THE GOOD, THE BAD AND THE EQUITY

- *Solicitors' breach of trust in the commercial context*

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by

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Introduction

Equity and common law have long had an unsettled relationship. Although in *Royal Brunei Airlines v Tan*[1], Lord Nicholls of Birkenhead commenced his speech with the observation that *"[t]he proper role of equity in commercial transactions is a topical question",* it was certainly not a new one. In *Re Wait*[2], Atkin LJ was critical in a commercial case concerning the sale of flour of the introduction of well established equitable principles "*into territory where they are trespassers"*[3]. Although in reality equity intervening in the commercial world was not uncommon, by the mid-1990s Sir Peter Millett wrote extra-judicially[4] *"[t]he intervention of equity in commercial transactions, long resisted by common lawyers, can no longer be withstood"* such that it had, he remarked, *"moved out of the family home and settled estate and into the market place"*.

In the recent Supreme Court decision in *AIB Group (UK) plc v Mark Redler & Co*[5], Lord Toulson began his speech with the observation that, *"140 years after the Judicature Act 1873, the stitching together of equity and the common law continues to cause problems at the seams."* This lecture looks at the approach adopted in that case and considers it against the context of remedies traditionally available for breach of trust[6].

The history, taxonomy and language of accounts

Some historical context may assist. In equity, the word 'account' describes different types of accounting processes and the liabilities that can arise, which are well-known to traditional trusts lawyers. Those different types of account could be described as (i) an account of administration in common form, (ii) an account on the basis of wilful default, and (iii) an account of profits. The first arises from a misapplication of trust funds, for

[1] [1995] 2 AC 378

[2] [1927] 1 Ch 606

[3] ibid at 635

[4] (1995) 9 TLI 35

[5] [2015] AC 1503

[6] The article by Elliott & Mitchell (2004) 67 MLR 16, the recent extra-judicial speech of James Edelman to the UNSW bemoaning the introduction of concepts of loss and causation into equitable monetary relief, the extra-judicial writings

of Sir Peter Millett mentioned elsewhere in this article and the learned authors of Lewin on Trusts in both the present and earlier editions have all been of invaluable assistance, both as regards the historical context and alternative analyses of decisions I consider below.

example, an unauthorised disbursement. The second arises in claim for loss caused by some type of default, even where the type of conduct was authorised, for example a breach of an administrative duty or the duty to act with due care and diligence. The third arises where there is a claim for profits made by the trustee.

The different forms of account and their governing principles and rules, were (despite the confusion we may now find in the all encompassing term account) well understood. The man for whom my chambers are named, Lord Selborne LC, commenced his speech in *Speight v Gaunt*[7] with:

> …the principles of equity, with respect to the duties and responsibilities of trustees, and the distinction between those losses of trust funds for which they are, and those for which they are not, liable, are so well settled, and are of such great general importance, that the present case, in which two Courts have differed as to their application, has naturally been considered by your Lordships with some anxiety.

One might be forgiven for wondering how then such confusion arose by the time that I was in practice as to the proper application of the accounting process and the availability of equitable remedies to which they give rise. More learned authors than I have remarked that this in part was a result of the loss of the split trial, presumably owing to its length and expense. I can see that where the question as to whether a defendant was accountable was considered at the same time as the taking of the account, focus on liability came to detract from a careful analysis as to the form of account and the rules governing it.

What is certainly true, and observable from the authorities, is that over the last hundred years or so the old language of accounts changed. Developments over the course of the 20th century have seen the old language of account became 'modernised' and, I fear, somewhat less precise. By the time I was in practice, I frequently saw claims (quite often by lenders in conveyancing transactions which had gone awry) for 'equitable compensation' for breach of trust or fiduciary duty, for example. Those same claims did not seek an account in their prayer, perhaps because it was unnecessary, and certainly did not seek split trials. The phrase is somewhat apt, in that it sounds broad enough to include any form of award on the basis of equity, but problematic in that it tends to bring to mind 'loss' and with it common law concepts relating to damages. Whilst the form of account on the footing of wilful default may sit comfortably with the language of equitable compensation, the others are obscured.

[7] (1883) 9 App Cas 1

The problem is not uniquely modern and there have for many decades been references to 'damages' in respect of monetary awards in equity, whatever their basis. This attracted the criticism of Sir Peter Millett again writing extra-judicially in 1998[8]:

> Woe betide a Chancery Junior who spoke of "damages for breach of trust" or "damages for breach of fiduciary duty". The judges knew that misuse of language often conceals a confusion of thought. Nowadays these misleading expressions are in common use. It is time that the usage was stamped out.

Just as confusion will arise when describing any monetary award as damages, collectively describing the different accounting remedies together as compensation is unhelpful. Firstly, a claim for profits, for example, is not readily described by the word compensation. No loss has been suffered which requires compensation; but where a breach of duty has resulted in the defendant profiting, the award to the claimant will be calculated by reference to the gains wrongfully made.

Secondly, as the very phrase 'equitable compensation' evokes the language of loss and damage, it in turn masks the existence of a debt. Historically, following from an account in common form, there arose an equitable debt. Debt carries with it a sense of entitlement and of being more absolute, or somehow less vulnerable; in any case, it is not compensatory.

The requirement to account in common form is *not* concerned with default or wrongdoing in contrast with an account on the basis of wilful default which *is* concerned with both a breach by a trustee and a loss, as was made plain in *Partington v Reynolds*[9]. As Kindersley VC said in:

> There are two different modes of accounting…and accordingly there are two different forms of decree in use to compel him to account. The one is a decree compelling him to account only for what he has received ...; the other is a decree compelling him to account, not only for what he has received, but also for what he might, without his wilful neglect or default, have received, although he has not received it. These are two perfectly different decrees.... They proceed upon totally distinct grounds. The one supposes no misconduct; the other is entirely grounded on misconduct.

As such, to consider the requirement to pay a sum of money following from a common account as compensatory is no more appropriate than regarding a claim for a

[8] (1998) 114 LQR 214

[9] (1858) 4 Drew 253.

contractual debt as a fallacy, on the basis that there is simply a claim in breach of contract compensated by damages. Despite this, some commonplace thinking appears to assume that an 'equitable debt' involves some 'default' by the trustee, which in turn connotes wrongdoing which has caused a loss and therefore there is no real 'debt'. Such an analysis is more easily arrived at where the umbrella term of equitable compensation is used.

On the taking of a common account, the primary duty of the trustee is to account, as a debt, for the value of the trust fund he holds at the date it is taken. The rules dictating the ambit of the account are concerned with calculating that debt, not estimating a loss suffered. Just as the procedure is unconcerned with wrongdoing, it is equally unconcerned with defences. The fund may be reduced by legitimate debits, such as fees, and other reductions may be treated as legitimate debits, such as insolvency of the fund or its theft, if independent of the trustee's acts such that he was not in breach of his duty to maintain the trust fund.

The transactions on the account may be falsified by the beneficiaries if the reduction arose as a result of an act or omission by the trustee, even if the trustee was entirely innocent. One may have sympathy with the trustee who releases funds to a wrongdoer on the strength of a forged document or other misrepresentation, but they are liable[10] notwithstanding that anyone might have been so deceived[11], because a trustee is bound to pay the trust fund to the right person.

The value of these falsified entries form part of the equitable debt that the trustee is liable to restore to the trust fund, or where there is a bare trust, directly to the beneficiaries. As such, they can be seen as claims for the enforcement of that which is promised by the trustee, his proper stewardship, or something as near to it as possible. For example, if the trust fund cannot be restored *in specie*, then alternative monies can be used to restore the trust fund. This has been referred to as substitutive performance.

The accounts on the basis of willful default, in contrast, are concerned with a breach by the trustee of a duty and result in the accounts being surcharged such that they are amended to show what the position would have been if the trustee had performed his duty. This has been referred to as reparative compensation.

10 although they may be relieved of their breach under the Trustee Act 1925

11 Lewin on Trusts 19th ed. 34-027

One can see therefore why terms such as compensation or damages are liable to cause the confusion they have and have effectively intermingled multiple distinct remedies each with their own rules.

All of this history was effectively before the Supreme Court in *AIB v Mark Redler*. I imagine that the Supreme Court would expect criticism of the decision (not least of all after the criticism of the House of Lords decision in *Target Holdings Ltd v Redferns*[12] which was factually similar and which was approved), but although reconstitution of the trust fund was claimed, as was equitable compensation for breach of trust, it does not appear a claim was expressly pursued on the basis of either an equitable or common law debt. Had it been, and had AIB sought to re-explain *Target*, it is more likely that reasoning consistent with the above trusts and accounting principles would have been adopted.

AIB Group (UK) Plc v Mark Redler & Co

AIB agreed to lend £3.3 million to the Sondhis and in July 2006 they jointly retained Mark Redler & Co for the transaction. AIB required a first charge over the borrowers' home, which had been valued at £4.25 million. Two Barclays's debts secured by a charge were to be discharged and AIB was to receive a first legal charge over the property. The Barclays' debts were for £1.2m and £300,000. In error, Mark Redler released £2.1m to the Sondhis and £1.2 to Barclays, instead of £1.8m and £1.5m respectively. As a result they did not receive a first legal charge for AIB. Mark Redler did not immediately inform AIB of the problem. The Sondhis promised to repay the £300,000, but did not do so. Barclays retained their first charge. Mark Redler notified AIB of the problem and they negotiated with Barclays and obtained a second charge ranking behind Barclays after entering in to a deed of postponement. Eventually the Sondhis experienced financial difficulties and were made bankrupt and Barclays repossessed and sold the property in February 2011 for £1.2m and AIB received £867,697.

The facts are not complicated, but again a little context is helpful. For many years now, the terms by which lenders and solicitors or licensed conveyancers have transacted their conveyancing business has been governed by the CML Handbook devised by the

[12] [1996] AC 421

Council of Mortgage Lenders. Money is transmitted to the solicitors who hold it on trust in their client account and generally only have authority to part with it in specified circumstances, typically completion of the transaction, which will generally involve the lender receiving an enforceable first legal charge by way of legal mortgage and all prior mortgages being discharged. The fact that the parties voluntarily assume a relationship of trustee and beneficiary is explicit in the provisions agreed, which included the critical obligation:

> You must hold the loan on trust for us until completion. If completion is delayed, you must return it to us when and how we tell you.

Any distinction to be drawn between delayed completion and a failure to complete is both unattractive and illogical. Prior to ascertaining that there has been a failure to complete, there will certainly have been what appeared to be a delayed completion. Also, had AIB learned of something which caused it to withdraw from the loan so that there would never be completion, the solicitors would have been obliged to return the money.

Further, there are the Solicitors' Account Rules, made under section 32 of the Solicitors Act 1974, which at the time of the transaction were the 1998 Rules (now the 2011 Rules). Payment of a sum out of the client account in breach of their client's instructions was a breach of Rule 22. Rule 7 provided:

> (1) Any breach of the rules must be remedied promptly upon discovery. This includes the replacement of any money improperly withheld or withdrawn from a client account.
>
> (2) In a private practice, the duty to remedy breaches rests not only on the person causing the breach, but also on all the principals in the practice. This duty extends to replacing missing client money or controlled trust money from the principals' own resources, even if the money has been misappropriated by an employee or fellow principal, and whether or not a claim is subsequently made on the Solicitors' Indemnity or Compensation Funds.

As was pointed out to me by a former pupil master of mine to whom I am indebted, in these days of telephonic and electronic communications, it is helpful when dealing with completion to consider the ambit of the solicitor's authority in a transaction such as this by reference to former practice. Traditionally, one might have expected to see on the part of the lender money passing across a table and simultaneously passing in the opposite direction, one would have seen the relevant security. The latter can now be in the form of an appropriate solicitors' undertaking or unconditional confirmation from the outgoing lender its charges will be discharged. In paying across any sum of their client's money without obtaining the necessary security, they acted in breach of trust, and the transaction never completed.

At first instance, His Honour Judge Cooke had considered that the breach of trust extended only to the £300,000 odd which was misapplied to the Sondhis rather than to Barclays, despite the absence of any security or acceptable undertaking in exchange. He said:

> It does not however in my judgment necessarily follow that the whole of the payment of £3.3m was made in breach of trust. The difference between what the defendant did and what it ought to have done if it had complied with its instructions was the £300,000 that should have been paid to Barclays but was instead paid to the borrowers. That in my judgment was the extent of the breach of trust committed….The breach consisted of the failure to retain an additional £300,000 and apply that to the discharge of the Barclays debt.

This was, perhaps unsurprisingly, successfully appealed by AIB. The Court of Appeal, accepted that completion required receipt of an appropriate undertaking prior to release of the funds. Despite the fact that this was not challenged by Mark Redler, this erroneous idea was not entirely vanquished. Both Lord Toulson and Lord Reed seem to have been attracted by the idea that the transaction completed 'commercially', albeit without AIB obtaining an essential element that they had bargained for, namely the first charge. Lord Browne-Wilkinson, with whose judgment the others agreed in the factually similar case of *Target Holdings v Redferns*[13] had said:

> I have no doubt that, until the underlying commercial transaction has been completed, the solicitor can be required to restore to client account moneys wrongly paid away.[14]

Although factually similar, the critical difference in *Target*, as we shall see in further detail below was that the transaction did fully complete and the lender obtained its security, albeit by an unexpected route. It was that sentence on which AIB apparently seized to support their argument and although therefore literally consistent with the *Target* decision, Lord Toulson described AIB's case as *"a dressed up attack on it"*, by which it appears he considered their submissions as an attack of the broader rationale. Considering Lord Browne-Wilkinson's words, Lord Toulson said:

[13] [1996] AC 421

[14] ibid at 436D

> When Lord Browne-Wilkinson spoke of completion he was talking about a commercial transaction. The solicitors did not "complete" the transaction in compliance with the requirements of the CML Handbook. But as a commercial matter the transaction was executed or "completed" when the loan moneys were released to the borrowers. At that moment the relationship between the borrowers and the bank became one of contractual borrower and lender, and that was a fait accompli. The Court of Appeal was right in the present case to understand and apply the reasoning in *Target Holdings* as it did[15].

Lord Reed, apparently acknowledging that AIB did not get what it bargained for, seemed attracted by the idea that it nonetheless got some security:

> If Redler had performed their trust, they would on completion have held a registrable first charge which secured a debt of £3.3m. In the event, on completion they held a second charge in respect of that debt….[16]

He also gave further life to the question of the extent of the breach of trust:

> …in my opinion all that was misapplied was the £309,000 which was paid to the Sondhis rather than Barclays. Since the Court of Appeal's decision to the contrary was not challenged, however, it is necessary to consider the appeal on the basis on which it was argued by both parties, namely that the breach of trust involved the misapplication of the entire £3.3m.[17]

Although *obiter*, one cannot help but think that another case in this area of law may reach the Supreme Court given the lower courts are now bound to apply an approach that has judicial support from the Supreme Court as being wrong.

On a traditional analysis, in the absence of the completion the parties had envisaged, Mark Redler was under a continuing obligation to hold the £3.3 million on trust for AIB and an obligation to repay when and how they were told. It is perhaps surprising to see the adoption of such a loose meaning of completion, seemingly as a result of the underlying commercial purpose of the transaction, despite the parties having expressly agreed the constituent parts of completion, that Mark Redler were to be held accountable as trustees and their breach of the statutory rules relating to the management of their client account.

[15] para 74

[16] para 139

[17] para 140

Although Lord Toulson correctly identified in AIB's argument the traditional analysis which gave rise to an equitable debt, he described it as 'literary costume' pre-dating 'equitable compensation'. Further, no claim had been made in common law for a debt and so no consideration was given to whether the claim could have been framed as one for the return of the money, as promised, where the transaction could not be completed.

A debt claim has considerable attraction for the reasons the learned authors of *Chitty* note:

> There is an important distinction between a claim for payment of a debt and a claim for damages for breach of contract. A debt is a definite sum of money fixed by the agreement of the parties as payable by one party in return for the performance of a specified obligation by the other party or on the occurrence of some specified event or condition; whereas, damages may be claimed from a party who has broken his primary contractual obligation in some way other than by failure to pay such a debt…. The relevance of this distinction is that rules on damages do not apply to a claim for a debt, e.g. the claimant who claims payment of a debt need not prove anything more than its performance or the occurrence of the event or condition; there is no need for it to prove any actual loss suffered by it as a result of the defendant's failure to pay; the whole concept of the remoteness of damage is therefore irrelevant; the law on penalties does not apply to the agreed sum; and the claimant's duty to mitigate its loss does not generally apply.[18]

Such a case may yet be argued, as lenders' lawyers turn to consider other ways of enhancing recovery for their clients and avoiding the difficulties of causation, contributory negligence and other rules on damages that beset many common law claims. The departure from a traditional analysis in claims brought in equity can only quicken such an attempt.

Target Holdings v Redferns

I have already referred to the earlier House of Lords decision in *Target*, which whilst superficially similar, was in fact different in the most important of respects. In that case Target loaned £1.525m to a purchaser and advanced that sum to the solicitors, Redferns, to be held on trust and paid away to the borrower only once a mortgage over the property (valued at £2m) had been obtained. Redferns paid away £1.49m before the mortgage was executed, but the lender did receive the security for which it had bargained. Later, the purchaser defaulted and Target sold the property for £500,000

[18] Chitty on Contracts 32nd edition at 21-041

and sought the difference from Redferns in equity only. Redferns denied that they had caused Target's loss, which they attributed to a fraudulent overvaluation and a string of undisclosed intervening sub-sales by related parties, which had the effect of escalating the purchase price to that disclosed to the lender. The transaction was described as *"redolent of fraud and negligence"*[19].

Target Holdings did not succeed. Lord Browne-Wilkinson acknowledged the historical approach, the liability of a trustee to restore the assets as if properly maintained by the trustee even if the immediate cause of the loss was the dishonesty or failure of a third party. On the facts of *Target* though, Lord Browne-Wilkinson rejected the traditional approach. The reason why he considered that the traditional approach should not apply was his concern that if performance were required of the trustees, it would render commercial arrangements useless in a modern world where the trust had become a valuable device in commercial dealings[20]. Lord Browne-Wilkinson therefore insisted that, in this commercial context, the claimant could only recover for losses which had been caused by Redferns' breach. This was in part because as this was a bare trust, the need to reconstitute the fund for the benefit of a class of beneficiaries was absent, and the loss suffered by the one beneficiary, namely the lender, as a result of the breach much less than the losses claimed. Controversially, he further considered that the equitable obligation arising from a breach of trust is to restore the fund to the position it would have been in but for the breach, thus introducing a requirement of causation to claims of this type.

After *Target Holdings*

The decision in *Target* was not universally welcomed and subject to much academic criticism. For example, the analysis did not appear to find favour in other cases such as *HMRC v Holland / Re Paycheck Services 3 Ltd*[21] in which the Court of Appeal and Supreme Court seem to have taken the view that a director would be under an obligation to restore to a company dividends wrongfully paid out on the basis that they owed trustee-like obligations to the company not to misapply its assets, which obligations justify the application of the traditional account in common form approach.

[19] *Target*, ibid at 432B

[20] ibid at 435G-H

[21] [2010] UKSC 51

There were also efforts to reconcile the *Target* decision with the traditional analysis. There have been various attempts, but I consider this to be the most cogent: Where a trustee has misapplied assets of the trust, the beneficiary is put to its election as to whether to accept the misapplication as an authorised disposition of the trust assets or not. A beneficiary does not have to complain of a breach of trust and where, for example, the misapplication is to an investment, whilst unauthorised, turns out to be profitable, he will not. If the misapplication is not accepted, the trustee is liable to restore the trust fund *in specie* or provide substitutive performance. If it is accepted, the beneficiary waives its right to substitutive performance and is limited to reparative compensation, which crucially *is* susceptible to proof of causation.

Lord Browne-Wilkinson had in *Target* noted that not all breaches of trust result in any remedy for the beneficiary:

> There can be cases where, although there is an undoubted breach of trust, the trustee is under no liability at all to a beneficiary. For example, if a trustee commits a breach of trust with the acquiescence of one beneficiary, that beneficiary has no right to complain.[22]

Despite having alighted on this thought, the foregoing explanation that Target waived its right to elect for substitutive performance having relied on the mortgage to exercise its power of sale was not adopted.

Had such an analysis been adopted, it would have been consistent with traditional principles whilst resulting in the same relief. Target may have done better not to accept the mortgage and instead rely upon a claim *in personam* against the trustees, together with a tracing claim which would no doubt have resulted in an equitable lien (by virtue of the misapplication of monies to the property) being established over the mortgage on the property.

[22] *Target*, ibid at 433G

Conclusions

I admit to some confusion, given the decision in *Target*, that Mark Redler did not take the step of discharging Barclays' loan for the relatively affordable sum of £300k odd. Had it done that which was required under the Solicitors' Account Rules and terms of the trust, namely replace the monies and seek instructions from AIB, it seems likely that AIB would have adopted the transaction and directed them to take that step of discharging Barclays' debt so as to obtain the security of first legal charge that it had required. No further claim could then have been brought against Mark Redler.

The result in *AIB v Redler* is not unattractive, even if the reasoning sits uncomfortably with the historical context for breach of trust claims. There are obvious reasons (absent fraud or similar which may give rise to different public policy decisions) to abhor the imposition on trustees of rules which make them liable for losses that their beneficiaries would have suffered even had the trustee performed its duties. No doubt the fact that AIB was plainly very keen to make the lending as it was connected to other commercial business, the fact that a sensible allocation of commercial risk is for the lender to suffer losses which relate to the commerciality of the transaction and the fact that the trust framework is coincidental to the contractual one, are all relevant considerations.

It is noteworthy that in essence, the form of relief that the Supreme Court thought fit for AIB was that which was consistent with what would have been obtained following an account on the footing of wilfull default, where the act complained of was a breach of trust, but authorised. This would give rise to a surcharged account, but one where causation would be relevant to the assessment of the reparative award that would be available.

Although Lord Toulson concentrated on the broader concept of completion in its non-technical sense when he referred to the relationship between the Sondhis and AIB as having become that of contractual borrower and lender, as a *fait accompli*, it is hard to see how the simple release of funds justifies his conclusions. A similar alternative analysis to that which I have set out in respect of *Target* may have been capable of deployment. Although in *Redler* the obligation to obtain the first legal charge was never completed, it may nonetheless be arguable that AIB waived its right to substitutive performance when it chose to negotiate with Barclays to obtain a second-ranking charge and enforce it whilst receiving repayments from the Sondhis, rather than demanding substitutive performance once aware of the breach of trust. The Supreme

Court could have reached the same result as they did, but in a way which was a good deal more consistent with the traditional approaches and they could have explained *Target* in a similar fashion.

It will certainly be interesting to see how matters develop as between England and Wales and the other commonwealth jurisdictions, which have often lead the way in equity, notably Australia, Canada and Hong Kong, especially given some decisions in those jurisdictions which seem at odds with *Redler*.

However, as matters stand, the effect of *Redler* is that the concept of an equitable debt has increasingly little, if any, application to trusts arising in a commercial framework and their lawyers will no doubt continue to seek alternative remedies which bring their clients' claims outside of the rules on damages which so often severely hamper their ability to recover. *Target* and *Redler* will provide guidance as to the circumstances in which a beneficiary looses the right to substitutive performance such that it is left with reparative compensation, which may depending on the facts still be more attractive than damages claims, given for example the absence of forseeability and the requirement to mitigate.

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