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## **The Jersey Law Review – June 2006**

### **FRAUD, FAULT AND FIDUCIARY LIABILITY<sup>1</sup>**

**Robert Walker**

1 I want to talk about two topics of considerable interest to academic lawyers, but of even greater interest (I dare say) to lawyers, accountants, bankers and others concerned with the provision of financial services and the administration of trusts and companies. The first topic is the circumstances in which a professional person engaged in these activities may find himself (and here and elsewhere in this talk, the male includes the female) liable as if he were a trustee, although he is not a trustee in the ordinary sense. The other topic is the circumstances in which a trustee or other fiduciary may be exonerated, under what is imprecisely called an indemnity clause, from liability for breach of a fiduciary obligation. These are separate topics but both tend to raise issues of *mens rea* (that is, the mental element) in the context of fiduciary liability. Every law student knows Bowen LJ's famous saying<sup>2</sup> that "the state of a man's mind is as much a fact as the state of his digestion" but it is often a fact on which the man's own evidence may be wholly unreliable, and which can be established only by inference.

2 I shall discuss some recent authority in England and Jersey. I hardly need say that I shall speak with more confidence in relation to the former. I am well aware that the law of Jersey is a complex and subtle creature with a long and colourful ancestry. It is not to be trifled with or taken for granted. So please take everything that I venture to say about Jersey law as tentative and respectful.

3 When I first studied law, nearly fifty years ago, students were taught that one could become a constructive trustee either by knowing assistance in a breach of trust, or by knowing receipt of trust money. The authority referred to was *Barnes v Addy*,<sup>3</sup> decided in 1874. In the course of the last generation it has been clearly demonstrated (very largely in cases concerned with commercial activities) that that account of constructive trusteeship is oversimplified and misleading. Nevertheless I will begin, if I may, with that old case. It has nothing to do with commercial life. It is a vignette of family life and family conflict in middle-class mid-Victorian England.

4 A testator had settled his residuary estate on his four children. Two of the settled shares had been released from the will trust before the story begins and we are concerned with the settled shares of two of the testator's daughters, Ann and Susan. Both were married: Susan, as it happens, to her cousin, who (following the deaths of his co-trustees) was sole trustee of the will trust. Unfortunately the two brothers-in-law did not get on at all

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<sup>1</sup> This is the text of a lecture delivered by Lord Walker of Gestingthorpe to the Society of Trust and Estate Practitioners ("STEP") on 10th March 2006 in St. Helier, Jersey. It is reproduced here with the agreement of STEP.

<sup>2</sup> *Edgington v Fitzmaurice* (1885) 29 Ch D 459, 482  
<sup>3</sup> (1874) 9 Ch App 244

well. Ann's husband (who was, as most of you will have guessed, Mr Barnes) sued Susan's husband (Mr Addy) for breach of trust. The proceedings were compromised, and it was proposed that Mr Barnes should be appointed in place of Mr Addy as sole trustee of the settled share of Ann and her children (this was before the enactment of statutory restrictions on the appointment of a sole individual trustee). Mr Addy's solicitor (Mr Duffield) advised him against this course, because of the risk of misapplication by a sole trustee. But Mr Addy insisted and Mr Duffield carried out his instructions to prepare a deed of appointment. Mr Barnes's solicitor (Mr Preston) saw it as his professional duty to write to Ann tactfully expressing his concern, and he did so, but he received an icily polite brush-off. So Mr Preston approved the draft deed, and the appointment was completed. On 31 March 1857 a holding of government stock representing Ann's settled share was transferred to Mr Barnes. On the very next day he sold the stock and, in flagrant breach of trust, used the proceeds in his business. Within a year he was bankrupt.

5 So there were two breaches of trust: an ill-advised but non-fraudulent appointment by Mr Addy and a deliberate fraudulent misapplication by Mr Barnes. But it was Mr Addy, Mr Duffield and Mr Preston whom Ann's six children sued for breach of trust. Mr Addy was held liable, but the solicitors were dismissed from the suit, and in 1874 their exoneration was confirmed by the Court of Appeal in Chancery. That was the context in which the presiding judge, Lord Selborne LC, made his famous statement<sup>4</sup> -

“. . .strangers are not to be made constructive trustees merely because they act as the agents of trustees in transactions within their legal powers, transactions perhaps of which a Court of Equity may disapprove, unless those agents receive and become chargeable with some part of the trust property, or unless they assist with knowledge in a dishonest and fraudulent design on the part of the trustees.”

6 For more than a century this statement has been repeatedly cited and analysed throughout the common law world almost as if it were a statutory text. Indeed Professor Charles Harpum<sup>5</sup> has, by reference to this very passage, identified one of what he sees as three serious judicial shortcomings in this area: I will quote all three -

- (i) a willingness to apply authorities on one ground of liability to another that was conceptually discrete;
- (ii) a preference for applying as if they were statutory provisions judicial dicta that were conditioned by the factual context in which they were made; and

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<sup>4</sup> At 251-2

<sup>5</sup> *The basis of equitable liability in the frontiers of liability* (ed P B H Birks) OUP 1994 p9

(iii) an obsessive concern with what might be described as the *mens rea* necessary for liability without sufficient consideration of the *actus reus*".

7 I have gone into the facts of *Barnes v Addy* in a little detail because Lord Selborne's much-cited observation is the foundation of the modern law, and the factual context of the case helps to explain why Lord Selborne did not find it necessary to explore various complexities which have since arisen. It was a case of an express trust and the two solicitor defendants knew enough about trusts to be concerned (absolutely correctly, as events turned out) about the risk involved in the appointment of a sole trustee. The only real issue was whether the solicitors' professional concerns about the general risk of appointing a sole trustee, without any particular apprehension of dishonesty on the part of Mr Barnes, made them liable as accessories.

8 Most of the other cases that I want to discuss were not concerned with express trusts, but with breaches of fiduciary duty by company directors and their associates. In England the notion that a company director owes fiduciary duties to the company was already familiar by the time of *Barnes v Addy*.<sup>6</sup> The law of Jersey has also for many years regarded a company director as owing fiduciary duties.<sup>7</sup> He does so because he is in a position of stewardship and the shareholders place their trust in him. One of the classic definitions of a fiduciary relationship was given by Mason J in the High Court of Australia in the *Hospital Products* case.

"The critical feature of these relationships is that the fiduciary undertakes or agrees to act for or on behalf of or in the interests of another person in the exercise of a power or discretion which will affect the interests of that other person in a legal or practical sense. The relationship between the parties is therefore one which gives the fiduciary a special opportunity to exercise the power or discretion to the detriment of that other person who is accordingly vulnerable to abuse by the fiduciary of his position."<sup>8</sup>

9 That is why a company director is much more likely to incur fiduciary liability if he engages in sharp practice towards his own shareholders than if he does so towards his suppliers, customers or competitors (with whom he is at arm's length).

10 I will not attempt any detailed survey of the development of the English case law. It is sufficient to say that it was gradually recognised that the two types of liability as a constructive trustee were (in Professor Harpum's phrase) "conceptually discrete" – not siblings or even first cousins but fairly remote relatives – and that there was no reason to assume that the same mental element was requisite for each. But for a long time that was

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<sup>6</sup> See for instance *Re Forest of Dean Coalmining Company* (1878) 10 Ch D450, *Flitcroft's case* (1882) 21 Ch D519, 535 and *Re Lands Allotment Company* [1894] 1 Ch 616, 631, all of which treat the proposition as commonplace.

<sup>7</sup> See *Re Overseas Insurance Brokers Ltd* 1963 JJ 349 and compare *Re Northwind Yachts Ltd* 2005 JLR 137.

<sup>8</sup> *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41, 96-7

an open question.<sup>9</sup> A decisive step forward was the judgment of Millett J in *Agip (Africa) Ltd v Jackson*.<sup>10</sup>

11 That judgment gives a vivid account of how Agip's subsidiary, drilling for oil in Tunis, was systematically defrauded of millions of dollars by its chief accountant, and how the money was laundered through a series of companies, registered in England but run by Isle of Man accountants (who were the defendants in the proceedings), before its final distribution by a French company ostensibly carrying on a jewellery business. Millett J's judgment also contains a penetrating analysis of the law, covering proprietary as well as personal claims. For present purposes the crucial passage is as follows -

"The authorities at first instance are in some disarray on the question whether constructive notice is sufficient to sustain liability under this head [knowing assistance]. In the *Baden* case Peter Gibson J accepted a concession by counsel that constructive notice is sufficient and that on this point there is no distinction between cases of 'knowing receipt' and 'knowing assistance'. This question was not argued before me but I am unable to agree. In my view the concession was wrong and should not have been made. The basis of liability in the two types of cases is quite different; there is no reason why the degree of knowledge required should be the same, and good reason why it should not. Tracing claims and cases of 'knowing receipt' are both concerned with rights of priority in relation to property taken by a legal owner for his own benefit; cases of 'knowing assistance' are concerned with the furtherance of fraud."<sup>11</sup>

A little later in the judgment he said -

"The true distinction is between honesty and dishonesty. It is essentially a jury question."

12 There is also a valuable passage about *what* the accountants had to know to found liability. Company minutes signed by one of the accountants suggested that they had been told that the purpose of the money-laundering manoeuvres was to evade Tunisian exchange control. Millett J said -

"It is no answer for a man charged with having knowingly assisted in a fraudulent and dishonest scheme to say that he thought that it was 'only' a breach of exchange control or 'only' a case of tax evasion. It is not necessary that he should have been aware of the precise nature of the fraud or even of the identity of its victim. A man who consciously assists others by making arrangements which he knows are calculated to conceal what is

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<sup>9</sup> See for instance the observations of Brightman J in *Karak Rubber Co Ltd v Burden No 2* [1972] 1 WLR 602, 639 (a passage which, I fear, would incur two of Professor Harpum's strictures) and the very learned but inconclusive discussion by Sir Robert Megarry VC in *Re Montagu* [1987] Ch 264.

<sup>10</sup> *Agip (Africa) Ltd v Jackson* [1990] Ch 265  
<sup>11</sup> At 292-3

happening from a third party, takes the risk that they are part of a fraud practised on that party.”<sup>12</sup>

Other English judges have however taken a more cautious view on this point.<sup>13</sup>

13 Without endorsing the comment about judges having an “obsessive concern” with *mens rea* I would suggest that judges have tended to concentrate on the question “what sort of knowledge?” – a tendency exemplified by the five-fold *Baden*<sup>14</sup> test – and have not so regularly asked themselves the question “knowledge of what?” In *Barnes v Addy* the solicitors acting for Mr Addy and Mr Barnes knew perfectly well what a breach of trust was. A company director may have (or may plausibly claim to have) a much less clear understanding of what is a breach of fiduciary duty, and the same may be true of some bank officials and even, regrettably, some accountants and lawyers. That is especially true if a breach consists, not of infringement of a specific statutory duty (such as the prohibition on a company giving financial assistance for the purchase of its own shares) but in the exercise of directors’ powers of control for an improper purpose.

14 To put much the same point less elegantly and more bluntly, a trustee of an express family trust who steals trust money must assuredly know that he is doing something seriously wrong. A director who is also controlling shareholder of a company may need a lot of persuasion that he is not fully entitled to feather his own nest at the expense of “his” company. Indeed he may find himself serving a custodial sentence before he begins to believe it. That may be what Lord Nicholls had in mind when he said, in *Royal Brunei Airlines v Tan*<sup>15</sup> that the standard of what constitutes honest conduct is not subjective, and honesty is not an optional scale, with higher or lower values according to the moral standards of each individual.

15 I have already referred to the five-fold *Baden*<sup>16</sup> test of knowledge. It will be well known to many of you, but I had better set it out. It occurs in a judgment delivered in 1983 by Peter Gibson J after a year-long trial arising out of the notorious IOS investment scandal in the 1960’s. The judgment is very long and was not reported (except in one specialist series) until 1993. Since it has had (to say the least) a mixed reception it is fair to point out that Peter Gibson J was recording a submission of counsel, and he himself expressed reservations about it. The classification is as follows -

“(i) Actual knowledge; (ii) wilfully shutting one’s eyes to the obvious; (iii) wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make; (iv) knowledge of circumstances which would indicate the facts to

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<sup>12</sup> At 295

<sup>13</sup> See *Grupo Torras SA v Al Sabah* [1999] CLC 1469, 1664-5; *Brinks Ltd v Abu-Saleh No. 3* [1996] CLC 133; also the discussion below of *Twinsectra Ltd v Yardley* [2002] 2 AC 164.

<sup>14</sup> *Baden v Societe Generale* [1983] BCLC 325, (1983) [1993] 1 WLR 509, 575-6

<sup>15</sup> [1995] 2 AC 378, 389.

<sup>16</sup> *Baden v Societe Generale* [1983] BCLC 325, (1983) [1993] 1 WLR 509.

an honest and reasonable man; (v) knowledge of circumstances which would put an honest and reasonable man on inquiry.”<sup>17</sup>

As I have said, this classification has had a mixed reception in several jurisdictions. It has been called “unhelpful” and “unrememberable” in New Zealand.<sup>18</sup> In England it has led to warnings against over-refinement<sup>19</sup> and over-elaboration;<sup>20</sup> but it has also been attacked from the other flank as not necessarily comprehensive.<sup>21</sup> In Australia Finn J, writing extracurially,<sup>22</sup> has described it as “technical to the point of the artificial and the arcane”.

Lord Nicholls has administered the *coup de grace*, so far as accessory liability is concerned, in *Royal Brunei* -

“ ‘knowingly’ is best avoided as a defining ingredient of the principle, and in the context of this principle the *Baden* scale of knowledge is best forgotten.”<sup>23</sup>

16 The judgment of Lord Nicholls in *Royal Brunei* is very well known and I shall resist the temptations to cite long passages from it. His conclusions are clear -

“ . . .that dishonesty is a necessary ingredient of accessory liability. It is also a sufficient ingredient.”<sup>24</sup>

I read the judgment as impliedly, if not expressly, approving Millett J’s observation in *Agip*,<sup>25</sup> that whether a defendant should be held liable for dishonest assistance is “essentially a jury question”.<sup>26</sup>

17 The prime characteristic of a jury question is the form in which it has to be answered. However imponderable the question, the answer must be short and unambiguous and never has to be backed up by reasons. In England the abolition of the civil jury, in all but a handful of special cases, has put an extra burden of reasoned decision-making onto the shoulders of trial judges. In Jersey the judge shares that responsibility with the jurats. It is one of the virtues of Lord Nicholls’ judgment in *Royal Brunei* that (once the discussion of the authorities is over) it is expressed in terms which a jury could be expected to understand. Hard experience in criminal trials shows that there are limits to the degree of refinement with which a jury can sensibly be directed on matters

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<sup>17</sup> At 575-6.

<sup>18</sup> Both by Blanchard J in *Nimmo v Westpac Banking Corp.* [1993] NZLR 218, 228.

<sup>19</sup> By Millett J in *Agip* at 293.

<sup>20</sup> By Hirst LJ in *Three Rivers DC v Bank of England (No. 3)* [2003] 2 AC 1, 53.

<sup>21</sup> By the Court of Appeal in *Agip* [1991] Ch 547, 567.

<sup>22</sup> In *Equity, Fiduciaries and Trusts* (ed Waters) Carswell (1993) 195, 196.

<sup>23</sup> At 392.

<sup>24</sup> At 392.

<sup>25</sup> Lord Nicholls referred at 388 to p.293 of Millett J’s judgment in *Agip*

<sup>26</sup> I am not aware of any pithy definition of this expression, but it goes back at least to *Bell v Kennedy* (1868) LR 1 Sc & Div 307, 324, a case on domicile.

of intention. If authority is needed for that proposition I would refer, with some diffidence, to the recent decision of the Privy Council in *Attorney General for Jersey v Holley*.<sup>27</sup>

18 Since *Royal Brunei* there has been clear blue water between liability for dishonest assistance, as it is now generally called in England, and liability for knowing receipt. I do not propose to say much more about knowing receipt. It raises different, and difficult, conceptual questions which would easily fill a whole lecture.<sup>28</sup> But I cannot forbear from saying something, as I shall in a little while, about the saga of the *Esteem Settlement*. In the meantime there are two further recent English decisions on dishonest assistance which I must mention. One is a decision of the House of Lords which some commentators regarded as making the law less clear; the other is a decision of the Privy Council, on appeal from the Isle of Man, which has, I hope, restored the clarity of the principles expounded in *Royal Brunei*.

19 The House of Lords decision is *Twinsectra*,<sup>29</sup> decided in 2002. The facts were unusual. Mr Yardley, an adventurous businessman, had two solicitors. His regular solicitor was Mr Leach but he also had a sort of *ad hoc* solicitor, Mr Sims, who acted because Mr Leach was unwilling to give a personal undertaking to be liable to the proposed lender, Twinsectra, for a loan of £1m. Mr Sims gave this undertaking and also a second undertaking to retain the £1m until it was applied in the acquisition of (unspecified) property. The second undertaking, vague though it was, was held to have created a trust, and Mr Leach knew of it. Mr Sims, in breach of his second undertaking, passed the money to Mr Leach who dispersed it on his client's instructions, and partly not in the acquisition of property. Mr Sims was insolvent and not worth suing.

20 The trial judge (Carnwath J) found that Mr Leach had not been dishonest although he had "shut his eyes" to the implications of the second undertaking. The Court of Appeal treated these conclusions as contradictory and gave judgment against the solicitor. The majority of the House of Lords thought that the judge's findings (although imperfectly expressed) were not contradictory, and restored his decision.

Lord Hoffmann said that the principles in *Royal Brunei* -

"... require more than a knowledge of the facts which made the conduct wrongful. They require a dishonest state of mind, that is to say, consciousness that one is transgressing ordinary standards of honest behaviour."<sup>30</sup>

He also said -

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<sup>27</sup> [2005] 2 AC 580

<sup>28</sup> See in particular Lord Nicholls, *Knowing Receipt: The Need for a New Landmark in Cornish and Others, Restitution Past, Present and Future*, Hart Publishing (1998).

<sup>29</sup> *Twinsectra Ltd v Yardley* [2002] 2 AC 164

<sup>30</sup> At 170.

“I do not suggest that one cannot be dishonest without a full appreciation of the legal analysis of the transaction”.<sup>31</sup>

The rest of the House (which did not include Lord Nicholls) took much the same view, except for Lord Millett, whose dissenting speech took a sterner attitude. It can be summed up in a phrase used in the High Court of Australia in a relatively early case<sup>32</sup> on dishonest assistance, that the liability arose from the defendant’s “failure to recognise fraud when he saw it.”

21 *Twinsectra* has been twice referred to with approval in the Royal Court, but not on the issue of the fiduciary’s state of mind. It was cited for the observations made by Lord Hoffmann and Lord Millett as to the state of mind (or understanding) necessary for the creation of a trust.<sup>33</sup>

22 The most recent case in the line of authority is the decision of the Privy Council in *Barlow Clowes International Ltd (in liquidation) v Euro Trust International Ltd*.<sup>34</sup> It is an awful warning of the dangers of (to put it mildly) getting too close to the client. Lord Hoffmann summarised the background in this way -

“In the mid-1980s Mr Peter Clowes, through a Gibraltar company called Barlow Clowes International Ltd, operated a fraudulent off-shore investment scheme purporting to offer high returns from the skilled investment of funds in UK gilt-edged securities. He attracted about £140m, mainly from small UK investors. Most of the money was dissipated in the personal business ventures and extravagant living of Mr Clowes and his associates. In 1988 the scheme collapsed and Mr Clowes was afterwards convicted and sent to prison.”

23 The liquidators of Barlow Clowes took proceedings in a number of jurisdictions, pursuing either personal or proprietary claims, in an attempt to recover the misappropriated assets. In the end the liquidators were acting largely in the interests of the British government, which paid out many millions of pounds in compensation and acquired the investors’ claims in return. One of the claims was against an Isle of Man company and two of its directors, who had provided financial services to Mr Clowes and his associates. One of the directors, Mr Henwood, was the sole respondent in the Privy Council. He had been held liable at first instance, after a trial lasting 31 days, for dishonest assistance in the misappropriation of over £6m. He appealed successfully in the Isle of Man, but the liquidators then made a further appeal to the Privy Council, which restored the first-instance decision.

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<sup>31</sup> At 171.

<sup>32</sup> *Consul Development v DPC Estates* (1975) 132 CLR 373, 411

<sup>33</sup> First in the magisterial judgment of Birt DB in *Re Esteem Settlement, Grupo Torras SA v Al Sabah* [2003] JLR 188, 218 and again by Bailhache B in *Mackinnon v Regent Trust Co. Ltd* [2004] JLR 477, 492.

<sup>34</sup> [2005] UKPC 37, so far reported only at [2005] WTLR 1453.

24 The opinion written by Lord Hoffmann is, if I may say so, eminently readable and an admirable analysis of why the appeal court was wrong to reverse the findings of the judge who had seen and heard the witnesses cross-examined at length. But for present purposes the most important passage is the explanation that *Twinsectra* is not at odds with *Royal Brunei* and that “consciousness that one is transgressing ordinary standards of honest behaviour” means, in context, “consciousness of those elements of the transaction which make participation transgress ordinary standards of honest behaviour.”<sup>35</sup>

25 It does not require much imagination to begin to understand the temptations which Mr Henwood faced. He was ambitious. Mr Clowes was his biggest client, a larger-than-life individual with apparently limitless wealth and a forceful personality; it was easy for Mr Henwood to persuade himself that his job was to carry out his instructions efficiently, and not ask questions (especially as he began to realise what the answers would be). That sort of attitude has always been imprudent, but with modern regulation of financial services, and stringent legislation against money-laundering (in Jersey as in the United Kingdom) it would now be professional suicide. It is now perfectly clear that a professional’s duty of confidentiality to his client must where necessary yield to statutory requirements imposed for the general public good. As Tomes DB said in one of the early *Norwich Pharmacal*<sup>36</sup> applications in Jersey, *IBL v Planet Financial Services* -

“Confidentiality depends on legitimate private business being properly conducted.”<sup>37</sup>

26 The footprints of money-laundering and dishonest assistance overlap but they do not coincide completely. *Barlow Clowes* was a case where they overlapped, as the funds which were being laundered were trust monies misappropriated from hundreds of misguided small investors. There is no obvious overlap if the laundered funds are the proceeds of drug trafficking (or are intended to bring about violent regime change in an equatorial state). Conversely dishonest assistance might consist of (for instance) the drafting of sham legal documents, in order to disguise a fraudulent transaction, by someone who had no contact with the misappropriated funds. These points have been made in an interesting article by Advocate Alan Binnington<sup>38</sup> who explains how (in an “overlap” case) a bank or other financial intermediary may face the uncomfortable dilemma of a possible claim by victims of fraud, if he parts with suspect funds, and possible prosecution by police or regulatory authorities, if he does anything to alert the suspected money-launderer. I regret that I cannot see any easy answer to that dilemma, which has been considered by the English Court of Appeal (I have to say, as a member of

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<sup>35</sup> Paras 14-16. This is the latest word from England on the subject. For the latest word from Australia see *Yeshiva Properties No. 1 Pty Ltd v Marshall* (2005) 7 ITCLR 577, paras 18 to 22 (Bryson JA); for the position in Canada see *Citadel General Insurance Co. v Lloyd’s Bank of Canada* [1997] 3 SCR 85. For knowledge of a corporate trustee see *Crown Dilmun plc v Sutton* [2004] 1 BCLC 468 paras 191-4, the High Court of Australia in *Krakowski v Eurolynx Properties Ltd* (1995) 183 CLR 563, 582-3 and the extraordinary New Zealand case of *Equiticorp Industries Group Ltd (in stat. man.) v R (No. 47)* [1998] 2 NZLR 481.

<sup>36</sup> *Norwich Pharmacal v Commissioners for Customs & Excise* [1974] AC 133

<sup>37</sup> 1990 JLR 294, 312

<sup>38</sup> *Constructive trusts and all crimes money laundering legislation: is there a problem?* (1998) 2 JL Review 272.

that Court, rather inconclusively) in a case reported as *Bank of Scotland v A Ltd*.<sup>39</sup> The judgment of the Court suggests that a bank in such a situation might seek relief from the Court as a “putative fiduciary.”<sup>40</sup> But English law in this area is still developing.

27 May I now say something about the *Esteem* saga? As you all know it arose out of four fraudulent transactions, each on a massive scale, perpetrated between 1988 and 1992. The immediate victim was a Spanish company, Grupo Torras SA, which was the vehicle used by the London-based Kuwait Investment Office for a huge programme of investment in Spain. The chief conspirator was Sheikh Fahad Al Sabah. He was the Chairman of the KIO, a member of the Kuwaiti ruling house, and a man who already had wealth beyond the dreams of avarice. That he should embark on several massive, carefully planned frauds – and should do so, as regards the third fraud, at a time when his country was in peril from the Iraqi invasion – beggars belief. It shows, yet again, that a client’s apparent wealth, reputation and position is no guarantee of honesty.

28 The frauds led to heavy litigation in many jurisdictions, which may still not be quite over. I have been involved in two rounds of this litigation, in the English Court of Appeal on an appeal by two of the alleged conspirators (not the Sheikh)<sup>41</sup> and in the Privy Council on an appeal from the Court of Appeal of the Cayman Islands<sup>42</sup> after the Cayman Court had been asked to give assistance in Bahamian bankruptcy proceedings against the Sheikh.

29 Jersey was involved, as you all know, because the Sheikh established and from time to time added to two Jersey trusts known as the Esteem Settlement and the Number 52 Trust with Abacus (CI) Ltd as trustee. The Esteem Settlement was originally established in 1981, long before the frauds, and it contained what came to be called “clean” assets, that is assets which plainly did not represent the proceeds of fraud. But some funds added to the Esteem Settlement, and arguably all the funds of the Number 52 Trust (established in 1992) were not clean. The trustee, Abacus, was faced with an extremely awkward situation, especially when the English proceedings against the Sheikh ended at first instance with a damning judgment against him (and most but not all of his alleged co-conspirators) delivered by Mance LJ (as he by then was) on 24 June 1999. The Sheikh was ordered to pay to Grupo Torras a sum of the order of US\$800m. He was made bankrupt in the Bahamas two years later.

30 The litigation in the Royal Court had three main elements. First, there was an application by Abacus for guidance as to the exercise of its fiduciary discretions. This was disposed of by a judgment of Birt DB in early 2001<sup>43</sup> and an appeal dismissed by the Court of Appeal of Jersey later that year.<sup>44</sup> The second action, claiming on various grounds to

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<sup>39</sup> [2001] 1 WLR 751, [2001] 3 AER 58

<sup>40</sup> See paras 25-39

<sup>41</sup> *Grupo Torras SA v Al Sabah* (No. 5) [2001] CLC 221

<sup>42</sup> *Al Sabah v Grupo Torras SA* [2005] 2 AC 333

<sup>43</sup> *Re Esteem Settlement* 2001 JLR 7

<sup>44</sup> 2001 JLR 540.

recover assets from the trusts, was taken by Grupo Torras against the principal beneficiaries, with Abacus also a party. The Deputy Bailiff gave judgment in this action in January 2002.<sup>45</sup> The third action, by which Grupo Torras sought to recover the “clean” assets, ended with a judgment of the Deputy Bailiff on 13 June 2003.<sup>46</sup> In all three cases the Deputy Bailiff sat with jurats who shared with him the burden of decision. I think I am right in saying that only Jurat de Veulle had the marathon achievement of sitting on all three cases.

31 The three judgments together amount to the remarkable total of 994 paragraphs. I am going to say little about them except to express deep and unfeigned admiration. The Royal Court had to grapple with novel and difficult issues, some (such as the Pauline action, and the maxim *donner et retenir*) peculiar to the law of Jersey. Other issues (on sham, tracing trust assets, proprietary and personal claims to restitution and the remedial constructive trust) arise in England also. On some of these common issues it may be that the law of Jersey is developing faster, and in a better direction, than English law. I have in mind first the Deputy Bailiff’s rejection of the rule in *Clayton’s* case<sup>47</sup> in the process of tracing<sup>48</sup>; second his rejection of the *Re Diplock*<sup>49</sup> restriction on tracing into improvements to immovable property;<sup>50</sup> third, his radical approach to a personal remedy against an innocent recipient of misappropriated trust funds;<sup>51</sup> and fourth his rejection of the remedial constructive trust as contended for in the “clean” assets action.<sup>52</sup>

32 At the end of the magisterial judgment in the third action the Deputy Bailiff made some general observations which merit repetition in full -

“ . . . All jurisdictions have to strike a balance between the freedom to dispose of one’s property and the interests of creditors. Jurisdictions vary as to where this balance should be struck . . .

Most jurisdictions settle somewhere in between these two extreme positions. In Jersey, customary law, drawing on the civil law, has developed the Pauline action for many centuries with its closely defined requirements. In addition, bankruptcy legislation has in recent years provided additional remedies where gifts or transactions at an undervalue have been undertaken within a certain period before bankruptcy. Furthermore, there are of course proprietary claims (i.e. where the asset never belonged to the debtor) and restitutionary claims (where there has been unjust enrichment).

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<sup>45</sup> *Re Esteem Settlement, Grupo Torras SA v Al Sabah* 2002 JLR 53.

<sup>46</sup> *Re Esteem Settlement, Grupo Torras SA v Al Sabah* 2003 JLR 188.

<sup>47</sup> (1816) 1 Mer 529

<sup>48</sup> Judgment of 17 January 2002, paras 105-111.

<sup>49</sup> [1948] Ch 465

<sup>50</sup> Judgment of 17 January 2002, paras 126-131.

<sup>51</sup> Judgment of 17 January 2002, paras 150-155; the Royal Court followed the approach suggested by Lord Nicholls (footnote 27 above).

<sup>52</sup> Judgment of 13 June 2003, paras 146-151.

This is the balance which Jersey has struck and it is fairly similar to that struck by many other jurisdictions. We have declined Mr Journeaux's invitation to take the law where it has not gone before. Even if we had considered that course to be open to us, it would not, in our judgment, be right for a court, based upon a perceived injustice in a particular case, suddenly to invent new causes of action which would render otiose the carefully developed balance referred to in the previous paragraph. There is an important public interest in the ability of persons to rest upon apparently valid transactions. Furthermore, trusts form an important part of Jersey's financial and commercial life and the law has to be very clear as to when trusts and gifts into trust can be set aside.”<sup>53</sup>

33 In the final part of this lecture I want to have a look at trustee exemption clauses, sometimes incorrectly called indemnity clauses. The English Law Commission's consultation paper<sup>54</sup> quotes a typical clause -

“No trustee shall be liable for any loss or damage which may happen to the trust fund . . . at any time or from any cause whatsoever unless such loss or damage shall be caused by his own actual fraud.”<sup>55</sup>

Three main questions arise on such clauses. Does the general law impose, or should it impose, prohibitions or restrictions on them? So far as they are permitted by the general law, how should they be interpreted, especially as regards any sort of *mens rea* on the part of the trustee whose conduct is impugned? What is the professional duty of a solicitor or advocate in advising a settlor about an exemption clause?

34 On the first question there is much to be said on each side, and the arguments are fairly represented in the Law Commission consultation paper. On the one hand, as Millett LJ said in *Armitage v Nurse* in 1997 -

“The view is widely held that these clauses have gone too far, and that trustees who charge for their services and who, as professional men, would not dream of excluding liability for ordinary professional negligence should not be able to rely on a trustee exemption clause excluding liability for gross negligence.”<sup>56</sup>

35 It has even been argued that a very wide exemption clause should be rejected as repugnant to the irreducible core of fiduciary duty essential to a trust. On the other hand, lay people who take on the heavy burden of trusteeship for no monetary reward are entitled to expect a generous measure of protection. Any change in English law (on which the Law Commission is likely to publish definite proposals next May) is likely to distinguish between remunerated and unremunerated trustees.

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<sup>53</sup> Paras 525-527.

<sup>54</sup> *Trustee Exemption Clauses*, Consultation Paper No. 171, published in December 2002

<sup>55</sup> That used in *Armitage v Nurse* [1998] Ch 241, discussed below

<sup>56</sup> At 256

36 In Jersey, where there are probably relatively few unremunerated trustees, the position is, as you all know, that the Trusts (Jersey) Law 1984 was amended in 1989<sup>57</sup> to introduce a new article 26(9) -

"Nothing in the terms of a trust shall relieve, release or exonerate a trustee from liability for breach of trust arising from his own fraud, wilful misconduct or gross negligence."

37 The effect of this change was considered by the Court of Appeal of Jersey in the very important case of *Midland Bank (Jersey) Ltd v Federated Pension Services Ltd*.<sup>58</sup> The judgment of Sir Godfray Le Quesne has been widely and rightly praised. The claim was against the corporate trustee of a pension scheme. The trustee had incompetently and wrong-headededly insisted on retaining a fund in cash and so had delayed its investment at a time of rising stock markets, resulting in a loss estimated at nearly £800,000. The trustee relied on an exemption clause which excluded liability for anything other than "a breach of trust knowingly and wilfully committed."

38 After an extensive survey of Commonwealth authority, Sir Godfray concluded that under Jersey law there was no general principle (apart from statute) which prevented a trustee from protecting himself against liability (save for fraud), but that such clauses should be narrowly and restrictively construed.<sup>59</sup> The first part of this holding in effect overruled the view taken by the Royal Court in *West v Lazard Bros. & Co (Jersey) Ltd*.<sup>60</sup> Sir Godfray went on to point out<sup>61</sup> that the relevant clause (and especially the words "knowingly and wilfully") were capable of two interpretations (reminiscent of the issues debated in *Royal Brunei*, *Twinsectra* and *Barlow Clowes*), that is either (a) the trustee is liable if it knowingly and wilfully commits an act which amounts to a breach of trust; or (b) the trustee is liable if it knowingly and wilfully commits an act known to it at the time to be a breach of trust. In accordance with the principle which it had just laid down the Court of Appeal preferred the strict interpretation, (a). It also held that the amendment to Article 26(9) was retrospective,<sup>62</sup> and overrode the exemption clause in a case of gross negligence.

39 Finally<sup>63</sup> Sir Godfray posed the questions whether the trustee's admitted conduct amounted to fraud, deliberate wrongdoing short of fraud, recklessness, gross negligence, negligence or a breach of trust outside any of those categories. He did not however find it necessary to answer all these questions. The trustee had deliberately placed the funds on deposit, instead of transferring them promptly to the new investment managers, and on construction (a) that was outside the range of the exemption, quite apart from any statutory restriction. Furthermore the trustee was grossly negligent, and so the amended

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<sup>57</sup> By Article 5 of the Trusts (Amendment) (Jersey) Law 1989. A similar change was made in Guernsey in 1990.

<sup>58</sup> 1995 JLR 352

<sup>59</sup> At 381.

<sup>60</sup> 1993 JLR 165 (see also the *Midland* case at 390-391)

<sup>61</sup> At 382.

<sup>62</sup> At 389.

<sup>63</sup> At 391-394.

Article 26(9) disentitled it from exemption. The Court of Appeal also overruled *West* on this point; in *West* the Commissioner had directed himself and the jurats<sup>64</sup> that gross negligence implied “a certain *mens rea*, an intentional disregard of danger, a recklessness.” All that it implied, the Court of Appeal laid down, was “a serious or flagrant degree of negligence.”

40 The leading English authority is *Armitage v Nurse*.<sup>65</sup> In that case the claimant was a young woman who was the principal beneficiary under a family trust which held agricultural land. The trustees (at the material time) were one professional man and two lay people, distant relatives of the claimant. The land had been managed by a company owned and run by the claimant’s mother and grandmother, and one of the main complaints was that the trustees had failed to supervise the company’s management of the land in the principal beneficiary’s interests. The trustees relied on a clause which excluded a trustee’s liability for loss caused by anything other than “his own actual fraud.” A preliminary issue on the effect of the clause was decided against the claimant, and she appealed to the Court of Appeal.

41 The judgment of Millett LJ deals first with the meaning of “actual fraud”, distinguishing it from so-called “equitable fraud”, which would today be more aptly described as breach of fiduciary duty.<sup>66</sup> In language reminiscent of *Royal Brunei*<sup>67</sup> he equated fraud with dishonesty. He concluded that clause 15 meant what it said and exempted each trustee -

“no matter how indolent, imprudent, lacking in diligence, negligent or wilful he may have been, so long as he has not acted dishonestly.”<sup>68</sup>

Such a clause was not, he held, void as contrary to public policy. He said -

“I accept the submission made on behalf of [the claimant] that there is an irreducible core of obligations owed by the trustees to the beneficiaries and enforceable by them which is fundamental to the concept of a trust. If the beneficiaries have no rights enforceable against the trustees there are no trusts. But I do not accept the further submission that these core obligations include the duty of skill and care, prudence and diligence. The duty of the trustees to perform the trust honestly and in good faith for the benefit of the beneficiaries is the minimum necessary to give substance to the trusts, but in my opinion it is sufficient.”<sup>69</sup>

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<sup>64</sup> 1993 JLR at 291

<sup>65</sup> [1998] Ch 241

<sup>66</sup> See *Nocton v Ashburton* [1914] AC 932, 953, and also Millett LJ’s trenchant explanation, in *Bristol and West Building Society v Mothew* [1998] Ch 1, 16, that “not every breach of duty by a fiduciary is a breach of fiduciary duty.”

<sup>67</sup> Which was cited by counsel, though not referred in the judgment.

<sup>68</sup> At 251

<sup>69</sup> At 253-4

42 It had been argued that even if protection from ordinary negligence was acceptable, immunity for gross negligence was unacceptable. English law has however always been wary of that phrase. There is the well-known saying of Willes J<sup>70</sup> that gross negligence is ordinary negligence with a vituperative epithet. Scottish law, which has been much more influenced by civilian systems, has paid more attention to *culpa lata*, the Roman law equivalent of gross negligence. That may perhaps be regarded as part of the ancestry of article 26(9). Millett LJ referred<sup>71</sup> to the survey of all the relevant authorities by Sir Godfray Le Quesne in the *Midland* case, describing his judgment as "masterly". So gross negligence is an important concept in Jersey law but not, at present, in English law (and it is unlikely that the Law Commission will recommend change on those lines). As we have seen, gross negligence does not require any particular mental state; it is to be determined on an objective assessment of conduct.

43 Finally, a brief word on the third question that I mentioned. Textbooks on settlements and wills used to tell the reader that a trustee exemption clause, like a trustee charging clause, should be inserted only with the express instructions of the settlor or testator. Such advice may seem rather old-fashioned and unrealistic today. But the fact is that clauses of both types do have important financial implications throughout the life of the trust. They modify the character of the fiduciary relationship between trustees and beneficiaries. It is right that the creator of the trust should be aware of this, and the duty of making sure that he is aware of it falls on his legal advisers at the time when the trust is established. In Jersey Article 26(9) provides an important minimum safeguard, but it does not, I think, cancel the need for proper advice.

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<sup>70</sup> In *Grill v General Iron Screw Collier Company* (1866) 1 CP 600, 612

<sup>71</sup> At 254