent. Snowden J had previously held, in favour

of the TIB, that the bankrupt and his estranged wife held the property in equal shares, as was declared in Form TR1 at the time of purchase. With regard to the account, it was held that no credit was to be given for payments that Mrs Jackson had made in respect of the property, as she had shown that they had increased with the value of the property and that she was prima facie entitled to credit for mortgage payments made.

25. However, Snowden J went on to cast doubt on previous cases, including *French v Barcham*. The Judge, holding that he was not bound to apply the statutory criteria in TOLATA and that he could rely on general equitable principles, stated that:

"Whilst I agree that cases such as Dennis's case and Pavlou's case have moved away from any need to show forcible or active exclusion as a requirement for rent to be paid, I do not think that they have moved as far as Blackburne J suggested. According to Jones's case and Dennis's case, the default position where a trustee in bankruptcy is not in occupation and the co-owner is in occupation should be that no occupation rent is payable. But because it would invariably be unreasonable for a trustee in bankruptcy to seek to take up occupation, Blackburne J's approach would have the result, as a virtually immutable rule, that an occupation rent should be payable. It therefore seems to me that the effect of Blackburne J's approach is to reverse the default position in any case involving a trustee in bankruptcy.

It also seems to me that Blackburne J's approach excludes the possibility of the court having any regard to the position that existed prior to the bankruptcy, or to the conduct or circumstances of the non-bankrupt party. I do not think that is consistent with cases such as Jones's case, where Lord Denning MR plainly thought that the stepmother, who had inherited her husband's interest in the property and had become a tenant in common with her stepson, should not be entitled to claim an occupation rent because of the agreements between her deceased husband and the son."

26. However, Mr Justice Snowden did not reach a firm conclusion on the decision in *French*, because (i) he held that he had a broad equitable discretion in any event and (ii) the facts in *Davis* were distinguishable because the bankrupt had not contributed financially to the property and it had never been intended that the bankrupt would occupy the property. As such, it was held that no occupation rent was payable.

27. Some guidance as to the proper interpretation of *Davis* was given by Foster J in the case of *Shilabeer v Lanceley* [2019] EWHC 3380 (QB), which considered the extent to which the executors of a deceased's estate could claim occupation rent. In that case, an appeal against a decision that the executors were entitled to an occupation rent on the basis of the decision in *Davis* was dismissed. As such, it appears that unless the relatively unusual circumstances in *Davis* arise, whereby the relevant property was never occupied by the bankrupt co-owner, the decision in *French* remains good law and the comments of Mr Justice Snowden are obiter.

28. However, parties should be aware that following *Davis*, it would be prudent for a TIB to make a positive case why an occupation rent is appropriate. *Davis* indicates that a case should be made on the basis of the position of the bankrupt owner and the intentions of the parties throughout the course of the ownership of the property.

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