How can you push the boundaries of the law of obligations to your client's advantage by stitching and unstitching equity and the common law?

Michael Pooles QC

Those of us who practice in the area of professional indemnity claims have long been aware of the importance of addressing claims and remedies in both equity and common law in this area. 25 years ago there was a very clearly defined distinction between claims against professional people arising out of “Chancery” issues which would be brought in the eponymous court and those arising out of commercial or common law issues which would not. Increasingly however practitioners would move from one area to the other without comment or surprise. This has now become so commonplace that within the specialty the distinction between equity and common law practitioners has all but disappeared and with it much of the rationale between choosing one court over another. The days have long since passed when a distinguished common lawyer, Thesiger LJ, could say, “if the judgement of Lord Justice Bramwell is looked at in that case, it will appear that even to the mind of a Common Law Judge the principles of law which have been applied now and for some time in Equity had been made perfectly plain": *Re Hallet's estate* (1879).

Nevertheless identifying the broader picture has remained, and remains, important. I will turn below to a number of areas in which equitable solutions can provide different, and potentially advantageous, outcomes but before doing so I would bring your attention to the recent speech by Lord Neuberger to the Singapore Conference on Protecting Business and Economic Interests (19 August 2016) in which he addressed a very closely related issue, indeed what might be described as the other side of this same coin, namely whether judges should decide tort cases by applying well-established principles to the facts of those cases, or whether they should decide such cases by reference to what they see as the appropriate policy considerations as applied to those particular facts. Adapting the words of the ancient Equity author, Selden, his Lordship appears to have been asking whether cases in tort should also be determined by reference to the length of the Lord Chancellor's foot.

Any speech by Lord Neuberger repays careful consideration. This one is of particular importance for, in a masterly and comprehensive review of a number of difficult areas, he clearly expresses the opinion that the suggestion that principle rather than policy can be applied to cases in tort may provide a dangerous guide to judges, lawyers and litigants. He suggests that, whilst certainty and clarity is important to the legal system there are real risks in developing “principles” in the field of torts as they may not infrequently “operate to mislead rather than to help”. Indeed, he suggests that there is a strong argument that, in some areas at least, it may be more helpful to abandon principle altogether and to accept that what is determinative is policy. He accepts that this may appear less reliable than principle in indicating a specific outcome in a specific case but that such an appearance of established consistency may itself be misleading to all involved.

Thus, the historic and fundamental asserted distinction between Equity and Common Law which provided that Equity would make a good the deficiencies of common law may well be a distinction which is now wholly lacking both as a principle and as a policy. There are a number of areas in which common lawyers are familiar with the difficulty in distinguishing which of a variety of principles is applicable to a particular set of facts, for example when dealing with issues relating to causation, remoteness or contributory negligence in a given set of circumstances. It may well be that a similar difficulty in distinguishing between Equity and Common Law and the remedies provided thereby is just around the corner.

Nevertheless the presently remain a number of areas where the distinctions between the two historic systems can provide advantages to litigants

LIMITATION

One of the obvious areas where there still appear to be differences and potential advantages to a claim in advancing a claim in Equity is found in the law of limitation. We are all familiar with the numerous difficulties presented by the Limitation Act 1980. Section 21(1) is an important provision but one which is not entirely straightforward to apply and is often overlooked or indeed misinterpreted by practitioners. Section 21(1)(a) provides that there is no limitation period for a claim brought by a beneficiary of a trust in respect of any fraud or fraudulent breach of trust to which the trustee was a party or privy or in order to recover from the trustee trust property or the proceeds of trust property.

Confronted with cases arising out of fraud many parties tend to concentrate upon section 32 of the 1980 Act which is of course not limited to trustees. However, there is no conflict between section 32 and section 21 because section 32 only applies where a limitation period is prescribed by the Act and section 21 expressly provides that there is <u>no</u> limitation period in respect of the cases for which it caters.

It is important to bear in mind that section 21 may not apply in respect of a constructive trustee whose constructive trust is created by the receipt of property: see *Kleanthous v Paphitis* [2011] EWHC 2287 (CH). However it is certainly applicable in respect of a trustee relationship which predates the receipt of property and it is immediately apparent that a solicitor receiving client funds does so in the capacity as trustee and there are a number of other professional men in respect of whom a similar assertion may be made. Whilst it cannot be said to be of universal application, in cases in which limitation may be an issue in a professional indemnity claim investigating whether a trustee relationship can be asserted and accordingly that section 21 provides a “get out of jail free” card may well provide a very valuable answer.

CAUSATION AND LOSS

Causation is frequently a difficult issue in the context of a professional indemnity claim. However, the difficulties which confront a claimant in the context of a claim in negligence may be avoided if the claim can be formulated for example as a breach of fiduciary duty. This is most tellingly illustrated by the decision of the House of Lords in *Hilton v Barker Booth & Eastwood* [2005] UKHL 8. It will be recalled that in that case the defendant solicitors had acted for client B in criminal proceedings in which he was sentenced to a term of imprisonment for fraudulent trading and became bankrupt. A few months after his release B approached a developer, A, with a proposal for a development scheme. Subsequently meetings took place at the solicitors' offices between the solicitor, A and B at which the proposal was discussed.

Eventually formal contracts were entered between A and B for the construction and sale of a number of flats. The contracts had been drafted by the solicitors on the joint instructions of the parties. In fact B had agreed a simultaneous sub-sale. In the event the whole scheme was disastrous when B failed to complete. A then sued the solicitors alleging a breach of fiduciary duty in that they failed to inform him of their knowledge concerning B's history.

In the House of Lords it was contended that damages on the basis of the claimant's actual loss were not recoverable from the solicitors because' had they acted in compliance with their obligations they would not have informed A of B's history but would rather have declined to act whereupon A would have gone to new solicitors who would have been unaware of B's history. The House of Lords rejected this assertion. There was an ongoing breach of fiduciary duty and, although the assessment of damages was remitted, it is clear that the House considered that there was no break in any chain of causation.

There will only be a bar to compensation in such a breach of fiduciary duty if it is clear that the claimant would have acted in the same way even if the fiduciary had disclosed all of the material facts: see *Gwembe Valley Development Co Ltd v Kosk*y [2003] EWCA civ 1478.

A like approach to that taken in *Hilton* was taken as long ago as the decision in *Nocton v Ashburton* [1914] AC 932. Being a case of breach of fiduciary duty, the House of Lords made it clear that the claimant's remedy was not limited by the existence of an entitlement to damages for breach of contract but that the court of Equity could direct accounts to be taken which extended further and were not necessarily limited to compensation and could extend to disgorging profits or otherwise restoring the loser to his prior position and depriving the fiduciary of any wrongful benefit. In some such cases it is clear that the claimant can actually recover more than he has lost.

In addition, a breach of fiduciary duty may open up the opportunity to pursue proprietary claims. A claimant who can show that he has a proprietary interest in an asset in the defendant's hands can obtain priority over the defendant's other unsecured creditors and may even be able to trace it into the hands of a third-party. The law in this area was the subject of significant uncertainty for a number of years following the decision of the Court of Appeal in *Sinclair Investments UK Ltd v Versailles Trade Finance Ltd* [2011] EWCA civ 347 that has been resolved by the decision of the Supreme Court in *SHR European Ventures LLP v Cedar Capital Partners LLC* [2014] UKSC 45. In that case the defendant had acted as an agent for a purchaser and had taken a secret commission from the vendor. This secret commission was held on constructive trust and was the subject of a proprietary claim as well as a personal claim for the sum received. The claimant was therefore entitled to the bribe and would be entitled to any profits which had accrued from the use of that money. He is also secured and would therefore have an advantageous position in the event of the insolvency of the defendant. This enforcement advantage is frequently overlooked.

It is important to bear in mind however that fiduciary obligations are not universal. Indeed, whilst it is possible to identify a number of relationships which the court will consider as fiduciary, it is remarkably difficult to find a robust definition or test for determining the existence of a fiduciary relationship. However, professional relationships, agency, company directorship and partnership are well-established examples and other instances have been found in senior management, and the relationship between a member of the security services and the Crown. The list is clearly not closed.

Of course, the existence of a fiduciary relationship in general will not always provide access to a fiduciary remedy. Professionals may owe fiduciary duties but that does not mean that any duty of which they are in breach is a duty owed as a fiduciary: see *Target Holdings Ltd v Redferns* [1996] 1 AC 421. It is also necessary to bear in mind that, albeit in a small minority of cases, remedies of this type may provide a trustee with the statutory defence under section 61 of the Trustee Act 1925. *Target* also demonstrates that, in some cases at least the court, accepting that the common law rules of remoteness and causation do not apply to equity, nevertheless applies an approach defined by the contractual relationship between the parties and assessing losses so as to lead to the same result which would have existed at common law.

I would suggest that, perhaps consistent with Lord Neuberger's recent speech, what one is in fact dealing with in this area is also an approach which is defined by policy rather than reason. A solicitor is a trustee. However, his relationship with the client is normally defined by the contract of retainer. Some retainers will appear to be strictly commercial relationships others will be founded upon a relationship which is viewed in a consumer context. In future, policy considerations may well expressly factor in such distinctions. Already, policy considerations may be discerned. In the case of a claim which is one of non-deliberate fault the court in *Target wa*s minded to approach the equitable claim in a similar fashion to the contractual claim. On the other hand, where there is a deliberate breach of obligation, a strict breach of trustee remedy is more attractive to the court and in a case in which the solicitor has placed himself in a conflict of interest for personal profit the remedies available for breach of fiduciary duty including disgorging profits are more attractive to the court. The policy appears to be one in which it is increasingly the disposition of the court to measure the ambit of the defendant’s financial exposure by reference to the degree of moral culpability rather than by reference to the title given to the particular cause of action.

I would therefore suggest that this is perhaps another area where the emergence of “policy” as an acknowledged determining factor is becoming apparent, particularly with the increasing emergence of the concept of proportionality being applied to questions of compensation. The most striking recent example is the decision of the Supreme Court in *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC. This is the Supreme Court’s latest word on penalty clauses in damages. The defendant had sold 47% of his shares in a company to the Claimant which had thus acquired a total stake of 60%. The Defendant had entered restrictive covenants in the agreement and thereby bound himself not to compete with the business and to a provision providing that such competition would disentitle him to his later instalments in the sale contract price. In breach of the competition provision the defendant did compete and the question for the court was whether or not the provisions constituted penalty clauses and were thus unenforceable. The Supreme

Court concluded, in the words of Lord Neuberger, that the key question was not one of genuine pre-estimation of loss (the traditional test for an enforceable penalty clause) but rather “whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation”. The Court concluded that the clauses providing for non-competition and the consequences of a breach thereof were primary obligations under the contract and not secondary provisions; and that they could not be treated as invalid without rewriting the contract as a whole, which was not a matter properly for a court. It was clear that the claimants were entitled to protect the goodwill which they were purchasing and this was a legitimate interest which the court would recognise and uphold. The provisions were certainly likely to act as a deterrent to any breach of contract but would only be considered to be invalid if the object thereof was to punish rather than the maintenance of a legitimate commercial object. This is patently a substantial rewrite of long established law by reference to clear policy considerations. It appears to be a fusion of the traditional approaches of the Courts of Law and of Equity.

<u>CONTRIBUTORY NEGLIGENCE</u>

Another attraction of claims in Equity is the inability of the party responsible for the breach of fiduciary duty, as the law presently stands, to assert contributory fault in order to reduce the compensatory award. This is certainly the case in respect of conscious disloyalty: See *Nationwide Building Society v Balmer Radmore* [1999] Lloyds Rep PN 241. It has been assumed to date, albeit with limited judicial debate, that this approach is to be taken in respect of all breaches of fiduciary duty: see *De Beer v Kanaar* [2002] EWHC 688 (Ch).

However this does not mean that the court wholly disregards the claimant's conduct and it has recognised that a principal with notice of a breach of fiduciary duty must act reasonably in the light of that knowledge thereafter and will <u>not</u> be able to recover losses consequent upon unreasonable conduct. I would suggest that, although the absence of contributory fault in general continues to provide an attraction to a would-be claimant to investigate very carefully the possibility of the claim in breach of fiduciary duty it should be appreciated that this is another area where a more case-by-case policy approach to judicial decision-making could lead to a significant review of the law in this area.

It is sometimes suggested that it is difficult to identify circumstances in which contributory fault would be a relevant consideration in a case of breach of fiduciary duty but I would suggest that this is an oversimplification. Of course, it seems offensive for the thief to assert that the victim should be considered partially at fault so as to limit recovery. However, change the facts very slightly. If the defendant is the employer of the bookkeeper supplied to a solicitor's practice who utilised the opportunities to steal money but was not detected for an extended period due to the solicitors' failure to comply with their professional obligations to reconcile their accounts, the position seems far less black-and-white. The defendants are vicariously liable for the conduct of their servant. They were not in any way personally at fault. The claimants were in breach of their professional obligations compliance with which would have abbreviated the opportunity to steal. Why is it in anyway offensive for the principles of contributory fault to be applied in such a case either for a claim in Common Law or in Equity?

This is clearly an area which is developing at a time when the higher courts seem open to innovation. It is not a universal panacea but can be useful both to claimants and in appropriate cases to defendants in recovery or contribution actions.

September 2016