Article by Rosamond McDowell, Private Client partner at Payne Hicks Beach, first published in Trusts and Estates Law & Tax Journal on 29 July 2016.

Lost founder's rights

Rosamond McDowell looks at Labrouche v Frey *[2016], which serves as a reminder of the different types of breaches of trust and their remedies*

Rosamond McDowell is a partner in the private client team at Payne Hicks Beach

'The court found that under Swiss law, the agreement between Hugo and Olga could exclude the rights of the heirs of her estate, and that the ability to enforce it survived Olga's death for the benefit of the beneficiaries of Newin.'

Could Thomas Cranmer have guessed, in compiling the Book of Common Prayer in the 16th century, that his words from the General Confession would echo in a 21st century piece of Chancery litigation?

> We have left undone those things which we ought to have done; And we have done those things which we ought not to have done; And there is no health in us.

But so it was in the case of *Labrouche v Frey* [2016], a long trial heard towards the end of 2015 by Asplin J who gave judgment in February 2016. The case was decided largely in favour of the defendants, though permission to appeal (refused by the judge) is now being sought from the Court of Appeal: the application is pending at the time of writing. However, it serves as a good illustration for different types of breach of trust, as considered in this article.

The law

Breaches of trust fall into two broad types:

- active breaches, where a trustee, in respect of their stewardship of trust property, is guilty of doing what they ought not to have done; and
- breaches by omission or passive breaches, where a trustee is guilty of failing to do what they ought to have done (see Brightman J in *Bartlett v Barclay's Bank (No 2)* [1980] at 546C). The latter type is known broadly as 'wilful default'.

In relation to active breaches, trustees are strictly liable to make good the loss.

In relation to wilful default breaches, it is necessary to prove that the trustee caused loss to the trust by omitting to do something which as a prudent trustee they ought to have done.

If a trustee personally makes a profit out of a breach of trust, they are liable to account to the beneficiaries for that profit.

Remedies

Trustees must keep accurate accounts *in common form* of the trust property (ie accounts showing receipts, expenditure on administration and distributions) and be ready to render them to the beneficiaries, or the court, when required. An order for an account can be obtained if necessary.

Where a breach of trust has occurred, beneficiaries can *falsify* or *surcharge* the accounts:

- *Falsification* means striking out items in the accounts that would not have been there if the trustee had properly performed their duties, the trustee then being liable to restore the fund to its proper value.
- *Surcharging* applies where a wilful default is established, ie a trustee's failure to act with the requisite care and diligence means there is value missing in the accounts, the trustee thus being required to account for what they ought to have received.

These remedies apply *in personam*, ie personally against the liable trustee.

In addition, to the extent that a trustee holds the traceable product of a

breach of trust, they are under an *in rem* proprietary liability, ie the beneficiaries can recover such property against the world at large, if necessary by imposition of a constructive trust.

Facts of *Labrouche v Frey*

The case was complex, but the salient facts were that it concerned the will trust of Olga Martin-Montis (Olga), a Swiss resident, who died in 1980. The will was governed by English law. Olga's daughter Soledad had a protected life interest in relation to the undistributed fund, and her grandson, Forester, a remainder interest in 75% of that fund.

Olga had, during her lifetime, set up a Liechtenstein establishment (Newin) to hold, via holding companies, a large part of her very substantial wealth. Importantly, by the time of Olga's death, Newin's constitution mirrored the beneficial terms of Olga's will, but was not subject to English law.

Olga had retained certain controlling powers in respect of Newin, known as founders' rights, which are typical of Liechtenstein establishments. By the time of her death, these were held by a company controlled by her Swiss adviser, Hugo Frey.

Olga appointed as the trustees of her will trust Hugo, Soledad and her third husband. Hugo's son Markus Frey was later appointed as a trustee.

Shortly before his retirement, Hugo arranged for Newin to be converted from an establishment to a Liechtenstein foundation, which automatically destroyed the founder's rights. Thereafter, Newin Foundation was controlled by its foundation council, which included particularly Hugo and later Markus Frey.

Some years later, large dividends were declared by the holding companies in Newin, and distributed to Soledad, which distributions were declared, in the course of litigation in Switzerland and Liechtenstein, to have been in accordance with Liechtenstein law.

Olga had agreed a particular method of charging with Hugo for his professional services in relation to all her affairs. This continued to be applied after her death in respect of her will trust by both Hugo and Markus, with a proportion of the fees being allocated to the investment managers, ZT, a company in which they were personally interested.

ZT also received payments from the custodian banks which held the portfolios in the will trust and in Newin.

The factual matrix on which he relied dated back some 30 years, and the main protagonists were not available to give evidence, since both Olga and Hugo were dead.

Forester's claims

Forester's central contention was that Hugo had held the founder's rights as nominee for Olga, and that she had retained the right to call for them until her death. He argued that any agreement between Olga and Hugo that the founder's rights or the right to call for them should not form part of Olga's estate was ineffective. After Olga's death, he said, these rights vested in Hugo as her executor, who was bound to exercise them in the best interests of the beneficiaries of the will trust. On that basis, Forester claimed that:

- Hugo was in breach of trust in failing to dissolve Newin and failing to secure that its assets were held directly by the trustees of the will trust (this claim was abandoned at the trial, as was the allegation of any dishonest motive on Hugo's part).

- Converting Newin to a foundation, and the associated destruction of the founder's rights, was a breach of trust (the '*conversion claim*'), and thus the foundation took the assets as constructive trustee on the trusts of Olga's will.

- The Newin distributions were excessive as distributions from the will trust, judged from an English law perspective, and in breach of the duty to hold the balance between income beneficiary and remaindermen (the '*distribution claim*'). Forester said that the terms of Newin's Liechtenstein constitution, and the position under Liechtenstein law, where no such duty applies, were irrelevant.

- The charges of Hugo and Markus were in breach of the professional charging clause in the will, and excessive (the '*fees claim*').

- The payments made to and retained by ZT in the course of the administration were in breach of trust (the '*ZT payments claim*').

Forester sought two basic remedies; first, an order that Hugo's estate, Markus and Soledad personally provide financial compensation to the will trust for causing or permitting the destruction of trust assets, namely the founder's rights, and secondly a proprietary remedy, a declaration that Newin held its assets, as constructive trustee, on the trusts of the will. If the latter claim succeeded and was enforced, this would diminish the quantum of the personal liability of the defendants under the first remedy.

Why did Forester's claims fail?

First, Forester failed to allow for the operation of legal presumptions. The factual matrix on which he relied dated back some 30 years, and the main protagonists were not available to give evidence, since both Olga and Hugo were dead. Accordingly, the court was heavily reliant on written evidence and presumptions. In particular:

- Forester had suggested that Olga's mental state may have been impaired, and thus the actions taken by Hugo in relation to the founder's rights could not have been properly authorised. This was not supported by documentary evidence, and the presumption in favour of capacity applied.

- Other than the allegations of dishonesty, which were withdrawn, Forester had not put forward a positive case to explain Hugo's actions. In the absence of any improper motive on Hugo's part, the best evidence for what was agreed between Hugo and Olga lay in what Hugo actually did, as the presumption of regularity applied.

- The inference of fact, therefore, was that Olga intended to divest herself of all assets and rights in relation to Newin.

Secondly, because both Olga and Hugo were Swiss resident, Swiss law applied to the agreement between them. Issues of foreign law are determined by the English court as findings of fact. The court found that under Swiss law, the agreement between Hugo and Olga could exclude the rights of the heirs of her estate, and that the ability to enforce it survived Olga's death for the benefit of the beneficiaries of Newin.

The conversion claim was therefore unfounded, and the distribution claim fell away, because English law did not apply to Newin.

Finally, in relation to the fees claim and the ZT payments claim, the court found the charges to have been both 'usual' (viewed from Olga's perspective) and 'reasonable' (on the basis of the expert evidence).

Remedies applied

As Forester's claims were not made out, the remedies he sought fell away. Nonetheless, the judge considered, *obiter*, what the position would have been, had she found differently on the facts.

The conversion claim

The destruction of the founder's rights was pleaded as a wilful default. However, as noted above, in order to establish this, Forester needed to show that the trustees had omitted to do something which as prudent trustees they ought to have done. The court decided that, in relation to Hugo and Markus, the alleged breach would have been active, giving rise to strict liability. In relation to Soledad, who had not taken active steps in respect of the conversion, there could not have been an active breach.

On the proprietary remedy sought against Newin, the judge thought that the destruction of the founder's rights did not entitle Forester to trace into the assets of Newin, as there was no transaction, or steps in a co-ordinated scheme which could form the basis of such a remedy. Accordingly, the trustees could not look to the value of Newin to reduce the quantum of their liability.

The distribution claim

This would have been a clear example of an active breach, though the court found on the facts that a fair balance between income and capital interests was held, and there was therefore no need to determine on what basis the accounts might have needed to be falsified.

The fees claim

This, again, would have been an example of an active breach by Hugo and Markus, but because the charges were reasonable, the accounts did not need to be falsified. To sustain an allegation of wilful default by Soledad (who had simply not objected to the charges being made), it would have been necessary to show a breach of the duty of ordinary prudence in failing to stop the payment of unauthorised fees, which had not been shown.

The ZT payments claim

Though no active breach was made out, the court noted that the failure by the trustees to take steps to recover the payments from ZT might have amounted to an instance of wilful default, but Forester had not showed how an ordinary prudent trustee would have taken such steps.

The judge further noted, *obiter*, that she would in any event, in the absence of any other defence, have allowed a counterclaim made for reasonable fees for the work done by the trustees.

Section 61 Trustee Act 1925 – judicial absolution?

For trustees who fall short of the required standard, the court has power in its discretion to relieve a trustee from personal liability under s61, whose terms are set out below:

> If it appears to the court that a trustee, ..., is or may be personally liable for any breach of trust, ..., but has acted honestly and reasonably, and ought fairly to be excused for the breach of trust and for omitting to obtain the directions of the court in the matter in which he committed such breach, then the court may relieve him either wholly or partly from personal liability for the same.

The best evidence for what was agreed between Hugo and Olga lay in what Hugo actually did, as the presumption of regularity applied.

In this case, the court clearly considered that the defendants had acted honestly and reasonably throughout, and, albeit *obiter*, Asplin J noted that had she found differently on the factual issues and/or the counterclaim, she would nonetheless have granted relief under the section in respect of all the claims.

Is there a moral to this story?

Trustees need to remember that the duties to which they are subject in equity are weighty, and the remedies for breach of such duties draconian. The position is slightly less severe in the case of a breach by omission where the standard required is that of an ordinary prudent trustee, than in the case of an active breach, where the trustee will be strictly liable. However, the standard for professional trustees will inevitably be higher than that for a lay trustee. Legal advice should be sought regularly, to ensure that the administration of any particular trust is protected from attack. ■

Bartlett v Barclay's Bank (No 2) [1980] Ch 515

Labrouche v Frey & ors [2016] EWHC 268 (Ch)