PERSONAL ACCOUNTABILITY OF STRANGERS AS CONSTRUCTIVE TRUSTEES

The article deals with the question of when equity will impose a constructive trust on strangers who deal with trust property. This has traditionally occurred in two types of situations, namely where the stranger has received such property knowing of a breach of trust, and where the stranger has knowingly assisted in a fraudulent and dishonest design; in the latter case there is controversy as to whether actual or constructive notice suffices. The article criticizes the classification, contending that the first category is covered by the general law of priorities, and suggests that actual notice be required for "knowing assistance".

I. PERSONAL AND PROPRIETARY ASPECTS OF TRUSTS

THE institution known as the trust requires there to be specific property subject to the trust. Whether this trust of property be express, resulting or constructive the beneficiaries have equitable interests in the property which are unaffected by the trustee's bankruptcy: the beneficiaries' property rights prevail over his creditors.

The trustee of property is as such under personal obligations. He is personally liable to account to the beneficiaries for any profits he makes out of his fiduciary position[1] and for any losses occasioned by any breach of his fiduciary duties. The beneficiaries' personal rights to make the trustee account are affected by the trustee's bankruptcy so that they rank alongside his other ordinary creditors.

Where the beneficiaries have a proprietary remedy against the property held by the trustee they also have a personal remedy against the trustee himself since he is personally liable to account to them for the trust property.[2] Indeed, if the beneficiaries do not want the specific trust property delivered up to them they may be satisfied by making the trustee account to them for an amount corresponding to the value of the trust property where the trustee is good for the money.

Exceptionally, a person who does not have any trust property vested in him and never had property vested in him as trustee may "constructively" be treated as a constructive trustee merely as a formula for equitable relief by way of personal liability to account as if he had been a trustee.[3] There is no constructive trust of specific property so as to afford priority to the beneficiaries if he becomes bankrupt. Trust and trusteeship normally go hand in hand but here constructive trustee-

[1] Profits made out of the trust property are "fruit" of the "tree" and so rank as trust property in respect of which the beneficiaries have a proprietary remedy.
[2] *E.g.* if he subsequently loses the trust property as a result of a breach of trust: *Bartlett* v. *Barclays Bank Trust Co. Ltd.* [1980] Ch. 515.
[3] *Selangor United Rubber Estates Ltd.* v. *Cradock (No. 3)* [1968] 2 All E.R. 1073, 1097; *English* v. *Dedham Vale Properties Ltd.* [1978] 1 All E.R. 381, 398; *Eaves* v. *Hickson* (1861) 30 Beav. 136.

ship is imposed as a personal remedy divorced from the proprietary institutional trust of specific property. Really, it is a fiction which provides a useful remedy where no remedy is available in contract or in tort but, as we shall see, courts of equity require some want of probity before making a defendant personally liable to account as if he had been a trustee.

II. WHERE TRUST PROPERTY IS STILL IN THE STRANGER'S HANDS

Where trust property or its traceable product is still in the hands of the stranger then he holds the property as trustee subject to the terms of the original trust unless he was a *bona fide* purchaser of a legal interest for value without notice (actual, constructive or imputed[4]) of the original trust.[5] This is simply a matter of the property law of priorities (assisted, if necessary, by tracing principles) making his legal title subject to a prior equitable interest. He must, therefore restore the property to the beneficiaries (or to trustees for the beneficiaries) or personally account to them for its value if that suits them better.

Once the stranger learns that it is trust property or its traceable product that he has, then he becomes constructive trustee thereof and becomes personally liable to account. Thus, if subsequently he sells such property and dissipates the proceeds so they are untraceable, he may be made personally liable to account for the value of the property. One would expect that if he sold the property and dissipated the proceeds *before* he learned that it was trust property then there would be no basis for making him personally liable to account for the value of the property. In confirming this expectation one has to examine and distinguish those cases treating a stranger as a constructive trustee under the "knowing receipt" head.

III. LIABILITY FOR "KNOWING RECEIPT"

A stranger may be personally liable to account as a constructive trustee if he received trust property with notice (actual, constructive or imputed) that it was trust property transferred in breach of trust.[6] This is undoubtedly the case where the stranger still has such trust property or its traceable product: as has just been seen this is the straightforward effect of the property law of priorities assisted if necessary by tracing principles. However, the courts[7] have been ready to apply the law

[4] Imputed notice is an agent's actual or constructive notice which is imputed to his principal. A person has constructive notice of those matters that a reasonable man would have discovered if he had made such inquiries and inspections as ought reasonably to have been made. These inquiries and inspections are extensive where land is being purchased but minimal in most commercial transactions unless a purchaser or agent knows of suspicious circumstances. See Megarry & Wade, *Law of Real Property* (5th ed., 1984) pp. 148-152 and *Baden Delvaux & Lecuit* V. *Societe Generale* [1983] B.C.L.C. 325, 414-415.

[5] Or unless he was protected by special statutory provisions relating *e.g.* to overreaching or to registration of title or of charges or to commercial exceptions from the principle *nemo dat quod non habet.*

[6] *Belmont Finance Ltd.* v. *Williams Furniture (No. 2)* [1980] 1 All E.R. 393, 405, 410; endorsed in *Rolled Steel Products Ltd.* v. *BSC* [1985] 3 All E.R. 52, 87-88.

[7] *Belmont Finance Ltd. (supra)* (where the defendant had actual notice), *Carl Zeiss Stiftung* v. *Herbert Smith & Co. (No. 2)* [1969] 2 Ch. 276 (not even any constructive notice), *International Sales* v. *Marcus* [1982] 3 All E.R. 551 (actual notice), *Nelson* v. *Larholt* [1948] 1 K.B. 339 (a short sweeping *ex tempore* judgment of Denning J., which he then tried (unconvincingly) to justify in (1949)

as stated in the penultimate sentence where a plaintiff has sought to make the wealthy defendant liable to account for the value of trust property (or other property subject to a fiduciary relationship) *without regard* to whether the defendant any longer has any such property or its traceable product.

One can hardly blame the courts for this since the defendants themselves did not raise the issue. Moreover, no longer having the trust property or its traceable product would not assist a defendant who, at the time of disposing of such property, had actual or "Nelsonian" notice that it was such or would have known it was such but for deliberately or recklessly failing to make such inquiries as an honest and reasonable man would make (which will hereafter be referred to as "naughty" notice). "Nelsonian" notice is what would have been actual notice but for deliberately turning a blind eye.[8] Actual notice must, it seems, extend to what would be actual notice to a reasonable man of ordinary honesty and intelligence though not the mentally or morally obtuse defendant.[9]

There remains to be considered the position of the defendant who received trust property merely with constructive notice that it was trust property transferred in breach of trust and who dissipated it before acquiring any actual, "Nelsonian" or "naughty" notice.

It is instructive first to consider the position of an innocent volunteer, a donee of trust property without notice[10] that it be such, who dissipated trust property or its traceable product before acquiring actual, "Nelsonian" or "naughty" notice. *Ex hypothesi* tracing is impossible and according to the Court of Appeal in *Re Diplock,*[11] the innocent volunteer cannot be made personally liable to account as a constructive trustee for anything done before he actually knew he had received trust property to which he was not entitled.

Carl Zeiss Stiftung v. *Herbert Smith & Co.*[12] illuminates the position of a purchaser with constructive notice. The East German *Stiftung* in an action claimed that the West German Foundation's assets were held on constructive trust for the *Stiftung*. The Foundation paid money over to Herbert Smith & Co., solicitors, to cover Herbert Smith's fees and disbursements in acting as solicitors for the Foundation. The *Stiftung* sought to make the solicitors personally liable to account to the *Stiftung* for the moneys paid to the solicitors by the Foundation. The Court of Appeal unanimously rejected the *Stiftung's* claim on the basis that notice of a doubtful disputed claim which could not properly be assessed was not constructive notice of the trust to which the claim related.

65 L.Q.R. 37, where he held that the defendant's constructive notice sufficed without thoroughly going into the facts which may well have revealed that the defendant had deliberately turned a blind eye to matters as indicated by Sachs L.J. in *Carl Zeiss* [1979] 2 Ch. 276, 298).

8 *Baden Delvaux & Lecuit* v. *Societe Generate* [1983] B.C.L.C. 325, 408.

9 *Consul Development Pty. Ltd.* v. *D.P.C. Estates Ltd.* (1975) 132 C.L.R. 373, 398, 412 and footnotes 35 and 36 *(infra), Karak Rubber Co. Ltd.* v. *Burden (No. 2)* [1972] 1 W.L.R. 602, 635.

10 Constructive notice will normally not enter into the picture since donees are under no duty of inquiry unless they know of suspicious circumstances.

11 [1948] Ch. 465, 477-479.

12 [1969] 2 Ch. 276.

However, Sachs L.J. went on to state that even if the defendant solicitors had constructive notice "a further element has to be proved" before they can, as strangers, be made personally liable to account as a constructive trustee.

> That element is one of dishonesty or of consciously acting improperly as opposed to an innocent failure tomake what a court may later decide to have been a proper inquiry. That would entail both actual knowledge of the trust's existence and actual knowledge that what is being done is improperly in breach of that trust — though, of course, in both cases a person wilfully shutting his eyes to the obvious is in no different position than if he had kept them open.[13]

Edmund Davies L.J. endorsed this approach in emphasizing that the defendants could not be made liable to account unless there was a "want of probity" on their part: "nothing short of want of probity will do".[14] These remarks of Sachs and Edmund Davies L.JJ. are particularly significant when one considers that the defendants' counsel had not argued that constructive notice did not suffice, concentrating successfully on the point that even if it did suffice the defendants had no such notice.

Unfortunately, an appeal was pending against the judgment of Ungoed-Thomas J. in the *Selangor* case[15] so Sachs and Edmund Davies L.JJ. had to be careful not to express any final views that might be decisive in *Selangor.* There, Ungoed-Thomas J. had held that a stranger is personally liable to account as a constructive trustee if he assists with actual, constructive or imputed notice in a morally reprehensible design (even though not fraudulent or dishonest) of the trustees. Sachs and Edmund Davies L.JJ. were not happy about the sufficiency of constructive notice or of a morally reprehensible design.

The *Selangor* appeal was not proceeded with but, subsequently, the Court of Appeal in *Belmont Finance Corporation* v. *Williams Furniture (No. 1)*[16] held that the design had to be fraudulent or dishonest, not just morally reprehensible, and opined that constructive notice did not suffice for liability for knowing assistance in a dishonest design. Earlier, in *Competitive Insurance Co. Ltd.* v. *Davies Investment Ltd.,*[17] a case not involving any dishonest design so that possible liability to account existed under the "knowing receipt" head, Goff J. had taken the view that constructive notice would not suffice, following the views expressed in *Carl Zeiss.*

Accordingly, it is submitted on principle and precedent that no distinction should be made between an innocent volunteer and a purchaser who merely has constructive notice. Each only becomes liable to account as a constructive trustee when he obtains actual, "Nelsonian" or "naughty" notice that the property he holds is trust property or its traceable product. No liability is incurred if before that time the property is dissipated.

[13] *Ibid., p.* 298. This view is supported by Oakley in *Constructive Trusts,* (1978) p. 72.
[14] *Ibid., p.* 301. Danckwerts L.J. merely accepted the conventional wisdom, not disputed by the defendants' counsel, that actual or constructive notice sufficed.
[15] [1968] 2 All E.R. 1073.
[16] [1979] Ch. 250.
[17] [1975] 1 W.L.R. 1240, 1250.

For example, take Victor, a divorced man, who marries Winnie and buys a house in his own name though Winnie provided half the purchase price, so that Victor holds the unregistered land on trust for himself and Winnie equally. Bored with her, Victor sends her off to Australia for three months to look after her elderly mother, but she leaves some evidence of her occupation in the house such that a court would subsequently find that a purchaser would have constructive notice of Winnie's equitable interest.

Victor then removes everything from the house and by deed of gift transfers the house to Simon, his son by his first marriage, who is ignorant of Victor's remarriage and has no notice of Winnie's equitable interest. Simon does not want to occupy the house so he has an estate agent sell it to a *bona fide* purchaser for value without notice of Winnie's equitable interest. Simon invests the money in a speculative biotechnological venture which fails so that he loses the money. Simon then learns of Winnie's interest.

Winnie cannot make Simon personally liable to account as a constructive trustee for her lost share of the proceeds of sale of the house.[18]

The position should be no different if, instead of gifting the house to Simon, Victor had sold and conveyed the house to Paul whilst Winnie was absent but in circumstances where Paul is treated as having constructive notice of her interest; Paul had then sold and conveyed the house to Quentin, a *bona fide* purchaser of a legal estate for value without notice of Winnie's interest, and Paul had then invested and lost the proceeds of sale before learning of Winnie's claim.[19]

If Simon or Paul still had Winnie's traceable property then the tracing remedy would prevent their unjust enrichment by requiring them to disgorge their unjustified benefit and so transfer the property to Winnie. However, a court of equity should not go further and require the impoverishment of the defendant to compensate the plaintiff where the defendant is innocent of any wrongdoing. Except where the defendant is an express trustee or has taken it upon himself to act as if he were an express trustee so becoming a trustee *de son tort,* it is notorious that to invoke the assistance of a court of equity the plaintiff has to establish some special equity[20] against a defendant *e.g.,* involving mistake, misrepresentation, fraud, dishonesty or unconscionable behaviour.

IV. KNOWING ASSISTANCE

Bearing the above in mind it is necessary to consider the other head of liability of strangers as constructive trustees. A stranger may be personally liable to account as if he were a trustee if he knowingly assists in a dishonest design on the part of trustees or other fiduciaries to the detriment of the beneficiaries. It is immaterial whether or not he received any property or only received it within the scope of his agency for the trustees or other fiduciaries.[21]

18 *Re Diplock* [1948] Ch 465, 477-479.
19 *Carl Zeiss* [1969] 2 Ch. 276, 298, 301, *Competitive Insurance* v. *Davies* [1975] I W.L.R. 1240, 1250.
20 See Rolt L.J. in *Harries* v. *Rees* (1867) 37 L.J. Ch. 102, 106-107.
21 *International Sales Ltd.* v. *Marcus* [1982] 3 All E.R. 551, 557-558, *Baden Delvaux & Leciut* v. *Societe Generale* [1983] B.C.L.C. 325, 403-404.

It is clear that a stranger knowingly assists in a dishonest design where he has actual notice thereof, "Nelsonian" notice or "naughty" notice.[22] It would also seem to suffice if a reasonable man of ordinary honesty and intelligence would have actual notice though not the mentally or morally obtuse stranger.[23] On principle and precedent the better view is that constructive notice will not suffice.

One's starting point has to be Lord Selborne's celebrated judgment in *Barnes* v. *Addy,*[24] where he stated:

> Those who create a trust clothe the trustee with a legal power and control over the trust property, imposing on him a corresponding responsibility. That responsibility may no doubt be extended in equity to others who are not properly trustees if they are found … *actually participating* in any fraudulent conduct of the trustee. 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 of which 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…. I apprehend those who create trusts do expressly intend, *in the absence of fraud and dishonesty,* to exonerate such agents from the responsibilities which are expressly incumbent upon the trustees.

There are then to be found plenty of *dicta* in *Carl Zeiss Stiftung* v. *Herbert Smith & Co. (No. 2),*[25] *Re Blundell,*[26] *Williams* v. *Williams,*[27] *Thomson* v. *Clydesdale Bank,*[28] *Competitive Insurance Co.* v. *Davies Investments Ltd.*[29] and *International Sales* v. *Marcus*[30] to the effect that constructive notice is not sufficient. "Knowing assistance" requires one to be a party or privy to the dishonest design.[31] Innocent failure to make what is subsequently held to be a proper enquiry so leading to innocent failure to know of dishonesty can hardly make one party or privy to such dishonesty.[32]

Finally, one comes to the *dicta* of Buckley L.J. in *Belmont Finance Ltd.* v. *Williams Furniture (No. 1)*[33] supported by Orr and Goff L.JJ. "The knowledge of that design on the part of the party sought to be made liable may be actual knowledge. If he wilfully shuts his eyes to dishonesty or wilfully or recklessly fails to make such enquiries as an honest and reasonable man would make, he may be found to have

22 *Belmont Finance Ltd.* v. *Williams Furniture Ltd.* [1979] Ch. 250, 267, 270, 275.

23 *Baden Delvaux & Lecuit* v. *Societe Generale* [1983] B.C.L.C. 325, 408, 415, *Consul Development Pty. Ltd.* v. *D.P.C. Estates Ltd.* (*1975*) 132 C.L.R. 373, 398, 412.

24 (1874) 9 Ch. App. 244, 251-252 (emphasis added).

25 [1969] 2 Ch. 276, 298, 301.

26 (1888) 40 Ch. D. 370, 381.

27 (1881) 17 Ch. D. 437, 445.

28 [1893] A.C. 282, 290.

29 [1975] 1 W.L.R. 1240, 1250.

30 [1982] 3 All E.R. 551, 557-558.

31 Re *Blundell* (1888) 40 Ch. D. 370, 381.

32 See Sachs L.J. in *Carl Zeiss* [1969] 2 Ch. 276, 298.

33 [1979] Ch. 250, 267 supported at pp. 270, 275 by Orr and Goff L.JJ.

involved himself in the fraudulent design, or at any rate to be disentitled to rely on lack of actual knowledge of the design as a defence. But otherwise he should not be held to be affected by constructive notice."

Barwick C.J. and Stephen J. in the Australian High Court[34] (McTiernan J. dissenting) have taken the same view, though pointing out[35] that "if a defendant knows of facts which themselves would, to a reasonable man, tell of fraud the case may well be different, as it clearly will be if the defendant consciously refrained from enquiry for fear lest he learn of fraud. But to go further is to disregard equity's concern for the state of conscience of the defendant." Gibbs J. emphasized [36] that "[i]t would not be just that a person who had full knowledge of all the facts could escape liability because his own moral obtuseness prevented him from recognising an impropriety that would have been apparent to an ordinary man."

Against the above line of authority are four High Court decisions, *Selangor,*[37] *Karak Rubber Co. Ltd.* v. *Burden (No. 2),*[38] *Rowlandson* v. *National Westminster Bank,*[39] and *Baden Delvaux & Lecuit* v. *Societe Generate,*[40] holding that constructive notice suffices. The judgments are vitiated by the fact that the judges considered it established that constructive notice sufficed for the "knowing receipt" head of liability and could not see any logic in preventing constructive notice sufficing for the "knowing assistance" head. It has already been submitted that constructive notice is only appropriate for the "knowing receipt" head where the defendant still has the trust property or its product.

In the most recent case, *Baden Delvaux,* counsel for both sides agreed that constructive notice sufficed, though Peter Gibson J. felt it necessary to examine the case law before agreeing with them. He pointed out that it sufficed if a stranger wilfully or recklessly failed to make such inquiries as an honest and reasonable man would make and that it is little short of commonsense that a stranger who has actual knowledge of all the circumstances from which the honest and reasonable man would have actual knowledge of the dishonest design should also be treated as having knowledge of the dishonest design. Logically, he considered [41] it followed that a stranger should be treated as having sufficient knowledge of the dishonest design if the stranger had actual knowledge of circumstances which would put an honest and reasonable man on inquiry (which would lead such man to knowledge of the dishonest design) and yet the stranger failed to make such inquiry. Thus constructive notice sufficed, though it was not present in the circumstances before him.

34 *Consul Development Pty. Ltd.* v. *D.P.C. Estates Ltd.,* (1975) 132 C.L.R. 373. (Also Jacobs P. at first instance [1974] 1 N.S.W.L.R. 443, 471-472; and see the similar approach of the New South Wales Court of Appeal in *Adams* v. *Bank of New South Wales* [1984] 1 N.S.W.L.R. 185).

35 *Ibid.,* p. 412.

36 *Ibid.,* p. 398.

37 [1968] 2 All E.R. 1073.

38 (1972] 1 W.L.R. 602.

39 [1978] 1 W.L.R. 798. Perhaps the judge should have justified his findings of liability in these three cases on the basis that the circumstances known to the bankers would have given actual notice of the dishonest design to an honest and reasonable banker or that the bankers must have been suspicious and yet deliberately or recklessly failed to make further inquiries.

40 [1983] B.C.L.C. 325.

41 *Ibid., p. 415.*

It is submitted that there is a flaw in the above logic. Is there not a real difference between a defendant's failure to recognize dishonesty when he sees it and his failure to discover dishonesty because of failure to pursue inquiries?[42] Is the former direct knowledge not really a form of actual notice whilst the latter indirect knowledge is constructive notice? Peter Gibson J. himself stated,[43] "It is important not to lose sight of the requirement that the Court must be satisfied that the alleged constructive trustee was a party or privy to dishonesty on the part of the trustee". The sufficiency of mere constructive notice would surely be inconsistent with this fundamental requirement.

V. CONCLUSIONS

The original catch-phrases "knowing receipt" and "knowing assistance" for the heads of liability of strangers as constructive trustees have been misleading. Indeed, the "knowing receipt" head has become "knowing receipt or dealing" and has been extended to cover (1) a person (other than "equity's darling")[44] who receives trust property without notice that it is trust property transferred in breach of trust but who subsequently acquires notice and yet deals with the property in a manner inconsistent with the trust[45] and (2) a person who receives trust property with notice that it be such, but without notice of any breach of trust because there be none, who subsequently deals with the property in a manner inconsistent with the trust.[46]

It is submitted that the "knowing receipt or dealing" head should be abandoned as conducive to confusion. The property law of priorities assisted, if necessary, by tracing principles leads to the imposition of a proprietary constructive trust on the trust property or its traceable product if still in the hands of the stranger. Personal liability by the imposition of constructive trusteeship is available where the trust property or its traceable product is not in the hands of the stranger if he assisted knowingly in a dishonest design to the detriment of the beneficiaries.

For personal liability for knowing assistance it is necessary to show that the stranger had actual notice, "Nelsonian" notice or "naughty" notice of the dishonest design. Actual notice, pragmatically, must extend to what would be actual notice to an honest and reasonable man though not the morally obtuse defendant.

DAVID HAYTON*

42 See Stephen J. in *Consul Developments* (1975) 132 C.L.R. 373, 411.
43 [1983] B.C.L.C. 325, 404.
44 Shorthand for "a bona fide purchaser of a legal estate for value without notice, actual, constructive or imputed, of an equitable interest".
45 *Karak Rubber Co. Ltd.* v. *Burden* [1972] 1 W.L.R. 602, 632.
46 *Baden Delvaux & Lecuit* [1983] B.C.L.C. 325, 403.

* LL.D. (Newcastle University), Barrister, of Lincoln's Inn and the Inner Temple, Honorary Reader of Inns of Court School of Law, Fellow of Jesus College, Cambridge, Visiting Professor, Faculty of Law, National University of Singapore.