4-2017

Misapplied trust funds and mortgage loans

Ruo Yu TAN

*Singapore Management University, ruoyu.tan.2009@law.smu.edu.sg*

Follow this and additional works at: [http://ink.library.smu.edu.sg/sol_research](http://ink.library.smu.edu.sg/sol_research)

Part of the [Estates and Trusts Commons](http://ink.library.smu.edu.sg/sol_research)

Citation


Available at: [http://ink.library.smu.edu.sg/sol_research/2594](http://ink.library.smu.edu.sg/sol_research/2594)
Misapplied trust funds and mortgage loans

TAN Ruo Yu

Published in Trusts & Trustees, Volume 23, Issue 3, 1 April 2017, Pages 311–318,

https://doi.org/10.1093/tandt/ttw217

Abstract

Where trust monies are used in breach of trust to pay for the deposit for a property, the courts have held that any mortgage loan which was used to fund the purchase does not count as the trustee’s contribution to the purchase price for the purpose of determining the trustee’s and the beneficiary’s respective beneficial ownership in the property. This article considers two issues. First, if trust monies are used only after the trustee has paid for the deposit using his own money, are the loan monies obtained by the trustee under the mortgage still liable to be discounted as his contribution? Second, does it make a difference in the assessment whether the beneficiary is seeking to trace the misapplied trust funds into the sale proceeds or an account of profits which the trustee obtained in breach of the no-profit rule?

Introduction

Conventionally, where a trustee uses a mixture of misapplied trust funds and his own money to purchase a property, the beneficiary of the trust is entitled to claim a share in the property proportionate to how much the trust monies contributed to the purchase price of the property. Thus, in Scott v Scott [1964] VR 3001 (Scott), where a trustee misused £1,014 from an estate to purchase a property with a cost of £1,700, the Supreme Court of Victoria held that the trustee was liable to pay the estate 1,014/1,700 of the property’s increment in value, over and above the sum of £1,014 which the trustee had repaid the estate. Likewise, in Foskett v McKeown [2001] 1 AC 1022 (Foskett), the House of Lords held by a majority that the plaintiff beneficiaries were entitled to a share in the proceeds from the trustee’s whole life policy commensurate to how much the misappropriated trust monies had contributed to the premiums paid under the policy.3 In that case, Lord Millett held:4

Where a trustee wrongfully uses trust money to provide part of the cost of acquiring an asset, the beneficiary is entitled at his option either to claim a proportionate share of the asset or to enforce a lien upon it to secure his personal claim against the trustee for the amount of the misapplied money.

However, the position is less straightforward in a case where the errant trustee also funded the purchase of the property using monies from a loan secured by a mortgage over the property. The question in such a situation is usually characterized as whether the loan monies ought to be counted as the trustee’s contribution to the purchase price, which in turn determines how the beneficial ownership in the property (or the sale proceeds thereof) ought to be divided between the trustee and the beneficiary. Interestingly, the issue has thus far only been considered in a handful of Australian cases. In the seminal case of Paul A Davies (Australia) Pty Ltd (in liq) v Davies [1983] 1 NSWLR 4405 (Paul A Davies), where the defaulting directors used the company’s money to fund the deposit for a property before obtaining a mortgage loan using the
property as security, the New South Wales Court of Appeal held that the loan monies did not count as the directors’ contribution; and since the only contribution to the purchase price came from the company, it was entitled to all the profits from the sale, subject to the court’s award of just allowances to the directors.

The purpose of this article is to examine two issues in this area of the law. The first is concerned with the applicability and relevance of Paul A Davies where trust monies are used after the trustee has paid for the deposit for the property and obtained the mortgage loan using his own resources. In such a situation, are the loan monies obtained by the trustee under the mortgage still liable to be discounted as his contribution for the purpose of calculating his share of the sale proceeds? The second issue, which appears to arise from certain observations which were made in Paul A Davies, is this: does it make a difference in the assessment whether the beneficiary is seeking to trace the misapplied trust funds into the sale proceeds, or an account of profits which the trustee obtained in breach of the no-profit rule?

Before considering these issues, it is apposite to first examine the case of Paul A Davies in closer detail.

**Paul A Davies**

In Paul A Davies, the defendant directors entered into a contract to purchase a property for the sum of $340,000. The purchase monies came from two sources: (i) monies that the directors obtained from the plaintiff company in breach of fiduciary duty, which were used to pay for the deposit of $17,000 and another sum of $35,000 towards the purchase price; and (ii) a bank loan secured by a mortgage on the property which was used to complete the purchase. At first instance, the judge held on the authority of Scott that the company was entitled only to a proportionate share of the profits from the sale of the property.

On appeal, the New South Wales Court of Appeal overruled the trial judge’s decision and held that the company was entitled to all the profits. In their separate written decisions, all three judges in the New South Wales Court of Appeal placed emphasis on the fact that it was through the use of trust monies in the first instance which enabled the directors to obtain the mortgage loan. Moffitt P held that:

\[
\text{a distinction should be drawn and the principle [in Scott] not applied where the fiduciary does not provide his own money, but, having used trust money to provide the deposit and/or part of the purchase money so as to acquire an equitable interest in the property provides the balance by a mortgage loan on the security of the property.}^6
\]

Likewise, Hutley JA held that since the directors held the property on trust for the company, they committed another breach of trust by mortgaging the property without the consent of the company. In Hutley JA’s view, it would be

\[
\text{inconsistent with any principle that resources which a trustee gained by further breach of trust can be treated as provided from his own resources for the purpose of the rule that profits are to be apportioned between the trustee and the trust estate in accordance with their respective contribution.}^7
\]
Finally, Mahoney JA held that there were two relevant principles in question: the tracing principle ("[w]here a trustee has misapplied trust money, the beneficiary may require the trustee to repay it with interest or, at his option, may claim that into which the trust money has been converted") and the profit principle ("[a] trustee must account to the trust for any unauthorised profit which he has made from the trust or his position as trustee"). Mahoney JA reserved his opinion as to the application of the tracing principle, but held that the profit principle prohibited the defendants from retaining the profit that was proportionate to the bank loan. This was so for two closely related reasons: first, the defendants’ contractual rights and/or proprietary interest in the property had been acquired using the company’s monies and were of the nature of trust assets; second, in order to borrow the money to complete the purchase, the defendants had made an unauthorized use of the property which they were holding for the company.

What if the trustee paid for the deposit using his own money?

The outcome in Paul A Davies appears eminently sensible: indeed, it would appear anomalous if a trustee could springboard from his breach of trust and acquire an interest in a trust property by using it as security to obtain further loans to complete the acquisition of the property. This then raises the question: in the situation where trust monies were eventually used to complete the purchase of the property, but the trustee had paid for the deposit for the property using his own money in the first instance, are the monies obtained under a loan secured by the property still liable to be discounted as the trustee’s contribution to the purchase price? In such a situation, there is plainly no breach of trust to speak of when the trustee mortgaged the property: the trustee obtained an equitable interest in the property using his own money and did not hold it on trust for anyone when it was used to secure the loan. If that is correct, then there appears to be no reason why the monies obtained under the loan should not be counted as the trustee’s contribution to the purchase price.

This conclusion is supported by a number of authorities. In the case of In the Marriage of Wagstaff (1990) 14 Fam LR 78 (Marriage of Wagstaff), the question arose as to how the profits from the sale of a property ought to be apportioned between the appellant wife, the respondent husband, and the wife’s children from a previous marriage. The deposit for the property had been paid for using, in breach of trust, $18,241 from funds which the wife held on trust for the children, and $2,550 which was borrowed from the husband’s mother. The balance which was needed to complete the purchase was borrowed under a loan secured by a mortgage over the property. Strauss, Baker, and McCall JJ in the Full Court of the Family Court of Australia emphasized that this was a case where, as was the case in Paul A Davies, ‘the trust moneys have been used as the deposit on a property and the balance coming from a loan to the parties which was only possible because of the use of the trust moneys in the first instance’. Accordingly, the court held that the children were entitled to 18,241/20,971 of the net proceeds from the sale of the property.

Consistent with the analysis above, the learned authors of Lewin on Trusts, citing the cases of Paul A Davies and Marriage of Wagstaff, observe that:

If trust money is used to pay the whole or part of the deposit on an asset, or the deposit and part of the purchase money paid on completion, the balance of the purchase money being raised by the trustee or other wrongdoer by mortgage secured on the asset, the money raised on mortgage does not count as a contribution by him to the purchase, since
his ability to obtain the loan was dependent on the unauthorised acquisition with trust money of the asset which formed the security.\textsuperscript{14}

In at least two cases where it was found or assumed that the deposit was not paid for using misapplied trust funds, the courts have expressly held that the monies obtained under the mortgage loan ought to be counted as the trustee’s contribution. In \textit{Telnet Pty Ltd v Linton} (unreported) BC9807776 (14 May 1998)\textsuperscript{15}(Telnet), the liquidators of the plaintiff company alleged that the defendant’s husband had obtained a loan of $1.06 million from the company in breach of his fiduciary duty which was used to fund the purchase of a property. However, the court found that the defendant had used her own money to pay for the deposit for the property. In relation to how the sum of $400,000 which she had obtained under a mortgage loan ought to be treated for the purpose of calculating the parties’ respective shares in the property, Hulme J distinguished the case on hand from \textit{Paul A Davies} and held:

What significance should be afforded the $400,000 borrowed from [the bank]? In my view it should go to the credit of [the defendant] in the determination of the respective interests of herself and [the plaintiff] in the subject property. \textit{This is not a case where the security for the money borrowed solely was, or was derived from, moneys affected with fiduciary obligations} – cf \textit{Paul A Davies (Aust) Pty Ltd v Davies} (1983) 1 NSWLR 440.\textsuperscript{16}

Subsequently, in \textit{Mavaddat v Lee} [2007] WASCA 141\textsuperscript{17}(Mavaddat), the appellant director, without authorization and in breach of fiduciary duty, used $150,000 from the company’s account to purchase a property with a purchase price of $320,000. The director obtained the remaining $170,000 through a bank loan secured by a mortgage over the property. However, it was not the respondent’s case at trial that the property was used to secure the balance of the purchase price. As such, when the matter reached the Western Australia Court of Appeal, the court held that it was to be assumed that ‘the balance of the purchase price was provided by the appellant from funds borrowed from the bank in circumstances in which there was not, and is not, any contention that these funds, too, were obtained only through the misuse of trust property, whether by way of mortgage or otherwise’.\textsuperscript{18} In the circumstances, Steytler P (with whom Pullin JA agreed) and McLure JA held that the principle in \textit{Scott} ought to apply, and the company’s interest in the property was limited to the extent of its proportionate contribution to the purchase price, ie 46.875\%.\textsuperscript{19}

It is worth noting, for completeness, that the case of \textit{JGM Nominees Pty Ltd v Caveat Finance Pty Ltd (in liq)} [2009] VSC 604\textsuperscript{20}(JGM Nominees) appears to depart from the authorities discussed above. In \textit{JGM Nominees}, Habersberger J in the Victoria Supreme Court did not regard the funds borrowed under the mortgage as the trustee’s contribution, even though the misapplied trust monies in question were not used to pay for the deposit for the property. Nevertheless, it seems unlikely that future cases will follow \textit{JGM Nominees}: the issue in relation to the mortgage loan was only briefly dealt with in two paragraphs in the judgment, and the court did not have the benefit of hearing the arguments on the relevant jurisprudence as the other parties who had initially made a claim to the funds in question all withdrew from the proceeding in the course of the trial.\textsuperscript{21}

In summary, therefore, it appears as a matter of principle and authority that the monies obtained under a mortgage loan ought to be counted as a trustee’s contribution to the purchase price of a property if the trustee paid for the deposit using his own money. As alluded to earlier, however, Mahoney JA’s judgment in \textit{Paul A Davies} appears to suggest that a different outcome may arise
depending on whether the tracing principle or the profit principle is being applied. Does this affect the analysis that has been presented thus far? It is to this issue that the discussion now turns.

The tracing principle and the profit principle

To put the issue in context, it is necessary to first set out the theoretical distinction between the two types of claim associated with the profit principle and the tracing principle, i.e. a claim by a beneficiary for a constructive trust over the illicit profits made by an errant trustee, and a claim by a beneficiary to vindicate his proprietary interest in the traceable proceeds of trust property. As to the former, the claim for a constructive trust over the illicit profits gained by the trustee is premised on the well-established principle that a trustee is prohibited from using his position as a trustee to make an unauthorized gain for himself. On the other hand, as to the latter, a beneficiary who is faced with the trustee's misapplication of trust property can elect to falsify the unauthorized transaction, in which case the trustee becomes personally liable to reconstitute the trust property, or he can elect to adopt the transaction, which is the tactical option where the transaction turns out to be profitable. Where the beneficiary elects to adopt the transaction, the beneficiary effectively asserts his beneficial ownership in the substituted asset; to that end, it is necessary to establish by the rules of tracing that the substituted asset represents the misapplied trust property.

As has been observed elsewhere, it is possible to 'deploy both theories on the same facts'. Nevertheless, the question for present purposes is whether the two types of claims ought to lead to different outcomes in the situation where a trustee purchased a property using a mixture of misapplied trust funds and his own money. In particular, does the mere fact that the beneficiary is relying on the profit principle entitle him to a more generous recovery? In *Australian Postal Corporation v Lutak* (1991) 21 NSWLR 584 (Australian Postal Corporation), which appears to be the only case after *Paul A Davies* where the issue was squarely considered, Bryson J held that the principle in *Scott* 'relates to a proportionate interest in the property, not to profits or gains arising from dealing in property purchased with a mixed fund'. According to Bryson J,

> The rule that a trustee may not derive a profit from his trust would seem to require that, irrespective of the source from which he raised his contribution, a trustee should not receive any profit related to that contribution; the whole of the profit of the investment should go to the beneficiary.

On this view, in contradistinction to the tracing principle, the profit principle would apparently require a trustee to surrender all the profits even if he had obtained the mortgage loan in question using his own resources. Further, the trustee would be required to surrender all the profits regardless of the proportion which the trust monies bore to the purchase price.

However, it would be peculiar if the issue is governed by two seemingly separate principles which give rise to different results. More importantly, it would appear unduly artificial and unfair if a beneficiary could significantly improve his position and claim all the profits from the sale of the property, simply by asserting that he is relying on the profit principle as opposed to the tracing principle. The argument to the contrary, as one might expect, is that a trustee who had misused trust monies to acquire an asset had used his position as a trustee to make the profits, and is therefore in breach of the no-profit rule. But as *Scott* and *Foskett* show, where a trustee
makes a profit from the use of a mixed fund comprising trust monies and his own money, the law does not go so far as to allow the beneficiary to claim all the profits. Indeed, if it were otherwise, there would never be any occasion for the proportionate division of profits as occurred in cases like Scott and Foskett.

Further, the strict position propounded by Bryson J in Australian Postal Corporation does not accord with Paul A Davies, nor has it been followed in later cases. In Paul A Davies, Mahoney JA held that the defendants were not entitled to any of the profits essentially for the reason that they had used the company’s monies to obtain an interest in the property, and thereafter used the property to secure the loan which was used to complete the purchase of the property. Thus, even though Mahoney JA was avowedly applying the profit principle, the learned judge nonetheless looked at whether the defendants had made their own contributions towards the purchase price, which is consistent with the approach taken by Moffitt P and Hutley JA in their concurring judgments. Properly understood, therefore, any perceived difference between the tracing principle and the profit principle in the present context is in fact more apparent than real.

Similarly, in the subsequent cases discussed above, the approach which has been consistently applied by the courts is to examine how much the trustee contributed to the purchase price in order to determine his proportionate share of the profits. The following observations by the Full Court of the Federal Court of Australia in V-Flow Pty Ltd v Holyoake Industries (Vic) Pty Ltd (2013) 296 ALR 418 further support the conclusion that notwithstanding the no-profit rule, a proportionate division of profits is available where the trustee makes his own contribution to the purchase price of the property:

Where property is acquired in breach of fiduciary duty, with trust money mixed with personal money, it may be appropriate, in some cases, to restrict the profit or gain for which an account is to be given to a proportionate part of the total profit or gain, based on the quantum of the trust money used compared with the quantum of personal money used. However, it will not be an appropriate case for the application of that principle where the fiduciary does not use his own money but, having used trust money to provide the deposit or part of the purchase price, so as to acquire an equitable interest in the property, provides the balance of the purchase price by way of a loan secured by mortgage on the property.

In any event, despite Bryson J’s statement in Australian Postal Corporation that the whole of the profits ought to be surrendered irrespective of the source from which a trustee raised his contribution, the learned judge in fact went on in the judgment to consider whether the trustees had contributed their own money towards the acquisition of the property. In that case, it was clear on any view of the matter that the trustees were not entitled to any profit: the purchase monies used by the trustees comprised only proceeds from the sale of stamps which had been stolen from the plaintiff (from which the deposit for the property was funded), and monies from loans which were secured by a mortgage over the property.

Is the fact that the trustee is allowed to retain a proportionate part of the profits contrary to the prophylactic nature of equity? It would be erroneous to take the view that the tenets of prophylaxis or deterrence require the trustee to surrender all the profits where the trustee purchased a property using a mixed fund comprising trust monies and his own money: the fact that the trustee is not allowed to profit from the misuse of trust property is precisely the reason why the trustee is only entitled to keep the portion of the profits commensurate to his own
contribution.\textsuperscript{33} As Lord Millett held in \textit{Foskett}, the rationale for allowing a beneficiary to recover a proportionate share of the profits is that ‘the trustee cannot be allowed to make a profit from the use of the trust money’.\textsuperscript{34} Rejecting the rule that the beneficiary is only entitled to a lien for the sum of the misapplied trust monies where the trustee also used his own money to acquire the new asset, Lord Millett further stated:\textsuperscript{35}

In my view the time has come to state unequivocally that English law has no such rule. It conflicts with the rule that a trustee must not benefit from his trust.

**Conclusion**

Where trust funds are used in breach of trust to purchase a property, the beneficiaries of the trust are entitled to claim a share in the property proportionate to how much the trust monies contributed to the purchase price of the property. The matter becomes complicated where the defaulting trustee also funded the purchase of the property using a mortgage loan. This article considered two issues in this area of the law. In particular, it is argued that where trust monies are used only after the trustee has paid for the deposit for the property and obtained the mortgage loan using his own resources, the monies under the loan ought to be counted as the trustee’s own contribution for the purpose of calculating his share of the sale proceeds. The same result obtains whether the beneficiary purports to trace the misapplied trust funds into the sale proceeds or to seek an account of profits which the trustee obtained in breach of the no-profit rule.

**Ruo Yu Tan** is an associate in the Commercial Litigation practice group of Rajah & Tann Singapore LLP.

3. The minority held that the beneficiaries were not entitled to any share in the proceeds except to the extent necessary for them to recover the misappropriated trust monies.
11. It is interesting to note, however, that for the purpose of the doctrine of resulting trust, a party who assumed the liability to the lender under a mortgage is regarded as having provided the proportion of the purchase price attributable to the monies borrowed under the mortgage: see *Curley v Parkes* [2004] EWCA Civ 1515 at [14]; *Calverley v Green* (1984) 155 CLR 242. Cf *Paul A Davies (Australia) Pty Ltd (in liq) v Davies* [1983] NSWLR 440 at 459, per Mahoney JA: ‘I do not think that the fact that the defendants undertook personal liability of this account should render them immune from the profit principle.’
13. *In the Marriage of Wagstaff* (1990) 14 Fam LR 78 at 86.
14. *Lewin on Trusts* (19th edn, Sweet & Maxwell 2015) [41-073] (emphasis added). See also *Underhill & Hayton: Law of Trusts and Trustees* (19th edn, LexisNexis 2016) [90.9] (‘… but for the £25,000 of trust funds the trustee would not have been able to provide the necessary security for the mortgage loan and so the fruits of the transaction should go to the beneficiaries’); Lee Aitken, ‘Loan Funds and the Trustee’s Profit’ (1993) 13 Legal Stud 371 at 380 (‘If trust money or other property is used merely to secure further advances with which the property is acquired, equity intervenes by depriving the defaulting trustee of any share of the resulting profit’).
15. *Telnet Pty Ltd v Linton* (unreported) BC9807776 (14 May 1998). The defendant successfully appealed to the New South Wales Court of Appeal against the trial judge’s finding that the loan of $1.06 million constituted a breach of fiduciary duty: *Linton v Telnet Pty Ltd* (1999) 30 ACSR 465. However, the trial judge’s decision in relation to the treatment of the mortgage loan was not disturbed.
21. See *JGM Nominees Pty Ltd v Caveat Finance Pty Ltd (in liq)* [2009] VSC 604 at [6], [21], [22], [23], [24].
22. *Keech v Sandford* (1726) Sel Cas Ch 61; *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134.
23. See *Harrison v Harrison* (1740) 2 Atk 121, 26 ER 476; *Knott v Cotee* [1852] 16 Beav 77 at 79–80; *Head v Gould* [1898] 2 Ch 250 at 266; *AG v Cocke* [1988] 1 Ch 414 at 420–21.


31. *V-Flow Pty Ltd v Holyoake Industries (Vic) Pty Ltd* (2013) 296 ALR 418 at [73] (emphasis added). See also Malcolm Cope, *Equitable Obligations: Duties, Defences and Remedies* (Lawbook Co 2007) [10.230] (‘In some circumstances the court may restrict the liability of the fiduciary to a proportionate part. … In instances where the property is not specifically severable an apportionment may also be available where an identifiable gain acquired in breach of fiduciary duty is mixed with the fiduciary’s own funds for the purpose of acquiring a property.’)


