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CONSTRUCTIVE TRUSTS IN A COMMERCIAL SETTING

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INTRODUCTION

Few concepts in the law are as resilient and controversial as constructive trusts. They are easier to illustrate than to define. Three unanimous decisions of the Gleeson / French High Court have marked a significant departure from the Mason High Court's approach to constructive trusts. The Mason High Court flirted with the idea that a constructive trust was a remedial device which could be pressed into action in order to prevent unjust enrichment. That momentum has now disappeared in Australia.

A constructive trust is an equitable remedy. A claim for a constructive trust in its most orthodox sense involves a plaintiff asserting a beneficial entitlement to a particular asset of the defendant. The paradigm example of the imposition of a constructive trust is where trust property is transferred by a trustee in breach of trust. If the property or its traceable proceeds can be identified, the holder of the trust property is liable to restore it unless he or she is a bona fide purchaser for value of a legal title without notice of the earlier equitable interest.[1] Despite the remedy granted in such a case being described as a constructive trust, the outcome will be governed by the persistence of the beneficiary's equitable proprietary rights. Equitable proprietary rights bind all subsequent holders of the property unless and until they are destroyed the act of good faith purchase.

For example, an errant company director may use company money to buy an asset for his or her spouse. A constructive trust may be sought in relation to the asset.[2] Where the value of the asset is rising, or will yield some other advantage to its holder (eg. dividends or profits) or there is doubt about the defendant's solvency, a constructive trust may be an advantageous remedy for a

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[1] *In re Montagu's Settlement Trusts* [1987] Ch 264 at 276 (Megarry VC) "I can leave on one side the equitable doctrine of tracing: if the recipient of trust property still has the property or its traceable proceeds in his possession, he is liable to restore it unless he is a purchaser without notice. But liability as a constructive trustee is wider, and does not depend upon the recipient still having the property or its traceable proceeds."

[2] Other paradigm examples include the constructive trust arising (1) when a specifically enforceable contract for the transfer of a property right is made: *Lysacht v Edwards* (1876) 2 Ch D 499; and (2) to protect a borrower's (or guarantor's) equity of redemption when a mortgagee holds surplus moneys and securities after recouping its debt: *Bofinger v Kingsway Group Pty Ltd* (2009) 239 CLR 269.

plaintiff to seek. The assertion of a constructive trust over property may also provide a firm foundation for seeking interlocutory relief in relation to the asset in question.

THE RIGIDITY OF EQUITABLE CAUSES OF ACTION

In a sense discussion of the constructive trust remedy starts things off at the wrong end. Determining rights then remedies is a sequential but distinct process. A plaintiff must first make good the elements of their cause of action before the question of remedies is enlivened. Speaking at a high level of generality, causes of action arise (1) at common law, (2) in equity, or (3) under statute. The categories are mutually exclusive and, together, are exhaustive of the circumstances in which the law generates a right in a plaintiff good against a defendant. Equity's causes of action have established elements. It is incumbent on a plaintiff to plead and prove each element of whatever cause of action is pressed.[3] The notion that equity, in determining liability, is institutionally more flexible than the common law is probably false.[4] The discipline of establishing elements of a cause of action provides the general law with a reasonable degree of certainty and predictability. Certainty is a value embraced by both law and equity. Today, equity is probably no more or less capable of flexibility in the incremental development of equitable causes of action than the common law.

Identifying the provenance of the cause of action is critical, because a constructive trust is more likely to be granted if the cause of action arises in equity's exclusive jurisdiction. Conversely, a constructive trust is less likely to be granted if a plaintiff establishes a common law cause of action and seeks the imposition of a constructive trust in equity's concurrent jurisdiction. The reason is that with a common law cause of action, a court – before considering the grant of an equitable remedy - is required to answer the anterior question: is the plaintiff's remedy at law

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[3] *Farah Constructions Pty Ltd v Say-Dee Pty Ltd* (2007) 230 CLR 89 at 148 [128].

[4] In Meagher Gummow and Lehane's Equity: Doctrines and Remedies, 4th ed, p.87 it is said *"...in 1903... Buckley J said with total accuracy: "This court is not a court of conscience". In Re Diplock's Estate [1948] Ch 465 at 481-2 the English Court of Appeal observed that "if a claim in equity exists, it must be shown to have an ancestry founded in history and in the practice and precendents of courts administering equity jurisdiction. It is not sufficient that because we may think that the "justice" of the present case requires it, we should invent such a jurisdiction for the first time. Again, in 1893 ... it was said "it is an old mistake to suppose that, because there is no effectual remedy at law, there must be one in equity"*. The passage in MGL which contains those remarks commences [3-025] "... *it has long been recognised that equity's naked power of improvisation is spent. If equity remedied mere misfortunes, it has long ceased to do so.*"

insufficient? Only when the common law response is inadequate will equity's concurrent jurisdiction be enlivened.

The usual remedy of the common law is damages, compensatory, aggravated or exemplary. In some actions at law, such as an action for money had and received, a defendant might be ordered to pay the plaintiff a sum which represented the defendant's gain, rather than the plaintiff's loss. But none of this alters the principle that a plaintiff, in vindicating a common law cause of action, will only be able to obtain an equitable response if the legal response is inadequate. Merely improving a plaintiff's recovery prospects by imposing a constructive trust is unlikely to prove attractive. Something more would usually be required, like demonstration of a defendant's fraud or intentional wrongdoing, as in *Black v Freedman & Co* (1910) 12 CLR 105.[5] But a breach of contract, even a breach that can be described as deliberate and high handed, will not usually do.[6]

THE FLEXIBILITY OF EQUITY'S REMEDIAL STRUCTURE

Equity developed a diverse and extensive array of remedies.[7] They developed because courts of equity began as courts of conscience and a plaintiff, in seeking equity's intervention, might be required to do equity.[8] For instance, if a party sought rescission of a contract made in circumstances that were unconscionable, equity might need to be able make allowances and adjustments between the parties to do practical justice between them. Or a plaintiff might be required to give (as a condition of obtaining equitable relief) a defendant credit for improvements

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[5] See also the example given by Gummow and Hayne JJ in *Lenah Game Meats* (at [102]) of the intentional trespass to land by a film crew with cameras rolling, thus creating an item of personal property – copyright – which might have been the subject of a constructive trust. This is so notwithstanding the film crew captured no confidential information.

[6] *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41. The reason is likely to be that expectation damages for breach of contract is considered sufficient protection of an innocent party's rights. The position may also have something to do with the attitude of Holmes J, who said at common law a party may either perform his or her contractual obligations, or pay damages. Justice O.W. Holmes is described as "the father of the bad man's theory of contract": Goff R and Jones G, The Law of Restitution (6th ed, Sweet & Maxwell, London, 2002) p 517.

[7] Rescission, account, equitable compensation, delivery or transfer of a specific asset and the equitable charge are other relevant examples.

[8] Common place instances of this principle involve an applicant for an interlocutory injunction being required to give an undertaking as to damages, or a defaulting but honest fiduciary being awarded a just allowance for his time and expertise in generating an unauthorized profit from office.

made to an asset whilst in the defendant's possession. These considerations necessitated a flexible remedial structure. Equity's remedial flexibility persists today.[9]

THE CONSTRUCTIVE TRUST

A constructive trust requires "the staple ingredients of the express and resulting trust: subject matter, trustee, beneficiary and personal obligation attaching to the trust property".[10] Unlike express and resulting trusts, however, constructive trusts arise without reference to the actual or presumed intentions of the trustee.[11] That does not mean that the remedy has no doctrinal mooring.

A constructive trust grants to the plaintiff a beneficial interest in the asset and will usually impose management obligations on the defendant in relation to the asset. The grant of a constructive trust may have consequences for third parties (mortgagees, lessees etc) who contend they have acquired proprietary rights in the asset following breach. Such a person will usually have standing to participate in the litigation.[12] If the defendant is insolvent, the grant of a constructive trust may undercut the principle of rateable distribution which underlies the policy of insolvency laws. These were the reasons given by the Gleeson High Court for warning that, in the exercise of its remedial discretion, a court should not grant a constructive trust if another equitable remedy is appropriate.[13] In *Giumelli,* for example, the promised parcel of land in a proprietary estoppel claim was not made the subject of a constructive trust. Improvements made

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[9] *Bridgewater v Leahy* (1998) 194 CLR 457. In defending *Bridgwater* extra-judicially in 2003, Gummow J said (see 77 ALJ 30 at 32) "... *the outcome in Bridgewater , where relief was given only on detailed terms, has been stigmatised as perhaps the "high water mark" of "a process of discretionary practical justice". The term "practical justice", used in the Australian cases, has an English pedigree. It comes from the speech of Lord Blackburn in Erlanger v New Sombrero Phosphate Co (1878) 3 App Cas 1218 at 1278-9 where he was considering the imposition of terms and the making of allowances in rescission decrees. Lord Blackburn went on (at 1279-1280) to refer to the defence of laches. The requirement that a person seeking equity must be prepared to do equity and the operation of the various equitable defences always have the potential to produce relief in a form which could not have been wholly anticipated. Indeed, as was pointed out in Bridgewater, the final result may not exactly represent what either side would have wished. Not to appreciate that is to fail to grasp rudiments of our legal system.*" (footnotes omitted)

[10] *ABC v Lenah Game Meats Pty Ltd* (2001) 208 CLR 199 at 316 [297] (Callinan J), citing a passage from *Jacob's Law of Trusts in Australia* 7th ed. at [1301] which drew on *Muschinski v Dodds* (1985) 160 CLR 583 at 613-614 (Deane J).

[11] *Muschinski v Dodds* (1985) 160 CLR 583 at 613 (Deane J).

[12] *John Alexander*

[13] *Giumelli v Giumelli* (1999) 196 CLR 101 at 113 [10] (Gleeson CJ, McHugh, Gummow and Callinan JJ), *Bathurst City Council v PWC Properties Pty Ltd* (1998) 195 CLR 566 at 585 [42] (Guadron, McHugh, Gummow , Hayne and Callinan JJ).

to the land made by third parties before and after the plaintiff's possession made a constructive trust remedy inappropriate.

There may be tension between equity's inherent remedial flexibility and the existence of a hierarchy of equitable remedies. But it is an error to apply the notion of a remedial hierarchy in a mechanical fashion. Given the range of equitable remedies, it will usually be the case that another equitable remedy is available. But will it be appropriate? The answer to the question involves taking a stand on matters of basic principle.

Writing the foreword in a book on restitution in 1998, Gummow J said:[14]

> "It is not immediately apparent why the fiduciary institution (in particular, the trust) may not stand beside the common law triptych of tort, contract and "quasi-contract", and why the equitable doctrines and remedies may not, in particular circumstances, operate upon that triptych and themselves continue to develop whilst doing so."

The fiduciary institution is an immensely important private law facility. It enables a principal to to repose "trust and confidence" in a fiduciary, and a fiduciary to accept the obligations that come with that office. The subjective reposing of trust in the fiduciary is not essential. Nor is factual vulnerability on the principal's part to a breach of (a non-fiduciary) duty. Fiduciary law protects the fiduciary institution, not necessarily the particular intentions and expectations of the principal.

Courts habitually impose a requirement of selfless and disinterested behaviour in the performance of the fiduciary's other duties (equitable, statutory and common law -usually contractual- obligations). These other obligations usually concern the holding of rights, information or advantages on behalf of and for the benefit of the principal. Because fiduciary duties were developed in the main to protect the fiduciary institution, a fiduciary duty can be breached despite the fiduciary acting in good faith. And fiduciary duties can also be breached even though no harm is suffered by the principal. In requiring a fiduciary to account for unauthorised profits, the law is ultimately protecting the fiduciary institution. That institution

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[14] IM Jackman *The Varieties of Restitution* 1998, The Federation Press, p.v; see also *Roxborough v Rothmans of Pall Mall* (2001) 208 CLR 516 at 540 [64] (Gummow J)

has a rather different value system to the value system underpinning the common law.[15] This is the main reason why substantive fusion of the common law and equity is a doomed exercise.

Traditional applications of the grant of a constructive trust beyond the paradigm case are illustrated by the following examples:

- A director, whose company lacks the resources to take advantage of a business opportunity, breaches his fiduciary obligation by taking advantage of the opportunity himself. A constructive trust is an available remedy against the director. [16]

- A solicitor used information of a client for personal advantage, in breach of a fiduciary obligation to act disinterestedly, and made a profit. A constructive trust may be ordered over the fund representing the profit.[17]

- An intending joint venturer acquires an asset for the mutual advantage of the venture, in circumstances where the other joint venturer(s) stays out of the market for the asset. If the interest of the silent joint venturer was subsequently denied, a constructive trust would be imposed in respect of the asset.[18]

- An employee accepts a commission from the employer's customer as an incentive to confine or fetter the employee's discretions. A constructive trust could be ordered in relation to the commissions.[19]

In each of these examples a fiduciary duty has been breached in relation to an asset or advantage and the constructive trust arises in response to that breach. The person the subject of the duty in each example is a status based fiduciary: director, solicitor, intending partner, employee. Further, the asset the subject of the fiduciary obligation (or its exchange product/traceable

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[15] Keane, *The conscience of equity* (2010) 84 ALJ 92.
[16] *Consul Developments Pty Ltd v DPC Estates Pty Ltd* (1975) 132 CLR 373 at 395 (Gibbs J). See also *Farah Constructions Pty Ltd v Say Dee Pty Ltd* (2007) 230 CLR 89 at 140 [110].
[17] *Boardman v Phipps* [1967] AC 46.
[18] *Banner Homes Group plc v Luff Developments Ltd* [2000] Ch 372.
[19] *Attorney General (Hong Kong) v Reid* [1994] 1 AC 324.

proceeds)[20] is identifiable. Such examples of an award of constructive trust are secure, because they remedy a breach of fiduciary duty and the fiduciary institution is the most important contribution equity makes to the law of personal obligations. They are orthodox, even though sometimes mired in complexity.

There are other examples of a constructive trust being imposed for breach of an equitable cause of action, such as a remedy in a case of proprietary estoppel or a remedy concerning a misuse of confidential information. But because proprietary estoppel and confidential information are not at the centre of equity jurisprudence, it is more likely that the hierarchy notion would be imposed and a less potent equitable remedy granted to a successful plaintiff. *Guimelli* itself was a proprietary estoppel case where the High Court said an award of equitable compensation was the appropriate remedy.

A SECOND USAGE OF THE LANGUAGE OF CONSTRUCTIVE TRUSTS

A confusing but ingrained use of the term constructive trustee concerns claims against "third parties" for breach of fiduciary duty by a primary fiduciary. It derives from the statement of Lord Selborne in *Barnes v Addy* (1874) Ch App Cas 244. In *Barnes v Addy* itself, two solicitors, had not received any trust property; the question was whether their knowledge of an imprudent decision of the trustee (subsequently found to be a breach of trust) made the solicitors accountable as parties to the breach of trust by the trustee and bound to make good as constructive trustees the loss of the trust assets. The cases against the solicitors failed. Lord Selborne said (at 251):

> "But, on the other hand, strangers are not to be made constructive trustees merely because they act as the agents of trustees in transactions within their legal powers transactions, perhaps a court of equity may disapprove, unless those agents receive and become chargeable with some part of the trust property, or unless they assist with knowledge in a dishonest and fraudulent design on the part of the trustees".

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[20] Where the asset held by the defendant is the exchange product of an asset that was earlier transferred, tracing will be required to identify the plaintiff's right in each particular subject matter from time to time. This has evidential and cost implications.

These two limbs of Lord Selborne's dictum have come to be known as a first limb *Barnes v Addy* claim (a claim known in shorthand as a knowing receipt claim) and a second limb *Barnes v Addy* claim (which has come to be known in shorthand as a claim in knowing assistance). Both are personal, not proprietary, claims.

In a first limb claim, a third party becomes chargeable in equity if he or she receives trust property[21] for their own benefit, and either then or later – but while still in possession of the property – knows or has notice (which includes constructive notice) that the property was misapplied trust property. That is, the third party is liable to restore the property's value to the beneficiary.

If the trust property is still in the hands of the third party at the time the claim is made, seeking to make out the elements of a first limb claim is unnecessary. On the hypothesis that the defendant still holds the asset (or its traceable proceeds), the defendant will be liable to restore it unless the defendant can make good the defence of bona fide purchase for value of a legal title without notice of the equitable interest. In such a case the plaintiff is best to bring a claim for a constructive trust with respect to the specific property in the hands of the defendant. That claim vindicates the plaintiff's equitable property rights.[22] It is not a first limb *Barnes v Addy* claim. A plaintiff undertaking the burden of proving knowledge or notice that the property was misapplied trust property is quite unnecessary.

In a second limb *Barnes v Addy* claim, no element of the cause of action involves proving that trust property has been received by the third party. Despite there being no trust property, the third party is still traditionally called a constructive trustee. This occurs so as to make the third party accountable in equity as if he were a trustee. The third party will be liable to make good a loss to the plaintiff, or give up a profit made, depending on the nature and consequences of the breach of fiduciary duty. But trust property is nowhere in sight.

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[21] Which includes obtaining a security interest in the trust property (*Jacobs Law of Trusts in Australia* p. 284 para. [1334]. Trust property extends to property subject to a fiduciary obligation, such as an agent holding his principal's property.

[22] *Re Montague's Settlement*

In both first and second limb *Barnes v Addy* cases, an English Judge[23] has said of the third party:

> "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."

The High Court recognises this second, and different, usage of the language of constructive trust as a means of requiring a person to account as if he was a trustee.[24] But the difference is not always plain to the profession.

CAN A CONSTRUCTIVE TRUST BE AWARDED BY EQUITY(IN ITS CONCURRENTJURISDICTION) FOR BREACH OF A COMMON LAW CAUSE OF ACTION?

The answer the High Court has recently given to this question, in relation to a cause of action for breach of contract, is "no".[25] In a unanimous decision, the High Court said "to impose a constructive trust for breach of contract would be, if not an impossible step, at least a very unusual and extreme one".

This marks a significant departure from the remedial flexibility provided by the constructive trust remedy, which so attracted the Mason High Court. In *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 at 124 Deane J was prepared to grant a constructive trust over the assets and undertaking of a company (HP) following a high handed and deliberate breach of contract by USSC's Australian distributor. The Australian distributor was found not to be a fiduciary. Deane J said:

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[23] *Paragon Finance plc v DB Thakerar & Co* [1999] All ER 400, 408-409 (Millet LJ).
[24] *Bofinger v Kingsway Group Ltd* (2009) 239 CLR 269 at 290 [47]-[50].
[25] *John Alexander's Clubs Pty Ltd v White City Tennis Club Ltd* (2010) 241 CLR 1 at 38 [97].

> "In my view, the constructive trust pursuant to which HPI is liable to account for the profits arising from the sale in Australia of its own re-packaged or manufactured competing products should properly be seen as imposed as equitable relief appropriate to the particular circumstances of the case rather than as arising from a breach of some fiduciary duty flowing from an identified fiduciary relationship."

A year later, in *Muschinski v Dodds* (1985) 160 CLR 583 at 612, Deane J (with whom Mason J agreed) acceded to a submission to declare a constructive trust "based on broad notions of fairness and unjust enrichment". And in *ANZ v Westpac* (1988) 164 CLR 662 at 673 the Mason High Court said, in a common law action for money had and received to recover an amount paid by mistake that "The common law right of action may arise in circumstances which …would lead a modern court to grant relief by way of constructive trust."

So it is of particular interest that Gummow J, in argument in the *John Alexander's Clubs* case,[26] should say "It may be necessary to look at those cases [Muschinski and another informal domestic arrangement case] some day". They are ominous words for the constructive trust that seeks to remedy "unjust enrichments".

CONCLUSION

The Mason High Court's approach to constructive trusts will not stand the test of time. But that does not mean that equity has lost its remedial flexibility or that the constructive trust has limited work to do in commercial litigation. What it does mean that the constructive trust will be most securely deployed when one of the accepted traditional categories of fiduciary relationship is proved. When we step beyond that orthodoxy, the constructive trust becomes fragile and insecure.

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[26] (2010) 241 CLR 1 at 8.