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Falsifying the Trust Account and Compensatory Equitable Compensation

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Abstract

The scope of decision of the United Kingdom Supreme Court in AIB Group v Mark Redler & Co will only be understood in view of its treatment in subsequent decisions, but it is submitted it is frail authority for the view that a beneficiary will be unable to falsify the trust account where property has been misappled. In this paper it is contended, first, that an alternative analysis of the facts in AIB Group indicates that the case was, plausibly, wrongly decided. Second, the uncertain ratio of the case will be examined to point out fact situations where the case should not be followed.

Keywords: equity, trusts and trustees, breach of trust, liability to account, falsifying the trust account, equitable compensation, AIB Group v Redler

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Whilst this paper was prompted by the landmark (landmine?) decision of the United Kingdom Supreme Court in *AIB Group v Mark Redler & Co*,[1] I shall not undertake a close examination of that decision, which has been done elsewhere.[2] Here my purpose is twofold. First, I shall suggest an alternative analysis of the facts in *AIB Group* which indicates that the case was, plausibly, wrongly decided. Second, I shall press upon the uncertain ratio of the case to point out fact situations where the case should not be followed. Given the frailty of its reasoning, I doubt that the scope of the decision, i.e. how broad or narrow as a matter of precedent the ruling actually is, can easily be discerned, but this second part of the the paper is, I submit, a start on that project.

I *The Bank adopted the misapplication of funds, so the solicitors ought not to have been liable at all*

The facts in *AIB Group* were as follows: In 2006 the defendant solicitors were instructed by the claimant lender, AIB Group, who wished to lend £3.3m taking a first mortgage over land of the borrowers worth £4.25m. The land was already subject to a prior mortgage from Barclays Bank of about £1.5m, which secured two different loan accounts of the borrowers, one of about £1.23m and the other of about £270,000. Prior to the date when this transaction was to take place, the solicitors erroneously overlooked the second smaller loan account, and therefore paid Barclays only £1.23m, and paid the balance of the £3.3m, about £2.1m, to the borrowers. As Barclays' outstanding loan balance on the second loan account was not discharged, it did not release its security over the borrowers' land, although now it only secured an indebtedness of about £270,000. For about two years, nothing

[1] [2014] UKSC 58.

[2] In particular I would endorse the criticisms of the decision set out by Jamie Edelman, 'An English misturning with equitable compensation' (this volume), Paul Davies, 'Remedies for Breach of Trust' (2015) 78 Modern Law Review 681, and Peter Watts, 'Agents' Disbursal of Funds in Breach of Instructions', [2015] Lloyd's Maritime and Commercial Law Quarterly 118. See also J.E. Penner, 'Distinguishing Fiduciary, Trust, and Accounting Relationships', (2014) Journal of Equity 202, at 223-26.

much further happened, but in 2008 AIB Group negotiated with Barclays to allow it to have a second mortgage on the land to secure the loan of £3.3m to the borrowers. The borrowers subsequently defaulted on the loan repayments, and the land was sold. The housing market had declined and the house only fetched about £1.2m, and so after paying the outstanding debt to Barclays, roughly £300,000, AIB Group recovered only £900,000.

In the Court of Appeal[3] it was held that, because of the solicitors' failure to discharge the prior mortgage, the entire outlay by the solicitors of AIB Group's £3.3m was a breach of trust, on the basis that obtaining a valid discharge of the prior mortgage (or obtaining a solicitor's undertaking from the prior mortgagee's solicitors that the mortgage would be discharged upon receipt of the payment) was a condition for paying out any funds at all. This finding was not appealed. Applying general principles of causation for loss as Lord Browne-Wilkinson did in *Target Holdings v Redferns*,[4] the Supreme Court, in concurring judgments by Lords Toulson and Reed, held the solicitors liable only for the £300,000 the lender paid to clear Barclays' prior mortgage; even if there had been no breach and both prior mortgages had been cleared, the house would still have sold for only £1.2m because of the decline in the housing market, so AIB Group's loss owing to the breach on this 'but for' test of causation was only the £300,000 odd needed to discharge the outstanding mortgage.

Unfortunately, neither Lord Toulson nor Lord Reed made it clear what the scope of the decision was, that is, it is not clear whether a beneficiary is now barred in all cases from falsifying the account so that the trustee's liability is to be determined on that basis, or whether only in certain cases. We shall consider this uncertainty in Part II.

But a better analysis, it is submitted, resolves the case without departing from traditional principles under which a beneficiary is *prima facie* entitled to falsify the

[3] [2013] EWCA Civ 45.
[4] [1996] AC 421.

trust account where the trustee, in breach of trust, misapplies trust property, in particular paying it away in contravention of the trust terms or his instructions where the trustee is acting under a mandate of agency. On the facts of the case, on the traditional analysis, AIB Group was entitled to falsify the account when the solicitors advanced the funds in the wrong amounts to Barclays and to the borrowers because each disbursement was a misapplication of the trust money, not being in accord with the instructions the solicitors were given. However, it is also clear that AIB Group, when informed of the situation, proceeded to accept the disbursements of money, and proceeded on its own to negotiate with Barclays ultimately to acquire Barclays' consent to the second charge over the property in question to secure the full value of its loan to the borrowers. By pursuing off its own bat the second charge with Barclays, they proceeded on the basis that it was indeed their money that went to Barclays to pay off its prior mortgage; that is, they adopted the expenditure of the funds to Barclays as a disbursement on their behalf, and thus made it impossible for the solicitors to restore the account. If transferring the money to Barclays in this way was indeed an expenditure on behalf of AIB Group, there was no account to restore: the trust funds must be taken to have been properly disbursed at which time the trust is no more. AIB Group's actions were entirely reasonable, given their understanding of the situation at the time. AIB Group's rationale for proceeding in this way can be inferred quite straightforwardly; they reasoned (as it turned out, wrongly) that there was sufficient value in the property to serve as security for the borrowers' entire indebtedness, as well as for the £270,000 odd owed to Barclays. If this is right, then AIB Group adopted, or accepted, the result following their negotiations with Barclays, i.e. that the borrowers' loan would be secured by way of a second mortgage inferior to Barclays' first mortgage . On this analysis the solicitors should not have been liable at all, for the expenditure, though in breach, was effectively adopted or ratified after the fact.

It is important to notice that the adoption of a misapplication of trust property can only occur after the fact, whereas a consent to a breach of trust arises before or at the time of the breach.[5] As Lord Millett said:[6]

> If the unauthorised investment has appreciated in value, then the beneficiary will be content with it. He is not obliged to falsify the account which the trustee renders; he can always accept it. … Where the beneficiary accepts the unauthorised investment, he is often said to affirm or adopt the transaction. That is not wholly accurate. The beneficiary has a right to elect, but it is really a right to decide whether to complain or not.

It is trite law that a sui juris beneficiary who freely consents to, participates in, or ratifies a breach of trust may not sue the trustee to make good any loss caused by the breach,[7] and we shall consider that law below. But as to adoption *per se*, I am unaware of any cases which consider what test might be applied to determine whether a beneficiary has adopted a misapplication of trust assets. Some assistance on the question is provided by the recent Singapore Court of Appeal decision in *Chng Weng Wah v Goh Bak Heng*.[8] The facts of the case were simple. Chng held shares on trust for himself and Goh in equal shares. Sometime in 1999 oo 2000 Goh asked Chng to sell the shares representing his beneficial interest, which Chng claimed he did, accounting to Goh for the money proceeds. Some thirteen years later, Goh applied to the court for an account.[9] In considering this claim, Chao Hick Tin JA said this:

> 38 In our judgment, a distinction has to be drawn between the case of a trustee having to establish that he no longer owes a duty to account as a result of there being settled accounts between the parties and the case of a trustee having to give an *actual account* in the course of defending a claim

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[5] I must thank Sean Chen and Isaac Tay for helping me to clarify my thoughts on this point.
[6] P.J. Millett, 'Equity's Place in the Law of Commerce', (1998) 114 Law Quarterly Review 217 at 226.
[7] See, eg , J E Penner, *The Law of Trusts 9th Edition* (Oxford: Oxford University Press, 2014), 11.55-58.
[8] [2016] SGCA 9.
[9] Goh's claim was found by the court to be barred under the doctrine of laches.

for an account. The Judge appeared to have considered only the latter approach in determining whether Chng still owes a duty to account for the MTK shares and the sale proceeds to Goh. As we have observed above (at [22]), the claim for a common account may be divided into three stages, namely: (a) whether the claimant has a right to an account; (b) the taking of the account; and (c) any consequential relief. While it is accepted that a trustee may, at the first stage of the claim, be able to prove that he or she no longer owes a duty to account *by providing an actual account* in the course of legal proceedings, that is only but one method by which the trustee is able to resist a claim for an account. For instance, if a trustee is able to produce a document evincing both parties' agreement that accounts have been settled conclusively, in the absence of any other evidence to the contrary, that should suffice and the trustee should not be made to go through the laborious, and if we may add, unnecessary, process of providing an actual account in the course of defending the action. Imposing a requirement for the trustee to provide an actual account at the first stage of the proceedings in each and every case will effectively render the three-stage process explained above nugatory. In other words, the first two stages will effectively be merged into one if the only way by which a trustee is able to defeat a claim for an account by the beneficiary is to render an actual account in the course of the legal proceedings.

39 While it is acknowledged that, unlike the example given in the preceding paragraph, Chng has not managed to produce any documentary evidence to show that parties had agreed that accounts have been settled, that does not necessarily lead to the conclusion that Chng has to provide an actual account in the course of defending the present claim by Goh. Based on the evidence that has been led (such as the correspondence between the parties), the court may be able to draw an inference, on a balance of probabilities, that settled accounts *have already been provided* (ie, at some earlier point in time). In the circumstances, a trustee does not necessarily

> have to provide full accounts in order to defeat a claim for an account by a beneficiary. [italics original]

As applied to the facts in *AIB Group*, the question is whether, by its actions, it is right to infer that AIB Group adopted the transaction in the sense of taking the disbursements to be applications of its money, thus bring the trust to an end. If so, then the trust accounts would be 'settled', that is, the solicitors liability to 'account' at any time in the future would be extinguished.

Although, as already pointed out, consent to a breach of trust is not equivalent to the adoption of a misaplication of trust assets after the fact, nevertheless some assistance on the test to be applied for determining whether a beneficiary adopts a misapplication of trust property can be derived from the law covering consent to a breach prior to or at the time of its commission. Of course, truly to consent to a breach, a beneficiary must be fully aware of the facts, although not necessarily of his legal rights. In *Re Pauling's Settlement Trusts*[10] Wilberforce J described the court's general approach to the question of consent or ratification as follows:

> [T]he court has to consider all the circumstances. . .with a view to seeing whether it is fair and equitable that, having given his concurrence, he should afterwards turn round and sue the trustees. . .it is not necessary that he should know that what he is concurring in is a breach of trust, provided that he fully understands what he is concurring in, and that it is not necessary that he should himself have directly benefited by the breach of trust.

In a recent review of the authorities in *Barescape Pty Limited v Bacchus Holdings Pty Limited*[11] Black J said the following:

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[10] [1962] 1 WLR 86 at 108.

[11] [2012] NSWSC 984. I thank Simone Degeling for bringing this case to my attention.

> [160] In Blackmagic Design Pty Ltd v Overliese [2011] FCAFC 24; (2011) 191 FCR 1; 276 ALR 646 at 668 [110], Besanko J (with whom Finkelstein and Jacobson JJ agreed) observed that:
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> > "There is no doubt that the disclosure required to avoid the consequences of a conflict is a full and frank disclosure of all material facts. The identification of the precise information which must be disclosed so that the fiduciary's principal is kept "fully informed of the real state of things" (Gray v New Augarita Porcupine Mines Ltd [1952] 3 DLR 1 at 14 per Lord Radcliffe) is likely to depend on the particular facts of the case before the court. It seems to me that the material facts in this case are the facts which give rise to the conflict …"
>
> In that case his Honour noted that certain matters were, and others were not, necessary to be disclosed to obtain informed consent to the relevant conduct.
>
> [161] It is also important to recognise that consent is not an absolute defence to a breach of trust or breach of fiduciary duty. In Spellson v George [(1992) 26 NSWLR 666] at 669 Handley JA noted that the authorities establish that:
>
> > "consent is only a prima facie defence and that the Court must consider in detail "all the circumstances" in order to determine whether it would be "fair and equitable" for that beneficiary to be permitted to complain of that breach."

Applied to the facts of *AIB Group* it would appear that AIB Group was fully aware of all the circumstances when they began their negotiations with Barclays, and at no stage does it appear that they suggested that the solicitors should do anything further once AIB 'took charge' of the matter. Moreover, whilst early on the borrowers promised the solicitors that they would themselves would pay off the remaining amount on the prior Barclays mortgage, they never did so, and AIB seemed content with this when they pursued the matter with Barclays.

One final way of considering the matter is in terms of 'acquiescence'. In *Holder v Holder*[12] the plaintiff sued to set aside the purchase of trust property by his brother who had technically acquired the status of an executor, for breach of the 'self-dealing' rule. The plaintiff was held to have acquiesced in the sale although unaware at the time of the legal position. He had subsequently received part of the purchase price as a beneficiary under the will, and throughout had full knowledge of all the facts concerning the sale. Besides considering these facts that went to determining the plaintiff's acquiescence in the sale to his brother, the 'fair and equitable' requirement for allowing the beneficiary now to 'turn round and sue' was also applied, so it might be argued that more than acquiescence is necessary to bar a plaintiff from bringing a claim for relief. Even so, it must be just as much for an adoption case, where a beneficiary chooses not 'to complain' once in full possession of the fact, as AIB Group was when it set out to negotiate with Barclays, as for a consent case, that acquiescence should be seen as a factor weighing in favour of barring a later claim for breach of trust.

This analysis of *AIB Group*, subject to one point concerning whether AIB Group could falsify the account 'in part' – adopting the expenditure of the money to Barclays but falsifying the over-payment to the borrowers – which shall be discussed shortly, is fortified by the essentially identical analysis of the facts from the perspective of agency law. In a recent article, Peter Watts, criticising the decision of the Supreme Court, argues that the case turns primarily on the application of the principles concerning the ratification of an agent's unauthorised acts. Watts says:[13]

> [I]t seems…equally plain that once told of the delinquency the principal must take a stance on what has happened. It is not inconceivable that a legal system might place the burden on the agent expressly to require the principal to elect whether or not to adopt what has been done, albeit wrongly, in the principal's name. But it does seem inconceivable that a legal system would allow a principal, when pressed, to refuse an answer. We can

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12 [1968] Ch. 353.
13 Watts, *supra* n. 2, at 120, 121 footnotes omitted.

> put such speculation aside, since the common law does impose a duty on principals where fully informed, and it is simple enough to do so, to speak out or risk their silence being treated as a ratification of unauthorized action.
>
> [W]hilst the solicitors in *AIB Group* were initially not forthcoming about their having accidentally released the money without a first mortgage being in place, they were soon driven to reveal the facts, and indeed some negotiations then directly occurred between their client and the existing mortgagee. In those circumstances, an inference of ratification was almost irresistible.

The only remaining question is whether AIB Group could have consented to the expenditure in part, say consenting to the payment of £1.23m to Barclays, but not to the £300k overpayment to the borrowers. On agency principles, Watts argues that the result in *AIB Group* can be justified on the basis that AIB Group's ratification of the transfer to Barclays need not encompass the overpayment to the borrowers. We shall return to that thought in a moment. On straight falsification principles, however, it would appear that AIB Group would have difficulty in making such a claim.

Where a trustee enters into two different unauthorised transactions, one of which causes a loss, but the other creates a gain for the trust, the beneficiary can, in principle, falsify only the loss-causing transaction, and adopt the successful one, *if the transactions are distinct*.[14] The trustee should not be exonerated of particular breaches because he can say, 'overall, the trust is in good shape'. However, where the losing and gaining unauthorised transactions form part of one composite transaction, the transactions must be falsified together or not at all.[15] For example, in *Bartlett v Barclays Bank Trust Co. Ltd*,[16] the court held that the disastrous investment in one property development project was part of a larger investment policy favouring land development. In taking the account, then, this decision

[14] *Wiles v Gresham* (1854) 2 Drew 258; *Dimes v Scott* (1828) 4 Russ. 195.
[15] *Fletcher v Green* (1864) 3 Beav. 426.
[16] [1980] Ch 515.

required the beneficiary to 'falsify' both the winning and losing projects as one invalid investment, with a resulting reduction in the amount of compensation. [17]

The facts in *AIB Group* are, if anything, *a fortiori* to those in Bartlett. The payments to Barclays and to the borrowers were clearly part of a 'composite' transaction or, even, *one* transaction if we think of the payments being made in pursuance of AIB Group's contract of loan with the borrowers.

Does an analysis of the facts drawing on agency principles give a different result? Contrary to Watts, I think not. The gist of Watt's argument is found in the following two passages:[18]

> A principal's decision to ratify *need not release the agent from all liability, particularly in respect of loss that has crystallised before any decision to adopt the agent's acts.* But loss that ensues from the transaction after its affirmation would ordinarily rest with the principal.
>
> In [the circumstances of *AIB*], an inference of ratification was almost irresistible. *[R]atification would not necessarily have released the solicitors from indemnifying the lender from the increased exposure that the substitute transaction had created*.

But, it is submitted, simply because the solicitors' actions exposed AIB Group to this loss, it does not follow that they are liable for it. Whilst there is no 'duty to mitigate' one's losses at common law, liability for damages both in contract and tort does not

[17] '[F]alsify' here is placed in quotation marks as, strictly speaking, *Bartlett* was not a falsification case. The trustee in *Bartlett* was liable for not preventing the company in which the trust held shares from embarking on property developments. Thus the case was one of negligence, and the beneficiaries surcharged the account. But the principles of causation for loss in falsification cases were relevant because the transactions the company entered into were essentially ones that, had the company been the trustee, would have been misapplications of trust property, and so it was appropriate to analyse the facts in terms of falsification when assessing the loss to the trust.
[18] Watts, *supra* n. 2, at 120, 121 (my italics in both passages).

extend to losses which could reasonably have been avoided. In this case, AIB Group could easily have avoided the £300k loss. It had an immediate claim against the borrowers: the borrowers held the excess they received on trust, this amount being misapplied when transferred to them, and were in addition personally liable for that amount as knowing recipients. AIB Group could easily have got an order against the borrowers to transfer the requisite amount to Barclays to discharge the remaining indebtedness to Barclays (at the borrowers' expense in costs) had the borrowers refused to do this themselves. On the facts, it is clear that AIB Group never concerned themselves with doing anything of the kind in keeping with the rationale for their actions following being informed of the solicitors' error, discussed above. On orthodox common law liability principles, then, the result would appear to be no different than on orthodox falsification principles, i.e., that the solicitors ought not to have been liable for any amount.

II The Scope of the Ratio Decidendi in *AIB Group*

The reasoning of Lords Toulson and Reed in *AIB Group* is far from crystalline, but the following two passages seem to be their respective statements of the principle of liability that arises from the decision.

> Lord Toulson: [19] All agree that the basic right of a beneficiary is to have the trust duly administered in accordance with the provisions of the trust instrument, if any, and the general law. Where there has been a breach of that duty, the basic purpose of any remedy will be either *to put the beneficiary in the same position as if the breach had not occurred* or to vest in the beneficiary any profit which the trustee may have made by reason of the breach (and which ought therefore properly to be held on behalf of the beneficiary). Placing the beneficiary in the same position as he would have been in but for the breach may involve restoring the value of something lost

[19] *AIB Group*, *supra* n. 1 at [64] (my italics).

> by the breach or making good financial damage caused by the breach. But a monetary award which reflected neither loss caused nor profit gained by the wrongdoer would be penal.
>
> Lord Reed: [T]he model of equitable compensation, where trust property has been misapplied, is to require the trustee to restore the trust fund to the position it would have been in if the trustee had performed his obligation.

Now whilst these statements purport to be fully general, applying to any case of breach of trust, in keeping with Lord Browne-Wilkinson's preoccupation with 'commercial' reality in *Target*,[20] both Lords Reed and Toulson refer to the fact that the trust in question was one element of a commercial transaction,[21] which may be taken to narrow the ambit of the decision to 'commercial' rather than to 'traditional' trusts, i.e. family wealth management trusts. Such a consideration might explain in part the very first line of Lord Toulson's judgment:

> [1] 140 years after the Judicature Act 1873, the stitching together of equity and the common law continues to cause problems at the seams.

The thought is that where a trust is a commercial one, both equity and the common law will have a role to play in analysing the facts, and any breach by the trustee, and thus common principles of liability ought to be found. But it is fair to say that there is no explicit statement by either of their Lordships qualifying the generality of the ratio, in particular narrowing it to trusts undertaken in 'commercial' circumstances, whatever they might be.[22] Nevertheless, it is submitted that the principle of liability endorsed by Lords Toulson and Reed cannot be general, and this can be shown by considering fact situations where its application would, intuitively at least, produce quite the wrong result.

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20 See, e.g. *Target Holdings*, *supra* n. 4 at 436.

21 *AIB Group*, *supra* n. 1 at [17], [34], [44], [67], [70-71], and [74] per Lord Toulson, at [101-106] per Lord Reed.

22 For a persuasive criticism of the soundness of any distinction between 'commercial' and 'traditional' trusts, see Davies, *supra* n. 2 at 687-88.

Drawing upon these statements of their Lordships, we can restate the *ratio decedendi* of *AIB Group* as follows:

> Henceforward, where a trustee misapplies trust property, a beneficiary of a trust will be disentitled from falsifying the account – the unauthorised expenditure will be regarded as an expenditure of the beneficiary's funds for the beneficiary's purposes. However, the trustee's breach in expending the funds on an unauthorised asset will, on the other hand, amount to a wrong sufficient to support a claim to surcharge the account, so that if the expenditure as wrongly made causally gives rise to a lower asset value than would have been obtained had the intended, authorised, asset been acquired, the trustee will be liable for the difference.

It is submitted that it cannot generally be the rule that a beneficiary is no longer entitled to falsify the account and has only a remedy for consequential loss, as the following examples demonstrate.

In the first place, if this were the general rule, then the House of Lords decision concerning the *Quistclose*[23] trust in *Twinsectra Ltd v Yardley*[24] was wrongly reasoned. The House of Lords found[25] that the lender, Twinsectra, advanced funds to the solicitor of the borrower, Mr Yardley, on trust for the purpose of purchasing 'property'. The funds were then transferred to a second solicitor of Mr. Yardley, who had some degree of notice or knowledge of the trust over the funds. The second solicitor released the funds to Mr Yardley, some of which funds were spent not in the acquisition of property.

It is worth point out first that the trust in *Twinsectra* was clearly a bare, commercial trust, identical in form to the trust in *AIB Group* itself, and yet the case proceeded on

[23] *Barclays Bank Ltd v Quistclose Investments* [1970] AC 567.
[24] [2002] UKHL 12.
[25] On pretty flimsy facts, it must be said: see Penner, *supra* n.5 at [7.28-29].

the basis that the trustee-borrower was liable for his wrongful expenditures of the trust money on falsification principles. As Mr. Yardley was insolvent by the time of the action, the lender sued Mr. Yardley's second solicitor for dishonest assistance, claiming that he was secondarily liable for the money wrongfully paid away. There would have been no claim against either the trustee-borrower or his solicitor if the claim was limited to one for consequential loss: had the trustee-borrower disbursed all the trust money *lawfully* – ie if the money was not disbursed in breach of trust – the lender would still have recovered little or nothing, for the borrower was insolvent. It was the borrower's insolvency that caused the loss, not the misapplications of the trust property, ie not the breach of trust. Indeed, on *AIB Group* principles no *Quistclose* trustee could ever be personally liable for the misapplication of the trust money, since on pure compensation for consequential loss principles the lender would always be in the position of an unsecured creditor whether the money is spent according to the trust terms or not.

Consider another example, which draws on the logic of *Clough v Bond*, where Cottenham LC said:[26]

> It will be found to be the result of all the best authorities on the subject, that, although a [trustee], acting strictly within the line of his duty, and exercising reasonable care and diligence, will not be responsible for the failure or depreciation of the fund. . .yet if that line of duty not be strictly pursued, and any part of the property be invested by such [trustee] in funds or upon securities not authorised, or be put within the control of persons who ought not to be instructed with it, and loss be thereby eventually sustained, such [trustee] will be liable to make it good, however unexpected the result, however little likely to arise from the course adopted, and however free such conduct may have been from any improper motive.

[26] (1838) 3 My & Cr 490 at 496.

Tom the trustee, in breach of trust, removes a gemstone from the trust collection held in a secure (ha!) vault in Hatton Garden in London, and sells it for £100,000. The gems, being in what is supposed to be secure safe-keeping, are uninsured. Later that week the secure vault is burgled, and all the gems are stolen. Tom must account for the £100,000 to the trust and cannot claim that had he complied with his duty all the gems, including the one he stole, would have been lost, so again, the claim that the beneficiaries undoubtedly have to the £100,000 cannot be founded as one for consequential loss. Rather, the beneficiaries in this case will elect not to falsify the account, but adopt the sale of the gem. This is the orthodox position, and it would seem that any claim by the trustee that he should not account for the funds because the beneficiaries suffered no conequential loss because of his breach (all the gems would have been lost in any case) would be rejected outright.

A similar set of facts presented itself in *Akai Holdings (in liquidation)*.[27] The case involved a fraudulent loan transaction, in which one Mr Ting purported to act with the authority of the Board of Directors of Akai Holdings. The transaction was a loan from the Farmers's Bank (the 'bank') of $30m US secured by the pledge of shares legal title to which belonged to Akai. The loan moneys were used to discharge a loan of the same amount that the bank held against Singer NV, a company more or less unrelated to Akai but one in which Mr. Ting was interested as a major shareholder. This was called a 'switch transaction' because the bank was able to switch a loan to Singer NV with negligible security for a loan to Akai with significant security in the form of the pledged shares. Later Akai defaulted on repayment of the loan, and the bank sold the pledged shares for about $20m, and sought to prove the outstanding loan amount in Akai's liquidation. The Court held that the bank should have realised that Mr. Ting had no actual authority to enter into the switch transaction on behalf of Akai, and thus it should have known that it was wrongfully pledged the shares. The court found the bank liable for conversion of the shares when the bank sold them, but was also willing to hold that the bank, on some extension or application of the principles of 'knowing receipt', owed Akai equitable compensation in the

[27] [2011] 1 HKC 357

amount of the money it received on the same of the shares. But the court also found this:

> 154. … it is clear on the balance of probabilities, indeed it is, in truth, clear beyond any real doubt, that, if the Bank had returned the share certificates to Akai, far from being sold earlier than the date upon which the Bank sold them, Akai would have kept the Shares until they had become worthless. The ironic fact is that Akai is substantially better off as a result of the Bank having received and sold the Shares. Of course, that does not mean that Akai has no right to equitable compensation, and the Bank is entitled to keep the proceeds of sale of the Shares: normal equitable principles entitle Akai to elect between receiving a sum equal to the proceeds of sale of the Shares or, unless it is impossible to obtain them, an equivalent number of Akai Electric shares.

If Akai was to be placed in the position it would have been in had no breach occured, in this case no switch transaction and no pledge of the shares to the bank, it would be entitled to no compensation at all. But that is not what the court held.

Take another example, where a trustee 'borrows' trust moneys. In personal financial difficulty, a trustee in breach of trust sells the trust's 20,000 shares in XYZ plc at $5 per share, thus for $100,000, and uses the money to discharge his debts. Later on, when the market price of XYZ shares has fallen to $1 per share, the trustee restores the trust by spending $20,000 to purchase 20,000 shares in XYZ.

The trustee makes a handsome profit from his breach of trust, viz $80,000, and the beneficiaries have not suffered in any way from his breach, i.e. they are in the same position they would have been in had the breach not occurred. They therefore have no personal claim against the trustee under the aegis of surcharging the account, i.e making a claim for consequential loss. Only upon falsification/adoption principles does one get the right result: Upon the sale of the shares – in breach of trust – for $100,000, the beneficiaries can elect either to falsify the account or adopt the transaction. They will clearly adopt the sale. The trustee will be treated as holding the $100,000 on trust as a substitute asset acquired in exchange for the shares. The beneficiaries will then go on to falsify each and every expenditure by the trustee of that money which was used to discharge his own personal debts. They can thus make a claim against the trustee for $100,000 plus interest, and it is neither here nor there that had the trustee not committed the breach of trust the trust fund would have declined in value by 80%.

It might be suggested that the same result, holding the trustee personally liable for £80,000, could be achieved by applying the no profit rule[28] governing fiduciaries. In my view, the suggestion is misguided. In the first place, the rule is not apt in these circumstances. The no profit rule is directed to receipts by a fiduciary from third parties acquired in conflict of interest; it is not directed to a trustee's misappropriation of the trust assets themselves. Moreover, the rule has no application where the trustee in question is not a fiduciary,[29] for example in the case of *Quistclose* trustees, so the rule would not cover all cases of concern, i.e. cases where trust assets are misappropriated. Finally, a misapplication of trust property is not *per se* 'a breach of fiduciary obligation' or, to put it better, is not *per se* an act attracting liability under fiduciary law. We can show this with a further example.

As we know from *Bristol and West Building Society v Motthew*[30], fiduciary liability, including the 'no profit' rule, does not attach to a merely negligent breach of trust or contract. So consider this case: A trustee sells shares to meet her own indemnity or charging clause, and uses the money to pay her debts, expenses, etc. It turns out the indemnity was not available (say because she negligently failed to realise that she was not empowered to delegate, and pay, an agent under the trust terms, or had litigation costs not authorised by the trust and failed to get a Beddoe order, or the indemnity owing to her was not properly calculated, etc, etc). There is no fiduciary

[28] This was suggested to me by Lionel Smith. For discussion of the 'no profit' rule, see Penner, *supra* n 2., 230-33; Penner, *supra* n. 5, at [12.48-59].
[29] For discussion of non-fiduciary trustees, see Penner, *supra* n. 2, at 219-23
[30] [1998] Ch 1.

liability here but there is also no way that the trustee can replace the shares at a lower price if the share price has fallen. Again, if there was a general decline in the market, there is no way she can replace the money she paid herself discounted by the percentage decline in the trust fund. The 'no profit' rule has no application to this fact situation. It's falsification/adoption principles or nothing.

We can consider another example, posed by Watts.[31]

> Let us then assume that the lender [in *Target*] discovered the borrower's fraud and contacted the solicitors, conscious that it might have become too late to stop the transaction but hoping otherwise. The solicitors told it that the funds had been released [to a third party, not the intended payee] but that the mortgage was not yet in place. At least before *Target Holdings*, it was clear that in such circumstances the lender could disown the solicitors' conduct and withdraw its authority, thereby laying the loss of the funds at their door. It would not be open to the solicitors in the face of the client's protest to proceed to get in the mortgage, even assuming the fraudster remained content to sign the documents. In such circumstances, Lord Browne-Wilkinson's test for liability, namely that the loss would not have occurred but for the breach, would not be met. Rather than being a cause of the loss, the solicitors' default would, from the claimant's perspective, be a piece of good fortune. But that could not be an answer to the claimant's right to a return of its money.

It is difficult to find a fault in this reasoning. Where a beneficiary/lender in such a case acts in time to withdraw its authority to lay out the funds, as a matter of principle it cannot be the case that the trustee can proceed anyway *without authority,* putting the risk of any loss on the beneficiary.

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[31] Watts, *supra* n. 2 at 125.

There is one further feature of understanding the beneficiaries' remedy for breach of trust as being a claim for consequential loss, which would lead to an *expansion* of the trustee's liability in certain cases. On orthodox principles concerning the trustee's liability to account, the only interest of the beneficiaries that the trustee's liability to account protects is their interest in the value of, or in the specific property in, the trust fund. It does not allow the beneficiaries any claim for consequential loss that they suffer which follows from the trust's being 'short of funds' owing to the breach.

Consider the following example: Because of the trustee's misapplication of the trust property, say making an unauthorised investment, Hazel, the income beneficiary, receives half the income in 2014 that she would have done if the authorised investment was retained. Let us also assume that Hazel can establish, on the standard 'but for' test of causation, that but for this reduction in her income she would have been able to make a profitable investment herself; instead, because of the reduced income, she could not afford it, and so can prove that the trustee's breach caused her a loss of profits. Has she any claim for this loss against the trustee?

Not by way of account. By falsifying the trust account her only claim is to have the trust restored, and this will include an amount of money to ensure that she receives the missing income for 2014, plus interest. But can she 'go outside the account' and claim her consequential loss on some broader notion of the trustee's breach of trust. That would require founding a claim that would not be traditionally conceived of either as falsifying or surcharging the account, because the loss claimed is not a loss to the trust funds No such claim has ever been argued for in any decided case, although Jamie Glister has raised the possibility.[32] At first this might seem unjust, especially if our understanding of breach of trust is, by virtue of the kind of reasoning in *AIB Group*, shifted from principles of falsification and adoption to principles of compensation for 'but for' consequential losses. It is submitted that there is no

[32] Jamie Glister, 'Breach of Trust and Consequential Loss', (2014) 8 Journal of Equity 235.

injustice. Whilst a beneficiary is entitled to ensure that she receives all the distributions from the trust fund to which she is entitled, a trust fund which has all the property in it which it should (which rights the power to falsify and surcharge the account ensures), she should not be entitled to recover any losses she suffers in her own personal affairs because she relied upon receiving such and such a distribution on a timely basis.

The common law parallel in the law of torts is a wrongdoer's liability for consequential economic loss, or 'pure' economic loss as it is sometimes put. In general, tortfeasors are not liable to their victims for economic loss that does not directly follow from damage to the victim's person or to his tangible property. Why this is so, why a tortfeasor is not subjected to unlimited liability for all the economic losses his victim suffers that can be shown to flow from his wrong, is a controversial issue, but following Stevens[33], the most satisfactory rationale for this position is this: the law does not protect your liberty to exploit economic opportunities for profit. It indirectly protects this liberty by prohibiting interferences to your person and property and, in the case of a beneficiary of a trust, by empowering the beneficiaries to claim distributions under a trust to which they are entitled. But the law does not make anyone, including wrongdoers, insurers of your economic well-being, even if their wrongful actions alter to your detriment the economic context in which you operate. So the question in this case is whether a trustee owes his beneficiaries a duty (presumably a duty of care) to ensure that he makes distributions of the right amounts on time under the terms of the trust such that he is liable to them for any consequential losses that might eventuate if he does not (beyond any amounts of interest the beneficiaries will receive for late distributions). There is, it is submitted, no good reason to impose such a duty, at least in the case of traditional trusts in which the benefits the beneficiary receives are by way of gift from the settlor; the trustee should not be liable for consequential losses you suffer because you receive the correct amount of a gift late. To hold otherwise would make the trustee liable for *foreseeable* losses occasioned by, say, the late distributions to Hazel in the

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[33] Robert Stevens, *Torts and Rights*, (Oxford: Oxford University Press, 2007), chs 1-3.

example above. Which aspects of a beneficiary's financial wherewithal are supposed to be within the contemplation of the trustee? A trustee may have a duty to know something about the financial circumstances of different beneficiaries when exercising a discretion to invest the trust funds,[34] or in exercising a discretion to distribute property amongst a class of discretionary objects, but would this make it foreseeable that Hazel was unable, say, to borrow money to make the investment, the interest on which loan would be compensated more or less by the interest to which she would be entitled on the late distributions when they are later made to her? It is not clear what would justify placing this burden of investigation on the trustee. Moreover, it might be argued that a trustee should have no right, much less a duty, to know about any particular beneficiary's access to other funds.

Finally, there is a flip-side to this line of thinking. If a trustee is to be liable for consequential losses of this kind, should the trustee be relieved of liability if no consequential loss ensues? Consider this final example. Trudy the trustee has a duty to distribute the entirety of trust income to Ben the beneficiary which duty, however, is subject to a power to accumulate up to half the income which will accrue to capital, held on trust for his wife and children. Ben is a notorious wastrel. Trudy, quite rightly, exercises her discretion to accumulate as much as she can with a view to distributing capital to his wife and children, when the former is released from Ben's affections by his death, and when the latter come of age. Trudy miscalculates. For the last 5 years she has accumulated 55% of the income, rather than 50%, such that Ben has received £250k less than he otherwise would have done. What if, during the period, Ben would, on the balance of probabilities, have lost the money gambling, or was a devoted collector of an artist whose work is junk? On orthodox accounting principles, neither of these facts would give Trudy any relief from her liability to make good the failure to pay Ben. But on pure 'compensation for consequential loss' priniciples, it would appear that they might do just that.

III Conclusion

[34] See *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260 at 1279C, D per Staughton LJ.

If *AIB Group* is not interpreted narrowly, or the decision comes to be understood by a future United Kingdom Supreme Court to have been based upon a faulty analysis of the facts as suggested in Part I above, then its scope, i.e. the extent to which it denies beneficiaries the power to falsify the account for misapplications of trust property, will need to carefully examined. To the extent that *AIB Group* suggests that beneficiaries are generally distentitled from falsifying the account and may only make claims on the basis of their consequential loss, it is not the law in Australia[35] or Hong Kong[36] and your author would not recommend that judges there or elsewhere follow it.

[35] See, e.g., Edelman *supra* n. 2; *Youyang Pty Ltd v Minter Ellison Morris Fletcher* [2003] HCA 15; *Agricultural Land Management Ltd v Jackson (No 2)* [2014] WASC 102

[36] *Akai Holdings Ltd v Kasikornbank plc* [2011] 1 HKC 357; *Libertarian Investments Ltd v Hall* Hong Kong Final Appeal Nos 14 and 16 of 2012 (Civil).