In London Allied Holdings Limited v Anthony Lee and ors\(^1\), the claimants sought to assert proprietary claims over the proceeds of a £1 million fraud perpetrated on it by the defendants, who had deceived the claimant into thinking that they were in a position to arrange for the claimant to purchase the Ritz Hotel. In that context, Etherton J considered whether English law should follow the US and Canadian model and use a discretionary remedial constructive trust to facilitate the assertion of the proprietary claim. Although the judge was able to sidestep the decision by finding that the circumstances of the fraud were sufficient to allow the imposition of an institutional proprietary constructive trust in accordance with recognised principles, the judge stopped short of concluding that English law would never recognise a discretionary remedial constructive trust and has, therefore, kept the debate alive.

**Introduction**

The constructive trust is an important tool for the victims of fraud – it is one of the primary means by which the courts are able to make proprietary remedies available against wrongdoers. Proprietary remedies are particularly advantageous where the defendant is insolvent (as the claim will have priority over unsecured creditors in an insolvency) or where the misappropriated assets have increased in value (as the claimant will be able to take the benefit of that increase in value).

In England and Wales, the constructive trust is institutional in nature – it arises by operation of law, upon the occurrence of certain events which the law regards as giving rise to the creation of an equitable proprietary interest. The court has no discretion as to whether or not the constructive trust should be recognised – it merely applies pre-determined rules to establish whether the trust has arisen and, if it has, declares that this is so. Thus a constructive trust will arise where, for example, a defendant owes fiduciary duties to the claimant and receives property in breach of duty. (The true institutional constructive trust is to be distinguished from liability in knowing receipt or dishonest assistance where, although the defendant is liable to account as if he were a constructive trustee, the remedy is personal rather than proprietary in nature.)

In other jurisdictions, notably the USA and Canada, the constructive trust is remedial in nature – i.e., it is a remedy which the court awards to create an equitable proprietary interest for the claimant. The remedial constructive trust may be awarded whenever the court, in its discretion, considers it appropriate to do so.

A recent judgment of the High Court confirms that, for the moment at least, the remedial constructive trust forms no part of English law. The judgment of Etherton J in London Allied Holdings Ltd v Lee and ors contains a useful summary of the current English position, and also highlights some of the issues that can arise when trying to establish an equitable proprietary claim against fraudsters.

**Background facts**

The proceedings related to a claim by London Allied Holdings Limited (“LAHL”) for recovery of £1 million paid to the first defendant, a Mr Lee. The payment was made to Mr Lee following negotiations and as part of an agreement between LAHL, Mr Lee and the second defendant, a Mr Dolan, for the sale of the Ritz Hotel to LAHL for £250 million. In fact Messrs Lee and Dolan were never in a position to sell the Ritz Hotel to LAHL and never had authority on behalf of its owners to enter into negotiations for its sale. LAHL had been the victim of an elaborate scam.

LAHL made claims in deceit, negligent misrepresentation and statutory misrepresentation and argued that, having procured payment of the £1 million dishonestly and under a mistake on the part of LAHL, the £1 million and its traceable proceeds were held by Mr Lee pursuant to a constructive trust. Personal and proprietary claims were asserted against both Mr Lee and Mr Dolan. Additional claims, based on conspiracy to defraud, breach of contract and restitution, were also made.

The judge found that:

- there was a contractual agreement between the parties that the defendants would repay the £1 million payment if contractual documentation in respect of the purchase of the hotel was not forthcoming within a reasonable time of payment being made;
- the defendants had made various fraudulent, alternatively negligent, misrepresentations;
- Messrs Dolan and Lee had agreed on the course of conduct that Mr Lee pursued with LAHL to induce payment of the £1 million, including the false
misrepresentations that were made, and that Mr Dolan knew of and was party to that conduct; and

- Mr Dolan was in partnership with Mr Lee, or alternatively Mr Lee was acting as Mr Dolan’s agent for these purposes, and Mr Dolan was therefore equally responsible for the misrepresentations made.

The judge concluded that Messrs Lee and Dolan were liable in damages for fraudulent misrepresentation and for conspiracy to defraud. Those damages were, however, recoverable only to the extent that LAHL’s losses were not fully recouped by its equitable proprietary claim in respect of the £1 million and its traceable proceeds. The question was whether LAHL could claim, through a constructive trust, a proprietary interest in what remained of the £1 million and its identifiable proceeds.

**Decision**

In order to assert a proprietary claim, LAHL needed to demonstrate, using the rules of tracing, that the defendants still held the £1 million paid by LAHL or its traceable proceeds. The common law rules of tracing were of no use to LAHL, as they do not permit a claimant to trace money if the claimant’s money has been mixed with money belonging to others – tracing at common law will inevitably fail if funds pass through an inter-bank clearing system.

The equitable rules of tracing are more flexible and do allow a claimant to trace into or through a mixed fund. In order to trace in equity, however, LAHL needed to establish a pre-existing fiduciary relationship. Prior to the payment of the £1 million to Mr Lee, there was no fiduciary relationship between LAHL and Mr Lee – “[t]hey had a purely commercial, arms length relationship. The question, therefore, is whether the circumstances surrounding the payment to, and retention by, Mr Lee of the £1 million gave rise to a trust of the £1 million in favour of LAHL. LAHL claims that the £1 million was received by Mr Lee on constructive trust for LAHL”.

The requirement of a pre-existing fiduciary relationship in order to trace at equity has been criticised by both the courts and academics. At present, however, it remains the law. The necessity of a pre-existing fiduciary relationship has led to the courts taking a rather inventive approach to discovering such a relationship. LAHL requested the court to take a similar approach in this case.

**Fraudster as constructive trustee**

First, LAHL argued that the defendants, as fraudulent recipients of its money, were fixed with a constructive trust by virtue of the fraud. LAHL relied on Lord Browne-Wilkinson’s judgment in Westdeutsche Landesbank Girozentrale v Islington LBC, in which it was said that “when property is obtained by fraud, equity imposes a constructive trust on the fraudulent recipient: the property is recoverable and traceable in equity”. As Etherton J noted, this passage has been the subject of considerable academic criticism and some judicial dissent – eg, Shalson v Russo. One of the key arguments against Lord Browne-Wilkinson’s analysis is that a fraudster typically does not obtain legal title to property stolen or obtained by fraud – if that is so, what is he holding on trust for the victim? Etherton J noted the differences of opinion on this issue, but declined to express a view on the matter.

**Payments made by mistake**

Secondly, LAHL argued that a constructive trust arose on receipt of the funds by Mr Lee, because it was paid pursuant to a mistake induced by fraudulent misrepresentation. In Chase Manhattan Bank NA v Israel-British Bank (London) Ltd, Goulding J took the view that where money was paid under a mistake, the mere receipt of the money constitutes the recipient a trustee, since the payer retains an equitable interest in the money and the conscience of the recipient is subjected to a fiduciary duty to respect that equitable right. Lord Browne-Wilkinson in Westdeutsche said that it was difficult to see how or why the recipient’s conscience could be affected if he was not aware of the mistake. He said, however, that the decision could be explained on the basis that it was the retention of the moneys after learning of the mistake (rather than the initial receipt of the funds) that fixed the recipient’s conscience with a constructive trust in favour of the payer. Even that analysis, however, has its difficulties and its critics. Again, Etherton J did not feel it necessary to express a view on the point on way or the other.

**Remedial constructive trust**

The artificiality of trying to discover a fiduciary relationship is one of the reasons cited by those in favour of the introduction of a remedial constructive trust in England. Although LAHL did not seek to argue for a discretionary remedial constructive trust, Etherton J nevertheless considered the issue, albeit briefly. He noted the difference between the institutional and remedial constructive trust, summarised above and in Westdeutsche. The judge continued:

> “The conventional view is that English law only recognises an institutional constructive trust. Any possibility of a remedial constructive trust was robustly rejected by Nourse LJ in Re Polly Peck International plc (No. 2) [1998] 3 All ER 812…"

On the other hand in Metal and Rohstoff AG v Donaldson Lufkin & Jenrette Inc [1990] 1 QB 391… the Court of Appeal… said that they were satisfied that there is a good arguable case that circumstances may arise in which the court would be prepared to impose a remedial constructive trust; and Lord Browne-Wilkinson in Westdeutsche … considered that the remedial constructive trust might be a suitable basis for developing proprietary restitutionary remedies, for example against a defendant who knowingly retains property of which the plaintiff has been unjustly deprived. The possibility of such a proprietary remedy was also left open by the Privy Council in Re Goldcorp Exchange Ltd [1995] 1 AC 74….”
The judge noted that one of the main arguments against the remedial constructive trust concept is that it would create uncertainty and unpredictability – the court would have an open-ended discretion to grant proprietary remedies, and could thereby retrospectively alter the property rights of the claimant, the defendant and third parties. The adverse implications for certainty in commercial transactions are obvious. Lord Millett and the late Professor Birks have both expressed opposition to the remedial constructive trust model (Birks has described it as “ugly, repugnant alike to legal certainty, the sanctity of property and the rule of law”), preferring to rely on the incremental development of the law in relation to unjust enrichment and/or resulting trusts to ensure that equitable proprietary remedies are available in appropriate cases, on a coherent legal basis.

Etherton J, while acknowledging these objections, appears to have had greater sympathy for the introduction of some form of remedial constructive trust. He noted that there were other areas of equity, such as proprietary estoppel, where the Court had a wide discretion to determine the appropriate form of relief, including whether it should be personal or proprietary in nature. Further, there was no binding authority in England against the remedial constructive trust in principle – the comments made in earlier cases were, in his view, all obiter. The judge accepted that the US or Canadian form of remedial constructive trust would be unlikely to be adopted in England, but said that “there still seems scope for real debate about a model more suited to English jurisprudence, borrowing from proprietary estoppel: namely, a constructive trust by way of discretionary restitutionary relief, the right to which is a mere equity prior to judgment, but which will have priority over the intervening rights of third parties on established principles, such as those relating to notice, volunteers and the unconscionability on the facts of a claim by the third party to priority”.

**Rescission of a voidable contract**

Ultimately, however, Etherton J did not feel it necessary to reach a concluded view on the remedial constructive trust question. This is because LAHL was able to establish the necessary trust relationship by another means – namely on the basis that the fraudulent misrepresentations of the defendants rendered the transfer of the £1 million voidable. Under a voidable contract, both legal and equitable title passes, unless and until the contract is avoided. As long as the transaction can validly be rescinded (e.g. there are no intervening third parties whose rights make rescission inequitable), the effect is to restore the equitable title in the property transferred back to the claimant and to impose a constructive trust on the defendant, thereby enabling tracing to take place and the proprietary claim to be made. The judge said that LAHL had validly rescinded the transfer, at the latest by issuing and serving the proceedings on the defendants. Accordingly, the judge ruled that Messrs Lee and Dolan held such of the £1 million as they retained, together with cars that they had purchased out of those funds, on constructive trust for LAHL, and that LAHL was also entitled to be subrogated to a bank’s charge over Mr Dolan’s property, the mortgage having been paid off using LAHL’s money.

**Concluding remarks**

While this case does not change the law in this complex area, it is a useful illustration of how these difficult equitable concepts and principles can be applied in cases involving the fraudulent misappropriation of funds. The judge’s observations about the possible introduction of a remedial constructive trust in England show that, while the theory is not currently part of our law, the argument as to whether it should in the future become so is certainly not over. The doubts expressed by the judge about fraud and/or mistaken payments as a basis for identifying a constructive trust reflect previous judicial and academic concern, and emphasise the need to think very carefully about possible alternative bases on which a proprietary claim can be asserted.

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**Footnotes**

1 [2007] EWHC 2061 (Ch)
2 [1996] AC 669
3 [2005] Ch 281
4 [1981] Ch 105