

What is the correct test for liability for those who receive assets dissipated in breach of trust?

The area of law under consideration comprises the personal liability of a third party to a trust who has received and misapplied trust property. Where they have retained the property, or its proceeds are traceable, the deprived beneficiary may have a *proprietary* remedy. Where the property has been dissipated, however, no proprietary remedy is available and the beneficiary's claim is in the law of obligation, as a right *in personam*. It is this head of liability with which we are concerned for current purposes. This area of law is most controversial, with Birks and Lord Nicholls advocating the approach that the Australian courts have recently adopted in *Say-Dee Pty Ltd v Farah Construction Pty Ltd*, that of strict liability for unjust enrichment. Conversely, the English courts and Professor Lionel Smith take the opposing view that fault is required where a third party receives and misapplies trust property.

The traditional view of the English courts requires fault in such cases, imposing constructive trusteeship upon the 'knowing recipient' if he is guilty in the eyes of equity. By this head of personal liability, once the requisite degree of fault has been found, the court has no relieving jurisdiction. The case law is confused on this matter; there is no unified body of jurisprudence determining the degree of fault required to give rise to the far-reaching personal obligations imposed by equity on the 'constructive trustee.' There are a number of reasons for this uncertainty, as noted by Lord Nicholls in 'Knowing Receipt: The Need for a New Landmark.' To summarise briefly, there are enormously varying circumstances in which this issue arises and it is most difficult to reconcile these. Furthermore, with no coherent body of underlying rationale how are the courts supposed to interpret each case, and in accordance with what rules? Another reason for the uncertainty in this area is the confusing use of terminology: the use of 'constructive trustee' is not used as it is in other areas of equity, and there is also a lack of consistency in the terms 'notice' and 'knowledge.' It is perhaps useful to

look, as a starting point, at the mischief which this area of law purports to remedy: “the receipt by a third party of property belonging to another in equity” (Nicholls). With this in mind, I turn to the recent legal developments (particularly in academia) that have occurred in this area, in attempt to reconcile them as a body of coherent law capable of being followed in the courts.

I speak first of the proprietary right of *vindicatio* if only to dismiss it. Where the misdirected trust property is either still in the possession of the third party, or there are traceable proceeds, the claimant may ask the court to declare that the defendant holds the goods on trust for him, asserting his proprietary right. I am dealing, however, with the liability of those who receive assets in breach of trust that have been *dissipated* and the sole test for liability can only regard personal rights. It shall be of importance later in this essay, however, that where property is non-consensually substituted the claimant has a proprietary claim to this substituted property (as per Lords Browne-Wilkinson and Millet in *Foskett v McKeown*). Lord Millet speaks of the “transmission of the claimant’s property rights from one asset to its traceable proceeds.” This arises by operation of law, upon an event which must be unjust enrichment (subject to contrary arguments by Swadling and others). Hence Professors Birks and Smith argue that this method of substitution allows for a species of unjust enrichment in relation to proprietary rights. This will become important for consistency between equitable and legal rights, but can be put aside for the time being.

How is liability then ascertained for those who receive assets that are *dissipated* in breach of trust? Under the present law of equity, fault is required for liability to be attached to a recipient of misapplied trust assets. This seems right, for there is a much longer reach by this personal head of liability, as opposed to *vindicatio* which depends on still having the property, or its traceable proceeds. On a closer analysis, however, this cannot be correct. The equitable wrong with which we are concerned here is the wrong of misapplication, the dominant aspect of this being conversion. Hence the requirement of ‘dishonesty’ (*Re Montagu*) is

stripped out, as this is a tort of strict liability. Furthermore, by the tort of conversion there is a choice whether the claim is measured in terms of compensation or restitution (*United Australia Ltd v Barclays Bank*); the gain-based 'restitution' measure being consistent with the unjust enrichment view. The correct view of 'knowing receipt' is therefore that there are two heads of liability: one based on the wrong-doing of the recipient and one based on unjust enrichment. This principle has been expounded by the New South Wales Court of Appeal ruling in *Say-Dee* and Lord Nicholls, endorsed and expanded by Professor Birks.

The first test of liability relies on fault. What degree of fault is required to satisfy this is however a matter of contention. In *Re Montagu* Megarry VC set the requisite level of fault at 'dishonesty'. This is viewed as a restrictive approach, however, with subsequent caselaw adopting a broader view, whereby 'actual or constructive notice' will suffice for establishing liability (Brightman J in *Karak Rubber Co Ltd v Burden*). In *BCCI v Akindele* the Court of Appeal held that for wrong-based liability it is sufficient if the defendant 'ought to have known'. The matter was not clearly addressed, however, and it was said to be a question of 'unconscionability'. This merely added to the inherent uncertainties of the wrong-based head of liability. The categories of 'dishonest' and 'careless' recipients are merged and it is unclear whether the 'careless' recipient will be personally liable or not. Were the second head of liability, unjust enrichment, embraced by the English courts, this fault-based test would gain a greater level of certainty, as shall be discussed. The need for clarity in the category of 'careless' recipient would also be addressed by the fact that they would be liable under unjust enrichment, but not to the same extent as onerous duties imposed by fault-based liability.

Unjust enrichment has already been embraced in other areas of related law and a similar extension to equity not so out of the question. The principle expounded in *Re Diplock* focuses the restitutionary principle differently, seeking to identify an

unjust gain and restore the parties to their original positions (as far as this can be achieved). Moreover, the unjust enrichment head of liability has already been adopted in the common law of 'knowing recipients' in *Lipkin Gorman*. This necessarily involves strict liability, albeit of a fragile nature, but this is justified for the following reason. The principle of unjust enrichment is about relocating gains; no-one is asking the defendant to bear a loss. This is because of the defence of 'change of position' (hence the fragile nature of the strict liability). Smith has rejected the notion of strict liability in equity. Despite caselaw appearing to be on his side and, with all due respect, this cannot be right. Smith's argument is that the owner of equitable title has no personal claim in unjust enrichment, but why should equitable owners have worse protection than legal owners? The suggestion that equitable ownership is some second-class form of ownership has the potential to distort and obstruct the development of new market mechanisms, relying heavily on the law of trusts.

Smith appears to have caselaw, particularly *Akindele* on his side, however, but this can be addressed in the following way. First, *Akindele* failed to make a distinction between wrong-based liability and liability based on unjust enrichment. Secondly, even if the claim were based on unjust enrichment, it would have failed as the defence of bona fide purchaser would have applied. Furthermore, it cannot be decisive that there are virtually no cases allowing unjust enrichment of the *Lipkin Gorman* type to equitable owners. The first reason for this is that the law of unjust enrichment has only recently come to light and begun to develop principles and rationale. Another reason is that it is no longer acceptable to refuse to take account of common law cases when establishing equitable principles; if unjust enrichment is allowed in common law, it must also apply to equity. The third reason is the principle expounded in *Re Diplock*: those entitled under will or intestacy now have a claim of the *Lipkin Gorman* type. Misdirectees will be personally liable, regardless of fault, in accordance with the principles of unjust enrichment. This must now be extended to the law of recipient liability.

As aforementioned, the Australian courts seem to have adopted the approach advocated by Lord Nicholls and Professor Birks in *Say-Dee*, recognising that “liability for unauthorised receipt of trust property is strict (subject to defences) and part of the law of unjust enrichment” (Edelman, 2006). Why have two heads of liability, then, as suggested by Nicholls and Birks? The reason for this is that where the test of liability requires ‘fault’ the onerous burdens of constructive trusteeship will be placed upon the recipient, perhaps a little harsh for the ‘careless’ recipient. In attributing strict liability for unjust enrichment, the liability would be purely restitutionary and would not unjustifiably overburden the defendant. For the ‘dishonest recipient’, in contrast, the restitutionary approach seems too lenient and it is desirable to maintain the wrong-based head of liability for this category of defendant. As a matter of consistency it also seems correct that this approach is adopted, in order that equity is not demoted to a second-class form of ownership. In terms of approaching the uncertain issue of ‘fault’ the *Re Montagu* requirement of ‘dishonesty’ would be the most beneficial and appropriate degree bearing in mind the category of recipient caught by the strict liability unjust enrichment head of liability. The criticism of strict liability centred on commercial uncertainty is met by the defences available in the form of ‘change of position’ and ‘bona fide purchaser for value without notice’.

Outlined above is what I see to be the correct test of liability for those who receive assets dissipated in breach of trust, in agreement with a large body of academic writing on this subject. Whether or not the House of Lords will address the matter in such a way when it comes before them remains to be seen.