KEY POINTS

- The Court of Appeal has held that in trusts cases interest can be awarded as a proxy for the investment returns which the claimant has missed out on.
- There is potential for a similar approach to be applied more widely.
- Companies and funds which hold investments should be aware of the possibilities when making a claim, and counterparties of such persons should be aware of the risks.

Feature

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Interest as a proxy for investment returns

In *Watson v Kea Investments Limited* [2019] 4 WLR 145, the Court of Appeal upheld an award of equitable interest at a rate of 6.5% per annum, compounded annually. That rate had been awarded by the trial judge as a proxy for the total investment return which might have been earned on the money lost in the defendant's fraud. This is believed to be the first occasion on which interest has been awarded expressly as a proxy for total investment return. Important questions arise as to how widely the decision may be applied.

In 2012 Kea had been induced by Mr Watson to invest £129m in a joint venture known as Project Spartan. The money had been transferred to the joint venture vehicle, Spartan Capital Limited. The parties then fell out and the joint venture stalled, so that most of the money was not actively invested but instead held by Spartan in bank accounts paying a low rate of interest. In 2015, Kea discovered grounds to believe that it had been defrauded by Mr Watson and brought proceedings alleging deceit and breach of fiduciary duty. Kea also claimed interest. Kea's claims were disputed, leading to a trial in 2017. During the trial, Spartan and the Jersey trust company which Mr Watson had used to participate in the joint venture on his side settled with Kea on terms which resulted in Kea recovering from Spartan a sum slightly in excess of £129m. However, since Kea's total claim was for £129m *plus interest*, a substantial shortfall remained.

The trial continued against Mr Watson and in July 2018 Mr Justice Nugee handed down judgment holding that the joint venture agreements had been procured by fraud and breach of fiduciary duty and that Mr Watson was liable to pay equitable compensation to Kea (see *Glenn v Watson* [2018] EWHC 2016 (Ch)). The quantum of Mr Watson's liability was to be calculated as the total amount of *Spartan's* liability to Kea for principal and interest, less the amount which Kea had been able to recover from Spartan. In this way, the amount of *Spartan's* liability to pay interest was determinative of the amount of *Mr Watson's* liability to pay equitable compensation.

At a further hearing in September 2018, Kea, which was an investment vehicle of a private trust, argued that the interest rate payable by Spartan should be fixed by reference to returns on proper trustee investments during the period from 2012 to 2018. Kea presented material from Asset Risk Consultants (ARC) and the Society of Trust and Estate Practitioners (STEP) which suggested that a typical trustee investor with a medium appetite for risk would have generated returns over that period equivalent to an interest rate of 6.89% per annum, compounded annually. Mr Watson argued that the interest rate should be fixed by reference to an assumed borrowing rate and indicated that he would not object to 3% over base, following *Challinor v Juliet Bellis* [2013] EWHC 620 (Ch). Mr Justice Nugee preferred Kea's submissions and adopted a rate of 6.5% per annum, compounded annually. This rate was intended to be "a proxy for the investment return that trust funds with the general characteristics of the fund in question could expect to make" (*Glenn v Watson* [2018] EWHC 2483 (Ch), at [49]). On the basis of this interest rate, Mr Watson's liability to pay equitable compensation was fixed in a maximum sum of about £43m. An interest rate of 3% over base would have yielded a figure about £20m lower. Mr Watson appealed.

In the Court of Appeal, as at first instance, the argument focussed on the authorities on awards of equitable interest against defaulting trustees. Mr Justice Nugee had held that, although *Watson v Kea* was a fraud case, those authorities were relevant because:

- Spartan was a knowing recipient and liable to account as constructive trustee; and
- Kea was itself a vehicle for trustee investment.

There was therefore a parallel with trusts cases both on the claimant side and on the defendant side. The Court of Appeal adopted essentially the same approach.

What the trusts cases showed was that courts had for many years awarded interest against defaulting trustees on three different bases. First, interest would be awarded to compensate a trust fund for the return which would have been made had the fund been properly invested. In the 19th century, interest on this basis was awarded at a conventional rate of 4%. Second, where a defaulting trustee had wrongly used trust money in his business, the claimant could elect not to have an account of the actual profits made but instead to have interest at a conventional rate reflecting what it was assumed could be made in business. In the 19th century this was 5%. Third, in cases of fraud the claimant could take the higher rate (ie in the 19th century, 5%) even if he could not prove what the defendant had used the money for.

The trusts cases also showed that whilst the three bases for awarding interest against defaulting trustees had remained consistent, the actual rates awarded on each basis had been adapted from time to time in light of changing economic conditions. In the 1970s and 1980s when inflation and interest rates were rampant, a practice had developed of awarding interest either by reference to deposit rates or by reference to borrowing rates. A deposit rate is, of course, a type of investment rate. One of the issues for the Court of Appeal in *Watson v Kea* was whether a modern trust claimant seeking an investment rate is confined as a matter of principle to a deposit rate, or whether instead a higher rate reflecting the real world returns on trustee investments can be sought.

The Court of Appeal agreed with Kea that in principle a court in a trusts case can fix an interest rate by reference to the returns which a person like the claimant might have earned on proper trustee investments. The awards of 4% made in the 19th century had been fundamentally of that nature. Insofar as Mr Justice Nugee in *Watson* had fixed a rate based not on long term convention but rather on evidence of what trustee investments had actually returned over the relevant period, that merely reflected the fact that he had had better information available to him than judges had ever had before. In a vivid passage at [73]-[74], McCombe LJ stated:

> "A borrowing rate is simply not the realistic proxy in a case of this sort. It is unrealistic to assume that the deprived fund would have borrowed to invest; it would not have done so. It is unrealistic to assume that the trust fund, duly replaced, would have been placed (in breach of trust, one might add) on deposit with no regard to capital accretion; it would not have been so placed. That is simply not the real world of trustee investment ... The material before the judge (ARC/STEP) illustrated precisely what a deprived fund of this type would have done with the misappropriated money ... There was no need to work in a way contrary to reality or to embark on an element of speculation, as Hildyard J was constrained to do in the *Challinor* case. Why ignore reality?"

Furthermore, the Court of Appeal expressly held that the investment return which may be taken into account when fixing an interest rate in a trusts case is not limited to *income* which might have been earned. In an appropriate case the court can have regard to total return when fixing an interest rate. Interest can therefore include an element of compensation for lost capital appreciation.

It is important to emphasise that nothing in *Watson v Kea* detracts from the well-established proposition that (leaving aside interest as damages, which must be distinctly pleaded and proved) interest is not to be used to compensate claimants for specific losses which the individual claimant has suffered by reason of being kept out of his money. The court is concerned with what would compensate *a person with the general characteristics of the claimant* for being kept out of his money. Where the claimant is a trustee or (like Kea) a vehicle for trustee investment, this may warrant looking at general returns on trustee investments over the relevant period. But a claimant who wishes to say that had he kept his money he would have invested it in some very specific way, generating an unusual profit, will get no assistance from *Watson v Kea*.

Looking ahead to the future, important questions remain about the scope of the decision in *Watson v Kea*. We have mentioned above that the authorities relied upon by Nugee J and the Court of Appeal were principally trusts cases. We have also mentioned that, although *Watson v Kea* was a fraud case rather than a traditional trusts case, the claimant was a vehicle for trustee investment and the relevant defendant was liable as a constructive trustee, so that there were clear parallels with ordinary trusts cases both on the claimant side and on the defendant side. But what if the parallel existed only on the claimant side, or only on the defendant side, or even on neither side: can interest still be claimed by reference to lost investment returns as long as the claimant falls within a category of person who would have invested?

The judgments in *Watson v Kea* do not provide a definitive answer, and no doubt the limits of the approach will have to be worked out in future cases. However, we will offer four observations.

First, as a matter of principle there is much to be said for the courts being willing to fix interest rates by reference to rates of investment return in any case where the claimant falls within a category of person who would have invested if not kept out of his money, irrespective of the nature of the defendant's liability. The leading cases on the fixing of interest rates in commercial and other common law situations establish that interest "may be regarded either as representing the profit [the claimant] might have made if he had had the use of the money, or conversely the loss he suffered because he had not that use" (*Prudential Assurance Co Ltd v Revenue and Customs Commissioners* [2019] AC 929 at [76], quoting *Fibrosa v Fairbairn* [1943] AC 32) and that the courts should approach the task of fixing an interest rate by first considering the general attributes of the claimant and then asking what would fairly compensate a claimant of that type for being kept out of its money (eg *Carrasco v Johnson* [2018] EWCA Civ 87). It would seem consistent with those principles that in any case where the general attributes of the claimant indicate that he would have invested if not kept out of his money the court should be willing to consider an award of interest fixed by reference to investment returns over the relevant period.

Second, however, it has to be recognised that in cases where the courts have actually considered and decided what type of interest award would fairly compensate a non-trustee investor, they have never yet (as far as we are aware) come down in favour of a rate based on the returns which could have been made on an actively invested portfolio. A good example is the *Challinor* case mentioned above. Hildyard J observed at [34] that it was unlikely that the claimants would have borrowed to invest and that their real loss was "the opportunity denied for further investment". But he nevertheless went on to award interest by reference to what he imagined the claimants would have had to pay to borrow monies for geared investment (ie a borrowing rate).

Third, it may be that the absence of reported examples of interest rates being fixed by reference to real world investment returns is a consequence of the courts never having been provided (until *Watson v Kea*) with objective and high-quality information showing what level of investment return a person like the claimant could have expected to earn over the relevant period. In *Challinor*, Hildyard J considered the value of the opportunity denied for further investment to be "not measurable". But why was it not measurable? One possible answer is that it was only not measurable because the court had not been given the necessary materials with which to measure it. Certainly, it appears from the judgment that the court

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had not been given any such materials. On this view, one might expect awards of interest based on rates of investment return to become much more common in the future as claimants, building on *Watson v Kea*, start to come along to post-judgment hearings armed with published investment return information such as that available from ARC and STEP.

Fourth, although clearly the availability of high-quality information about investment returns over the relevant period will be *necessary* to obtain an award of interest fixed by reference to such returns, it may yet be that something more is required. It may be that such an award is only practicable where the general attributes of the claimant are such that the court can be confident, not only of the fact that such a person would have invested, but also of approximately *how* such a person would have invested. Where the claimant is a trustee or a vehicle for trustee investment, the court may be able to be reasonably confident of those things because, subject to any special terms of the trust, trustees are generally obliged:

- to invest; and
- to invest in accordance with certain requirements, eg with the benefit of professional advice and having regard to the benefits of diversification (see, in England, ss 4(3)(b) and 5 of the Trustee Act 2000).

In a case where the claimant is a trustee, the court may therefore be inclined to accept that information about the returns generated by professionally managed and diversified portfolios provides a good guide to what a person like the claimant has missed out on. By contrast, if the claimant is simply a private individual, free to invest in whatever manner he wishes from time to time, or to stay out of the market altogether, it may be difficult to persuade the court that any particular set of data about the investment returns achieved by other investors is of much relevance. It is important to recall that on a claim for interest the court will not look at evidence about what the individual claimant would have done.

Overall, whilst there is clearly scope for argument about the limits of *Watson v Kea*, it seems to us that a similar approach to interest may be possible in any case where the claimant falls within a category of persons who would have invested and whose likely investment performance over a given period can reasonably be assessed (on a broad brush basis) from published data without any need to enquire into the circumstances or preferences of the individual claimant. Categories of claimant who meet these criteria may include, in addition to trustees of private/family trusts, pension fund trustees, trustees and companies who hold and operate investment funds, and other investors who for whatever reason are contractually or statutorily obliged to invest in a particular way.

In our view, claimants falling within such categories should consider when pleading claims for interest whether it would be beneficial to seek interest on the *Watson v Kea* basis and, if so, whether the evidence which would be required to support such a claim is available. We would also suggest that contracting counterparties of persons falling within the above categories should consider the possibility that they may in the future be ordered to pay interest on the *Watson v Kea* basis: it may be that where this possibility is seen as introducing undesirable uncertainty, the risks can be mitigated to some extent by appropriate contractual terms. ■

Further Reading:

- Trustee liability for poor investment performance (2009) 10 JIBFL 599.
- LexisPSL: Financial Services: Investor compensation and redress – overview.