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# Tracing, Restitution and Innocent Donees: Who Wants to be a Volunteer Anyway?

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# Tracing, Restitution and Innocent Donees: Who Wants to be a Volunteer Anyway?

## **Abstract**

The interaction between property principles and restitution for unjust enrichment is controversial. Property theorists resent the attempts by the proponents of restitution theory to assert that property is subordinate to restitution. Restitution theorists are critical of property theorists for refusing to accept their new ordering of the law. In addition, the issues involved are technical and difficult.

## TRACING, RESTITUTION AND INNOCENT DONEES: WHO WANTS TO BE A VOLUNTEER ANYWAY?

*Susan Barkehall Thomas* \*

The interaction between property principles and restitution for unjust enrichment is controversial. Property theorists resent the attempts by the proponents of restitution theory to assert that property is subordinate to restitution. Restitution theorists are critical of property theorists for refusing to accept their new ordering of the law. In addition, the issues involved are technical and difficult. Burrows has said that:

the relationship between the law of property and the law of unjust enrichment/restitution has long been regarded as fiendishly complex and problematic. Indeed one can regard it as the last great unsolved mystery for those working in the law of restitution.<sup>1</sup>

The dispute between the property and restitution theorists is at the core of the problem of the innocent volunteer. What happens when beneficiaries of a trust attempt to trace their equitable property entitlement into the hands of a volunteer who has since changed position on the faith of the receipt?

The traditional property approach permits the claimants to assert their continuing proprietary interest in the traceable proceeds of their stolen property, unless and until it is dissipated or received by a bona fide purchaser for value without notice. Accordingly, the volunteer recipients will be liable provided that they retain the traceable proceeds.

The restitutionary approach permits the volunteer recipient to claim the defence of change of position. If the defendants retain the traceable proceeds, but have otherwise satisfied the requirements of the restitutionary defence, they will not be liable to repay.

The opposing views have been well-stated before, but little attempt has been made to go beyond theory.<sup>2</sup> This article moves beyond the theory and seeks to solve the dispute through economic analysis, and by the presentation of alternative solutions. Part 1 of this article sets the scene by summarizing the approaches and examining the

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<sup>1</sup> A Burrows, *The Law of Restitution*, 2<sup>nd</sup> ed, (Butterworths Lexis Nexis, London, 2002 at 412.

<sup>2</sup> Those who have attempted some resolution are Burrows in *The Law of Restitution*, n 1 above, and C Rotherham, *Proprietary Remedies in Context* (Hart, Oxford, 2002).

particular implications which rise from preferring one analysis over the other. In part, this will be achieved by establishing a hypothetical variation on the facts of the House of Lords decision in *Foskett v McKeown*.<sup>3</sup>

In Part 2 economic analysis will be applied to the problem to determine whether one approach can be preferred over the other. Fundamentally it is necessary to determine which party should bear the loss. The analysis in Part 2 will demonstrate that there are no compelling reasons from economic analysis to depart from the property-based liability rule.

Part 3 involves discussion of alternative models of beneficiary protection that restructure the problem. If the beneficiary is sufficiently protected by other means, there should be no objections to making the defence available to the volunteer recipient. This Part explores what models might be available, and how they might work.

### The Competing Analyses in Depth

The House of Lords decision in *Foskett* brought to a head the debate between property law theorists and unjust enrichment theorists. The case involved a claim by trust beneficiaries to trace their misappropriated property into the hands of innocent volunteers.<sup>4</sup> The core question involved in the decision was whether the beneficiaries could recover a proportionate interest in the payout, rather than merely the actual sum of their funds diverted towards payment of the premiums.

Central to the reasoning of the members of the House of Lords were propositions regarding the basis of the plaintiffs' claim. Two fundamentally opposed views were canvassed. The first, conventional, view is that the plaintiffs were merely tracing their existing equitable property rights into a new form. In this article, this will be called the 'property approach'.

The second view, argued but not accepted, was that the case should be viewed as a question of proprietary rights raised to reverse a claim in unjust enrichment. This analysis of the case proceeds on the basis that (1) the defendants were enriched by the receipt of the insurance premiums; and (2) the enrichment was unjust, because the

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<sup>3</sup> [2001] 1 AC 102.

<sup>4</sup> In this case, a wrongdoing trustee had diverted trust funds to his own use, paying premiums on his life insurance policy. On his death, the proceeds of his policy were paid out to his children.

plaintiffs were ignorant of the trustee's misappropriation. This is the 'unjust enrichment approach'.<sup>5</sup>

### The Property View

There was clear adoption of the property approach (with a corresponding rejection of the unjust enrichment approach) in *Foskett*.

Lord Millett stated:

The transmission of a claimant's property rights from one asset to its traceable proceeds is part of our law of property, not of the law of unjust enrichment. There is no 'unjust factor' to justify restitution (unless 'want of title' be one, which makes the point). The claimant succeeds if at all by virtue of his own title, not to reverse unjust enrichment. Property rights are determined by fixed rules and settled principles.<sup>6</sup>

Further, in relation to the relationship between property and tracing, his Lordship stated:

A beneficiary of a trust is entitled to a continuing beneficial interest not merely in the trust property but in its traceable proceeds also, and his interest binds every one who takes the property or its traceable proceeds except a bona fide purchaser for value without notice.<sup>7</sup>

The conventional property analysis adopted by the House of Lords can be broken down into a number of steps, as follows:

1. Beneficiaries under a trust have equitable title to trust property.
2. Equitable title is good against the world except for a bona fide purchaser for value without notice.
3. The beneficiary's equitable rights to the property subsist notwithstanding any change in form, or transmission to a third-party.
4. The equitable tracing rules exist to identify the continuing equitable property rights of the beneficiary's notwithstanding changes in form.
5. The property rights are defeated if the third-party is a bona fide purchaser for value or if the property is dissipated.

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<sup>5</sup> The terms 'property approach' and 'unjust enrichment approach' are intended as nothing more than convenient labels. In this area, there is a danger in the overuse of labels to the detriment of analysis, but some convenient reference point is required.

<sup>6</sup> *Foskett v McKeown* [2001] 1 AC 102 at 127.

<sup>7</sup> *Ibid.* See also, for example, the judgment of Lord Browne-Wilkinson at 108-9.

6. If an application of tracing rules permits a conclusion that the property can be traced, the plaintiffs are considered to be asserting their original and ongoing equitable title.
7. The equitable property rights of the plaintiff beneficiary defeat any rights of a volunteer.

The property analysis is supported by, among others, Virgo<sup>8</sup> and Rickett and Grantham.<sup>9</sup>

### *Fictions inherent in the property approach*

One of the criticisms of the property approach is that it contains an important and fundamental fiction. The fiction is that tracing involves no new property rights, but only the continuation of existing property rights, although in a new object. The fiction underlies points 3 and 6 of the above summary. Burrows offers a colourful example to illustrate the point.

He argues:

Property is non-fictional and does have explanatory force when the claim being asserted is "I want that back because it is mine". That is the true *vindicatio* claim. It is a pure proprietary claim... No new proprietary rights are being created. One is merely passively recognising existing rights that have previously been created. The same is true of extracted minerals or the fruits of property. If I own land, I own the oil under it. But this cannot, without invoking fiction, be extended to tracing through substitutes. Ownership of a pig can explain ownership of the piglets but does not explain why P can be said to own the horse that D has obtained in substitution for the pig stolen from P.<sup>10</sup>

Rotherham uses a more metaphysical approach. Responding to the conventional view that tracing is merely an evidentiary process, he states:

We normally think of the institution of property in terms of the vindication of existing rights. For this reason we are inclined to infer that tracing is not essentially remedial. Thus, jurists conclude that tracing is a way of "establishing" the plaintiff's property rights, in the sense of adducing facts to

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<sup>8</sup> G Virgo, *The Principles of the Law of Restitution*, (OUP, Oxford, 1999). See, also, extrajudicially Lord Millett 'Proprietary Restitution' Chapter 12, in eds S Degeling and J Edelman *Equity in Commercial Law*, (Lawbook Co, 2005, Sydney).

<sup>9</sup> R B Grantham and CEF Rickett, 'Property and Unjust Enrichment: Categorical Truths or Unnecessary Complexity' [1997] NZLR 668.

<sup>10</sup> A Burrows, 'Proprietary Restitution: Unmasking Unjust Enrichment' (2001) 117 LQR 412 at 417-8.

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*prove* that he or she has particular rights. However, tracing also entails to the plaintiff “establishing” rights, in the sense of *creating* a new legal relation. Tracing is the exercise by the plaintiff of a power to change his or her legal position and, in doing so, that of the defendant. This process allows the plaintiff to enjoy those rights conventionally associated with the institution of ownership.<sup>11</sup>

Rotherham also refers to a further problem inherent in the property approach to tracing, described by Birks as the ‘geometric multiplication of the plaintiff’s property’.<sup>12</sup> When a plaintiff beneficiary seeks to recover their stolen property, the plaintiff may choose to proceed against the holder of the original asset (if that person is not a bona fide purchaser) and claim the return of the asset in specie, or the plaintiff may choose to claim against the holder of the substitute, and recover the substitute.

As Rotherham says:

Because A cannot be simultaneously the owner of both the original thing and the substitute, it cannot plausibly be argued that, prior to A’s election to trace, a full-blown proprietary interest arises in respect of the proceeds of the sale held by B. Prior to tracing, B has a defeasible title to the proceeds of the sale – a title that he is liable to lose if A elects to claim title to those proceeds.<sup>13</sup>

The necessary consequence of this analysis is that there is a creation of rights.

The property approach has no real answer to this criticism. It glosses over the way that interests can, and do, jump from one object to another. Assertions that title is retained are conclusory. Fundamentally, the supporters of the property approach either deny the fiction, or accept it as necessary.

Essentially the fiction exists to serve one point. That is: the law regards property rights as enforceable against third parties. Unless tracing rules permit the ongoing recognition of property rights despite changes in form, the concept of property is attacked at its very core.

### Unjust Enrichment Analysis

The alternative analysis says that *Foskett* is a case about unjust enrichment, which provides some guidance for when proprietary remedies can be granted to reverse

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<sup>11</sup> C Rotherham ‘The Metaphysics of Tracing: Substituted Title and Property Rhetoric’ [1996] 34 *Osgoode Hall Law Journal* 321 at 328-9.

<sup>12</sup> P Birks *An Introduction to the Law of Restitution* rev (OUP, Oxford, 1989) at 394.

<sup>13</sup> Rotherham, *Proprietary Remedies*, at 330.

unjust enrichment. The strongest advocates of the unjust enrichment analysis as applied to *Foskett* have been Professors Birks and Burrows.<sup>14</sup>

Under this framework, tracing has a role to play at the remedial level. The argument is established as follows:

1. The misappropriation of trust property by a trustee functions as the unjust factor of ignorance or powerlessness.<sup>15</sup>
2. The recipient of trust property transferred where the beneficiary is ignorant of the transfer is strictly liable to make restitution.
3. Liability is usually personal but can be proprietary.
4. Whether the remedy is proprietary will depend upon the ability of the plaintiff to trace.
5. If the property can be traced into the third-party's hands, and is still in their possession, this justifies the grant of the proprietary remedy to reverse unjust enrichment.
6. In this case the proprietary interest is purely remedial: it is a new proprietary interest to reverse unjust enrichment.<sup>16</sup>
7. Because unjust enrichment is the basis of the claim, rather than property, normal restitution defences apply.

The unjust enrichment approach differs from the property approach in two critically important ways.

### **No need for fictions**

The traditional property rule requires an inchoate hovering property interest capable of jumping from one item of property to another. The conceptual difficulties with this approach were discussed above. The unjust enrichment approach, on the other hand, is prepared to accept that any proprietary remedy is created in this scenario in order to reverse unjust enrichment. This analysis avoids the need for the fiction inherent in the proprietary analysis. Rather than tracing being used to identify property rights, it

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<sup>14</sup> See, for example, P Birks 'Property, Unjust Enrichment and Tracing' (2001) 54 CLP 231, Burrows *Proprietary Restitution* and *The Law of Restitution*.

<sup>15</sup> Burrows, 'Proprietary Restitution' n 10 above.

<sup>16</sup> Cf the view of Swadling who argues that although the traced interest must be new, the fact that it is a new interest does not mean that it is an interest generated by unjust enrichment. Swadling 'Property and Unjust Enrichment' Ch 11 in *Property Problems From Genes to Pension Funds*, JW Harris (ed), (Kluwer Law International, London, 1997) at 132. He argues that there is doubt as to whether the interest is generated by unjust enrichment, as the recipient is never enriched.

is used here to identify value. The defendant's continued possession of the value justifies the imposition of the proprietary right.

As the grant of the property right is remedial only, this analysis does not encounter the conceptual difficulties that arise from the property approach. The question of where the proprietary rights subsist prior to judgment does not arise. Instead, the plaintiff has a power to assert a proprietary right.<sup>17</sup> This is seen to be preferable to the property approach which cannot explain the fluidity of property rights.<sup>18</sup>

### Availability of defences

This second distinction is critical. The unjust enrichment approach permits the defendant volunteer to claim a defence of change of position in the appropriate case. However, the property approach permits no such defence. The significance of this distinction can best be illustrated by the following example.

*M is a trustee and misappropriates \$20,000 in trust funds by using them to pay the premiums on his life insurance policy. When he dies, his insurer pays out \$1 m to his nominated beneficiaries: his children. Upon receiving the proceeds into a bank account, M's children decide to spend their own pre-existing money on an expensive holiday. The insurance proceeds are untouched, but the defendants have changed their position by spending their own money on a holiday. If not for the receipt of the insurance proceeds they would not have taken the holiday.*

As discussed above, the property approach asks only whether the defendant continues to retain the traceable substitute for its property. If so, the plaintiff will have a successful proprietary claim against the volunteer. The volunteer's change of position is irrelevant to the property analysis. In the example, the volunteers will remain liable to return the proportion of the \$1 million that represents the plaintiffs' misappropriated property.

By comparison, using the unjust enrichment analysis, the defendant volunteers would claim that their good faith change of position renders it unfair that they now be

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<sup>17</sup> See Rotherham, *Proprietary Remedies* at 93-4.

<sup>18</sup> See, for example, S. Worthington, *Proprietary Interests in Commercial Transactions*, (Clarendon, Oxford, 1996) who states at 175: 'before the plaintiff makes a claim and elects which property to pursue, it seems unreasonable to assume that the plaintiff has an equitable ownership in both [assets]. If a strict analysis is applied, it must be conceded that the tracing rules really give the plaintiff the power to crystallize a proprietary interest, rather than a continuing proprietary interest in a changing and multiplying class of assets'.

required to make restitution to the plaintiffs.<sup>19</sup> Although the misappropriated property can be identified in the defendants' hands, the defendants' expenditure of their own money enables them to resist the restitutionary claim.<sup>20</sup>

### The Dispute: Again

The unjust enrichment analysis of *Foskett* marginalizes one of property law's core concepts: the proposition that property rights are maintainable against third parties. It is part of the fundamental nature of equitable title that it can be enforced against the world, until it arrives in the hands of a bona fide purchaser for value without notice. The unjust enrichment approach involves an unprecedented suggestion that property rights will be subject to personal defences: in this case the defence of change of position.

Taken at a broad conceptual level, this is a debate about the power of equitable property rights within the legal system. Should equitable property rights subsist against all but bona fide purchasers for value? In the long run, the debate is not furthered by dogmatic doctrine-driven statements. To assert that 'property rights subsist against third parties, thus the property analysis is right' does not answer the real question. So, for example, Grantham's and Rickett's assertion that we must protect property misses the point. They state:

Property rights are a significant matter in the common law and represent one of the fundamental building blocks of the Anglo-American legal tradition. ... property rights have a powerful normative force that attracts a level of protection that borders on the absolute. One's right to do as one pleases on or with one's property is constrained only at the margins and protection from interference is available against even the most innocent. From such a perspective the idea that a plaintiff's property rights should be extinguished, to be replaced by rights born of unjust enrichment, merely because the subject matter of the right has changed form, would be a contradiction quite out of keeping with the otherwise generous protection afforded to rights to property.<sup>21</sup>

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<sup>19</sup> *Lipkin Gorman (a firm) v Karpnale Ltd*; [1991] 2 AC 548; *David Securities Pty Ltd v Commonwealth Bank of Australia* (1992) 175 CLR 353.

<sup>20</sup> The defence operates pro tanto, so a complete defence would only be available if the holiday was of equal value to the enrichment.

<sup>21</sup> Ross Grantham and Charles Rickett 'Tracing and Property Rights: The Categorical Truth' (2000) 63 MLR 905 at 911.

This only serves to repeat the standard mantra: this is the law of property; the property law is right; anything that contradicts property is wrong.<sup>22</sup> It fails to explain *why* the formula is right. To break the impasse and reach the solution we have to ask the right questions. Therefore, we should be asking what reasons exist to support the maintenance of equitable title against third parties. Is there justification for refusing to permit personal defences to impinge upon the claim?

In the next part, economic analysis will be applied to the debate to provide some suggestions for whether the primacy of equitable property rights can be supported.

### **Economic Analysis**

The purpose of this part is to use a normative economic analysis to see if it provides any guidance for preferring one approach over the other.

First, we need to consider the consequences and incentives produced by each of the competing approaches. Consequences and incentives must be considered at the level of individual transactions, but also at the broad social level. If a rule produces inefficiencies or undesirable results on a broad scale, it may not be appropriate.

Having examined the operation of the existing rules, it may appear that from a normative perspective that they are equally balanced. If this were to be the case, broad policy objectives may be used to decide upon a preference.

#### **A. Areas of Commonality**

We can easily envisage a scenario where the property approach and the unjust enrichment approach reach the same conclusions regarding liability.

As *Foskett* stood on its facts, there is no dispute from either camp about the outcome. Trust property was transferred to volunteers. It was still in their possession and had to be returned. No change of position had occurred.

There is a clear normative rationale for this common solution. The volunteers paid nothing for the property, and have received the benefit of its full value. If they are required to return it they will suffer no actual loss, and the beneficiaries will also

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<sup>22</sup> As Rotherham says: 'the use of metaphysical justification – the argument that something simply *is* property... stifles any comprehensive consideration of how the interest in question *ought* to be protected'. Rotherham, *Proprietary Remedies*, at 118.

suffer no loss. This rule is efficient, as it ensures that no party suffers a loss. It is the 'least cost' option.<sup>23</sup>

## B. The Disputed Area

The example offered in Part 1 (a modified version of the *Foskett* facts) represents the problem case. In the problem case, a decision in favour of one party necessarily involves the other party suffering a loss. As the defendants have acted in reliance on the wealth being their own, they will suffer loss if they are required to return the property still in their possession. Equally, the beneficiary will suffer loss if property is not returned. The competing analyses represent the opposite poles in a loss shifting exercise.<sup>24</sup>

If we are to go back and take a normative approach to the question, it is clear that any solution involves the balancing of competing priorities. The purpose of this part is to examine the competing concepts, and to see what approach is suggested when the priorities are considered openly.

### *Security of receipts*

The rationale most commonly accepted for the change of position defence is that it enables the recipient to act on the basis that wealth believed to be his own is his to spend, or otherwise deal with. Birks argued that all recipients, even donees, need to be able to act on the basis that a receipt is theirs to deal with, unless there is reason to believe otherwise.<sup>25</sup>

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<sup>23</sup> See also A Duggan 'Constructive Trusts from a Law and Economics Perspective' 55 *UTLJ* (2005) 217 at 237 where he explains that a rule requiring a recipient of a mistaken payment to return the money is efficient. He says 'in cases where P tells D about P's mistake before D spends the money,... giving the money back is a virtually costless way of avoiding P's loss'. See also S Levmore, 'Explaining Restitution' 71 (1985) *Va LR* 65.

<sup>24</sup> A separate line of argument could be developed that the settlor should bear the risk. This would involve major change to the underlying law of trusts, and the traditional role of the settlor. For reasons of space this more controversial argument is not pursued in this paper.

<sup>25</sup> P Birks 'Change of Position' The Nature of the Defence and its Relationship to Other Restitutionary Defences' in M McInnes *Restitution: Developments in Unjust Enrichment* (LBC Information Services, Sydney, 1996) at 50 – 54. Note that other views are that the defence is an individualistic one, which prevents unfairness to the defendant. Thus, for example, Lord Goff's statement in *Lipkin Gorman*; see also Kit Barker 'After Change of Position: Good Faith Exchange in the Modern Law of Restitution', Ch 7 *Laundering and Tracing*, ed P Birks, (Clarendon Press, Oxford, 1995). Barker argues that change of position is 'an individualistic

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Recent English case law has implicitly supported this view, by providing a wide statement of the availability of the defence. Thus, if a recipient is no longer enriched, for example because the value was stolen or lost, the plaintiff may be unable to recover from the plaintiff. The defence is enabled if there is a causal relationship between the loss and the enrichment, on a 'but for' test.<sup>26</sup>

The security of receipts rationale has been applied by others. Gardner has used it to suggest that the change of position defence creates an efficient rule, as follows:

a person who enjoys, and perceives himself to enjoy, broad security in his wealth will be more ready to spend it (other things being equal) than one who feels it necessary to look over his shoulder before doing so, so as to check that it is really his to spend – in our context, that it cannot be reclaimed from him by a trust. The former state of affairs thus allows the market to approach full efficiency more closely than the latter, and from an economic point of view is therefore to be preferred.<sup>27</sup>

Gardner's discussion was confined to personal claims, and he noted that the bona fide purchase defence operates to protect a purchaser's security of receipt against property claims. He did not extend his analysis to ask whether his argument forces a reconsideration of the property-based defences.

Others, however, have argued that where the proprietary claim is dependent upon tracing,<sup>28</sup> the change of position defence should operate to protect the defendant. Nolan's argument is that unless the defendant has the personal defence available, the:

proprietary claim would, often as not, subvert the operation of the defence on the personal claim: by asserting a proprietary claim against a solvent defendant, the plaintiff would get what a defence denies him in a personal claim against the same defendant which arises out of the same facts.<sup>29</sup>

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defence with moral foundations' at 196 and the bona fide purchase defence is the one which 'deploys a broad policy of transactional security in exchange dealings' at 192.

<sup>26</sup> *Scottish Equitable plc v Derby* [2001] 3 All ER 818 at 827, per Robert Walker LJ; *Jones v Commerzbank AG* [2003] EWCA Civ 1663.

<sup>27</sup> S Gardner, 'Knowing Assistance and Knowing Receipt: Taking Stock' [1996] *Law Quarterly Review* 56, 91. This discussion was related to the action for knowing receipt, and whether it should be reframed as a strict liability action. Only the operation of the defence in relation to personal claims was under consideration.

<sup>28</sup> Nolan calls this a restitutionary proprietary claim. This is distinct, in his view, from the scenario where the plaintiff is asserting a pre-existing equitable title. The latter scenario gives rise to a proprietary claim. See R Nolan, 'Change of Position', Ch 6 in *Laundering and Tracing* n 25 above, at 177-9.

<sup>29</sup> *Ibid* at 178-9.

The argument has much support in the literature, and there is a body of academics who support it.<sup>30</sup> Nonetheless the analysis is still open to criticism. In order to achieve consistency between personal and proprietary actions, a choice is made to prefer the framework applicable to the personal action, rather than asking which of the responses is the better one.<sup>31</sup>

This is the question that must be asked now.

What happens if we use the change of position defence to protect the defendant against proprietary claims? For our analysis it will not matter whether the defence is applied to only 'restitutionary proprietary' claims, or also to 'pure proprietary' claims. The position of the volunteer recipient is the same in both scenarios. Essentially the question is whether the defence provides a better normative rule than the bona fide purchase defence. Is it more efficient to allow the change of position, or to rely on the normal property rules?

*Can we identify an efficient rule?*

First we need to set out the consequences of each scenario. Then they can be analysed.

Scenario 1: Allowing the defence in the problem case:

- The plaintiffs will suffer a loss of \$20,000.<sup>32</sup>
- The donee recipients will be protected to the extent of their change of position.

Scenario 2: Denying the defence in the problem case

- The plaintiffs will recover in full.
- The volunteer will suffer loss to the extent of their reliance on the faith of the receipt.

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<sup>30</sup> This view is also supported by Burrows, *The Law of Restitution*, n 1 above, at p 527; Birks: 'Overview: Tracing, Claiming and Defences', ch 11 in *Laundering and Tracing*, n 25 above, at 319; Virgo *The Principles of the Law of Restitution*, n 8 above, at 729.

<sup>31</sup> The alternative approach to prefer the proprietary position could just as easily be taken. See, for example, K Barker, 'After Change of Position', Ch 7 in *Laundering and Tracing*, n 25 above. In order to solve the problems adverted to by Nolan, Barker argues at 194-5 that the defence of bona fide purchase should be available against personal and proprietary claims.

<sup>32</sup> In fact, as the House of Lords held that the beneficiaries were entitled to a proportionate amount of the insurance payout, their indirect loss is greater than \$20,000.

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Scenario 1 gives the plaintiff the incentive to prevent the fraud. The scenario 1 rule will be more efficient if the plaintiffs can more easily discover the fraud than the defendants. It will be less efficient if the volunteers could have discovered the fraud. The recipients are not only 'more ready to spend' the amount (as Gardner argues), but are actively encouraged by the law to do so, without making any inquiry into the gift's source. If the recipients have a simple means of ascertaining the legitimacy of a receipt the scenario 1 rule does not encourage them to take that step.

The scenario 2 rule will be more efficient if the volunteer defendants are better able to discover the fraud.

So far, the analysis raises more questions than answers. Can the plaintiff prevent the fraud? Can the defendant prevent the fraud? What does it cost each party to do that?

What is the ability of each party to identify and prevent the fraud?

Some brief observations can be made about the volunteer defendant before considering the plaintiff's ability to prevent the fraud.

What is the normal response of a recipient of a gift? If we assume that the donee knows and trusts the donor, she is unlikely to make inquiries into the source of the gift. If the donor is not personally known to the donee, but the source of funds is apparently legitimate, as in *Foskett*, it is also unlikely that the donee will inquire into the gift's source.

It would also seem safe to assume that most donations of gifts do not come from improper sources. If this is correct, then in most cases, a lack of inquiry on the part of the volunteer recipient will in fact be the appropriate response.

Furthermore, in many cases, the volunteer will be unable to probe deeply into the provenance of the gift. In *Foskett*, it would have been impossible for the beneficiaries to identify that the plaintiffs' money had been used to purchase the insurance premium that led to the payout to them. Accordingly, a rule which requires the volunteer to make inquiry in every case, will in many cases involve the volunteer in wasting the money spent on inquiry, as inquiry will usually be fruitless.

However, there will be scenarios where it is appropriate for the volunteer to make inquiries. Where the recipient has grounds to suspect that a gift is not legitimate, inquiries are appropriate.

What conclusions can be drawn from this? In the normal case, refusing the defence will not change the volunteer's conduct. The volunteer will normally not make inquiry into the source of the gift, and there will normally be no need for inquiry. However, from an economic perspective she would still be well-off *if she had* made

inquiries. The gift cost her nothing. Therefore, in the case where inquiry is appropriate, it would seem acceptable to place the burden of such inquiry on the volunteer.

Ultimately though, this only says that the volunteer should bear some risk. Both the change of position defence and the bona fide purchase rule contain limiters to deal with the suspicious scenario.

The next stage of the analysis requires consideration of the position of the plaintiff.

A helpful starting point can be found in an analysis undertaken by Menachem Mautner in a similar context. Mautner has considered the efficiency of the American Uniform Commercial Code (UCC) rules regarding the liability of third parties who purchase property from agents. Although his scenario is not exactly the same, it is sufficiently similar to be useful. Mautner's discussion centres on the scenario of a principal who has entrusted property to an agent, who improperly sells the property to a third party.

In determining whether the UCC rules are efficient, his starting point was the same as ours. He said:

In cases in which one of the two competing parties could have clearly prevented the occurrence of the conflict ex ante by incurring expenses relatively smaller than the value of the interests at stake, ... taking into account the probability of the occurrence of a conflict, priority should be accorded to the other party.<sup>33</sup>

Mautner then considers whether the plaintiff, who has entrusted property to the agent, could have prevented the fraud. Mautner's analysis is almost entirely directed to discussion of the entrustment rules in commercial cases. His commercial case example is where:

*A*, the manufacturer of a product, appoints *B* to be his selling agent in the market in which *B* is located. *A* delivers goods to *B* on consignment. *B* sells the goods to *C* and absconds with the proceeds. Alternatively *B* pledges the goods to *C* to secure a loan made by *C* to *B*.<sup>34</sup>

Mautner suggests that the entrusting party is better able to prevent the fraud than the recipient.<sup>35</sup> His argument can be summarized as follows:

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<sup>33</sup> M Mautner 'Eternal Triangles of the Law' (1991) 90 *Mich LR* 95 at 100.

<sup>34</sup> *Ibid* at 129.

<sup>35</sup> It is generally the view of the commercial law that 'a person who in relation to the handling of his property reposes confidence in another thereby assumes, in relation to third parties

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1. The entruster-trustee relationship is 'usually intended to be stable and continuous' and 'it is easier for the trustee to bear the first-starter cost of gathering information for verifying the honesty of the trustee' than for the recipient.<sup>36</sup>
2. In an 'institutionalized' entruster-trustee relationship, 'the entruster gains an additional opportunity both to acquaint himself further with the conduct of the trustee and to foresee potential dishonesty on his part'.<sup>37</sup>

Mautner then considers whether these considerations apply in a non-commercial context. He offers an example of non-commercial entrustment as follows:

*A*, a university professor, plans to go abroad on sabbatical for a year. *A* entrusts his beloved painting to *B*, his friend, to keep for him for the year. *B* sells the painting to *C*. Alternatively, *B* pledges the painting to *C* to secure a loan made by *C* to *B*.<sup>38</sup>

He suggests that:

at least the first above-mentioned argument applies to non-commercial entrustments as well: in the non-commercial setting, the entrustment will usually take place between persons having a stable, long-term relationship, so that, as between the entruster and the buyer, the former would usually enjoy a clear informational advantage over the latter in terms of his ability to foresee potential misconduct on the part of the trustee.<sup>39</sup>

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dealing with such property, the risk of improper behaviour on the part of the party entrusted.' Roy Goode, 'Proprietary Restitutionary Claims', chapter 5 in W Cornish, Nolan, O'Sullivan and Virgo (eds), *Restitution Past, Present and Future* (Hart Publishing, Oxford, 1998) at 72-3. Goode refers to this as a 'well-established principle'.

<sup>36</sup> Mautner, n 33 above, at 131.

<sup>37</sup> Ibid at 132.

<sup>38</sup> Ibid at 129. The fact that Mautner's examples deal with purchasers and our core question relates to volunteers is not a problem, as the question is whether the entruster can prevent the fraud ex ante. The ability of a defendant volunteer or purchaser to identify the fraud is the same.

<sup>39</sup> Ibid at 132. He also raises a further argument at 132, n 133 for why the entruster is better able to prevent the fraud, saying that 'as a general rule, it is easier to provide information "downstream" than it is to ferret out information "upstream"'. In our context, it is reasonable to assume that the owner-entruster, who already had possession of the disputed goods prior to their entrustment, would be better located to inform potential purchasers of his interest (by engraving or branding) than would the potential purchaser to discover the existence of the owner-entruster'. This additional argument is unhelpful where the property entrusted is not goods which are capable of physical marking.

If we take this analysis as our starting point, we have two main arguments as to how the entruster is in a better position to prevent the fraud. The following discussion will analyse those arguments.

(a) *Making inquiries prior to the commencement of the relationship:*

The conclusion that the entruster is in a better position to verify the honesty of the trustee may be true where the parties already have an ongoing relationship. However, Mautner's analysis breaks down at the point where it is assumed that the entruster will make those inquiries. Economic analysis assumes parties act rationally. In fact, many choices – including the choice of whom to trust – are not made on a rational basis.<sup>40</sup> If the entruster already knows the trustee, the choice of trustee is likely to be based on an emotional analysis of the trustee's character. The entruster is simply unlikely to make stringent checks of the entruster's character, even if to do so is relatively simple.

In any event, in cases where no personal prior relationship exists between the entruster and trustee, (so a rational decision can be expected) it will frequently not be feasible for the entruster to make meaningful inquiries (contrary to Mautner's assertion). The facts of *Foskett* (a commercial case) are themselves illustrative of this proposition.

The beneficiaries under the trust were individual investors. The investment was apparently reputable. If a prospective investor wished to make inquiries as to the reputation, and prior history of the trustees, they would have had to consider both the individuals who controlled the company, and the company itself. To do this they could have searched regulatory records to identify, for example, a history of personal bankruptcy or involvement in corporate insolvencies. It is unlikely, however, that individual investors could have obtained any information regarding prior criminal behaviour. The process would have to be undertaken by every purchaser, and there were over two hundred purchasers who invested in this project. The huge outlay of time and cost that would be involved is unlikely to produce any substantial probability that material information will be obtained.

A rule which requires individual beneficiaries to make these inquiries is not efficient. A more efficient use of resources is to permit beneficiaries to rely on the regulatory process to exclude any obviously unsuitable individuals.

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<sup>40</sup> It is also clear that people continually underrate the probability of an adverse event happening to them. See Melvin Eisenberg 'The Limits of Cognition and the Limits of Contract' 47 (1995) *Stanford LR* 211.

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*(b) Monitoring conduct during the relationship:*

Mautner's second proposition asserts that 'the entruster gains an additional opportunity both to acquaint himself further with the conduct of the trustee and to foresee potential dishonesty on his part'. This proposition is able to be refuted, both generally and in relation to the specific example provided. In Mautner's non-commercial scenario, the entrusting professor requires the services of the trustee because he, the professor, is about to go overseas. If the professor is overseas, how does he have the opportunity to monitor the trustee's conduct for dishonesty?

In fact, it is even questionable whether the entruster is generally able to monitor the trustee's performance sufficiently to identify dishonesty even when the entruster is within the jurisdiction.<sup>41</sup> Most entrustment situations involve fiduciary relationships which encompass more than the bailment scenario envisioned by Mautner. It has been convincingly argued by Easterbrook and Fischel<sup>42</sup> that the fiduciary relationship is inherently one in which it is *not* possible for the entruster effectively to monitor the conduct of the fiduciary, as an essential characteristic of the relationship is 'unusually high costs of ... monitoring'.<sup>43</sup> High monitoring costs result from two main causes: the necessary discretions accorded to the fiduciary and the practical fact that the fiduciary controls the asset. It is difficult for the entruster to monitor the fiduciary's honesty as (1) poor performance may not result from dishonesty, and (2) the fiduciary as controller of the assets is in the best position to hide evidence of fraud in relation to the controlled asset.

This second proposition is important. In fact, not only will the fiduciary be in the position to hide the evidence of fraud, but it would also seem that the fiduciary will be likely to hide evidence of his/her dishonesty. If there is active misappropriation (rather than loss caused by negligence or third party factors) it is unrealistic to suggest that the fiduciary will ordinarily confess the conduct. Once we acknowledge that the fiduciary who misappropriates the principal's assets is also likely to take active steps to hide the evidence of misappropriation, the chance of the entruster adequately monitoring the trustee's behaviour appears small.

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<sup>41</sup> Irrespective of whether the case is a 'commercial' one or not.

<sup>42</sup> FH Easterbrook and DR Fischel, 'Contract and Fiduciary Duty' (1993) 36 *Journal of Law and Economics* 425.

<sup>43</sup> *Ibid* at 427. See also R Cooter and BJ Freedman 'The Fiduciary Relationship: Its Economic Character and Legal Consequences' (1991) 66 *NYULR* 1045, at 1046-7, where they state: 'because asset management necessarily involves risk and uncertainty, the specific behaviour of the fiduciary cannot be dictated in advance. Moreover, constant monitoring of the fiduciary's behaviour, which would protect the beneficiary, often is prohibitively costly'.

Dishonesty may be relatively simple to spot in Mautner's non-commercial example, but it is suggested that this will not usually be the case.

*(c) Identity of entruster:*

Mautner's example is confined to voluntary entrustment by competent adults. Mautner's analysis does not work well in a conventional trust scenario, where the entruster is not an adult, but a minor. Apart from any other factors which render monitoring difficult, the minor is certainly not capable of supervising the fiduciary to any sensible degree. In addition, the minor does not choose the fiduciary, and does not have the opportunity to gather information to verify the fiduciary's honesty.

*Conclusions so far*

At this point it has been demonstrated that Mautner's assertions that the entruster is able to take steps *ex ante* to prevent the fraud are open to serious question. The analysis above suggests that in the usual entrustment case it is very difficult for the entruster to identify dishonesty both prior to and during the entrustment relationship.

Nonetheless, there would also still be extreme cases where, with hindsight, the risk of fraud was so clear that no reasonable person would have chosen the agent/fiduciary. In that situation, should the plaintiff bear the risk of such poor choice?

Perhaps the answer to this depends on why the plaintiff chose so poorly. Does a poor choice of fiduciary indicate that the principal took the risk of the fiduciary's misconduct? Not necessarily. If the agent hid their evidence of past dishonesty, and the plaintiff trusted the agent, she did not deliberately run an increased risk of fraud.<sup>44</sup> Further, penalizing her for a poor choice of person to trust will not make it easier for her to make a better choice in the future. If, on the other hand, she had the evidence of past dishonesty available to her and chose to entrust her property to the fiduciary despite that evidence, there is more reason to make her bear the loss.

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<sup>44</sup> Cf the analysis of American academic Emily Sherwin in her article 'Constructive Trusts in Bankruptcy' [1989] *University of Illinois Law Review*, 297 at 356 where she argues that in consensual fiduciary relationships, 'in entering the arrangement, the beneficiary takes the risk that the fiduciary not only will be dishonest but also will be insolvent when the beneficiary asserts a claim'.

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The analysis has also demonstrated that there is frequently no easy way for the recipient to identify the fraud. Nonetheless, there are situations in which fraud will be more obvious.<sup>45</sup>

In those cases, it is not inappropriate to require the volunteer to bear the risk of loss, as the cost of any inquiries merely reduces the size of the windfall gain coming to her. Unlike the entruster, she has not earned her wealth, and the removal of the windfall carries no disincentive. This perhaps tips the scales slightly in favour of volunteer liability. The cost to the volunteer of making inquiry, in the necessary case, is cheaper than the cost to the plaintiff of making inquiry.

*Other economic considerations*

If neither party has a clear advantage over the other, Mautner offers some further arguments. He says:

In all other cases in which no party enjoys a clear advantage over the other in terms of the ability to prevent the conflict, priority should be granted to the party likely to suffer the greatest loss ex post if he is denied priority and the other party prevails. Additionally, priority rules should be shaped in such a manner as to minimize the parties' resort to the court system and the administrative costs involved in litigation.<sup>46</sup>

I will address the second proposition first.

One possible solution is to adopt a relative or comparative fault liability test, to ensure that the circumstances of each case were carefully analysed to determine whether the loss should fall on the entruster or the recipient. However, such a rule involves substantial adjudication costs in the individual case, and creates a high level of uncertainty in the law.<sup>47</sup>

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<sup>45</sup> Although these are still likely to be infrequent if we factor in the likelihood of the trustee attempting to hide the proof of her fraudulent behaviour.

<sup>46</sup> Mautner, n 33 above at 100.

<sup>47</sup> Similarly see the discussion in D Fox, 'Constructive Notice and Knowing Receipt: An Economic Analysis' (1998) 57 Camb LJ 391 at 401 on the costs of possible liability tests for knowing receipt. The discussion compares the likely costs of a 'bright line' rule of liability compared to an 'open-textured standard of liability'. The Privy Council rejected the uncertainty of a relative fault test in *Dextra Bank and Trust Ltd v Bank of Jamaica* [2002] 1 All ER (Comm) 193. See however the analysis by H Dagan 'Restitution and Unjust Enrichment: Mistake' (2001) 79 *Tex L Rev* 1795, who argues that a comparative fault rule along the lines adopted in US tort law is efficient, although he highlights the high adjudication costs of such a rule.

Although this approach would ensure justice in the individual case, the Privy Council's clear rejection of relative fault in *Dextra Bank and Trust Ltd v Bank of Jamaica*<sup>48</sup> renders it unlikely that such a rule will be adopted here. Therefore, this paper will continue with the search for a single liability rule.

Arguably, a rule which definitively prefers the plaintiff over the volunteer (the property approach) is cheaper to administer than a rule requiring consideration of whether a recipient has changed position (the unjust enrichment approach). The change of position rule requires judicial examination of whether, on the facts, the volunteer did acts constituting change of position; and whether in law the acts fit within the test. In our problem case the bona fide purchase test is simple to apply. The rule enables the plaintiff to recover without any need to consider the volunteer's position.

What about the first proposition: that priority should go to the party who will suffer the greatest loss ex post if denied a remedy?

To test this proposition we need to go back to our core example. As discussed earlier, there is no dispute that on the original facts of *Foskett* the volunteer should return the funds. Economic analysis reaches the same answer. The plaintiff, if unable to recover against the volunteer who has changed position, suffers the loss of the full value of the misappropriated funds: in this case \$20,000. The volunteer however, suffers no loss if she is required to return the funds. She retains all her own funds, and being required to return the gift only returns her to her original position.

The position is different in the problem case (using the modified facts of *Foskett*) once we assume that the volunteer recipient has changed position as a result of the receipt. The plaintiff beneficiary will suffer the loss of \$20,000 if the defence is available to the volunteer who has changed position. What of the volunteer? Until she has spent money consequent upon receipt, she has suffered no loss. However, once she starts to spend money believing in the irreversibility of the gift, any requirement to repay the gift will result in her suffering a loss.

If she has only partially changed position her loss will not be as great as the plaintiff's loss. If, however, she has spent the equivalent amount of the receipt, she will suffer an equal loss to the plaintiff, as she is now worse off to the value of the amount she spent (and cannot recoup).<sup>49</sup>

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<sup>48</sup> [2002] 1 All ER (Comm) 193.

<sup>49</sup> The facts of *Foskett* actually raise the possibility of the volunteer incurring significantly greater loss, as the volunteer believed in the correctness of a £1 million payment, as compared to the exact amount flowing from the beneficiaries' money.

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If the potential losses to be suffered by the plaintiff and defendant are the same, then a cost-based economic analysis confined to the parties is inconclusive. If the answers are as finely balanced as the above analysis suggests, it is appropriate to consider whether any broad policy imperatives assist in deciding the question one way or the other.

*Policy: vulnerability of equitable plaintiffs*

One argument in favour of recovery by the plaintiff is that the plaintiff is vulnerable to the abuse by the fiduciary, and is deserving of the law's special protection. This is in fact one of the bases of equitable title - the personal obligation in relation to property is the source of the beneficiary's title.<sup>50</sup>

It could of course be queried whether the 'tenderness' towards such plaintiffs needs to continue in the modern day. The trust is no longer solely a family device to protect the interests of children who are too small to protect themselves. Is it saying too much to suggest that plaintiff beneficiaries of a fiduciary duty are a 'vulnerable class'?

The analysis of Easterbrook and Fischel of fiduciary relationships is important again here. As discussed above, the conclusions drawn are that the fiduciary relationship involves high monitoring costs for the represented party, and a high level of trust on their part. The represented party is unable to cost-effectively monitor the activities of the fiduciary without undertaking the job themselves. This applies whether the plaintiff is a child or a shareholder in a corporation. The identity of the plaintiff is irrelevant. It is the nature of the relationship between the plaintiff and the fiduciary which is critical.

An alternative reason is offered by Emily Sherwin. She argues that the property approach can be justified by reasons of utility. She states that trusts and fiduciary relationships provide a useful social purpose and that preferential treatment of entrusters is necessary to ensure that these relationships continue to be attractive. She argues that 'the assurance of a ... remedy that will give the beneficiary a prior right to recover the property or its traceable products... may have a real impact on her initial decision to enter the arrangement.'<sup>51</sup>

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<sup>50</sup> In fact, the trustee's personal obligation as the source of equitable property rights goes some way to explain the fiction. If the beneficiary's title is directly derived from the personal obligation owed by the trustee to the beneficiary, that obligation subsists notwithstanding any change in form of trust property, at least while it is still the trustee's possession.

<sup>51</sup> Emily Sherwin 'Constructive Trusts in Bankruptcy' [1989] *University of Illinois Law Review*, 297 at 356.

## **An Alternative Solution**

Both the property approach and the unjust enrichment approach involve one party suffering a loss. We need not accept a rule that requires one innocent party to suffer if alternative rules can be identified.

Mautner had a third proposition not discussed earlier. He said:

The 'entruster can protect himself against misconduct... by insisting upon a guarantee of the trustee's liabilities toward the entruster by such means as a cash deposit, guarantee or security interest.<sup>52</sup>

This part will analyse a bond proposal in more depth. It will be demonstrated that although a version of the bond process may have some attractions, the position is not as simple as Mautner suggests, particularly in relation to commercial entrustments. Other alternatives are possible and this part will consider whether an insurance regime or compensation scheme would also serve a satisfactory purpose.

Essentially however, if a viable alternative model can be found, then the dispute between the property and unjust enrichment approaches is easy to solve. If the interests of the entruster are protected through an alternative model, the change of position defence can be made available to the volunteer recipient.

## **A bond framework**

Initially, consideration would need to be given to how a bond system would work. Important factors are: how is the system to be implemented, what relationships are to be governed by the system, and how would the bond be set?

### *Implementation issues*

Will the system work if trustees are left to protect themselves by 'insisting' upon a bond? Given the earlier analysis of this problem, it appears unlikely that an entruster who reposes actual trust in the trustee will insist upon a bond from the trustee.<sup>53</sup> The existence of trust will itself alter the entruster's behaviour. Therefore it would seem to be necessary for any bond requirement to be imposed by legislation.

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<sup>52</sup> Mautner, n 33 above at 132.

<sup>53</sup> This is particularly true in the non-commercial case. It is not likely that the entrusting professor in Mautner's own non-commercial example would say 'I trust you and want you to mind my painting, but give me a bond anyway'.

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If a bond is a required, rather than agreed, feature of entrustment relationships, there must be an agency with the power to set the bond. In non-commercial cases, it could be appropriate to give jurisdiction to a court or tribunal. A model for this already exists in some jurisdictions in relation to the appointment of administrators of deceased estates.<sup>54</sup> It is also common in American for courts to have the authority to impose a bond as part of the appointment process for conservators of a minor or incompetent's property.<sup>55</sup>

In more commercial cases, for example where entities take public money for investment, jurisdiction to set and administer the bond could be given to the relevant regulatory body which supervises public investments. In Australia, securities dealers were required to provide a security bond of \$20,000 under the Corporations Act prior to the introduction of the financial services regime. The administration of the bond requirement has been the work of the ASC and now ASIC. This requirement is ongoing on a transitional basis,<sup>56</sup> until the Government finalises the compensation arrangements under the new s 912B of the Corporations Act 2001 for the financial services sector.

Serious consideration would need to be given to the types of relationships governed by the bond requirement. If the bond requirement is limited to parties who are already required to submit to the jurisdiction of the court<sup>57</sup> or regulatory authority,<sup>58</sup> the cost increase will be relatively small, as the relevant agency/court and the parties have already invested time and cost in the process. Adding a bond component to the process is unlikely to be disruptive.

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<sup>54</sup> For example: in Australia, administration bonds are required in New South Wales: section 64 of the *Wills, Probate and Administration Act 1898* (NSW) and in Tasmania: section 25 *Administration and Probate Act 1935*. In Ireland, s 34 of the *Succession Act 1965* requires a bond to be given by 'every person to whom a grant of administration is made'. See also s 14 *Administration of Estates Act 1959*

<sup>55</sup> There are too many provisions to warrant mentioning all of them. The exact terms of bonds vary across States. Some States, such as Arizona (see Arizona Revised Statutes s 14-5411), Alaska (Code of Alaska s 26-2A-139), Kansas (KSA s 59-3069) make a bond compulsory, although the Court may be able to waive or reduce the bond. In other States, the Court may order a bond, without being required to: see, for example, District of Columbia Code s 21-2058; Hawaii Revised Statutes, s 560:5-415; Idaho Code s 15-5-411. In Maine, the Court is not required to set a bond until the value of the estate concerned is \$25,000, although it may exercise a discretion to set a bond where the estate is less than that: (Maine Revised Statutes, s 5-411A.

<sup>56</sup> Currently until 31 December 2006: see ASIC IR 06-21.

<sup>57</sup> For example, when a person is applying to become administrator of an estate.

<sup>58</sup> Eg entities governed by corporate regulators. In Australia this is ASIC.

However, this solution would mean that entrustment cases that do not currently require prior court/authority approval will continue to fall outside the bond requirements. This would mean, for example, that private trusts would not be within the bond regime.<sup>59</sup> If the bond process were to be expanded to cover as many fiduciary/entrustment relationships as possible, the relevant authority will need to be provided with more resources to cope with the increased workload or long delays would occur. Another possibility would be to require a bond for only the relationships in which the entruster is most vulnerable (for example minors).

*How would the bond work?*

Even in relationships which are to be governed by a bond requirement, a further choice must be made. A bond could be compulsory in all regulated relationships, or it could be set by the exercise of discretion.<sup>60</sup> A compulsory bond could be dealt with at an administrative level, and the process does not require the consideration of individual cases. However, cases where the entrustment is for a short period or the assets entrusted are of low value may not warrant the costs of the bond process.

A bond process which is discretionary is more expensive to administer. The decision maker must consider each individual application to determine if a bond is required. It is also inevitable that discretion will occasionally be exercised wrongly, with the consequence that wrongdoing occurs in a case where it was deemed not necessary to set a bond. Cases have arisen in America in which a Court exercised its discretion not to set a bond, or to set a small bond, and the fiduciary misappropriated the funds under their control.<sup>61</sup> In such a scenario, the costs of the bond process are wasted.

One possible solution would be to establish a system with the bond being compulsory once a certain value of assets are under entrustment. The asset value at which the relationship becomes regulated would be necessarily be set rather arbitrarily, but this would be a way to manage the process.

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<sup>59</sup> In Australia, another unregulated area is self-managed funds. The financial assistance provisions in Part 23 *Superannuation Industry (Supervision) Act 1993* do not extend to self-managed funds.

<sup>60</sup> Or the decision maker could have discretion to waive a bond.

<sup>61</sup> A common feature of these cases is that the fiduciary was a family member, typically a parent, and the plaintiff was a minor. See, for example, *Reed v Valley Federal Savings and Loan Company* 655 SW 2d 259 (CA Texas, 1983). The guardianship estate was worth approximately \$35,000 but a bond of only \$5000 was set by the court. The guardian dissipated the assets of the estate.

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*Setting the amount of the bond*

Once a model is established, decisions must be made regarding the size of any bond required. Existing private bond models demonstrate various possibilities,<sup>62</sup> but have the common feature that the bond is at least the value of assets under entrustment. This makes sense, as the bond will not act as a deterrent to misappropriation unless the bond is at least equal to the value of assets under control. In Australia, the \$20,000 bond set under the old Part 7 of the Corporations Law has been recognized to be insufficient to compensate investors for loss.<sup>63</sup>

Even if the bond is set at a sufficiently high level to deter fraud, some other issues remain. In particular, how is the bond to be secured?

If the trustee is required to put up her own assets to meet the bond, this should function as a deterrent. However, this model could be a problem if the trustee does not have sufficient assets, or if the trustee's assets are jointly owned with others. Additionally, if the trustee's main asset is a matrimonial home, and is used for security, the home could not be sold without the security being released. It would be understandable if the trustee's spouse were reluctant to use the home as security for the entrustment relationship.

These considerations could be addressed by a model which did not require the fiduciary to post the entire bond personally. Instead, the fiduciary could be permitted

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<sup>62</sup> In New South Wales, for example, the bond is normally to be equal to the value of property of the deceased: section 65 *Wills, Probate and Administration Act 1898* (NSW). In Ireland the bond is to be 'double the amount at which the estate of the deceased is sworn': s 34(2)(a) *Succession Act 1965*. American models differ. There are multiple models. The one which most often appears requires 'the amount of the aggregate capital value of the property of the estate in the conservator's control, plus one year's estimated income, and minus the value of securities' deposited with the Court and land which the conservator cannot sell without Court authority. This model is used, for example, in Alaska (see Code of Alaska, s 26-2A-139(a)); Arizona: (Arizona Revised Statutes s 14-5411); Colorado: (CRS 15-14-415); District of Columbia: (s 21-2058) and Hawaii (s560:5-415). The calculation required in Kansas is for '125% of the combined value of the tangible and intangible personal property in the conservatee's estate and the total of any annual income from any sources which the conservator may be expected to receive on behalf of the conservatee, minus any reasonably expected expenses': KSA s 59-3069 (b).

<sup>63</sup> See 'Compensation for Loss in the Financial Services Sector - Issues and Options', Department of Treasury, 6 September 2002, para 168; Australian Securities Commission Licensing Review Report Investment Advisory Services "Good Advice", November 1995, p 40 and P Latimer, 'Compensation of Investors for Failure of a Securities Industry Licensee' (1997) 14 *C&SLJ* 495 at 498, summarising the ASC view.

to find sureties. Problems exist with this model too. Once it is not the fiduciary's own assets being applied to the bond, the deterrent feature of the model disappears. The fiduciary no longer bears the cost of their misappropriation. Instead, if the fiduciary commits wrongdoing, the effect of this model is simply to shift the burden of loss from the fiduciary's wrongdoing to a new third party: the surety. Commercial sureties could be found, but the entruster would still need to guarantee the funds to the provider of the bond.<sup>64</sup>

A bond is also unsuitable for public/commercial relationships, such as the public investment that featured in *Foskett v McKeown*. There is no way that a bond process could adequately protect against the potential large scale misappropriation in such a case. As discussed above, this was recognized as a problem with the security bonds for Australian securities dealers.

### **Is insurance a better response?**

Particularly where substantial protection is required, insurance companies would seem better able to deal with the uncertainties inherent in the bond process. Insurance companies are used to assessing risks of adverse events and setting premiums at an appropriate level.

*Is it feasible to require compulsory insurance cover?*

In Australia, the question of an appropriate compensation regime within the financial services sector is under consideration by the Department of Treasury. Section 912B of the Corporations Act requires financial services licensees to have 'compensation arrangements' in place. The Position Paper released by the Department of Treasury preferred an insurance model over both security bonds and a statutory compensation scheme.<sup>65</sup>

Appropriate insurance would need to include fidelity insurance as a requirement rather than an optional extension. As dishonesty is normally excepted from standard professional indemnity insurance, a full compensation scheme through insurance requires fidelity insurance. Treasury has not indicated whether fidelity insurance will be mandatory, and the availability in the market of such insurance was not clear.

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<sup>64</sup> In Treasury's Issues and Options Paper, the view was taken at para 168 that 'a substantial bond may prove an impediment to those wanting to start in the financial services sector in a small way'.

<sup>65</sup> In England, there is a financial services compensation scheme for consumers and small business. In Australia the National Guarantee Fund operates for market transactions.

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In the commercial sector (such as financial services) where annual licences are required to be issued, the requirement for insurance could be incorporated into the approval process with only a moderate level of difficulty. There would be a certain amount of additional administrative work and cost in checking that insurance has been provided. For the regulator, this will be less than the work of administering a bond process.

In the private sector, it is harder to establish an insurance requirement. If, for example, the establishment of the entrustment requires legal advice, the adviser can inform of the requirement for insurance. However, in entrustment relationships which are established informally, it is much harder to identify an appropriate insurance regime.

*What are the problems with an insurance system?*

The most obvious question must surely be 'who pays the premiums?' A fiduciary acting gratuitously could not be expected to pay, and a professional fiduciary will charge the costs of insurance on to client. Ultimately, therefore, the cost of insurance will be paid for by the represented party.

In fact, if the cost of insurance is borne by the represented party, either directly or indirectly, this means that the represented party is paying to ensure that her choice of fiduciary is a good one. This method actually requires the plaintiff entruster to bear the risk of her fiduciary's fraud, through the payment of insurance premiums. It ensures that the fund is protected in the event of misappropriation, but does not place the risk of loss onto any innocent party.

More problematic could be the impossibility of ensuring that insurance is maintained. Treasury noted that 'a requirement that insurers automatically alert ASIC to the cancellation or non-renewal of professional indemnity/fidelity cover... would assist' and that there is no current obligation to provide ASIC with a certificate of currency.<sup>66</sup> If the compensation method is to be offered via insurance, this obligation seems necessary.

An insurance model also encounters the moral hazard problem. Moral hazard describes the problem where the dishonest fiduciary is not deterred from dishonest conduct, because they know that the loss is borne by an insurance company, and not the plaintiff. Moral hazard also arises in the security bond scenario where the security for the bond is provided by a corporate surety.

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<sup>66</sup> Department of Treasury, 'Compensation for Loss in the Financial Services Sector - Position Paper,' 24 December 2003, chapter 3, para 160. Another concern is whether the insurer should be able to cancel the insurance.

Perhaps the risk of moral hazard is one that must be present in order to adequately protect entrusters. Furthermore, the type of misappropriation under discussion will almost inevitably also constitute a crime and the trustee will be subject to criminal charges. If the trustee is not deterred by the possibility of criminal charges, it seems unlikely that the moral dilemma would impact substantially upon their decision making processes.

There is, however, a positive feature of insurance, in that parties who wish to comply and put risk management procedures in place will ultimately benefit through reduced premiums.

Ultimately, if insurance is adopted as the primary compensation method for financial services in Australia under s 912B, time will determine if the correct option was chosen.

### **Statutory compensation schemes or industry fidelity funds**

Treasury also considered the possibility of a statutory compensation scheme. Compensation schemes are funded by levies on licensed parties. The National Guarantee Fund operates in Australia, and there are overseas examples for stock exchange operators. Fidelity funds can also exist within certain professions or industries. For example, fidelity funds exist in Australian states to protect solicitors' clients from loss occurring through default or dishonest failure to account.

In England, the response to the need for investor compensation in the financial services sector was to establish the Financial Services Compensation Scheme (FSCS). The scheme is funded by levies, and provides compensation to consumers and small business in the event of insolvency of a provider.<sup>67</sup>

#### *Costs of statutory compensation scheme/fidelity fund*

Treasury determined that 'the administration of a statutory fund would involve significant costs'.<sup>68</sup> It also considered that there was insufficient evidence of loss in the financial services sector to warrant the costs of implementing a compensation scheme, although it indicated that the question of such a scheme could be reconsidered if more data regarding losses became available in the future.

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<sup>67</sup> See the FSCS homepage: [www.fscs.org.uk](http://www.fscs.org.uk) for further information.

<sup>68</sup> Position Paper, Chapter 3, at para 178, the anticipated costs were the cost of developing a scheme; the cost to industry of additional returns necessary to set levies; the cost of levies; the administration of the scheme and paying claims.

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In England, the costs of establishing the FSCS were recovered from levies, and the scheme's management expenses are funded by levies on an ongoing basis.<sup>69</sup>

*Advantages and Disadvantages*

Many of the effects of this scheme are the same as insurance model. As with insurance, this model creates a moral hazard issue, as the operator knows that innocent investors will not suffer from their behaviour. However, it does provide protection to entrusters. Further, the costs of the system are borne by entrusters, which appears appropriate.

One substantial administrative benefit that occurs if a statutory scheme is implemented, is that the problem of maintaining insurance cover ceases to be a problem. Entities are levied on a yearly basis, and no further checking or reporting of their status is necessary. This eliminates one of the more difficult administrative problems that arises with an insurance model. It could also be anticipated that cost efficiencies could occur if all processes are conducted by associated government organizations.<sup>70</sup>

However, unlike an insurance system there is no inherent incentive for regulated entities to improve their services as this will give them no reduction in levies.<sup>71</sup>

**Some recommendations**

The analysis demonstrates that the issues are different in private fiduciary relationships compared to public/commercial entrustment scenarios. The level of regulation and questions of scale in the commercial scenarios make insurance or fidelity funds more feasible than bonds. Although a statutory compensation scheme may be expensive to establish, it would eliminate any concerns regarding the insurance market, and the capacity of parties to obtain (and maintain) insurance.

However, in the private arena, the lack of regulation makes any change significantly costly to establish. Both fidelity funds and insurance models appear infeasible in an arena where no registration, licence or ongoing professional qualification is required. The bond process is the most feasible for private entrustments, but would entail

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<sup>69</sup> FSCS also generates income from recoveries against parties in default. Financial information is available in the FSCS Annual Reports, available on their web site.

<sup>70</sup> For example, in England, the Financial Services Authority (the regulatory authority) invoices regulated licensees for levies under the Financial Services Compensation Scheme.

<sup>71</sup> Although if there are no or few claims, the fund may be self-funding after a period of time.

substantial costs to implement. Perhaps a workable model would involve compulsory bonds only in situations where property was entrusted on behalf of minors.

## **Conclusions**

It has been demonstrated that there is no conclusive result from law and economics analysis to justify shifting from the property approach to the unjust enrichment approach. Neither the beneficiary nor the innocent volunteer is clearly the least cost avoider who can take precautions to identify and prevent the fiduciary fraud. Further, the loss to be borne by either party *ex post* is the same. The analysis also discussed how broader policy arguments tend towards maintaining the property approach.

Ultimately, it is suggested that for many relationships, the answer lies elsewhere, through the use of compensation models which ensure that an entruster's interests are protected in the event of the trustee's fraud. If the trustee's interests are protected through a true compensation model, there is no reason to deny the change of position defence to the volunteer.

If there is no appropriate compensation model, which may be the case with private entrustments, the property rule should remain.