CONSTRUCTIVE TRUSTS

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My answers to John Lehane's questions are, of course, that I have not the faintest idea what the answers are. I too had the privilege of reading Mr Justice Thomas' paper. It arrived on the day I left London. It was then, I regret to say, 72 pages long (John says it was 64 pages - it was not - it was 72, I have just added them up). It was just long enough to fill adequately a plane journey to Honolulu. I have to say I found it so good that, when I got to Honolulu, I read it again by the pool. And I still thought it was very interesting. I then tried to think of a stimulating comment on it - and I could not think of one - because what it says and what Mr Justice Thomas has reminded us all today, is that this is "judges liver" law - nothing else. That is why we poor old practitioners who actually have to advise our clients about the law have a huge problem. And there is nothing, as far as I can make out, that anybody can do about it.

Mr Justice Thomas is an extraordinarily lucky man - because he is a judge. I am not talking about having secure employment in times of inflation or depression or anything like that; the point is that he can disregard authority and he has just talked to us for 45 minutes saying that that is exactly what he has done.

We, on the other hand, are forced to advise our clients and we have to pay them very large sums of money indeed if we do disregard authority. But when we are faced with someone like Mr Justice Thomas who tells us in advance that he is going to disregard authority, what on earth do we do next? Actually, Mr Justice Thomas puts me in mind - just to continue to be complimentary because I do strongly recommend his paper to you, it is very stimulating - he puts me in mind of a comparison that I have previously drawn between Lord Denning and Pope John XXIII. I think it is possible that in years to come we will be able to include Mr Justice Thomas as a third member of this troika. The reason is that great legal reformers have to have very similar characteristics to great religious reformers, certainly in the Roman Catholic church, not merely in order to have that ability to cut right through an area of considerably complexity and come out at the end of the day with something which is intelligible and simple and capable of being followed - which is what Pope John XXIII did and one or two other Christians including the very earliest one did before that - but also you do have to have that essential quality of ..... innocence.

I am not therefore going to talk about the law at all, because I have not the faintest idea what it is. Neither of the two previous speakers has succeeded in telling you either. I am going to make just three observations about the nature of the relationships we are talking about in the context of commercial reality. These considerations have to be taken into account and I do not think they are being taken into account. The first observation is about negligent behaviour. The English courts certainly are using the phrase "want of probity". They are obviously struggling to define something more than

mere negligence in this area and I am sure they are right to do so, but their ability to define what they are talking about is very limited. The courts have, for example, over the last few years spent a lot of time limiting the extent to which negligence can give rise to a claim for damages for economic loss. Cutting back. Now this is not the place to debate the rights and wrongs of that principle, but it is the right introduction to the statement that, so far as banks are concerned, it ought to be reasonably clear to them to whom they owe a duty of care and to whom they do not, and for what they will be held liable. They certainly owe a duty of care to their customers, a duty not to be negligent. And equally certainly, they do not owe a duty of care to the rest of the world or to anyone else who chooses to deal with them.

That is also true of you and me. It applies to all other professionals. I owe my clients a duty of care. I certainly do not owe that duty to people who come off the street or who come and deal with my clients - the other parties to a transaction. Actually, I frequently owe my client a duty to take advantage of these other people.

These principles are very clear. I am not saying that there should be no liability for negligence at all. What I am saying, however, and I think that the English courts are very clear about this and are beginning to get clearer, is that it should be quite clear to whom that duty is owed and what negligence actually means. If in fact banks are going to be held liable as having some form of duty of care to the beneficiaries of trusts, then that is going to be the end of any form of bank account labelled a trust account. Or, alternatively, you are all going to have to advise your clients to ask the person who seeks to open such an account, who the beneficiaries of the trust are, to obtain a copy of the trust deed, and to take an indemnity from every single beneficiary. That is silly.

Furthermore, that will not solve your problem anyway because, of course, your company client is your client, your customer. You certainly owe a duty of care to your company client and, therefore, if in fact that duty of care extends to being alert or at least not negligent in looking after the interests of the company when the directors decide to rip it off, you have a very serious problem indeed. That is simply not what banks are in the business of doing. There can be no doubt, and we can all stand up and shout this loudly, there can be no doubt that you and I, as lawyers, do not owe a duty of care to anyone other than our client and we do not owe a duty to be alert in any shape or form to the interests of third parties. And the same applies to banks.

The second point is that professionals (such as lawyers, bankers or accountants), when they take on a client, enter into a relationship of very considerable complexity. We all have to live with that relationship every day. I have already touched on some aspects of that - for example, the duty to pursue the client's interests even to the extent of taking advantage of the other side's stupidity. Even if you are not prepared to express the duty as forcibly as that, most of you surely would agree that the duty to pursue the client's interests cannot be cut down or trammelled in any way by a duty to others to be alert in any way at all to their interests.

In our context, there is an even more important aspect of that professional/client relationship which needs to be emphasised and that is the need to acquire the client's confidence. You and I have that problem all the time. The client never knows whether the advice he is receiving is right or wrong. If he did he would be a lawyer himself advising himself and saving the money he is paying to you. But he has to believe the advice is right. Take the patient: he goes to the surgeon and the surgeon says "look, I can solve your problem by opening you up and cutting out that thing that you cannot see, but I tell you is in there". Either the patient believes him or he does not. He entrusts himself completely to the professional. And so do our clients. They have to have confidence. Without that the professional/client relationship is dead.

From our point of view, the first thing we always have to do with the client is to convince him that we are on his side. The last way that we are ever going to do that is to give the client the impression that we think he is a liar, a knave or a cheat. But the moment we start asking him the sort of questions which Mr Justice Thomas and John Lehane think we ought to start asking him, we have a problem.

That is exactly what too strict a rule of behaviour in the law of constructive trusts would require us to do. We need some judges somewhere to understand the complexities of this sort of relationship. Banks perhaps do not have the same kind of problem that we have in (a) securing and (b) maintaining our client's confidence in our willingness and determination to look after his interests. But they do have another, much stricter duty to their clients than we do, and that is to honour their cheques **promptly**. Immense claims for damages can follow if they do not. You only have to return a cheque for the client to rush off to his lawyer and say "can I sue them for libel?". In this context, it is a ridiculous idea that before he honours a cheque a banker should actually go away and read the law of constructive trusts, or read Mr Justice Thomas' paper which is 72 pages long and does not tell us what the law of constructive trusts is anyway - it tells us what he thinks it ought to be.

My third point concerns the efficient conduct of commercial activity. In a capitalist system, this requires that the sort of inquiries one has to make before one does business with someone have to be very strictly limited indeed, otherwise business just cannot be done. In essence the commercial activity that we and our clients engage in can only take place efficiently if most people, most of the time, are honest. That is, in fact, the assumption that we all make most of the time in our commercial dealings - that the people on the other side are honest. They may be incompetent, stupid, difficult, unreasonable ..... But they are nevertheless honest.

We even make that kind of assumption on a grand scale when there is a substantial body of evidence to the contrary. To take two recent examples in England - BCCI and Robert Maxwell. There was a widespread belief for the last ten years that BCCI was riddled with dishonesty from top to bottom, yet people continued to deal with them, continued to put deposits with them, the Bank of England continued to authorise them (we will find out why - in about 15 years time). As for Robert Maxwell - a thief! In his case there was actually a DTI inspectors' report 18 years ago which more or less said so. But he bought a newspaper and everybody started dealing with him. Large numbers of very reputable people dealt with him. Now they all look like idiots, and his case is going to spawn in due course, I would guess, somewhere between three and five leading cases on the law of constructive trusts, because an awful lot of people dealt with, received and passed on the assets he stole from his pension funds. The point, of course, is that people went on, against all the evidence, assuming this man was honest and dealing with him.

My point is this, that it is not merely just important for the efficient conduct of commerce that the courts should allow us to continue to assume that most of the time most people are honest. It is actually a recognition of reality. The fact is that we do not want to believe that people are dishonest even when the evidence stares us in the face and neither lawyers nor bankers nor members of the public anywhere should be unfairly penalised by the courts for being that generous to their fellow man.

The conclusion, it seems to me, that emerges from all this is that there is only one test you can apply, if you are asked to advise or you are asked to advise yourself, and that is this: disregard your own interest completely, including your interest in securing your client's confidence, in fact assume he is not your client at all, assume you do not want him as a client, assume that you do not mind if he goes away and never pays the

accumulated bill for all the work you have done for him for the last six months; and if you think that a man with somewhat higher - I am not quite sure how much higher - moral standards than you have would regard what was proposed as morally wrong, then do not do it. That, it seems it me, is the test you have to apply in practice when advising a client in the light of the law as it stands at the moment.

I have produced and set out at the end a couple of cases, because it seemed to me, sitting on an Hawaiian beach, that this was the one thing I could amuse you with. Fortunately we have run out of time. I am sure the chairman is going to say that we cannot discuss the cases and we cannot have any questions. This is fortunate, as far as I am concerned because, as I have already confessed, I do not know the answers. I make, therefore, just four points about the cases.

1. Both of them are drawn from real life. I really have not made any material change. One of them you may recognise, the other, hopefully, you will not.

2. They both involve a lawyer, not a banker, but if you analyse them, they both involve a lawyer being asked to act as a banker. Consequently, they raise a question which I find interesting, namely would the answer be different in either case if it was a banker involved and not a lawyer? Would it make a difference to the outcome and, if so, why?

3. The third point is one which has begun to emerge recently in England, namely how difficult it is to apply the grand principle of best practice which our Securities and Investments Board and all our self-regulatory organisations now put forward of "know your client". When you think about it, what a difficult thing it is to know your client. What a silly idea! You can never know your client, because your client will never tell you anything he does not want you to know.

4. Finally, each of the cases demonstrates, it seems to me, that if the lawyer in the particular cases did ask further questions, it would not be difficult for the client to give him satisfactory answers. They might be total lies, but there would never be any way in which the lawyer could actually get at the truth which he suspected.

Thank you.

CASE ONE

Your client, James Wishful, the inventor of a method of creating perpetual motion, is the sole director and shareholder of Wishful Thinking Limited ("WTL") which owns all the patents and know-how etc relating to the invention. WTL has run out of money and for some time you have been helping Wishful to try to find new sources of finance, to such an extent that you are probably now WTL's largest creditor (or would be if you submitted a bill). The other largest creditor is WTL's bank, which is fully aware of the situation and has indicated that WTL's overdraft will not be allowed to increase further, but the bank appreciates that the overdraft will not be reduced until new funding can be found.

Just when all seems lost, Wishful telephones you in great excitement to say that he has found a fairy godfather who is prepared to invest A$500,000. This will be just enough to cover the cost of building a prototype, plus the costs of maintaining the patents and paying the company's overheads while this happens, but not enough to repay the bank or to pay you. You express your pleasure for Wishful in securing this last minute reprieve, note silently the implication that you will be expected to negotiate the terms of

the new investment without being paid for doing so and, just before putting the phone down, offer the gratuitous advice that the cash had better not be paid into the bank or else the bank will take half of it in repayment of the overdraft.

The next day Wishful telephones again to say that he has persuaded the godfather to pay in A$100,000 immediately (before any agreement is signed) because of the pressing need to pay some of WTL's expenses at once and, in view of what you said yesterday about the bank, would it be all right for the money to be paid into your client account for the benefit of WTL? It turns out that he has already told the godfather to pay the money to your firm and all he needs to know is the number of your firm's bank account.

The money arrives the next day - at least, you think it does, because A$100,000 arrives in your client account and you cannot trace another client who is expecting such a sum, but there are no instructions. Upon making further inquiries, the paying bank tells you the money is being paid "for Mr James Wishful", by order of a company you have never heard of, which Wishful assures you is connected with the godfather. Wishful then asks you to arrange for him to collect from you the next day A$80,000 in cash "to pay various pressing creditors". Your secretary tells you that, when she was talking yesterday to Wishful's secretary (whom you know to be his mistress), she said that they were planning together a fortnight on Bedarra Island as soon as time and funds permitted.

What do you do next?

CASE TWO

You are telephoned by Mr Alan Word, a partner in an eminently respectable firm of London solicitors, Word, Bond and Associates, which your firm has not dealt with much before but is keen to establish a relationship with. He says that he is involved in a very large, highly confidential transaction which has hit some last-minute snags, as a result of which he urgently needs three shelf companies in your jurisdiction: "the tax people" are still working out the details, but it seems certain that they will want one or more of the companies to be resident in your jurisdiction, so would you also be so kind as to supply the directors and secretary etc: the objects of the companies must be as wide as possible and must include both the borrowing and lending of money: the transaction must close within the next 48 hours, so please could you put the shelf companies in place and he will telephone you with further details as soon as he has them.

Eager to impress with your ability to move as fast as any city slicker, you assure him the companies will be ready for him first thing tomorrow morning; and so they are.

When you arrive at your office the next morning, there is a fax waiting for you from Mr Word asking for details of your client account and the names of the companies. You fax back the information immediately.

You hear nothing more that day, but the following morning your accounts department tells you that the sum of A$50 million has been credited in already cleared funds to your client account for the benefit of the three companies in the proportions 10:10:30. No other details are known. At the earliest opportunity you try to telephone Mr Word, but his secretary tells you that he has been in a meeting since the day before yesterday and she has no idea when she will be able to give him a message or when he will be able to ring you. She ventures the comment that, by the time he emerges from his meeting, he will be so tired that she doubts he will be capable of telephoning anybody.

You hear nothing more that day, but overnight you receive a fax from Mr Word's assistant apologising profusely for failing to telephone, explaining that this is due to frantic, all-night sittings in an effort to close the transaction and that the A$50 million is a loan in the relevant proportions to each company from the British Motor Industry Reconstruction Trust at 10% pa repayable on demand. The fax goes on to ask you to arrange for each company to lend the whole sum immediately, at 10.5% pa repayable on demand, in parcels of $10 million each to five companies called Nose Dive (Nos 1, 2, 3, 4 and 5) Limited respectively and gives details of the bank accounts in the Bahamas to which the money should be sent. The fax ends by thanking you in advance for your swift and efficient help and emphasising that the money must reach the Bahamas today, failing which the entire transaction will fail.

What do you do next?