



## Introduction

The second limb of *Barnes v Addy*<sup>1</sup> provides a cause of action against persons who provide knowing assistance to a trustee or fiduciary who dishonestly and fraudulently breaches their duties as trustee or fiduciary.

This paper looks at the elements of that cause of action and reviews recent Australian cases including *Farah Constructions Pty Limited v Say-Dee Pty Limited*<sup>2</sup>.

## The rule in *Barnes v Addy*

In *Barnes v Addy*, Lord Selborne LC, referred to two grounds or limbs upon which third parties to a trust can become constructive trustees.

The first ground occurs in circumstances where the third party (the defendant) receives and becomes chargeable with some part of the trust property. This has become known as the first limb of *Barnes v Addy* and is referred to as involving 'knowing receipt'.

The second ground occurs in circumstances where the defendant assists with knowledge in a dishonest and fraudulent design on the part of the trustee. This is known as the second limb of *Barnes v Addy* and is the subject of this paper. It is referred to as involving 'knowing assistance'.

The rule in *Barnes v Addy* most recently received High Court consideration in *Farah Constructions*. In that case it was noted that, as conventionally understood in Australia, the second limb of *Barnes v Addy* makes a defendant liable if that defendant assists a trustee or fiduciary with knowledge of a dishonest and fraudulent design on the part of the trustee or fiduciary.<sup>3</sup>

## The elements of the second limb

There are three elements that must be satisfied in order to establish liability under the second limb of *Barnes v Addy*. Those are:

- A dishonest and fraudulent breach of duty by the trustee or fiduciary;
- Knowledge on the part of the defendant;
- Assistance by the defendant towards the trustee's or fiduciary's dishonest and fraudulent breach.

Below, we comment on each of those elements.

## Dishonest and fraudulent breach of duty by the trustee or fiduciary

In *Farah Constructions*, the High Court confirmed that the fiduciary's or trustee's breach of fiduciary duty or trust must be a dishonest and fraudulent breach.<sup>4</sup> Mere breach of trust or fiduciary duty without dishonesty and fraud will not suffice as an element of the second limb of *Barnes v Addy*.

The High Court observed that breaches of trust and breaches of fiduciary duty vary greatly in their seriousness and some breaches are well intentioned and some are trivial.<sup>5</sup> Not all breaches of fiduciary duty necessarily involve dishonesty and fraud.

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<sup>1</sup> (1874) LR 9 CH App 244 at 251- 252.

<sup>2</sup> (2007) 230 CLR 89.

<sup>3</sup> *Farah Constructions*, paragraph 160, per Gleeson CJ, Gummow, Callinan, Heydon and Crennan JJ.

<sup>4</sup> *Farah Constructions*, paragraph 180.

<sup>5</sup> *Farah Constructions*, paragraph 184.

In *The Bell Group (In liq) v Westpac banking Corporation (No 9)*,<sup>6</sup> Owen J said with reference to the decision in *Farah Constructions* that:

'It seems, therefore, that the impugned conduct must be attended by circumstances that would attract a degree of opprobrium raising it above the level of a simple breach of trust or breach of a fiduciary duty'.<sup>7</sup>

An allegation of a dishonest or fraudulent breach of fiduciary duty is a serious allegation which should be properly pleaded and particularised and the assessment required by *Briginshaw v Briginshaw*<sup>8</sup> should be kept in mind<sup>9</sup>.

In attempting to determine, therefore, whether this first element has been satisfied it is necessary to consider whether the trustee's or fiduciary's dereliction of duty is sufficient to merit the description 'dishonest and fraudulent' as that expression is understood by reference to equitable principles.<sup>10</sup>

In *Farah Constructions* the alleged breach of fiduciary duty did not merit the description 'dishonest and fraudulent.' In that case:

- Farah Constructions Pty Ltd (the appellant) and Say-Dee Pty Ltd (the respondent) entered into a joint venture agreement for the development of real property. This required, amongst other things, redevelopment approval from the local council.
- Mr Elias controlled Farah Constructions and was responsible for managing the progress of the local council development application.
- Mr Elias became aware that the local council refused to approve the redevelopment since the land area was too small but there was indication that the local council might agree to redevelopment if neighbouring properties were amalgamated with the subject site.
- Mr Elias then acquired some of the neighbouring properties through another company controlled by him and through his wife and two daughters. The *Barnes v Addy* claim was made against the wife and two daughters.
- There was a factual issue about whether Mr Elias had disclosed to Say-Dee the knowledge he had received from the local council. Farah Constructions and Say-Dee each asserted that Mr Elias had made a different level of disclosure to Say-Dee.
- The High Court held that Mr Elias had made sufficient disclosure such that Mr Elias was not in breach of his fiduciary duty.
- The High Court also held that even if the lesser level of disclosure asserted by Say-Dee had been made this was not necessarily a 'dishonest and fraudulent' breach of fiduciary duty by Mr Elias since a 'man like Mr Elias might not necessarily appreciate the difference between' the statements he was found to have made and the statements Say-Dee asserted he had made.<sup>11</sup>

## Knowledge

Before a defendant can be liable under the second limb of *Barnes v Addy*, the defendant must have *knowingly* assisted in the dishonest breach of trust or fiduciary duty.

In *Farah Constructions*, the High Court referred to the earlier High Court case of *Consul Development Pty Limited v DPC Estates Pty Limited*<sup>12</sup> and held that the four relevant categories of knowledge are:

- First category: actual knowledge;
- Second category: Wilfully shutting one's eyes to the obvious;
- Third category: Wilfully and recklessly failing to make such enquiries as an honest and reasonable person would make;
- Fourth category: Knowledge of circumstances which would indicate the facts to an honest and reasonable person.

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<sup>6</sup> [2008] WASC 239

<sup>7</sup> *The Bell Group v Westpac*, paragraph 4727.

<sup>8</sup> (1938) 60 CLR 336.

<sup>9</sup> *Farah Constructions*, paragraph 170. See also *Corporate Systems Publishing Pty Ltd v Lindgard (No 4)* [2008] WASC 21 at paragraphs 326 and 327.

<sup>10</sup> *Farah Constructions*, paragraph 181.

<sup>11</sup> *Farah Constructions*, paragraph 186.

<sup>12</sup> (1975) 132 CLR 373.

The first three categories of knowledge are generally understood as involving 'actual knowledge' as understood both at common law and in equity.

The fourth category is an instance of 'constructive knowledge' as developed in equity<sup>13</sup> and is seen as providing that the 'morally obtuse' cannot escape liability by a failure to recognise an impropriety that would have been apparent to an ordinary person applying the standards of such persons.<sup>14</sup>

A fifth category of knowledge, being knowledge of circumstances which would put an honest and reasonable person on inquiry, was held not to satisfy the knowledge requirement under the second limb of *Barnes v Addy*.

The distinctions between the four categories of knowledge are subtle and 'one might justifiably question whether even the trained legal mind is capable of making such fine distinctions (and even if so, whether there is any utility in making them)'.<sup>15</sup> In *Immobiliari Pty Ltd v Opes Prime Stockbroking Ltd*,<sup>16</sup> Finkelstein J suggests that the proliferation and refinement of various categories of 'knowledge' is 'unhelpful at best'.<sup>17</sup> His Honour suggests it would be simpler to assess the knowledge requirement based on the standard categories of mens rea being:

- Intent, which would suffice to establish liability under the second limb of *Barnes v Addy*;
- Actual knowledge, which would suffice to establish liability under the second limb of *Barnes v Addy*;
- Recklessness,<sup>18</sup> which would suffice to establish liability under the second limb of *Barnes v Addy*;
- Negligence. Finkelstein J is of the opinion that negligence would not suffice to establish liability under the second limb of *Barnes v Addy* since, the High Court's rejection of the fifth category of knowledge (being knowledge of circumstances which would put an honest and reasonable person on inquiry) was effectively the rejection of a negligence standard<sup>19</sup>; and
- Strict liability, which would not suffice to establish liability under the second limb of *Barnes v Addy*.

Finkelstein J sees the third category of knowledge put forward by the High Court in the *Farah Constructions* case as meaning something like 'recklessness plus.' The fourth category of knowledge is seen as equating to standard recklessness.<sup>20</sup> On this approach, Finkelstein J is able to summarise the position as being that the minimum knowledge element required for liability under the second limb of *Barnes v Addy* is recklessness.

On the facts of *Farah Constructions*, the High Court found that even if there had been a dishonest and fraudulent breach of fiduciary duty (it was held there was not), there was no evidence that the fiduciary's wife and daughters (against whom the *Barnes v Addy* claim was made) had any knowledge of the alleged dishonest and fraudulent breach.<sup>21</sup>

*Quince v McLaughlan*,<sup>22</sup> is a case where it was held that the defendants had breached the first and second limbs of *Barnes v Addy*. On the question of knowledge it was held that the defendants' behaviour had '... consciousness of those elements of the transaction which make participation transgress ordinary standards of honest behaviour'.<sup>23</sup> In that case:

- The plaintiff provided money to McLaughlan in the belief that McLaughlan would invest that money on the plaintiff's behalf;
- The money was paid into a trust of which McLaughlan's son was the trustee. From there the money was disbursed to the benefit of McLaughlan, his wife and his son;

<sup>13</sup> *Farah Constructions*, paragraph 174-178.

<sup>14</sup> *Farah Constructions*, paragraph 177.

<sup>15</sup> *Immobiliari Pty Ltd v Opes Prime Stockbroking Ltd* [2008] FCA 1920 at paragraph 29.

<sup>16</sup> [2008] FCA 1920

<sup>17</sup> *Immobiliari v Opes Prime* paragraph 28.

<sup>18</sup> Meaning 'a conscious disregard of a substantial and unjustifiable risk that the property was subject to a trust and was received pursuant to a breach of trust or of fiduciary duty or a misapplication of trust property'.

<sup>19</sup> *Immobiliari v Opes Prime* paragraph 28.

<sup>20</sup> *Immobiliari v Opes Prime* paragraph 29 and 30.

<sup>21</sup> *Farah Constructions*, paragraph 186.

<sup>22</sup> [2008] QSC 61. This case was appealed in *Quince v Varga* [2008] QCA 376, referred to below.

<sup>23</sup> *Quince v McLaughlan*, paragraph 157 and see *Farah Constructions* at paragraph 161.

- It was held that McLaughlan was in a fiduciary relationship with the plaintiff in respect of the investment money and that McLaughlan had breached his fiduciary duty to the plaintiff;
- A summary of the particular matters held to be known by the wife and son is provided at paragraphs 86 and 104 of the judgment. Some of those matters include knowledge that: McLaughlan had a criminal history and was bankrupt, the money from the plaintiff was being deposited into the trust and was being withdrawn in large amounts at McLaughlan's direction, and family expenses were being paid from the money being withdrawn from the trust.

The case of *Lurgi (Australia) Pty Limited v Ritzer Gallagher Morgan Pty Limited*<sup>24</sup> provides a discussion about the elements of knowledge in the context of a *Barnes v Addy* claim made against a firm of accountants. In that case:

- Mr Dietrich and Mr Gratz (not parties to the proceedings) were directors of the plaintiff and were also associated with a company called PRS Engineering Pty Limited (**PRS**). PRS performed engineering and fabrication work for the plaintiff;
- In breach of their fiduciary duties as directors of the plaintiff, Dietrich and Gratz arranged for PRS to issue false invoices to the plaintiff (invoices for work not performed). The money received in response to those invoices was paid to Dietrich and Gratz or was used for their purposes;
- A second limb *Barnes v Addy* claim was made against the accountants of PRS;
- Byrne J found that the accountants knew that some of the invoices were relevantly false including because:
  - One subject invoice was for \$197,000 in labour costs which was a substantial extra in the circumstances;
  - The accountants had agreed that the plaintiffs had no obligation to pay for the extra work the subject of the invoice;
  - The payment was used by Dietrich and Gratz to buy the silence of the named directors of PRS;<sup>25</sup>
  - Gratz was using PRS to engage in transactions which were in breach of his fiduciary duty;
  - There were no employees on the PRS payroll at the time of the later subject invoices.<sup>26</sup>

### Assistance

Before a defendant can be liable under the second limb of *Barnes v Addy*, the defendant must have *assisted* in the dishonest and fraudulent breach of trust or fiduciary duty.

Precisely what acts or omissions will suffice to constitute the required assistance appears unclear. In *Quince v McLaughlan*<sup>27</sup>, Lyons J of the Queensland Supreme Court noted that the element of assistance:

'has not been comprehensively addressed in any of the cases, but it is generally taken to mean any action by the stranger taken with the intention of furthering the trustee's or fiduciary's fraudulent and dishonest purpose'.<sup>28</sup>

The Queensland court of appeal decision in *Quince v Varga*<sup>29</sup> offers an example of assistance being provided, in effect, by 'standing by' or by not properly exercising trustee powers to stop the misuse of the trust funds. A summary of the facts has been provided above. As mentioned, a successful *Barnes v Addy* claim was made against the fiduciary's wife and son. In that case:

- The wife's knowing assistance was said to be comprised of her 'standing by' including when:
  - McLaughlan made representations to the plaintiff about the security of the plaintiff's investment;
  - She knew that large amounts of money were coming into the trust and were being expended for the benefit of the McLaughlan family rather than for the benefit of the plaintiff;

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<sup>24</sup> [2007] VSC 277

<sup>25</sup> *Lurgi v Ritzer* paragraph 59.

<sup>26</sup> *Lurgi v Ritzer* paragraph 69.

<sup>27</sup> [2008] QSC 61.

<sup>28</sup> *Quince v McLaughlan*, paragraph 151.

<sup>29</sup> [2008] QCA 376. This was the appeal of the *Quince v McLaughlan* case referred to above.

- She had power to remove the trustee but stood by while McLaughlan used the trust funds as his own and directed the expenditure of funds (against a background where she knew McLaughlan was an undischarged bankrupt);<sup>30</sup>
- The knowing assistance by McLaughlan's son was said to be comprised of allowing McLaughlan to access the trust money without sufficient regard to the son's duty as trustee against a background where the son knew that the funds coming into the trust could not have come from McLaughlan given he was an undischarged bankrupt.<sup>31</sup>

Merely being the company which acquired the property the subject of the breach of fiduciary duty can amount to assistance. In *Pedersen v Larcombe*<sup>32</sup> the corporate 'alter ego' of the dishonest fiduciary was held to be liable under the second limb by being the vehicle used to acquire the benefit. In that case:

- Larcombe was a real estate agent who, it was found, entered into an agency relationship to sell Pedersen's property;
- After very brief enquiries of the market which suggested a sale price of about \$850,000, Larcombe offered to purchase the property for \$900,000 less the agent's commission he would have received if he had sold the property;
- The purchaser was Varinya Pty Ltd, a company controlled by Larcombe. In the space of a year, Varinya sold the property for \$1.935 million;
- At the trial, it was not disputed that Varinya was 'an active and knowing participant in Larcombe's breach of fiduciary duty' and was therefore liable to make equitable compensation under the second limb.<sup>33</sup>

The assistance provided by the accountants in the case of *Lurgi (Australia) Pty Limited v Ritzer Gallagher Morgan Pty Limited*<sup>34</sup> (the facts of which have been summarised above) appears to have included performing accounting and administrative services for PRS including preparing and issuing the subject PRS invoices and calculating the amount of extra work and fees to be charged in the subject false invoices<sup>35</sup>.

### Insurance coverage issues

As can be seen from the case of *Lurgi (Australia) Pty Limited v Ritzer Gallagher Morgan Pty Limited*<sup>36</sup>, an action under the second limb of *Barnes v Addy* can be brought against professional persons (including, but not limited to, accountants or solicitors) who provide ancillary services or assistance to trustees or fiduciaries.

The bringing of such an action against a professional may raise certain issues in relation to the cover provided by the defendant-professional's professional indemnity insurance. Typically such policies contain an exclusion for fraudulent or dishonest conduct by the insured. While the starting point must always be the words of the particular exclusion being considered, the elements of an action under the second limb of *Barnes v Addy* would generally appear to raise a question about the possible application of the fraud or dishonesty exclusion of a professional indemnity policy.

An element of the cause of action is that there must be a dishonest and fraudulent breach of duty by a trustee or fiduciary. However, it is not this dishonesty or fraud by the trustee or fiduciary that by itself may trigger the application of a fraud or dishonesty exclusion. Instead the particular coverage issue which arises is whether the defendant-professional's knowing assistance in relation to the fraud and dishonesty was of a type that constitutes fraud or dishonesty within the terms of the specific exclusion clause being considered.

In relation generally to the meaning of dishonesty and fraud as used in an insurance context, we note that whether there has been dishonesty is to be assessed by reference to the standard of the ordinary, honest person and is not a term of art.<sup>37</sup> A person may be relevantly dishonest if they make a statement or representation which they know to be false.<sup>38</sup> Similarly, conduct found to be

<sup>30</sup> *Quince v McLaughlan*, paragraph 155.

<sup>31</sup> *Quince v McLaughlan*, paragraph 156.

<sup>32</sup> [2008] NSWSC 1362.

<sup>33</sup> *Pedersen v Larcombe*, paragraph 138. The company was also found liable under the first limb of *Barnes v Addy* to account for the profits derived from Larcombe's breach of duty: paragraph 136.

<sup>34</sup> [2007] VSC 277

<sup>35</sup> *Lurgi v Ritzer* paragraph 69.

<sup>36</sup> [2007] VSC 277

<sup>37</sup> *McCarthy v St Paul Insurance Co Ltd* [2007] FCAFC 28 at paragraph 34.

<sup>38</sup> *Derry v Peek* (1889) 14 App Cas 337.

dishonest or fraudulent must be wilfully so.<sup>39</sup> It is not necessary to prove that the defendant's motivation was to cheat or deceive or to seek to advance a personal interest.<sup>40</sup>

The possibility that the fraud or dishonesty exclusion may apply would seem to highlight the need for the parties to the insurance contract to carefully consider the benefits or protection available to any innocent persons (being persons not involved in providing the knowing assistance) covered by the policy.

### Conclusion

In cases of dishonest and fraudulent breaches of trust or fiduciary duty, the second limb of *Barnes v Addy* broadens the range of persons against whom recovery might be made to include third parties to the trust or fiduciary relationship.

A starting point for an action under the second limb is that there must have been a dishonest and fraudulent breach of duty by the person in the position of trustee or fiduciary. An action under the second limb therefore involves making a serious allegation against a person who is not the defendant to the cause of action.

As against the actual defendant to the action it is necessary to establish a mental element and a conduct element. The minimum mental element is 'knowledge of circumstances which would indicate the facts to an honest and reasonable person'. It appears the conduct element may be satisfied by any action which furthers the trustee's or fiduciary's dishonest and fraudulent purpose.

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<sup>39</sup> *A & D Douglas Pty Ltd v Lawyers Private Mortgages Pty Ltd* [2006] FCA 520 at paragraph 600.

<sup>40</sup> *A & D Douglas Pty Ltd v Lawyers Private Mortgages Pty Ltd* [2006] FCA 520 at paragraph 600; *McMillan v Joseph* (1987) 4 ANZ Ins Cas 60-822; *McCarthy v St Paul Insurance Co Ltd* [2007] FCAFC 28 at paragraph 35.