Constructive Trusts in Fraud Cases

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Introduction

> "English law provides no clear and all-embracing definition of a constructive trust. Its boundaries have been left perhaps deliberately vague, so as not to restrict the court by technicalities in deciding what the justice of a particular case may demand."

This quote from Edmund Davies L.J. in *Carl Zeiss Stiftung v Herbert Smith (No.2)*[1] highlights both the importance and complexity of constructive trusts.

There are essentially two types of constructive trust and these were explained by Millett L.J. in *Paragon Finance Plc v DB Thakerar & Co*[2]:

> "A constructive trust arises by operation of law whenever the circumstances are such that it would be unconscionable for the owner of property (usually but not necessarily the legal estate) to assert his own beneficial interest in the property and deny the beneficial interest of another. In the first class of case, however, the constructive trustee really is a trustee. He does not receive the trust property in his own right but by a transaction by which both parties intend to create a trust from the outset and which is not impugned by the plaintiff. His possession of the property is coloured from the first by the trust and confidence by means of which he obtained it, and his subsequent appropriation of the property to his own use is a breach of that trust … In these cases the plaintiff does not impugn the transaction by which the defendant obtained control of the property. He alleges that the circumstances in which the defendant obtained control make it unconscionable for him thereafter to assert a beneficial interest in the property.
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> The second class of case is different. It arises when the defendant is implicated in a fraud. Equity has always given relief against fraud by making any person sufficiently implicated in the fraud accountable in equity. In such a case he is traditionally though I think unfortunately described as a constructive trustee and said to be 'liable to account as constructive trustee'. Such a person is not in fact a trustee at all, even though he may be liable to account as if he were. He never assumes the position of a trustee, and if he receives the trust property at all it is adversely to the plaintiff by an unlawful transaction which is impugned by the plaintiff. In such a case the expressions 'constructive trust' and 'constructive trustee' are misleading, for there is no trust and usually no possibility of a proprietary remedy; they are 'nothing more than a formula for equitable relief': *Selangor United Rubber Estates Ltd v Cradock (No 3)* [1968] 1 WLR 155 at 1582 per Ungoed-Thomas J."

In fraud cases, constructive trusts commonly arise in the following situations:

1. where a person in a fiduciary position makes an unauthorised profit;
2. where a person is in "knowing receipt" of trust property;
3. where there has been rescission of a contract entered into as a consequence of fraud.

The article briefly considers each of those situations and then considers questions of tracing and proprietary remedies.

Unauthorised profits by fiduciaries

Fiduciaries are those who have a duty of single-minded loyalty to their principles, such as directors of companies and agents. The fiduciary must act in good faith, not make an unauthorised profit out of his position and not place himself in a position in which his duty and own interests may conflict. If the fiduciary makes an unauthorised profit by use of his position, he is liable to account for the profit to his principal, and this is said to be a "liability to account as constructive trustee". However, whether this gives rise to a proprietary claim is another issue, as discussed below.

Typical examples of unauthorised profits by fiduciaries include the receipt by an agent of a bribe. The word "bribe" has certain connotations, suggesting corrupt motive in order to influence the agent being bribed, causing loss to the principal. However, the civil courts do not require proof of corrupt motive, influence and loss: "the safety of mankind requires that no agent shall be able to put his principal to the danger of such an enquiry as that."[3]

The essential vice inherent in bribery is that it deprives the principal, without his knowledge or informed consent, of the disinterested advice which he is entitled to expect from his agent, free from the potentially corrupting influence of an interest of his own.

The civil courts therefore look to whether a payment was secret and has put the agent in a position of conflict in order to determine whether such payment was a bribe. There is no need to show some sort of dishonesty

[1] *Carl Zeiss Stiftung v Herbert Smith (No.2)* [1969] 2 Ch. 276 CA (Civ Div).
[2] *Paragon Finance Plc v DB Thakerar & Co* [1999] 1 All E.R. 400 CA (Civ Div).
[3] *Parker v McKenna* (1874) L.R. 10 Ch. App. 96.

normally associated with the word "bribe" and it is immaterial whether the parties thought that they were doing anything wrong.

According to Slade J. in *Industries & General Mortgage Co Ltd v Lewis*,[4] for the purposes of the civil law a bribe means the payment of a secret commission, which only means:

- that the person making the payment makes it to the agent of the other person with whom he is dealing;
- that he makes it to that person knowing that that person is acting as the agent of the other person with whom he is dealing; and
- that he fails to disclose to the other person with whom he is dealing that he has made that payment to the person whom he knows to be the other person's agent.

The bribe is an unauthorised profit received by the agent and the agent is said to have a duty to account to the principal as constructive trustee.

It should also be noted that a contract induced by a bribe may be liable to rescission, even if the contract would have been entered into absent the bribe. In *Logicrose Ltd v Southend United Football Club*,[5] Millett J. said that the principal, having been deprived by the other party to the transaction of the disinterested advice of his agent, is entitled to a further opportunity to consider whether it is in his interests to affirm it. In *Ross River Ltd v Cambridge City Football Club Ltd*,[6] Briggs J. stated that where a contract ensues following a secret payment received by a party's agent, the principal is entitled to rescission if he neither knew nor consented to the payment. If he knew of it, but did not give his informed consent, the court may award rescission as a discretionary remedy, if it is just and proportionate to do so.

Another example of an unauthorised profit by a fiduciary is where a director of a company diverts a corporate opportunity of the company for his own benefit.

Knowing receipt

Where persons receive trust property that has been taken in breach of trust, they may find themselves constituted as "constructive trustee".

The essential requirements of knowing receipt were stated by Hoffmann L.J. in *El Ajou v Dollar Land Holdings Plc*[7]:

> "For this purpose the plaintiff must show, first, a disposal of his assets in breach of fiduciary duty; secondly, the beneficial receipt by the defendant of assets which are traceable as representing the assets of the plaintiff; and thirdly, knowledge on the part of the defendant that the assets received are traceable to a breach of fiduciary duty."

The requirement of knowledge was considered by the Court of Appeal in *Bank of Credit and Commerce International (Overseas) Ltd v Akindele*.[8] In particular, the court considered two questions: first, what, in this context, is meant by knowledge; secondly, is it necessary for the recipient to act dishonestly? After reviewing the authorities on the second question, the court concluded that dishonesty was not a requirement for knowing receipt.

On the first question, Nourse L.J. concluded:

> "I have come to the view that, just as there is now a single test of dishonesty for knowing assistance, so ought there to be a single test of knowledge for knowing receipt. The recipient's state of knowledge must be such as to make it unconscionable for him to retain the benefit of the receipt. A test in that form, though it cannot, any more than any other, avoid difficulties of application, ought to avoid those of definition and allocation to which the previous categorisations have led. Moreover, it should better enable the courts to give common-sense decisions in the commercial context in which claims in knowing receipt are now frequently made ..."[9]

This remains the test under English law, though there have been calls for a strict liability test subject only to a change of position defence.

Contracts induced by fraud

Where funds are stolen or are transferred pursuant to a void transaction, a constructive trust arises in favour of the victim.

Where a contract is voidable, e.g. because it has been induced by fraudulent misrepresentation under which assets are transferred by the victim, both legal and equitable ownership in the assets are transferred. If the victim, with knowledge of the fraud, elects to affirm the transaction, no constructive trust will arise. The victim will have to seek rescission of the contract.

In order to obtain rescission, the victim will need to be able to give *restitution in integrem*, i.e. to be able to return the parties to the position they were in prior to the performance of the contract. Where there has been fraud, the courts are willing to achieve substantial justice through directing an account which will give the fraudster a fair financial allowance for what cannot be restored to him *in specie*. Rescission can also be barred by delay and the intervention of third-party rights.

Once there is notification of avoidance of the contract for fraud, the fraudster becomes a constructive trustee of the property.

[4] *Industries & General Mortgage Co Ltd v Lewis* [1949] 2 All E.R. 573 KBD.
[5] *Logicrose Ltd v Southend United Football Club* [1988] 1 W.L.R. 1256 Ch D.
[6] *Ross River Ltd v Cambridge City Football Club Ltd* [2007] EWHC 2115 (Ch); [2008] 1 All E.R. 1004.
[7] *El Ajou v Dollar Land Holdings Plc* [1994] 1 All E.R. 685 CA (Civ Div) at 700.
[8] *Bank of Credit and Commerce International (Overseas) Ltd v Akindele* [2001] Ch. 437 CA (Civ Div).
[9] *Akindele* [2001] Ch. 437 at 455.

Proprietary and tracing remedies

Where the victim of fraud seeks rescission of a contract induced by fraud, the remedy of tracing (which is an evidential exercise in locating assets) is available to him to seek restitution of what has once again become his property.

Moreover, the victim can trace in equity rather than at common law. This is an exception to the normal rule that tracing in equity only arises where there is a pre-existing trust or fiduciary obligation. The importance of being able to trace in equity is that under the common law, tracing is more restricted: the common law does not allow tracing into and through a mixed fund, nor does it permit tracing into a substitute for the original asset.

The question of proprietary claims in respect of other constructive trust claims arose for consideration in the recent case of *Sinclair Investments (UK) Ltd v Versailles Trade Finance Ltd (In Administration)*.[10] In that case Lewison J. undertook a careful analysis of previous authority and in particular two important conflicting cases: the Court of Appeal's decision in *Lister & Co v Stubbs*[11] and the decision of the Privy Council, hearing an appeal from New Zealand in *Attorney General of Hong Kong v Reid*.[12] Lewison J. concluded that he was bound by the decision of the Court of Appeal and that there had to be a pre-existing trust (or trust-like obligation) in respect of the property in question for there to be a proprietary claim.

Further, he undertook a careful analysis of the previous authorities which he concluded supported the position in *Lister v Stubbs*. That analysis included consideration of cases regarding limitation. The current statutory provision is s.21 of the Limitation Act 1980, which provides that:

> "(1) No period of limitation prescribed by the Act shall apply to a beneficiary under a trust, being an action -
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> (a) in respect of any fraud or fraudulent breach of trust to which the trustee was a party or privy; or
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> (b) to recover from the trustee trust property or the proceeds of trust property in the possession of the trustee, or previously received by the trustee and converted to his use.
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> (3) Subject to the preceding provisions of this section, an action by a beneficiary to recover trust property or in respect of any breach of trust, not being an action for which a period of limitation is prescribed by any other provision of this Act, shall not be brought after the expiration of six years from the date on which the right of action accrued."

In the context of those provisions there have been a number of cases in which the question has arisen as to whether an action alleging breach of fiduciary duty is a claim to recover "trust property", so that no limitation period would apply in accordance with s.21. In *Metropolitan Bank v Heiron*,[13] the Court of Appeal, in considering limitation issues in a claim for recovery of a bribe paid to a company director, drew a distinction between: (1) money that was held on trust and taken by the trustee; and (2) money not held on trust but which the trustee receives in circumstances that oblige him to pay the money into the trust, the latter not being trust property for the purposes of the issue of limitation. In *Lister v Stubbs*, Cotton L.J. applied the principle in *Metropolitan Bank v Heiron* (in which he had also been one of the Lords Justice), not limiting that principle to limitation cases.

In the two Privy Council decisions of *Taylor v Davies*[14] and *Clarkson v Davies*,[15] in the context of limitation issues, the same distinction was drawn as had been done by the Court of Appeal in *Metropolitan Bank v Heiron*. In the subsequent case of *Dubai Aluminium Co Ltd v Salaam*,[16] this distinction was relied upon in the context of a non-limitation case, from which Lewison J. concluded that the distinction was of general application and not confined to limitation cases: where a case falls into the second class of case identified by Millett L.J. in *Paragon Finance v Thakerar*, the property that the fiduciary acquires is not trust property; and there is usually no chance of a proprietary remedy.

The issue of limitation arose again in the case of *JJ Harrison (Properties) Ltd v Harrison*.[17] That was a case where a company director was accused of concealing material facts about the development potential of land that he purchased from the company. Chadwick L.J. considered that where the asset was originally owned by the company, its directors, though not strictly trustees, were in an analogous position and in that regard he referred to the two categories of constructive trust referred to by Millett L.J. in *Paragon Finance v Thakerar*:

> "There is no doubt that Millett LJ regarded it as beyond dispute that a director who obtained the company's property for himself by misuse of the powers with which he had been entrusted as a director was a constructive trustee within the first category … The true analysis is that his obligations as a trustee in relation to that property predate the transaction by which it was conveyed to him. The

[10] *Sinclair Investments (UK) Ltd v Versailles Trade Finance Ltd (In Administration)* [2010] EWHC 1614 (Ch); [2011] W.T.L.R. 839.
[11] *Lister & Co v Stubbs* [1890] L.R. 45 Ch. D. 1 CA.
[12] *Attorney General of Hong Kong v Reid* [1994] 1 A.C. 324 PC (NZ).
[13] *Metropolitan Bank v Heiron* (1879–80) L.R. 5 Ex. D. 319.
[14] *Taylor v Davies* [1920] A.C. 636 PC (Canada).
[15] *Clarkson v Davies* [1923] A.C. 100 PC (Canada).
[16] *Dubai Aluminium Co Ltd v Salaam* [2003] 2 A.C. 366 HL.
[17] *JJ Harrison (Properties) Ltd v Harrison* [2002] 1 B.C.L.C. 162 CA (Civ Div).

> conveyance of the property to himself by the exercise of his powers in breach of trust does not release him from those obligations. He is trustee of the property because it has become vested in him; but his obligations to deal with the property as a trustee arise out of his pre-existing duties as a director; not out of the circumstances in which the property was conveyed."[18]

By contrast, in *Gwembe Valley Development Co Ltd v Koshy (No.3)*,[19] a director made secret profits that did not come from property previously owned by the company, and therefore it was held that those profits fell in class 2 of the Lord Millett's two classes. Consequently there was only a personal duty to account.

The Court of Appeal upheld the decision of Lewison J.[20] Although the Master of the Rolls said it was possible that the Supreme Court might follow *Attorney General of Hong Kong v Reid*, he was far from satisfied that it would do so; and the Court of Appeal should follow its previous decisions. In that regard he considered there was a consistent line of decision of the Court of Appeal which had reached the same conclusions on this point.

Thus it would seem that the present state of English law is that the second class of constructive trusts referred to in the *Paragon Finance* case does not give rise to a proprietary claim (save in the rescission cases referred to above where the rescission results in the beneficial interest in the assets paid over pursuant to a voidable contract re-vesting in the claimant).

By way of example, if a company director receives a bribe, then he will have a personal duty to account to the company for the value of the bribe received, but, if he were to invest the proceeds of the bribe into a profitable venture, the company would not have a proprietary right so as to trace into the benefit of the same (though the Court of Appeal in *Sinclair* considered that in such a situation the personal remedy against the recipient of the bribe might extend to such benefits). The distinction may be particularly important in an insolvency situation, where the company would not have a proprietary right over the proceeds of the bribe so as to defeat the claims of other creditors.

On the other hand, if a company director obtains an unauthorised profit by misappropriating company property, then he had a pre-existing fiduciary duty in respect of that company property such that the company may well have a proprietary claim in respect of the profits made.

The decision in *Sinclair v Versailles* is a controversial one in that many commentators had previously favoured the reasoning in *Attorney General of Hong Kong v Reid*, where it was held that when a fiduciary accepted a bribe as an inducement to betray his trust he held the bribe in trust for the person to whom he owed the duty as fiduciary; and, if property representing the bribe increased in value, the fiduciary was not entitled to retain any surplus in excess of the initial value of the bribe because he was not allowed by any means to make a profit out of a breach of duty.

This is also a fertile area and it remains to be seen how the law will develop on this important matter for victims of fraud being able to effectively recover the proceeds.

Conclusion

The law relating to constructive trusts is still developing in important respects, particularly as regards the availability of proprietary claims in fraud cases. Such claims are particularly important where the fraudster is insolvent, and to enable the proceeds of fraud to be traced.

In *Sinclair*, the party that unsuccessfully sought to assert proprietary claims was seeking to do so in preference to other creditors rather than as against the fraudster. The rejection of the proprietary claim therefore does not appear to result in an unjust outcome. As for the situation where the fiduciary who receives a bribe invests the bribe into a profitable venture, the Court of Appeal suggested that the personal remedy of equitable compensation might extend to such profits, thereby again ensuring that the outcome would not be unjust.

However, in today's world, fraudsters are increasingly more sophisticated about the way in which they arrange their affairs, including for example by the use of offshore discretionary trusts. Were the fraudster to pay the bribe to a trustee of such a trust to invest for the benefit of himself and his family, and that trust generated profits using the bribe, the fraudster would effectively obtain the benefit of that profit. A personal remedy against the fraudster might be worthless, and relevant insolvency legislation seeking to set aside the transaction may be limited in its effectiveness.

In those circumstances, the absence of a proprietary claim could lead to an unjust result and it remains to be seen how the courts will approach such a case.

[18] *Harrison* [2002] 1 B.C.L.C. 162 at [29].
[19] *Gwembe Valley Development Co Ltd v Koshy (No.3)* [2004] 1 B.C.L.C. 131 CA (Civ Div).
[20] *Sinclair Investments (UK) Ltd v Versailles Trade Finance Ltd (In Administration)* [2011] EWCA Civ 347; [2011] W.T.L.R. 1043.