Causation in Equitable Compensation

Case Comment

Aleksi Ollikainen

Subject: Trusts. Other related subjects: Equitable compensation.
Keywords: Breach of trust, equitable compensation, trustees’ liability

Case: AIB Group (UK) Plc v Mark Redler & Co (A Firm) [2014] UKSC 58

Introduction

AIB Group (UK) Plc v Mark Redler & Co (A Firm) [2014] UKSC provided the Supreme Court with a welcome opportunity to introduce a much-needed measure of sophistication into the law regarding the measure of liability for breach of trust and equitable compensation. The law has been in some turmoil after the decision in Target Holdings Ltd v Redfem [1996] AC 421 (HL), where a claim to have the trust fund reconstituted after an admitted breach of trust was limited to the extent of the claimant’s actual loss. Regrettably this opportunity was missed, and further confusion has been introduced into the law by muddling the chains of causation in equitable compensation.

Facts and Issues of AIB

In AIB v Mark Redler, the claimant bank AIB (appellant) paid £3.3m to the defendant solicitors, Mark Redler & Co (respondent), as a remortgage advance on the security of the borrowers’ home, at the time of the advance in 2006 being valued at £4.25m. The claimant instructed the defendant to redeem an existing mortgage in favour of Barclays Bank out of the advance, and to obtain first charge on the property. The defendant solicitors negligently failed to redeem the entire Barclays mortgage and released the monies held on trust prematurely. The claimant then negotiated with Barclays directly for the relaxation of Barclays’ covenant against further charges on the property. Having obtained the relaxation AIB then registered a second charge with substantial delay to the original schedule of the transaction. The defendant did not challenge the Court of Appeal’s finding that its release of the £3.3m without obtaining a first charge was in breach of trust.

The borrowers defaulted, and eventually were bankrupted. Following a collapse in the real estate market, the appellant sold the property in 2011 for only £1.2m, paid off the remainder of Barclays’ first charge and was left with a sum of £867,697. Lord Toulson states the amount of the appellants’ claim to be £2.5m in round figures, representing the difference between the amount recovered in sales proceeds and what
was paid out of the trust fund (para 8). The respondent solicitors argued that the extent of their liability should be just £273,777.42 plus interest, as it represents the total amount the appellant would have been better off had the first charge been duly obtained.

The only issue in the case therefore was the nature and extent of the remedy for the defendant’s breach of trust. Judgments were given by Lord Toulson and Lord Reed, both dismissing the claimant’s appeal to have the trust fund reconstituted.

Judgments

Lord Toulson, after stating the facts and discussing relevant case law stated the general principle to be that ‘the basic right of a beneficiary is to have the trust fund duly administered in accordance with the provisions of the trust instrument, if any, and 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 vest in the beneficiary any profit which the trustee may have made by reason of the breach’, but continued that ‘a monetary award which reflected neither loss caused nor profit gained by the wrongdoer would be penal’ (para 64). His Lordship then concentrated on the loss caused to the appellant in paras 65 and 66, stating that it would be ‘an artificial and unrealistic view’ to treat the trust fund as having lost £2.5m as a result of the solicitors conduct when most of that sum would have been lost if the solicitors had performed their duty, and that ‘as the beneficiary is entitled to have the trust properly administered, so he is entitled to have made good any loss suffered by reason of a breach of the duty’.

In para 70 his Lordship argues that ‘a commercial trust differs from a typical traditional trust in that it arises out of contract rather than the transfer of property by way of gift.’ Interpreting Lord Browne-Wilkinson’s dicta in Target Holdings, Lord Toulson states that although the principles of equity are no different for different types of trust, the purpose of a trust may have an effect on the appropriate relief for breach (para 70) and that the entire commercial transaction including its contractual roots and its ultimate purpose are to be taken into account when assessing the situation (paras 71-74). His Lordship holds that in Target the ‘proper performance of the trustee’s obligations to the beneficiary would have produced the same result’ (para 70), a statement which can be said to lie at the heart of Lord Toulson’s judgment in this case.

The ultimate purpose of the trust in AIB was to obtain security in the borrowers’ property, and security was eventually obtained, albeit it was worth less than the initially contemplated first charge. As in AIB the proper performance of the trustee’s obligations would only have made the appellant approximately £275,000 (plus interest) better off, that was to be the amount of recovery.

1 The bank also recovered from the borrowers a total of £531,219.71 in interest payments. The appellant in fact sought to recover from the respondent the difference between the amount wrongfully paid away and the total sums recovered, namely some 1.9m.
Lord Reed’s judgment proceeds on a more delicate theoretical basis. First, his Lordship states that a distinction is to be drawn between the concepts of liability and remedy in paras 90 and 91, but does not explicitly explain the difference or its relevance. His Lordship appears to start from the premise that ‘a breach of trust involving the misapplication of trust property can be remedied by means of proceedings designed to secure the performance of the trust’. The trustee must restore the trust to the position it would have been in ‘but for the breach’, either by restoring the trust assets in specie or by an equivalent pecuniary compensation (para 90).

Secondly (paras 92-93), by analogy to the different damages rules in different torts, Lord Reed draws the conclusion that the rules appropriate for a breach of duty by a trustee are to be determined by reference to the characteristics of the obligation being breached. A negligent defendant must compensate for the reasonably foreseeable loss caused by his negligent conduct. According to Lord Reed this is because reasonable foreseeability is part of the rationality of the tort of negligence. By contrast, a defendant committing deceit must compensate for all losses flowing from that deceit. His Lordship holds that as reasonable foreseeability does not enter into the wrong of deceit, it should not limit the liability the defendant comes under. According to Lord Reed, this same approach applies to contracts, torts and equity.

Thirdly, this analysis brings his Lordship to the following conclusion (in para 93). As compensation for breach of an obligation, be it in tort, contract or equity, seeks to place the claimant in the position he would have been in had the obligation been performed, equitable compensation aims to provide ‘the pecuniary equivalent of the performance of the trust’. As his Lordship later concluded, the important focus is on the nature of the parties’ relationship and the nature of their obligations, which is the reasoned basis for maintaining historical differences between law and equity (paras 136-138).

His Lordship then commented in some length on the decision in Target Holdings, noting in para 114 that its result was correct as the deficiency in performance of the trust was remedied when the trustee obtained, albeit with some delay, the charges on the property which he ought to have had before releasing the trust moneys. At that stage ‘[t]here was nothing missing from the trust fund, and therefore no basis for a claim of restoration’, and on the same basis no basis for equitable compensation. To establish a successful claim, the loss claimed for ‘must be caused by the breach of trust, in the sense that it must flow directly from it. Losses resulting from an unreasonable behaviour by the claimant will be adjudged to flow from that behaviour (…’) (para 135).

As to applying these conclusions to the case at hand, Lord Reed in para 140 pointed out three fallacies in the appellant bank’s case: first, it assumes that the entire £3.3m was misapplied whereas in his Lordship’s opinion only the £309,000 which was paid to the borrowers rather than to discharge the Barclays charge was paid in breach of trust. This was also the conclusion of the trial judge, His Honour Judge Cooke ([2012] EWHC 35 (Ch), para 24): ‘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.’ However, as the finding of the Court of Appeal that the entire £3.3m was paid in breach of trust was unchallenged in the Supreme Court, Lord Reed reluctantly accepted it as a premise.

The second fallacy according to Lord Reed is that the appellant bank’s case assumes that liability is to be fixed at the date of the breach of trust, a notion rejected in
Target. The third fallacy is in the appellant’s case is that it assumes liability does not depend on the causal link between the breach of trust and the loss: AIB accepted the security it received, which later proved to be hopelessly inadequate. The only loss attributable to Redler's breach of trust was the difference in value of the security contemplated initially and the security actually obtained – the appeal failed.

Discussion

It is with some regret submitted that the case represents a missed opportunity to bring structural clarity and sophistication into the law regarding equitable compensation. Instead of concentrating on ill-defined notions of the commercial purpose of the trust or the nature of the parties’ obligations which give very little concrete guidance to first instance judges deciding similar cases, the case had all the elements for the Supreme Court finally to establish a clear structural difference between equitable compensation and common law damages, putting to rest the controversy surrounding Target.

It is submitted that the appropriate way to deal with the case would have been to concentrate on the difference between the relevant causative events between law and equity. By instead concentrating on the commercial purpose of the whole transaction, of which the trust was but a part, the Supreme Court allowed for actions external to the governance of the trust with no causal connection to the breach to determine the amount of equitable compensation, and thus steered the law away from its central principle: that the trust is to be brought into the position it would have been in but for the breach.

The basic reason for this is the court confuses breach with loss. As we know, ‘[t]here is no equitable by-pass of the need to establish causation’ (Mummery LJ in Swindle v Harrison [1997] 4 All ER 705 at 733-34). There is, however a difference between equity and common law as to what event is to be considered causally relevant.

This is because the primary obligation of a trustee is to account for his stewardship, and the primary remedy of the beneficiary “is to have the account taken, to surcharge and falsify the account, and to require the trustee to restore to the trust estate any deficiency (…)” (Sir Peter Millett in ‘Equity’s Place in the Law of Commerce’ (1998) 114 LQR 214, 225). As Lord Toulson correctly notes, the basic rule is that the beneficiary’s right is to have the trust ‘duly administered’, and equitable compensation seeks to put the trust in the position it would have been in ‘but for the breach’.

In contract law, for instance, the principle is different. As Lord Diplock noted in Photo Production v Securicor [1980] AC 827 at 848-50, a contracting party is under a primary obligation to perform his contract, and a breach of such primary obligation gives rise to a secondary obligation to pay damages (and let us not forget, that the rule that damages are to put the party who sustains a loss by reason of a breach of contract in the position he would have been in had the contract been performed, is a ‘rule of common law’, per Parke B in Robinson v Harman (1848) 1 Exch 850, 855). In other words, under the common law rule of damages it is the loss as a result of the breach that is eradicated, as common law contract damages seek to treat the contract as having been performed. In equity it is the breach of trust itself that is being eradicated, by having the trust ‘duly administered’.
We see here, then, that common law causation actually operates on the loss – as a general rule, if there is no loss, there is no recovery. There being a breach is a necessary prerequisite for the claimant’s right to bring a claim, but where no loss is caused by the breach the damages will be nominal – the loss is the relevant causative event for substantial recovery (though it is the breach of right that gives rise to the claim). Causation in equitable compensation, on the other hand, operates on the breach, as exemplified in the beneficiary’s power to falsify and surcharge accounts. Where the claimant chooses to falsify an unauthorised disbursement of trust assets, he in effect is asking ‘(…) for the disbursement to be disallowed. This will produce a deficit which the defendant must make good, either in specie or in money.’ (Lord Millett in the Hong Kong Court of Final Appeal in *Libertarian Investments v Hall* [2013] HKCFA 93, para 168, a case cited with approval in *AIB*.)

It is, of course, absolutely open to the beneficiary to falsify an account which not only causes no loss but is profitable. To illustrate, let us assume that a trust deed prohibits investment of trust capital on tobacco companies. This is to reflect the beneficiary’s strong ethical views against use of tobacco. If the trustee invests in such companies profitably but in breach of trust, the beneficiaries are within their rights to falsify those investments and demand the trust assets to be reconstituted. The claimant beneficiary therefore has the power to ask the court to treat the breach as never having occurred – no reference to any loss caused to the trust fund need be made, and the claimant still recovers in equitable compensation where the trust assets cannot be returned in specie. This was the basis upon which the Australian High Court unanimously distinguished *Target Holdings v Youyang Pty Ltd v Minter Ellison Morris Fletcher* [2003] HCA 15, para 69: ‘The trust moneys were lost when paid out in breach of trust. That is the injuria with which equity is concerned, not the failure of the investment transaction.’

The court in *AIB* repeatedly states that the basic position is that the trust is to be brought back to the position it would have been in but for the breach. Regrettably this is always followed by an analysis of how to bring the claimant to the position but for the loss. It is submitted this confusion of the two concepts is because of a related confusion as regards performance versus due administration.

The way the courts approach the basic proposition of ‘but for the breach’ is to treat the trust as having been performed. But performance and due administration (or lack of breach) are different. If a trustee holds money for the beneficiary to be paid over to him when Prince George becomes king, the trust is performed when that event occurs. If the trustee misappropriates the money today, he has committed a breach of trust. The correct rule to deal with this situation is not to treat the trust as having been performed, but to bring the trust back into the position it would have been in but for the breach. To confuse these two in that case would be an obvious flaw, and to treat the trust as performed would vest in the beneficiary something that he currently has no right to possess.

In the case where the trust has come to an end the flaw is more insidious. To talk of performance rather than non-breach or due administration directs the court to look at loss, as it invites the court to compare the current situation at the time of trial with the situation of the performed trust. But the current situation may have been affected by intervening causes. The flaw of this approach is visible in *AIB* itself.

In *AIB* the breach could have caused the loss of the entire trust fund, but there was an intervening act by a third party which prevented it. *AIB* negotiated with Barclays directly, and release of the covenant against subsequent charges was completely up to
Barclays’ decision. Had it not released this covenant, AIB would not have obtained any security in the property, its entire mortgage advance would have been lost (subject to a possible claim of subrogation to Barclays’ position – see below) and it would have had to claw back its advance in claims of unjust enrichment against the borrowers and Barclays. If at that stage the borrowers had been insolvent, most of the advance would have been completely irrecoverable. It therefore seems that an action by a third party – Barclays’ release of its covenant – was allowed to reduce the amount of recovery by the claimant, because the court concentrated on ‘loss’ rather than ‘but for breach’. The amount of loss can be affected by intervening causes. The breach or its affirmation or eradication can only be affected by the parties internal to the transaction, AIB or its trustee-solicitor.

To put the law on equitable compensation into the language of causation, AIB on its facts gives rise to three distinct types of case, which when appreciated together would have articulated the a sophisticated and principled approach in this area of law. In the first case, there is no breach of trust and thus no equitable compensation; there is no relevant causative event present. In the second, there is a breach of trust (causative event) but this breach is later rectified in some way by the trustee, partially or fully, or affirmed by the beneficiary through surcharge of the account given, serving as an intervening cause. In the third, there is a breach of trust and it is not rectified or affirmed, giving rise to equitable compensation in full.

This is because of a fortunate peculiarity in the facts of AIB, which meant the Supreme Court were not forced into a choice of whether to overrule Target. In Target, Lord Browne-Wilkinson (at 436) stated that there is ‘no doubt that, until the underlying commercial transaction has been completed, the solicitor can be required to restore to the client account moneys wrongly paid away. But to import into such trust an obligation to restore the trust fund once the transaction has been completed would be entirely artificial.’ In AIB, unlike in Target, the solicitor-trustee never actually completed the transaction it was instructed to do, namely to obtain the first (or indeed any) charge on the property. In Nationwide Building Society v Davisons Solicitors [2012] EWCA Civ 1626, para 40, Sir Andrew Morritt C stated that “the trust imposed on the loan moneys in the hands of Davisons (...) could only be discharged by completion of the purchase or return of the money”. The trust imposed on the loan moneys held by Mark Redler has not been discharged – the purchase as contemplated was never completed, and thus the only way to discharge the obligations of the trustee is to pay back the moneys paid out in breach of trust. That is the only course of action which eradicates the breach.

Lord Browne-Wilkinson in Target seems to be sensitive to this, as his Lordship holds there to be a relevant factual difference between the cases where the transaction is not completed (where the solicitor is liable to reconstitute the trust assets in full) and cases where the transaction is completed albeit there is a breach of trust present initially. In light of this factual difference, Target it is to be read as creating an intermediate class in the causation analysis of equitable compensation, where a causative event (breach of trust) is present but it is rectified by the trustee’s subsequent actions. Only a case like AIB could have provided this clarification, as the breach in that case was not rectified by the trustee (who never completed the transaction) but another transaction was entered into by the appellant and a third party.

None of this is to suggest the end result of AIB is necessarily wrong, if Target is accepted (as the court reaffirmed in AIB). It is submitted that Lord Reed, in following His Honour Judge Cooke’s analysis, is potentially correct in pointing out that the extent of the breach is only the money that should have been paid to Barclays but was paid
instead to the borrowers. It is to be regretted that this point was not subject to a full discussion in his Lordship’s judgment, though some possible analyses are considered below.

*Target* allows for the extent of the trustee’s breach to be limited by his subsequent actions. In *Target* this meant the whole eradication of the breach by eventually registering the charges required. In *AIB* this principle could have potentially been used to establish the money paid to Barclays as the extent of the breach. Though the solicitor-trustees never managed to register the first charge, they did pay off most of the debt owed by the borrower to Barclays using trust moneys – the claimant bank would have been subrogated to the position of Barclays, obtaining security in the property. This could then have been taken to partially rectify the trustee’s breach under *Target*, leaving the extent of the trustee’s breach to be exactly what the claimant was ordered. Alternatively, AIB could have been treated as having affirmed the breach (surcharged the account) to the extent of the money paid to Barclays by entering into negotiations with Barclays and registering the second charge without the help of the trustee. To put the trust in the position but for that breach under these analyses would have been equal to the amount ordered in compensation. However, as noted by Lord Reed at para 140, the case is to be considered on the basis upon which it was argued, and the Court of Appeal’s finding that the entire £3.3m was paid in breach of trust without any subsequent qualification was not challenged. This is a tragic feature of the case.

The case represents a missed opportunity to bring clarity into the law of compensation by pointing out the structural difference between common law damages and equitable compensation as regards causation. What we now must go by is the nature of the parties’ relationship or their obligation, or the commercial purpose of the trust, neither of which are satisfactorily clear-cut in their definitions. It is possible that *AIB v Mark Redler* will further muddy the waters left behind after *Target Holdings v Redferns*, and lead to a fundamental confusion between damages in law and equitable compensation by introducing into trust law considerations that should not matter – that the trust is commercial in nature and that the parties owe common law obligations to each other. Only time will tell how the lower courts apply these principles. Had the Supreme Court concentrated on the different causative elements of law and equity, the case could have been decided with structural clarity and without offending the basic principles of trust law – that the trustee is to account for his stewardship.