SLUMDOG-LEG MILLIONAIRE

1. In spring and times of recession young beneficiaries' minds turn to thoughts of litigation. In particular when things have gone wrong with a trust's assets, when they have dropped in value or just dropped off the balance sheet altogether, they start to think about who they can sue. The obvious answer is "the (former) trustees". But what happens when that trustee is a company, and the company has no assets or insurance, or those assets are likely to be eaten up by other creditors? It is at this moment that the concept of the 'dog-leg claim' rears its head.

WHAT IS A 'DOG-LEG CLAIM'?

2. The basic nature of a dog-leg claim is as follows:
   (a) The trustee of a trust is a private trust company ("**PTC**").
   (b) The director of the PTC owe it duties, fiduciary, contractual or tortious. When the director breaches those duties the PTC holds the benefit of a cause of action[1] against the director.
   (c) If the PTC holds that cause of action as an asset of the trust then in appropriate situations the beneficiaries (or new trustees) may themselves directly enforce that duty.

3. It is this last part that sets dog-leg claims apart from the norm. It allows the beneficiaries or new trustees to enforce a cause of action **directly** against the directors. It is also this last part - the concept of the PTC's claim against the director being a trust asset - that underwrites the problems with this sort of claim. The real question at the heart of the dog-leg issues is: **why** should such a cause of action be a trust asset? The problem is that there are arguments both for and against it.
   (i) Against:
      - If the duty of a director is to avoid his company suffering loss, then this is a duty which is owed to the company for the company's benefit. There is no particularly obvious reason why this duty should be a trust asset.
      - It would go against the rule that directors do not owe duties direct to beneficiaries or shareholders.
      - It could cut across exoneration or indemnity clauses.

   (ii) For:
      - If the duty of a director to the company extends to avoiding loss to the trust fund, it is difficult to see why the claim should not be a trust asset.
      - If the duty is owed to the company, how the company holds it is irrelevant to the question of whether directors should owe duties direct to third parties.
      - Exoneration / indemnity clauses are for the benefit of the company, not the directors. If they want to claim such protection, then they should have such terms embodied in their terms of office and/or contracts of employment

4. To my mind, it all really comes down to **what** duty is owed - a duty to avoid loss to the company, or loss to the trust? This question is not as simple as it might appear. If a trustee company hires, say, a solicitor then that solicitor will owe contractual and tortious duties to avoid loss to the trust company **AND** it is plainly arguable that those duties

[1] Obviously in some situations merely breaching the duty will not give rise to a cause of action - see below.

extend to a duty to avoid loss to the trust and/or beneficiaries. After all, the trust company does not hold the assets beneficially, so if the solicitor negligently looses the assets then for the trustee company to sue it (at least in tort) it would have to show that the duty extended to avoiding loss to the trust. And this sort of claim is regularly made, almost daily one suspects, by trustees against negligent former advisers. If their duties can extend to preventing loss to the trust, then why should directors be in a better position?

5. The answer, I suspect, depends on the circumstances of the directors and the trust companies. It is trite law to say that duties arise out of and are prescribed by the circumstances that give rise to them - so the nature and extent of a director's duties must be determined by the circumstances of their office and employment. With this in mind, if the trust company is a large, professional multi-trust administering body then **in the absence of anything more** it is difficult to see a director's duties being ascribable to, or calculated by reference to, a single trust. Therefore it is difficult to see why such a duty should be to avoid loss for that trust. For one thing, to hold so could potentially raise impossible difficulties of conflicts of interest between the different trusts. However, if the trust company was created to manage a specific trust, and the directors were put in place for that purpose and knowing that this was the situation, then why should their duties not extend to preventing loss to the trust?

6. It is this issue which in my opinion explains most of the cases on this topic. It is also the issue which ultimately determined the most recent case in this saga.

WHY USE A DOG-LEG CLAIM AT ALL?

7. This is clearly the first and most obvious question to ask. The basic reason for its use arises out of the company law principle that a director only generally owes duties to their company, and not to the company's shareholders or (usually) other third parties. Therefore, save for the derivative action exceptions of the rule in <u>Foss v Harbottle</u> (1843) 2 Hare 461 it would be for the PTC to sue the director.

8. This principle can be seen in a number of cases, but the one most commonly cited in the dog-leg claim authorities is <u>Bath -v- Standard Land Ltd</u> [1911] 1 Ch 618 (CA). In that case the defendant company were mortgagees in possession and therefore were obliged to account to the mortgagor. The argument was about whether the mortgagee was entitled to charge the mortgagor for any profits or remuneration for its directors or for any firm of which the directors were members so far as they had been engaged as professional advisers to the company in relation to the plaintiff's affairs. At first instance the court held they were not, on the basis that a fiduciary could not profit from his position, so the directors should not profit from their position and therefore the mortgagor company should not have to pay them the profits of their actions. However, on appeal the mortgagor defendant argued that it was able to charge for professional fees notwithstanding that the professionals concerned were directors of the defendant company. Cozens-Hardy MR agreed with this, essentially on the basis that the fiduciary relationship between the mortgagor company and its directors was not relevant to the account between the mortgagees and the mortgagor. In particular, at 625–6 he said:

"Directors stand in a fiduciary relation to the company, but not to a stranger with whom the company is dealing. It is of course true that a company acts through its directors. ***But that does not involve the proposition that if a breach of trust is committed by a company, acting through its board, a beneficiary can maintain any action against the directors in respect of such breach of trust****. Of course I except the case where trust property can be followed into the hands of a director, or of any stranger with notice. No such point arises here." (emphasis added).*

And at 627 he said:

"I base my decision upon the broad principle that directors stand in a fiduciary position only to the company, not to creditors of the company, nor even to individual shareholders of the company, still less to strangers dealing with the company. This principle applies equally whether the relation between the company and the stranger is one purely of contract, such as principal and agent, or is one of trustee and cestui que trust."

9. Buckley LJ agreed with Cozens-Hardy MR. However, Fletcher Moulton LJ disagreed. In particular at 637 he held that where a limited company undertook the administration of a trust its directors came under a duty direct to the beneficiaries of the trust. He said that:

   "[In] my opinion they [the directors] are liable for matters of personal conduct inconsistent with their full knowledge of the fiduciary character of the duties which, in the name of the company, they have to carry out."

10. Equally, the situations where a director will owe direct tortious duties to third parties are extremely rare; see, for example, Williams -v- Natural Life Health Foods Ltd [1998] 1 WLR 830.

11. So the reason for a beneficiary not having a direct claim against the directors is clear and relatively straight forward, but why should this be a problem in practice? After all, if the PTC is holding an asset then shouldn't this be enough? The answer is 'no' in two situations:
    (a) First - where the PTC itself is not liable to the beneficiaries, perhaps because of an exoneration or indemnity clause; and
    (b) Secondly - where the PTC is insolvent.

    In the latter case in particular two difficulties arise. First, the liquidator may not be willing or able to pursue the recalcitrant directors. Secondly, unless the cause of action is a trust asset then even if realised it will be distributed to the PTC's creditors *pari passu*, which may not assist the trust to any great degree.

ORIGIN OF THE DOG-LEG THEORY:

12. One might have thought that with statements as clear as the majority position in Bath -v- Standard Land Ltd (*supra*) that the issue would not be a live one. However, that would be without the benefit of Lord Nicholl's 'magisterial' speech in Royal Brunei Airlines Sdn Bhd v Tan [1995] 2 AC 378 (PC). In that case, whilst considering the question of accessory liability and having gone over the issues of strict liability, fault-based liability and dishonesty (in particular put in the context of taking risks) Lord Nicholls turned to the question of negligence.

"It is against this background [of dishonesty and taking risks] that the question of negligence is to be addressed. This question, it should be remembered, is directed at whether an honest third party who receives no trust property should be liable if he procures or assists in a breach of trust of which he would have become aware had he exercised reasonable diligence. Should he be liable to the beneficiaries for the loss they suffer from the breach of trust?

"The majority of persons falling into this category will be the hosts of people who act for trustees in various ways: as advisers, consultants, bankers and agents of many kinds. This category also includes officers and employees of companies in respect of the application of company funds. All these people will be accountable to the trustees for their conduct. For the most part they will owe to the trustees a duty to exercise reasonable skill and care. When that is so, the rights flowing from that duty form part of the trust property. As such they can be enforced by the beneficiaries in a suitable case if the trustees are unable or unwilling to do so. That being so, it is difficult to identify a compelling reason why, in addition to the duty of skill and care vis-a-vis the trustees which the third parties have accepted, or which the law has imposed upon them, third parties should also owe a duty of care directly to the beneficiaries. They have undertaken work for the trustees. They must carry out that work properly. If they fail to do so, they will be liable to make good the loss suffered by the trustees in consequence. This will include, where appropriate, the loss suffered by the trustees, being exposed to claims for breach of trust." (emphasis added).

13. With this judgment in hand, the lawyers got to work.

THE DOG-LEG AUTHORITIES:

14. Outside of Royal Brunei Airlines there are four authorities on dog-leg claims:
    (a) Young v Murphy (1994) 13 ACSR 722 (Supreme Court of Victoria)
    (b) HR -v- JAPT [1997] OPLR 123 [1997] PLR 99 (1997) 2 oflr (ITELR) 252
    (c) Cross -v- Benitrust, sub nom Rowe -v- Cross (1998) 1 ITELR 341
    (d) Alhamrani -v- Alhamrani [2007] JLR 44
    (e) Gregson -v- HAE Trustees Ltd [2008] BCLC 542.

15. Young -v- Murphy:

16. Somewhat frustratingly this case deals with a preliminary issue, so the facts were only sketchily described in the judgment. Essentially what appears to have occurred was that the former trustees, BPTC, had been put into liquidation. Prior to its insolvency, however, BPTC had been concerned with the administration of a number of what appear to have been (possibly *inter alia*) unit trusts. There was an allegation that assets of the trust had been lost or diminished **and** that the directors were liable to BPTC to make good that loss. Then came the dog-leg issue -

    "The right of action for breaches of these duties was vested in BPTC before it ceased to be trustee and the new trustees claim to sue, by virtue of their appointment, as successor to the former trustee. ***The question is whether these rights of actions did pass to the new trustees upon their appointment****." (emphasis added) Phillips J at 738.*

17. The answer was an emphatic "no" because the cause of action was not a trust asset.

"The right of action held by the former trustee cannot be shown to have been trust property; there is no basis upon which to conclude it was. Unlike the valuer whom I have used for illustration, ***the directors cannot be said on the pleading in this case to have owed their duties to the company only in relation to some particular trust or trusts; nor were those duties imposed upon them in relation to some particular item or items of trust property as such****. Rather the existence of both the trusts and the trust property was but the context in which the duties fell to be discharged by those who owed duties to the company generally as its officers. There is no basis, then, for supposing that the right of action was trust property in the hands of BPTC or for supposing that the right of action passed to the new trustees, upon their appointment as such." (emphasis added) at 747.*

18. So - no trust asset, no dog-leg claim.

<u>HR -v- JAPT:</u>

19. This is, bluntly, the high water mark of dog-leg claims, and not a very high mark at that.

20. In this case the trust was an occupational pension scheme. The former trustee of the scheme was a single-purpose corporate trustee (described mysteriously at "Mr C") was a solicitor who had been both a director of the trustee **and** a director of the principal employer. The corporate trustee had the exclusive conduct of all aspects of the management and administration of the scheme. Crucially, it had an authorised share capital of only £100, issued to its directors, of which 30p was paid up. It was incorporated for the sole purpose of acting as trustee of the scheme and never had any other business. Furthermore, save for the 'cash at bank, 30p' shown in its balance sheet, it had no assets other than the assets held on the trusts of the scheme. It also had no insurance.

21. In July 1990, the corporate trustee lent £3m of scheme monies to the principal employer, without any security or provision for interest. The sum was not repaid, following which the trustee contracted to buy a site owned and occupied by the principal employer at a price of £3.5m, a sum substantially in excess of the market value. A large deposit was paid, together with further sums for the expressed consideration of bringing the completion date forward. As a result, over 50 per cent of the scheme's funds were invested in the site and yielded no interest. The site was ultimately transferred, and then sold by the corporate trustee at a substantial loss. It was also alleged that the corporate trustee had given grossly inflated figures to the scheme's actuary when investigating whether to augment the pension of another of its directors who was also a director of the principal employer. Mr C was actively involved in these dealings by 'initiating, approving and implementing' them.

22. The new trustees of the scheme sued Mr C (amongst others) raising claims on a number of grounds. In particular for our purposes they alleged that Mr C had owed duties to the former trustee company in the performance of his duties *qua* director which the trustee company had held as assets of the pension scheme trust. Mr C sought to strike out the claims against him personally. On that strike out application Lindsay J held:
    (a) First - there was no direct fiduciary duty possible in this case.
    (b) Secondly - again, there was no direct tortious duty possible on the facts of this case.
    (c) Thirdly - there was no accessory liability possible.

23. Finally, however, Lindsay J turned to the dog-leg claim. Having analysed Royal Brunei Airlines and Young -v- Murphy he held that it was "arguably at least" possible to distinguish the latter from the case before him on the facts given that this was a 'single purpose trust company'.
    (a) "Given that there were no separate assets or business in the former corporate trustee and given the one-trust nature of the former corporate trustee which I shall not enlarge upon yet again, there is, in my view, a stronger case than may be common and stronger than there was in Young itself for seeing a right of action against directors of the former corporate trustee to be trust property." at OPLR 141-142.

24. On this basis, he allowed the dog-leg claim to go to trial. Where it actually went after the hearing, history is silent on. The important point for our purposes is that the dog-leg claim could be run at all.

<u>Cross -v- Benitrust:</u>

25. The next case everybody refers to on this topic was a slight red herring.

26. This was a Guernsey case. The Crosses were an elderly couple who settled property on trust. The trustee was Benitrust International (CI) Ltd, the 1st Defendant, and its directors were the remaining defendants. The Crosses claimed that the directors gave 'disastrous' advice in relation to a loan, which they agreed to the trust making, as a result of which they lost the entire loan[2]. They therefore sued the trust company, and its directors personally. The claim against the directors was on two grounds:
    (a) First - that the directors owed the beneficiaries a direct fiduciary duty.
    (b) Secondly - that the directors were liable for the trust company's breaches of trust as guarantors under section 70 of the Trusts (Guernsey) Law 1989.

27. The Guernsey courts held that:
    (a) The directors could be sued under s.70, and the Crosses did not need to wait for liability against the trust company to be first established.
    (b) There was no direct fiduciary duty owed to the beneficiaries by a trust company's directors.

28. A true dog-leg claim was not pleaded and the issue was therefore not decided on. However, there was one brief judicial reference to the issue, at 357:
    "There was a further matter considered by Lindsay J [in <u>HR -v- JAPT</u>] which has been called the 'dog-leg claim'. This is a suggestion which has been floated that beneficiaries could sue directors in respect of the asset represented by the trust company's claim against the directors for breach of duty of care owed by it in circumstances where the company elects not to sue itself; but ***such claim is not pleaded in the instant case and we need say no more about it than that, if it is to become a binding principle of law it still has some progress to make.****" (emphasis added).*

29. It is worth noting that section 70 has since been repealed - as far as I can tell on the express basis of being bad for the development of Guernsey's financial services business.

---

[2] FYI - the loan was $300,000, to a Mr Sadique who was said to have connections to the Sultan of Brunei and the Crown Prince of Saudi Arabia. It was supposed to last for just 55 days, when he was to be paid $7m, and would carry interest of $100,000 - i.e. 200% per annum. Perhaps unsurprisingly, not a cent was repaid.

Alhamrani -v- Alhamrani:

30. This was part of the Jersey based, but internationally famous, Alhamrani and Russa litigation. Needless to say, this litigation appears to have left no conceivable legal stone unturned.

31. The plaintiffs were beneficiaries of several substantial Jersey trusts, and were suing the corporate trustees (including JP Morgan in one of its guises) for what appeared to be considerable losses to those trusts. They also sued the corporate trustees' directors directly. Originally they did so under Trusts (Jersey) Law 1984 article 56, which was Jersey's equivalent to Guernsey's Trusts (Guernsey) Law 1989 s.70 - i.e. a guarantor provision. However, article 56 was repealed, and this left the beneficiaries with no direct claim against the directors. (I note here that it appears to have been accepted that the repeal of article 56 let the directors off the hook *ex post facto* - presumably on the basis that they were only liable qua sureties and pending determination of the trustees' liability they were not subject to a fully extant liability?)

32. So the beneficiaries applied to amend to plead a dog-leg claim against the directors. The Jersey courts refused this application. Having, once again, considered Royal Brunei, Young-v- Murphy, HR -v- JAPT and Rowe -v- Cross Commissioner Page concluded that on the "wholly unexceptional nature of the facts pleaded in the present case" (at 61) there was no basis for concluding that the directors owed a duty to the trustees which was held as an asset of the trusts. In particular, he noted:
    (a) That this would effectively bypass the repeal of article 56.
    (b) That these were large, insured trustees with multiple trusts under their administration, and that in these circumstances there was no lacuna for the law to fill.

33. In particular it is worth noting that Commissioner Page concluded at 62 that
    (a) "...the mere fact that a director may have had particular responsibility for the affairs of a particular trust cannot, in my view, be sufficient to displace the fundamental nature of a director's statutory duties to his company or justify any equivalence with the sort of exceptional circumstances that existed in HR -v- JAPT, certainly not in a case such as the present where there is no suggestion that the responsibilities of directors were confined exclusively to the trusts in question."

34. So whilst defeating the dog-leg claim on its facts, Alhamrani left the door open to single trust PTC's.

Gregson -v- HAE Trustees:

35. This was an English case. The Claimant was a 25% beneficiary under a family discretionary trust set up in 1960, the principle asset of which was shares in Courts plc, the furniture retailer. The first defendant was a trustee company set up in 1960 to act as trustee of two different family trusts prior to becoming trustee for this discretionary settlement as well, and it went on to end up acting as trustee of a number of other family settlements and insurance policies. When Courts plc became insolvent the shares in it became worthless, and the beneficiary sued it and its directors for failing to diversify the trust's assets. In particular, she sued the directors on a dog-leg claim basis. Robert Miles QC, sitting as a High Court judge, determined a summary judgment / strike-out

application albeit on complete evidence so the judge was urged to make a final decision on the point. In doing so he gave the dog-leg claim ***very*** short shrift.

36. First, he noted the starting point as being that a director of a trustee company does not owe duties direct to a beneficiary of the trust. Then he noted that a dog-leg claim would drive a coach and horses through that principle.

    "I accept that there is, at least in theory, a structural difference between a direct fiduciary or tortious duty and the indirect route involved in the dog leg claim. But the real difference between the two seems to me to be approaching vanishing point. The duty advanced by the claimant is a duty to avoid losses to the Settlement, and has to be: the directors may well have owed entirely separate and different duties to the company, so, to be even arguable, the duty has to be limited to correspond with the specific losses to the trust. But, stated in that way, the duty is for practical purposes a duty owed by the directors (through the medium of a claim by the company held on trust for the beneficiaries) in identical terms to those that would arise under a direct duty."

37. Then, if this were not enough, he went on.

    "[45]...The next consideration is whether the claimant is able to offer any intelligible legal mechanism whereby the rights of a company against its directors are said to be held on trust for the beneficiaries of the Settlement."

38. Having considered this in detail e failed to find any "established or recognisable legal mechanism by which it could be said that their duties become part of the trust estate" (see paragraphs 48 to 49). In particular, he looked at the analogy with advisers to the trust and discarded it for two reasons (or possibly one reason in two formats):

    "[50]... First, as Phillips and Brooking JJ stated in <u>Young v Murphy</u>, the contract with the adviser is trust property because the engagement is made in the course of administering the trust and for the purposes of the trust. In that regard a contract for services is akin to an investment made by the trustees under their administrative power of investment: the benefit of the contract, like an investment, is property of the trust. Second, as already discussed, it makes no sense to say that the trustee company appoints the directors, whether in the administration of the trusts or, indeed, were it relevant, as part of the discharge of its duties to protect the trust property. It may be that in performing their duties the directors of the trustee company are engaged in acts of administration of the trust, but it does not follow, in my judgment, that the directors have been appointed by the trustees, whether under their administrative powers or pursuant to their duties."

39. Finally he went on to point out that:
    (a) There was no lacuna, as the beneficiaries could sue the trustee company or procure that the liquidator sued the directors (paragraph [52]).
    (b) For the concept to work it would require a duty to avoid losses to a particular trust, but a director's duties were embodied in statute (or common law) as being for the benefit of the company (paragraph [58]).

40. However, despite all of the above Robert Miles QC then went on to, just about, distinguish <u>HR -v- JAPT</u> on the basis that it was a single trust trustee company; see paragraphs [65] to [68].

WHITHER NOW THE DOG-LEG CLAIM?

41. Bluntly speaking, it is not going anywhere. It appears to me that for a dog-leg claim to stand any chance of survival it would have to be raised in a single purpose, single trust PTC situation. On top of that you might, just, get some assistance from the following possible circumstances:
    (a) Where the PTC had the benefit of an exoneration or indemnity clause, but the directors did not (although this point might well cut both ways).
    (b) Where the terms of office or employment of the directors in question made reference to the trust.
    (c) Where the appointment of the director was performed in some manner as an exercise of trust powers.
    (d) Where the administration of the trust and its trust property was delegated to the director / officer not qua director / officer, but simply as an available agent of the trust.

42. To be quite clear about this, however, I do not think that any dog-leg claim stands a realistic chance of success today in light of Robert Miles QC's judgment. He might be said to have got some aspects of the analysis wrong - although that is a matter of judgment - but it is pretty persuasive and to overcome it you would need an exceptional case, a brave judge and a good headwind. Overall, I believe that we have seen the last of dog-leg claims.

43. The question of how one could effectively replicate a dog-leg claim is therefore of far greater importance. The answer is three-fold:
    (a) First - find a direct tortious / fiduciary duty on a Williams -v- Natural Life type basis.
    (b) Secondly - take control of the PTC or get the liquidator of the PTC to bring the claim.
    (c) Thirdly - take an assignment of the cause of action from the liquidator of the PTC.

    In the absence of one of these options, (and because I have resisted puns up until now) I think that the dog-leg is broken.

FENNER MOERAN
3 Stone Buildings
April 2009