BLEAK CHOSES? TRUSTING IN EQUITY

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For many common lawyers – certainly me – trusts and equity seem exotic things. At one point, I supposed the closest I would get to equity in action was by reading Bleak House, which in length and majesty even rivals some of the equity textbooks. But in this (as many other things) I was proved wrong. One cannot properly understand the law of assignment – a bedrock of the commercial construction lawyer's practice – without comprehending equitable assignment. And it is at the outer fringes of assignment where one may bump – or even lapse – into trusts.

A few experiences of mine – plus some other items – indicate these encounters are not so rare. So with apologies to Snell, Hanbury and the wards in Jarndyce v Jarndyce, I offer some thoughts.

1. SOME SCENARIOS

Consider a few situations:

- Collateral warranties or third party rights are not available to a purchaser in a sale. Or, perhaps, the seller is unwilling to procure warranties in favour of a purchaser, given the age and value of the construction contract package. The usual standby here is for the seller to assign its rights under the construction contracts to the purchaser. But what if the rights are not assignable?

- Conversely, the rights are assignable, but the seller cannot assign to the purchaser at sale completion. This may be because the works are still in the defects liability period and the seller has promised in the sale contract to procure that defects are make good

under the building contract. Plainly, it cannot undertake to do this and part with those rights which allow it to discharge its promise. Similarly, it may be unwilling to part with its rights if it has contingent liabilities in relation to the works (for example, under an agreement for lease).

- Or the seller would – in the absence of collateral warranties or third party rights – gladly assign its rights to one purchaser or tenant, but is concerned that a subsequent purchaser or tenant of another part of the property may also require similar rights. As is well-known, there cannot be a legal, absolute assignment of part only of a contractual right. That would not comply with section 136 of the Law of Property Act 1925. Nor may an equitable assignment of part of a right prove attractive either. For example, how would one describe the scope of partial rights assigned?

Naturally, variations on these scenarios are possible.

2. A TRUSTY SOLUTION?

The handy solution often offered to these puzzles is to place the relevant rights in trust for the benefit of the interested third party. The nature of the trust will depend on the extent to which others – including the seller in its own name, not merely as trustee – may require the right to enforce the rights following creation of the trust.

There is little doubt that this arrangement can work. It is trite to say that a trustee can sue and recover substantial damages on behalf of the beneficiary of a trust. In this, the arrangement is very like an equitable assignment. Further, one need not fear the spectre of a no loss argument clanking its chains.

The document establishing the trust will typically state the basis on which the beneficiary can bring claims. This will usually be on the basis that it can do so itself – albeit using the trustee's name – provided that it gives the trustee sufficient indemnity for legal costs. The trustee will undertake – though it would be implied anyway – to account to the beneficiary for any monies recovered in respect of (say) the defects claim made under the building contract.

3. A POSSIBLE TRAP

How is a trust created? The person creating the trust – the settlor – can go about things in two ways.

- The settlor may appoint trustees and transfer assets into the trust to be held for the benefit of the beneficiaries.

- Or it may simply declare itself the trustee of the assets (in our case, rights under construction contracts), again for the benefit of one or more identified persons.

The distinction may seem inconsequential. But it is important. The first route requires there to be a *disposition* into the trust of the relevant assets. For rights in contract, that would mean a legal assignment to the trustees. But that option is impermissible in the first of our scenarios: in that case, there can be no assignment, because the underlying contracts are not assignable.

So the second option is the one to use. Under it, there is no transfer of legal title, so a prohibition on assignment is immaterial. Instead, the law will recognise an effective trust (assuming three basic tests or "certainties" are satisfied) created by what may appear to be little more than an act of the settlor's will.

The ease with which a trust may be created – and its apparent effectiveness – may surprise some people, especially if their carefully crafted clauses limiting the right to assign appear susceptible to circumvention. But in this the law is clear: assignment and trust are distinct concepts, however much the interests of a beneficiary under a trust and an equitable assignee seems akin.

4. DON'T TRUST TOO MUCH

There may be a temptation to think of the trust solution like a magic wand, making some real difficulties disappear in our example situations. But things aren't so simple – perhaps unsurprisingly, given that trusts are only deployed where more orthodox contractual tools (such as collateral warranties) are not available.

Some obvious limitations on the trust solution are:

- *Prohibition on creating trusts:* It is very unlikely that a building contract, appointment or collateral warranty/third party rights will prevent the client or beneficiary from creating a trust over its rights. But if the development or property is subject to finance, the finance documents will have charged or assigned the rights to the lender. There will also be provisions preventing the borrower from creating legal or equitable interests over its rights without lender consent. The trust option may be a non-starter in such cases.

- *The purchaser's needs:* A purchaser may also be resistant to a trust arrangement, other than as a last resort. That's particularly likely to be the case where the acquisition of its interest in the works is being debt financed. I would expect a lender to look at any trust arrangement quizzically, not least how it may be regarded by any future purchaser or on a refinancing. Context may be all in such matters: if the trust arrangement applies to a smattering of older or minor contracts, there may be little issue. But things may be different where more material contracts feature.

- *Old habits die hard:* I've learnt not to discount the force of habit: until recently, purchasers and other third parties typically expected to see collateral warranties. These are reassuringly physical documents. Third party rights – now mercifully becoming more of a norm – were seen as new-fangled, even nebulous. Whatever the legal arguments

and niceties, somehow a trust may appear that bit more nebulous still. So if one is thinking of recommending a trust, it will be wise to have a clear sales pitch prepared.

As a practical matter, then, trust arrangements may be best suited where the underlying transaction is intra- group, involves older or less valuable contracts and doesn't have a finance element.

5. POLICY?

One nagging concern I had about trust arrangements is whether they may be prone to attack on policy grounds. In *Alfred McAlpine Construction Ltd v Panatown Ltd* [2001] 1 AC 518, the House of Lords found that a transferred loss argument could not succeed where there was specific provision in the building contract for delivery of a collateral warranty to the building owner. That warranty was delivered. To permit transferred loss would be to bypass the contractual scheme.

One could, I suppose, argue by analogy that an exhaustively drafted set of construction contracts should be allowed to determine the full extent of third parties entitled to recover substantial damages for breach. Trust law should not be allowed to avoid restrictions on assignment. But the argument may well be hopeless: as mentioned, trusts and assignments are different species. There is no overriding reason why words regulating one should be interpreted to undercut the other, unless the language is very clear. If so, objections to what appear to be valid trusts may disappear – like the assets in *Jarndyce* – into the maw of equity.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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