CONSTRUCTIVE TRUSTS

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We are indebted to Mr Justice Thomas for a learned, stimulating and provocative paper. It - and the Judge's decision in **Powell v Thompson**[1] - will demand careful study by commentators, practitioners and courts seeking to grapple with the intricacies of the law as to constructive trusts: or, at least, that part of the law as to constructive trusts which is generally taken to have its genesis, in its present form, in **Barnes v Addy**,[2] for there are numerous other categories of constructive trusts as well.

An unrepentant Australian commentator may, however, be allowed a few misgivings. One may welcome an approach which resorts to fundamental principle in a quest to find a path through the complexities and conflicts of the decided cases; one could hardly take exception to a suggestion that a survey of the wood may be more productive than an inspection of individual trees. But when there is added the suggestion that we should accept that the relevant law cannot with confidence be extracted from the cases, doubts begin to emerge: for what, in our system, is non-statutory law other than principles (and rules) which can be derived from decided cases? The point is made by Deane J in **Muschinski v Dodds**:[3]

> "The fact that the constructive trust remains predominantly remedial does not, however, mean that it represents a medium for the indulgence of idiosyncratic notions of fairness and justice. As an equitable remedy, it is available only when warranted by established equitable principles or by the legitimate processes of reasoning, by analogy, induction and deduction, from the starting point of a proper understanding of the conceptual foundation of such principles".

If further clarification be needed of what Sir William Deane was saying, it may be found in the passage to which he refers in the Forward[4] written by Sir Frank Kitto:

> "Lord Simonds ... was not one to suggest that modern equity Judges may no longer contribute to the substantive of law and continue the development of the principles of their own special discipline; but he insisted that *'the range of its (equity's) authority can only be determined by seeing what jurisdiction the great equity Judges of the past assumed and how they justified that assumption'*. The last five words might well be written in letters of fire. An understanding of the conceptual foundations of established principles, and that alone, provides a permissible foundation for further advance."

However that may be, one may be permitted to wonder whether the particular general principles selected in the paper (unjust enrichment in the "knowing receipt or dealing" category and unconscionable conduct in the "knowing participation" cases) are appropriate or, in the end, helpful in elucidating this notoriously difficult area of the law.

KNOWING RECEIPT OR DEALING

This[5] is the case, described by Lord Selborne[6] in relation to a stranger acting as a agent of trustees, of one who "receives and becomes chargeable with some part of the trust property" and expanded by Brightman J[7] to encompass "a person who ... (although not nominated as a trustee) ... has received trust property with actual or constructive notice that it is trust property transferred in breach of trust, or because (not being a bona fide purchaser for value without notice) he acquires notice subsequent to such receipt and then deals with the property in a manner inconsistent with the trust". It is easy enough to see the relevance of a concept of unjust enrichment to a situation of this kind: the stranger receives property to which he is not entitled, and the beneficiary (who is entitled to it) is deprived of it. But it is important to recognise that the concept is of no help, so far as our law is concerned, in determining whether or not a proprietary remedy is available, if by proprietary remedy we mean (as we must) a remedy which confers or recognises an entitlement to an interest in specific property which will (among other things) prevail over the claims of unsecured creditors in the bankruptcy or liquidation of the defendant. To say this is, of course, to dispute the paper's adoption of "unjust enrichment as the cardinal principle of this form of equitable proprietary relief allowing the court to pursue the same flexible approach as the Court of Equity of old", and calls for explanation.

The explanation, it is suggested, is not far to seek. First, the equitable interest of the defrauded beneficiary in the trust property will ordinarily prevail, except against a bona fide purchaser of the legal estate for value and without notice (including, of course, constructive notice) of the trust, or unless (in very general terms) the beneficiary has been guilty of some conduct of a kind which equity regards as sufficient to postpone the beneficiary's interest to a later interest (legal or equitable) acquired by another. That is a result of the law of priorities.[8] It is impossible, it is suggested, to rationalise it simply as a result of a principle relating to unjust enrichment: generally, after all, a bona fide purchaser of a later equitable interest, without notice of the claim of a beneficiary, will nevertheless be postponed to that claim; and the fact that it is an equitable, rather than a legal, interest which is acquired for value does not evidently mean that the enrichment (if any: the value given may, after all, equal that of the property acquired) is unjust. It is not, it is suggested, a matter of a Court of Equity having regard to "all the circumstances relating to the acquisition of the property as well as the factors relating to the deprivation of the innocent beneficiary". The trust persists unless displaced by the operation of clearly established principles of priority, about the operation of which there is very little room for doubt or dispute.

Secondly, if the actual property has been disposed of in a way which makes it irrecoverable in specie (either for legal or for practical reasons) the law as to tracing may give the beneficiary an effective proprietary remedy; again, however, the availability of the tracing remedy is governed by well-established principles. It may be perfectly true that the administration of the remedy will in many (if not most) cases prevent or remedy an unjust enrichment; but the concept is not of much assistance in applying the principles by reference to which that remedy is administered.

If (as must be true) a beneficiary's right to maintain that his title to a specific property persists in priority to other interests and his right to trace into other property together exhausts his proprietary claims, what is left? The answer is, no doubt, (leaving aside whatever personal remedies he may have against the defaulting trustee) a personal remedy only against the stranger ranking, in bankruptcy or winding-up, equally with other unsecured claimants. This may be a claim for an account of profit or for reimbursement to the beneficiary of, or compensation for, that which has been taken from him. The next question is, according to what principle is such a personal remedy

granted? Where the assets of a deceased person are misapplied by the executors, the answer, apparently, is given by the judgments in the **Diplock** litigation: particularly, the decision of the House of Lords in **Ministry of Health v Simpson**:[9] the result of that case is that the innocent volunteer, to whom the estate assets are wrongly transferred, is liable to the beneficiaries to the full extent of the value of the assets transferred; change of position is no more a defence than innocence; the only limitation is that the beneficiaries must first exhaust their remedies against the executors. Exactly how far that principle applies in the present context is by no means clear. The cases, however, in which Lord Selborne's statement is applied[10] all proceed on the assumption that there is no personal liability without notice of some kind, and there is no suggestion that remedies are first to be exhausted against the defaulting trustees (or other fiduciaries). But again, why is unjust enrichment the appropriate touchstone? The stranger who receives or deals with trust property (or property received from someone who controls it in a fiduciary capacity) will usually, but not necessarily, be thereby enriched. If he receives but does not deal, presumably he will retain the property in specie, so that an application of the law as to priorities will return it to the person entitled, and whether the receipt enriched the stranger or not will be a question of academic interest only. But equally if he deals with the property, why should it make any difference whether he is enriched or not? If, with the requisite notice of the trust or fiduciary obligation, he disposes of or deals with the property inconsistently with the trust or obligation, why should he not be liable in either case to make good what the beneficiary has lost? That is, it is suggested, the conclusion to which the Courts have come. To the question, what kind of notice is sufficient, the answer seems clearly that in these cases constructive notice will do (that is plainly the result of **Selangor** and **Karak** and seems to have been accepted for these cases - but not knowing receipt cases - in **Consul Development Pty Ltd v DPC Estates Pty Ltd**.[11] That leaves, of course, a large degree of flexibility as to the circumstances in which a Court will hold a duty to enquire to arise: an area in which (see below) it is to be hoped that the Courts will have regard to commercial reality and tread warily.

KNOWING ASSISTANCE

If the views expressed so far are correct, there may be little - perhaps no - difference between the personal remedy in a knowing receipt or dealing case and that which is available in a knowing participation case.[12] Particularly:

(a) "What of probity" is certainly a notion which has given rise to difficulty in several of the English cases, where it has been seen as what is encompassed in the concept of participation in a fraudulent or dishonest design. But it seems not, in Australia, to be an independent requirement: knowledge, of the requisite kind (see below) of circumstances constituting a breach of trust or fiduciary duty (and the participation in it) suffices: see **Consul** at 397. This, it is suggested, accords with principle.

(b) The High Court has apparently decided, in **Consul**, that constructive notice (in the form of knowledge of circumstances which would put a reasonable person on enquiry) is insufficient to give rise to liability in these cases. It may well be, however, that this will be reconsidered.[13] I fully and respectfully agree with Mr Justice Thomas' suggestion that the refined classification of notice in **Baden Delvaux v Société Générale**[14] is not merely unnecessary, but mischievous.

All this being accepted, one may be excused for wondering whether it is helpful to introduce, in this context, unconscionable conduct (on the part of the knowing participant) as a touchstone. There is, it may be suggested, sufficient flexibility in the concept of "participation" or "assistance" on the one hand and (if constructive notice is

accepted as sufficient) in the need to decide, on the other, whether particular circumstances are such as to put a reasonable person on enquiry. To introduce (instead, or in addition?) an invitation to courts to consider whether a defendant has acted unconscionably, without further definition, is surely to do precisely that against which Deane J has warned in the passage quoted at the beginning of this commentary; as is (in the knowing receipt or dealing cases) to introduce the concept of unjust enrichment.[15] In T G Youdan (Ed) *Equity, Fiduciaries and Trusts* (1989) p205, particularly at 207. Nor, as I have attempted to show, is ehe introduction of either necessary to deduce from the cases following **Barnes v Addy**, at least from an Australian perspective, a coherent doctrine consistent with both authority and equitable principle.

"COMMERCIAL REALITY"

It may be unfashionable, but I suggest that it is desirable, to recall the warnings of both Lord Selborne and James LJ[16] (himself no novice in matters of equitable principle) against excessive zeal in compelling strangers to make good loss to beneficiaries caused primarily by defaulting trustees or fiduciaries. Risk allocation is all very well, but one should not be tempted into excessive enthusiasm in the search for a deep (and full) pocket from which to recompense beneficiaries for the misdeeds of their trustees, or principals for those of their fiduciaries. Equity has, it is true been assiduous in protecting the interests of *cestuis que trust*. It must be recognised, however, that not all beneficiaries are in all circumstances equally deserving of protection. In particular, those who, for tax or other reasons, conduct trading ventures through trusts may reasonably be expected to bear some of the risks inherent in structures of that kind.

To be more specific: acceptance of the warnings of Lord Selborne and James LJ need not lead one to doubt the correctness of **Selangor** or **Karak** (both involving large and unusual transactions reasonably calling for enquiry) but it may very well lead to qualms about circumstances such as those postulated in the "hypothetical example" given towards the end of the paper. Let us assume, by way of variation of that example, that the bank in fact has actual notice of the trust. Even so, on what basis should it be liable? Upon the basis, apparently, that it has "negligently facilitated a breach of trust in circumstances where it stood to benefit". But what is "negligence" in this context other than failure to enquire (as to the possibility of a breach) in circumstances where, reasonably, enquiry was called for? And if enquiry was called for, but not made, and the bank thus unwittingly but with constructive notice facilitated the breach, why should it not be liable irrespective of the possibility of benefit? But, finally, what was there in the circumstances calling for enquiry? Surely a bank is not required at its peril to enquire into the propriety of each cheque drawn on a trust account (obviously some - eg a cheque for a large amount drawn by the trustee in his own favour - call for enquiry). The bank, in the example, sees on the cheque the name of a drawee about which there is nothing apparently remarkable; even if the bank knows that the name is that of a mechanic, what is there about that knowledge that should prompt enquiry as to whether the payment might not be for proper trust purposes?

Perhaps more fundamentally, it is clear (**Selangor**, **Karak**, **Consul** and many other cases) that these principles apply in the case of breach of fiduciary duties other than those of trustees. Is a higher degree of vigilance called for by a bank in the case of the trustees of a trading trust, given by the trust deed very wide powers to deal with property and carry on business, than in the case of directors or other agents operating (under a proper mandate) on the account of a company? Or an attorney operating on his principal's account under a power?

It may be trite, but it is true nevertheless, that questions of this kind are much more easily answered after the event, with hindsight, than in advance. An example may serve to complete this commentary.

A number of practitioners will have vivid recollections of the time when "bottom of the harbour" schemes, and transactions of a generally similar kind, occurred with relative frequency. They occurred in great numbers, and were regarded by their participants as particularly urgent, in the few days preceding 30 June in each year during which arrangements of this sort were in vogue. Banks unavoidably were caught up in these arrangements. Usually they involved the passing, through a series of hands, of large sums of money, frequently by bank cheque. Banks were under considerable pressure to facilitate the transactions, and their advisers had to cope with a stream of anxious bank officers seeking immediate advice as to whether on the one hand, these were cases where they were obliged to honour instructions which, on their face, were properly given in accordance with a valid mandate or whether, on the other hand, the circumstances were such as to put the bank on enquiry as to whether the transaction involved a breach of duties by directors giving rise, potentially, to a liability, on the part of the bank, as constructive trustee under the **Barnes v Addy** principle. Very frequently the form of these transactions was such that, if in **Selangor** or **Karak** enquiry was called for, it was equally called for there, and one would advise the banker that he should not facilitate the transaction before making enquiry and ensuring that the enquiry was satisfactorily answered. Frequently, the making of an enquiry would produce an outburst of rage, followed by a comment that other banks were considerably more "commercial" than the bank concerned and a request for a bank cheque in favour of some other bank allegedly so disposed. What did one do in response to that request made in those circumstances? Having more than a shrewd idea why it was proposed that the money should be moved to the other bank, might one be knowingly participating in a fraudulent and dishonest design by facilitating the movement? One would hope not, but could not entirely dismiss the possibility. What, on the other hand, if the response to the initial enquiry was a statement such as "we are fed up with the obstructive attitude of your bank and propose to deal with you no longer; kindly pay out the balance of our account by bank cheque in favour of the company itself (or in cash)"? So far as I recall, the advice given in those circumstances, not without some qualms, was that the bank was probably obliged to comply.

That was the way it looked, at the time, in advance; it might not be the way it would have looked to a court hearing the matter after the event when the company's funds had been dissipated through a scheme which could not possibly be said to have been in the interests of the company, and where a liquidator sought recovery from the bank for the benefit of the Commissioner of Taxation and any other creditors the company may have had.

FOOTNOTES

1. [1991] 1 NZLR 597.

2. (1874) LR 9 Ch App 244.

3. (1985) 160 CLR 582 at 651.

4. To the first edition (1975) of Meagher Gummow and Lehane, *Equity - Doctrines and Remedies* pp v - vi.

5. My debt to Professor R P Austin (in what follows) will be obvious to those who have read his essay "Constructive Trusts" in Finn (Ed) *Essays in Equity* 1985, p196.

6. **Barnes v Addy** (1874) LR 9 Ch App 244 at 251.

7. **Karak Rubber Co v Burden (No 2)** [1972] 1 All ER 1210 at 1234.

8. As to which, see Meagher Gummow and Lehane *Equity - Doctrines and Remedies* (2nd Ed) 1984 Ch 8.

9. [1951] AC 251.

10. Eg **Selangor United Rubber Estates v Cradock (No 3)** [1968] 2 All ER 1073; **Karak Rubber Co v Burden (No 2)** [1972] 1 All ER 1210.

11. (1975) 132 CLR 373.

12. That, indeed, is Professor Austin's thesis: *loc cit* p217.

13. R P Austin, *loc cit* p239.

14. [1983] BCLC 325.

15. Which is also, of course in any event contrary to Australian authority: See **Stephenson Nominees Pty Ltd v Official Receiver** (1987) 76 ALR 485 (Gummow J). See also David Hayton "Constructive Trusts: Is the Remedying of Unjust Enrichment a Satisfactory Approach?"

16. **Barnes v Addy** at 255, 256.