Constructive trusts, tracing and the requirement of a fiduciary obligation

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This article examines the requirement of a fiduciary relationship in equitable tracing claims and the notion that the imposition of a constructive trust on the recipient wrongdoer may provide an alternative basis for establishing an equitable proprietary right in a tracing claimant.

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The orthodox view, supported by modern authority, is that a tracing claim in equity is dependent upon the existence of an initial fiduciary relationship. The prerequisite of a fiduciary obligation, however, which originates from the decision of the Court of Appeal in ***Re Diplock*** [1948] Ch. 465, has been the subject of considerable academic criticism as lacking any proper legal basis and as being inherently unsound. There has also been some indication of a judicial willingness to relax this requirement so as to permit the circumstance of the misappropriation itself to give rise to a fiduciary relationship entitling the claimant to trace the property in equity.

Thus, in ***Chase Manhattan Bank NA v Israeli-British Bank (London) Ltd*** [1981] Ch. 105, Goulding J. held that, where money was paid under a factual mistake, the receipt of such money, without more, constituted the recipient a trustee. The payer, in turn retained an equitable interest in the funds and the conscience of the recipient was subjected to a fiduciary duty to respect that proprietary interest. Significantly, in this case, the two parties (both being commercial organisations) did not stand in any fiduciary relationship with each other and the money mistakenly paid clearly had not been the subject of a pre-existing trust. This, however, did not deter the court from recognising that a fiduciary duty could arise from the mere act of making a mistaken payment. Interestingly, in another case, the necessary fiduciary duty was held to arise from a reservation of title clause contained in the parties' agreement for the supply of goods: ***Aluminium Industrie v Romalpa*** [1976] 2 All E.R. 552. Here, the court was prepared to accept that equity could raise a trust out of the transaction itself in the absence of a prior fiduciary relationship between the parties.

What remains controversial is whether or not an equitable tracing claim is available to recover funds which are misappropriated by someone (eg, a thief) who is a stranger to the victim and paid into his mixed bank account. The traditional view, which requires the breach of a fiduciary obligation, maintains that equity cannot trace into the stranger's mixed fund. It is arguable, however, that the right to trace in equity should be available in this situation because the victim either already enjoys an equitable proprietary interest in the money prior to the misappropriation, or acquires such interest by the imposition of a constructive trust on the wrongdoer.

JUDICIAL ADHERENCE TO A FIDUCIARY RELATIONSHIP

The notion that a fiduciary relationship is a pre-condition to an equitable tracing claim was confirmed by the House of Lords in ***Westdeutsche Landesbank Girozentrale v Islington Borough Council*** [1996] A.C. 669. Their Lordships, while overruling the earlier decision in ***Sinclair v Brougham*** [1914] A.C. 398, were at pains to stress that they were not casting any doubt on the principles of tracing established in ***Re Diplock***.

The requirement has also been applied consistently in several Court of Appeal decisions. In ***Agip (Africa) Ltd v. Jackson*** [1992] 4 All E.R. 451, Fox L.J. stated that "it is ... a prerequisite to the operation of the remedy in equity that there must be a fiduciary relationship which calls the equitable jurisdiction into being". In ***Boscawen v Bajwa*** [1995] 4 All E.R. 769, Millett L.J., adopting the words of Fox L.J. in ***Agip***, concluded that the fiduciary relationship was satisfied as soon as the purchasers' solicitors received the bank's money and held it on trust for the bank. Interestingly, his Lordship also alluded to equitable tracing as being essentially a process (as opposed to a claim or remedy) based on the retention by the claimant of a beneficial interest in the property which the wrongdoer handled or received: ibid, at 776. This, it is submitted, is the true basis for equity's jurisdiction despite the court's continued adherence to the technical need to satisfy a fiduciary relationship in equitable tracing claims.

This adherence is, perhaps, most vividly illustrated in ***Trustee of The Property of C.F. Jones & Sons v Jones*** [1997] Ch. 159, where the tracing claim had to be brought at common law (by means of an action for money had and received) because the requisite fiduciary relationship was held to be lacking between the parties. Here, partners in a firm of potato growers fell into financial difficulties and were adjudicated bankrupt. After the act of bankruptcy, the wife of one of the partners opened an account with commodity brokers in order to deal in potato futures and paid in the proceeds of cheques (totalling £11,700) drawn by her husband on a joint bank account in his name and one of the other partners. The wife received over £50,000 from her dealings which was paid into a deposit account with a public company. At first instance, the deputy judge held that the wife was a constructive trustee which justified the use of a tracing claim in equity. His reasoning was that "where A pays money to C, and B retains the beneficial title to the money, then C becomes a bare trustee". The Court of Appeal, however, rejected this approach.

Millett L.J., who gave the leading judgment, held that the wife had not received the money in a fiduciary capacity and she had not become a constructive trustee of it. The deputy judge's reasoning presupposed that A (who was the bankrupt husband) had a legal title to transfer. In fact, the husband (as was the position with the other bankrupt partners) had been divested of all title to the money from the date of the act of bankruptcy in favour of the trustee in bankruptcy (see Section 38 of the Bankruptcy Act 1914). Because the husband had no title (at law or in equity) to the money, he could not confer any such title on his wife. She, therefore, never had any legal or beneficial title to any of the sums paid into the deposit account. The trustee in bankruptcy, on the other hand, could assert (at common law) a legal title to the money including the profit made by the wife's use of it. Although the case proceeds on the premise that there was no fiduciary relationship apparent on the facts, it is, perhaps, better understood as an illustration of the broader principle that equitable tracing is dependent on the claimant showing the presence of a beneficial proprietary interest in the property either prior to the misappropriation or subsequently by the operation of a constructive trust.

The requirement of a fiduciary relationship has also found its judicial critics. Most notably, perhaps, Lord Millett in ***Foskett v McKeown*** [2000] 3 All E.R. 97 observed (at 121):

> "There is certainly no logical justification for allowing any distinction between [tracing at law and in equity] to produce capricious results in cases of mixed substitutions by insisting on the existence of a fiduciary relationship as a precondition for applying equity's tracing rules."

He did not, however, consider it appropriate to explore the point further since the case was a straightforward one of a trustee who had wrongfully misappropriated trust money, mixed it with his own, and used it to pay for an asset for the benefit of his children: see also, ***Agip (Africa) Ltd v Jackson*** [1992] 4 All E.R. 385, 402, at first instance, where Millet L.J. (as he then was) states:

> "the requirement has been widely condemned and depends on authority rather than principle".

Significantly, his Lordship also alluded to the broader principle underlying all tracing claims in equity as being essentially proof of a "continuing beneficial interest" in the subject property and its traceable proceeds: ibid, at 119 and 120.

PRE-EXISTING EQUITABLE RIGHT

It has been cogently argued by Pearce, in an influential article, that the requirement of a fiduciary relationship is inherently at odds with the basic concept of equitable tracing, namely the recovery of property which the claimant can identify as his own: see, R.A. Pearce, "A Tracing Paper", (1976) 40 Conv. 277, at p287. In his view, the decision in ***Re Diplock***, properly interpreted, requires proof **either** of (1) a fiduciary relationship or (2) a right of property recognised in equity. Moreover, proof of the former serves only to create an equitable proprietary interest where none previously existed. Significantly, points out Pearce, the claimants in ***Re Diplock***, being merely next of kin claiming under the deceased's will, were never equitable owners of the various funds they sought to trace. Hence, in the absence of a right of property recognised in equity, the need, in that case, was to establish the alternative basis for a tracing claim founded on the existence of fiduciary relationship between the claimants and the executors of the will. He concludes that the true principle emanating from ***Re Diplock*** is to be found in the judgment of Lord Greene M.R., who based the equitable right to trace on the existence of "what equity regards, in effect, as a right of property": ibid, 543. This, he says, is also consistent with the earlier decision in ***Sinclair v Brougham***, where the claim of the depositors could not have been based on a fiduciary relationship with the society with which the funds were deposited. In that case, in his view, the right to trace was dependent on the wider principle that "a claimant may trace whenever property which belongs to him in equity is found in the hands of the defendant, without any need to show a fiduciary relationship": [1976] 40 Conv. 277, at p291.

The proposition that the true basis for tracing in equity is the equitable ownership of the property rather than the presence of a fiduciary relationship has gained support from a number of academic commentators. As Pearce and Stevens point out in their book, *Law of Trusts and Equitable Obligations*, (3rd ed., 2002), at p843:

> ☆ "equity is not concerned with the presence of a fiduciary relationship per se, but rather with the identification of a trust".

Hence, where the misappropriation involves trust property, the beneficiaries will be entitled to trace because they are the equitable owners of the property. This equitable right of property stems from the trust itself, although a fiduciary relationship between trustee and beneficiary clearly also exists in these circumstances. Where, however, a person is entitled to the ownership of money or property absolutely (ie, both at law and in equity), he does not enjoy a separate equitable

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interest in that property: see, ***Westdeutsche***, at 706, per Lord Browne-Wilkinson. The legal title carries with it all rights so that, until there is a separation of the legal and equitable interests, there is no separate or distinct equitable title. Where, therefore, there is a misappropriation of absolute property, the right to trace will not depend on a pre-existing equitable right of ownership but on whether the circumstances of misappropriation are such as to impose a constructive trust on the wrongdoer. In other words, the requisite equitable interest will arise for the first time under this remedial form of trust. Whatever route, however, is adopted, (ie, pre-existing or subsequent equitable title), the correct inquiry, it is submitted, is whether or not the claimant can point to a trust from which his equitable title to trace can be founded.

EQUITABLE INTEREST ARISING UNDER A CONSTRUCTIVE TRUST

The notion that a thief (or fraudster) does not gain title to the stolen property but holds it on a constructive trust for the victim was postulated by Lord Templeman in ***Lipkin Gorman v Karpnale*** [1991] 2 A.C. 548, approving the judgment of O'Connor J. in the Australian case of ***Black v S Freedman & Co*** (1910) 12 C.L.R. 105 who said that "where money has been stolen, it is trust money in the hands of the thief." Similarly, in the ***Westdeutsche*** case, Lord Browne-Wilkinson postulated the example of a thief who steals a bag of coins. As soon as the coins are mixed with other coins or paid into a mixed bank account, they will cease to be traceable at common law. What, however, is the position in equity? According to his Lordship (at 716):

> "I agree that the stolen moneys are traceable in equity. But the proprietary interest which equity is enforcing in such circumstances arises under a constructive trust, not a resulting trust. Although it is difficult to find clear authority for the proposition, when property is obtained by fraud equity imposes a constructive trust on the fraudulent recipient: the property is recoverable and traceable in equity ... Moneys stolen from a bank account can be traced in equity ..."

In his Lordship's view, the decision in ***Chase Manhattan***, mentioned earlier, could be better understood by applying the constructive trust doctrine. The recipient bank in that case became aware of the mistake shortly after the receipt of the moneys from the paying bank. That knowledge, coupled with the retention of the moneys, was enough to affect the recipient's conscience so as to give rise to a constructive trust. In broader terms, in the absence of the claimant having any pre-existing equitable interest in the funds (as in ***Chase Manhattan***), such a trust could only be raised for the first time either at the date on which the recipient received the money or at the date on which payment into the mixed account was made. Contrary to Goulding J.'s judgment, therefore, the mere receipt of money, in ignorance of the mistake, was not enough to create a proprietary base on which the tracing claim could be founded. Some element of fraud or unconscientious dealing was required to trigger the creation of the claimant's equitable right of property.

Further support for the constructive trust analysis is to be found in ***Neste Oy v Lloyds Bank plc*** [1983] 2 Lloyds Reports 658,at 666, where Bingham J., inspired by Goulding J.'s decision in ***Chase Manhattan***, propounded a general principle that money paid as a result of accident, mistake or fraud would become held on a constructive trust by the recipient. More recently also, in ***Commerzbank Aktiengesellschaft v Imb Morgan plc*** [2004] EWHC 2771 (Ch), the victims of suspected fraud sought recovery of their money from mixed accounts. Lawrence Collins J. held that the claimants had shown that they had the requisite proprietary right (and not just a debt due from the defendant) which entitled them to trace the money on the basis of being defrauded or because the defendant was a constructive trustee of their money. His Lordship, relying on the observations of Lord Browne-Wilkinson in ***Westdeutsche***, concluded that "a person who has been defrauded may trace property into the hands of the recipient": ibid, at para. 36. In any event, in this case, the claimant had made double payment at the request of the defendant and this, by itself, had made it unconscionable for the defendant to retain the benefit. In effect, therefore, the defendant had become a constructive trustee for the claimants who thus had proprietary rights to trace their money into the mixed accounts.

REJECTION OF CONSTRUCTIVE TRUST APPROACH

The question whether a constructive trust can successfully be raised so as to support an equitable tracing claim was considered more recently in ***Shalson v Russo*** [2003] EWHC 1637 (Ch), where the primary claim was to trace money into a valuable motor yacht which was acquired pursuant to a joint venture between the parties. The tracing claim was based on the general proposition that:

> ☆ "... if C is fraudulently induced by D to lend money to him, D's conscience is immediately so affected by his fraud that he is regarded as holding the money on a constructive trust for C, who remains the

> beneficial owner of the money lent."

On discovery of the fraud, therefore, C was entitled to bring a proprietary claim to the money which entitled him to trace the money into other assets into which it may have been applied. Rimer J., however, concluded that this approach was "contrary to principle": ibid, at para. 108. In his Lordship's view, the instant case was no different from any other case in which a party is induced to enter into a disadvantageous transaction by a dishonest deceit. The contract between the parties remains valid until set aside by the party induced by the misrepresentation. He gave the following example:

> "A typical case ... is one in which C overpays for a house as the result of a fraudulent misrepresentation by D as to its physical condition. In such a case, when C pays over the purchase price he intends D to become the legal and beneficial owner of the money, as D does; and D has a reciprocal intention in relation to the house when he assigns it to C on completion. The contract remains voidable despite completion; but until it is avoided, those respective beneficial entitlements to price and house remain the same."

According to his Lordship, therefore, the claimant's argument would involve a reversal of these basic principles because, from the moment of completion, D would become a trustee of the purchase money for C (and, conversely, C a trustee of the house for D since C cannot become beneficially entitled to both house and purchase price at the same time). Although the claimant's submission was supported by Lord Browne-Wilkinson's analysis of the constructive trust in ***Westdeutsche***, there were inherent difficulties, according to his Lordship, in accepting the notion that D could become a trustee of the stolen money for the true owner. In his Lordship's view (at para. 110):

> "... a thief ordinarily acquires no property in what he steals and cannot give a title to it even to a good faith purchaser: both the thief and the purchaser are vulnerable to claims by the true owner to recover his property. If the thief has no title in the property, I cannot see how he can become a trustee of it for the true owner: the owner retains the legal and beneficial title. If the thief mixes stolen money with other money in a bank account, the common law cannot trace into it. Equity has traditionally been regarded as similarly incompetent unless it could first identify a relevant fiduciary relationship, but in many cases of theft there will be none."

In his Lordship's view, therefore, stolen money is either trust money or it is not. If it is not, "it is not legitimate artificially to change its character so as to bring it within the supposed limits of equity's powers to trace": ibid, at para. 110.

Rimer J. also considered that there was little judicial authority for Lord Browne-Wikinson's more general proposition that property obtained by fraud is automatically held by the recipient on a constructive trust for the person defrauded. The first two cases cited by Lord Browne-Wilkinson (ie, ***Stocks v Wilson*** [1913] 2 K.B. 235 and ***R. Leslie Ltd v Sheill*** [1914] 3 K.B. 607) in support of his more general analysis in ***Westdeutsche*** concerned the recovery in equity of property obtained by an infant under a void transaction. The rationale for recovery in these cases was that the infant obtained the property by fraud and, hence, was compelled to restore it. According to Rimer J., however, there was no suggestion in either case that the infant fell to be characterised as a trustee of the property or money paid to him as a result of his fraud. The right of recovery (or restitution) stemmed simply from the claimant's legal ownership of the property, not the existence of any supposed trust relationship between the parties. In the words of Rimer J. (at para. 114):

> "I ... do not understand how property or money purportedly passing from C to D under a void contract can be held by D as a trustee for C: D acquires no proprietary interest in it, the entirety of which is retained by C, and so D holds no interest in respect of which he can be a trustee."

Two other cases were mentioned by Lord Browne-Wilkinson in support of his more general analysis, namely, ***McCormick v Grogan*** (1860) L.R. 4 H.L. 82 and ***Bankers Trust Co v Shapira*** [1980] 1 W.L.R. 1274. In ***McCormick***, involving a secret trust, Lord Westbury opined (at p97) that equity had jurisdiction to convert a party who had committed a personal fraud into a trustee for the party who was injured by the fraud. This statement, however, has since been judicially confined to its particular context and held not to support any general proposition that property acquired by fraud becomes held on trust for the victim: see, ***Halifax Building Society v Thomas*** [1996] Ch. 217, at 228, per Peter Gibson L.J. and ***Box, Brown and Jacobs v Barclays Bank*** [1998] Lloyd's Law Reports, Banking 185, at 200, per Ferris J. Similarly, Rimer J. in the ***Shalson*** case was unable to treat ***McCormick*** as establishing the broad principle (applicable to all cases of fraud) ascribed to it by Lord Browne-Wilkinson in ***Westdeutsche***. There are also passages in the ***Bankers Trust*** case, above, which suggest that a claimant who has been defrauded has a right in equity to trace the money. In this case, however,

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the bank had already rescinded the transaction prior to the court hearing and was, therefore, asserting a proprietary claim to follow what was its own money. The question of the beneficial entitlement to the money prior to rescission did not, therefore, arise for consideration.

The upshot, therefore, of Rimer J.'s review of the authorities was that they did not support Lord Browne-Wilkinson's broader principle recognising the constructive trust as an appropriate proprietary mechanism for the purpose of establishing a tracing claim in equity. This also mirrors the view of Ferris J. in the ***Box*** case, referred to above, who concluded that the principle favoured by Bingham J. in ***Neste Oy*** was essentially unsound as being founded on the availability of a remedial constructive trust in English law. Rimer J.'s own analysis in ***Shalson*** was that, upon an implied rescission of the loan contracts, the claimant had revested in him the property in the money advanced thereby entitling him to trace it into the assets into which it was subsequently applied: ***Lonhro plc v Fayed (No. 2)*** [1992] 1 W.L.R. 1, at 12, and ***El Anjou v Dollar Land Holdings plc*** [1993] 3 All E.R. 717, at 734.The basis of Rymer J.'s conclusion, therefore, rests not on the existence of a constructive trust but the proprietary consequences of the remedy of rescission for fraudulent misrepresentation.

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CONCLUSION

While there is clearly some judicial support for Lord Browne-Wilkinson's general principle that stolen moneys are traceable in equity, the trend of the more recent authorities is to deny that the proprietary interest which equity seeks to enforce arises by virtue of a constructive trust imposed on the fraudulent recipient.

The notion that property acquired by fraud becomes held on trust for the victim does have the attraction of providing the victim with the ability to trace in equity into the stranger's mixed account without the need to show an initial fiduciary relationship between the parties. The right to trace, it is submitted, should not depend on this arbitrary requirement but on the establishment of an equitable proprietary title in the subject property. Most recently, the Court of Appeal in ***Sinclair Investment Holdings SA v Versailles Trade Finance Ltd***, 12th May 2005, Lawtel, has had occasion to consider once again whether equity permits the imposition of a constructive trust on a fraudster. Here, the claimant had entered into an agreement to invest funds with the defendant. The claim concerned the misuse of those funds by an alleged director of the defendant's associated company. The funds had been used to create a false market in shares, the profits from which were used by the director to purchase a property which was later sold and the proceeds paid to the defendant's administrative receiver. On an application to strike out the claimant's proceedings on the grounds that no cause of action arose, the Court of Appeal concluded that it was arguable that a constructive trust could be imposed by virtue of the fraud so that the director held any profit from the transaction on trust for the defendant subject to the claimant's interests. Interestingly, although the court acknowledged that there were "powerful dicta" supporting the view that no constructive trust could arise in these circumstances, this was by no means conclusive or binding on the court. It is hoped, therefore, that the Court of Appeal will seize the opportunity to review this area again more fully at the substantive trial of the issues.

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News Item

Draft legislation to enforce a Brazilian tax amnesty

The Brazilian Government is currently considering draft legislation to enforce a tax amnesty, in an effort to encourage the repatriation of funds held abroad by individuals and legal entities resident in Brazil. Federal taxes and contributions, penalties and interests will be covered by the amnesty. Naturally, funds derived from illegal activities will not be covered.

If Bill No. 5.228/05 is approved by the Brazilian Senate, taxpayers will be given six months to declare or repatriate undeclared funds held abroad. Funds then would be taxed either at 3%, if the money is transferred to commercial banks in Brazil and remains invested in the country for a minimum of two years, or at 6%, if the funds are held in a commercial bank abroad.

According to the Government, undeclared funds held abroad by Brazilian individuals and legal entities could be as much as R$150 billion (US$61 billion).