Equity’s new darling and the pitfalls of remedial absolutism

Elizabeth Houghton*

Abstract
This article considers the protection afforded to unsecured creditors in the context of equitable proprietary remedies. First, it argues that recent attempts to cater for hypothetical unsecured creditors when formulating a general rule are unprincipled and result in the interests of other innocent third parties being overlooked. Secondly, it is argued that the best way to accommodate third-party concerns in the context of fiduciary wrongdoing is through the exercise of remedial discretion. Such a framework would match the approach taken to discretionary considerations in the context of other equitable remedies such as injunctions and specific performance.

Introduction
For many decades, equity has been concerned with protecting the interests of unsecured creditors. Nowhere is this concern more evident than in cases involving the imposition of a constructive trust to remedy fiduciary wrongdoing. The courts’ concern for the interests of unsecured creditors permeates the well-known cases of *Lister v Stubbs*1 and *Attorney General for Hong Kong v Reid*.2 In both cases it was a significant consideration for the court but each came to opposite conclusions. In *Lister*, the impact on unsecured creditors was one important reason for the court’s refusal to grant a constructive trust. Conversely, in *Reid* the court concluded that an unsecured creditor could not be in a better position than his debtor, and so could not lay claim to an asset that his debtor was not entitled to. Accordingly, the court in *Reid* recognized a constructive trust existed over bribe monies taken by a fiduciary.

Concerns about the interests of unsecured creditors are not historical. The same issue was again a significant one recently before the Court of Appeal in *Sinclair v Versailles*,3 the Supreme Court in *FHR European Ventures v Cedar Capital Partners*,4 and in the Full Federal Court of Australia in *Grimaldi v Chameleon Mining*.5 Nor is the issue confined to the question of whether a constructive trust should be recognized in fiduciary wrongdoing cases. The concern also pervades the reasoning in other cases concerning proprietary remedies. For example, the position of unsecured creditors was also a concern for the Privy Council recently in *Brazil v Durant International*,6 a decision about ‘backwards tracing’.

It is therefore clear that the position of unsecured creditors is a longstanding and established fixture on the proprietary remedies landscape. One therefore should be able to articulate precisely why that protection is being afforded, its limits, and its strength relative to other interests. Unfortunately, the case law and the courts often accept without question the premise that a *hypothetical* unsecured creditor is deserving of

---

* Elizabeth Houghton, Barrister, Wilberforce Chambers, 8 New Square, Lincoln’s Inn, London WC2A 3QP, UK.
1. (1890) 45 Ch D 1, 15.
3. Sinclair Investments (UK) Ltd v Versailles Trade Finance Ltd [2012] Ch 453 (Sinclair) [54], [90], [128], [141].
4. FHR European Ventures LLP v Cedar Capital Partners LLC [2014] UKSC 45 (FHR) [1], [43]–[44]. In that case, the court overruled the decision in Sinclair (n 3), see [100].
5. Grimaldi v Chameleon Mining NL (2012) 200 FCR 296 (Grimaldi) [310] considering third parties more generally.

© The Author (2016). Published by Oxford University Press. All rights reserved.

doi:10.1093/tandt/ttw153
Advance Access publication 9 August 2016
protection, and in some instances, deserving of protection in a way that disadvantages equally innocent, and real, claimants.

Debates about proprietary remedies often proceed in such a blinkered fashion that one might be forgiven for thinking that unsecured creditors are the only third parties deserving of protection. But proprietary remedies by their very nature have the capacity to disrupt relationships and disadvantage many different types of third parties. The aim of this article is to propose a refocused approach in the fiduciary context that caters for both unsecured creditors and other deserving third parties in a principled and coherent manner. It is suggested that a fact-sensitive and flexible approach to third-party concerns would be better aligned to the approach adopted by other equitable remedies.

The current approach

There is a large web of case law dealing with the interests of unsecured creditors, but it suffices for present purposes to summarize only the current approach as set out by the Supreme Court in FHR. The criticisms which follow are not criticisms of that case alone, but rather of the general approach taken to accommodating concerns about unsecured creditors.

In brief, in FHR the Supreme Court held that an agent who receives a bribe or secret commission holds that bribe or secret commission on trust for his principal. In the course of reaching that decision the Court, as many courts have done previously, took into account the impact of the decision on unsecured creditors. The Court commenced its reasoning by noting that the decision between a proprietary remedy and a personal remedy was significant because of the impact on unsecured creditors in an (hypothetical) insolvency. This was deemed to be an important policy consideration even though the errant agent in FHR was not insolvent.

Later in the judgment, the Court said that while prejudice to unsecured creditors ‘has considerable force in some contexts, it appears to us to have limited force in the context of a bribe or secret commission’ for two reasons. First, the bribe or secret commission consists of property that should not be in the fiduciary’s estate at all. Secondly, the bribe or secret commission will very often have reduced the benefit obtained by the principal, and so can fairly said to be the principal’s property. The Court then concluded that arguments about potential prejudice to unsecured creditors were balanced by the fact that it was just for the claimant (the wronged principal) to have the advantages of tracing, which come with a proprietary remedy.

It is implicit in the reasoning of FHR, and the cases before it (except perhaps Reid), that the courts consider that possible damage to unsecured creditors is a legitimate concern and is a valid argument against a proprietary remedy, even if ultimately the court concludes that such a concern is outweighed by other considerations. In FHR, it is submitted that the Supreme Court ultimately reached the correct conclusion in holding that a constructive trust should be awarded on the facts of that case. However, the Court’s approach to unsecured creditors reveals a number of issues. It is important to address those issues before they become entrenched, and because concerns about unsecured creditors are not limited to cases involving fiduciary gains.

For the reasons that follow, I argue that the latitude given to potential unsecured creditors is unwarranted and disproportionate. Ultimately, if there are real unsecured creditors who would be prejudiced by the award of a proprietary remedy, they are best catered for through the exercise of judicial discretion in an individual case, not by modifying the general rule applicable in all cases.

If there are real unsecured creditors who would be prejudiced by the award of a proprietary remedy, they are best catered for through the

---

7. See the Court of Appeal decision FHR European Ventures LLP v Mankarious [2013] EWCA Civ 17 [14]
8. FHR (n 4) [43].
Four objections

At least four objections can be made to the current approach to accommodating the interests of unsecured creditors. To illustrate the difficulties with such an approach, I compare the protection afforded to unsecured creditors with that of ‘equity’s darling’: the bona fide purchaser for value without notice (BFP). The four issues are:

1. The plight of unsecured creditors is often used to influence (or to attempt to influence) the general rule, rather than being catered for as an exception.
2. The possible disadvantage caused to unsecured creditors is almost always a hypothetical concern because there will either be no question of insolvency and/or no actual creditors before the court who will be prejudiced.
3. The protection afforded to unsecured creditors elevates their interest because it ‘secures’ assets to the pot, which would not otherwise form part of the insolvent estate.
4. The primacy afforded to protecting unsecured creditors obscures the fact that there might be other equally deserving (and existing) third parties whose interests deserve protection.

These four issues reveal deeper concerns about the courts’ approach to proprietary remedies. The strict rule to be applied following the Supreme Court decision in FHR is that all benefits received by an errant fiduciary are held on trust for his principal. The rule applies in all cases, and does not permit any flexibility. It will be argued that such rigidity makes the rule poorly suited to cater for the variety of factual situations in which fiduciary wrongdoing occurs, and the even more varied benefits that might spring from such wrongdoing.

Exception not the rule

When fashioning remedies between a defendant (a trustee or fiduciary wrongdoer) and a claimant (their beneficiary or principal), it suggested that courts should first attempt to set down a general rule applicable in ‘two-party’ cases before looking to check the effect of that rule on third parties. An approach that attempts, at the outset, to fashion a rule applicable in every factual situation and that caters for the interests of all possibly interested parties is likely to be doomed to fail. In the case of unauthorized fiduciary gains, the court should set down a robust rule applicable between the wrongdoer and their principal before attempting to cater for any third-party interests.

The approach advocated but not accepted in FHR (but previously accepted in Lister and Sinclair) was that because there might be unsecured creditors who might be unfairly prejudiced by a rule that grants proprietary relief, the general rule should provide for a personal remedy only. Although the Supreme Court did not adopt this approach, it accepted that the argument made was a legitimate factor weighing against proprietary relief. It is suggested that this reasoning is erroneous because hypothetical third-party concerns should have no place in determining the ‘two-party’ rule.

By way of contrast it is worth considering the operation of the BFP rule. That rule is a defence to a claimant’s ability to assert a proprietary right.9 The rule operates to prevent an innocent purchaser of property from losing their interest if it is later revealed that vendor did not have good title to the property. However, the rule is applicable in three-party cases only, not in two-party cases. It has never been suggested that because a BFP might exist, a claimant should not be entitled to assert his proprietary rights or claim proprietary relief in circumstances where they would otherwise be entitled to do so.

---

9. Pilcher v Rawlins (1872) LR 7 Ch App 259, 268–69 (James LJ) ‘the case of a purchaser for valuable consideration, without notice, obtaining, upon the occasion of his purchase, and by means of his purchase deed, some legal estate, some legal right, some legal advantage ... is an absolute, unqualified, unanswerable defence, and an unanswerable plea to the jurisdiction of this Court.’
There are many different ways in which an errant fiduciary might benefit from his own wrongdoing: by obtaining bribes, secret commissions, business opportunities, advantageous information, and so on. Those varied factual situations may then in turn lead to a multitude of actual third parties (not just unsecured creditors) who may be disadvantaged by the imposition of a proprietary remedy. For example, in the Grimaldi case the Full Court of the Federal Court of Australia was concerned with the impact on innocent third-party shareholders and stakeholders who would be forced into an unwanted commercial relationship with the claimant principal if a constructive trust over shares arising from an ill-gotten corporate opportunity were granted. If there are third-party concerns to be addressed in any given case, those are best dealt with as a separate, and limited, discretionary inquiry. Such an approach benefits from clarity and avoids overloading the primary rule.

**Unsecured creditors are usually hypothetical**

When considering whether the interests of unsecured creditors should be a relevant concern in two-party cases, it must be remembered that, in such a case, those interests are often hypothetical. In any given dispute, there may be no affected third party. It would be extraordinary if, in determining the initial allocation of rights between an existing principal and their fiduciary, the interests of unrelated, and hypothetical, third parties were to influence the outcome. But that is precisely the approach that has been advocated and previously adopted. Even though the Court in FHR considered that the interests of possible unsecured creditors were outweighed by other factors, they nonetheless gave those (hypothetical) interests considerable weight.

Conversely, the BFP rule does not operate in the abstract to influence the initial allocation of rights as between a claimant and defendant. The rule is only relevant where there is in fact a concerned third party. The criticism made here is that hypothetical concerns should not be permitted to influence the general rule. Of course, courts should ‘test’ how a principle might operate against third parties if applied in other cases with different facts, but it should be a rare case where those hypothetical concerns are so overriding that they cause the court to re-consider the application of the general rule to the parties actually before the court. As set out above, even the BFP, equity’s darling, does not have such an influence.

The BFP rule does not operate in the abstract to influence the initial allocation of rights as between a claimant and defendant. The rule is only relevant where there is in fact a concerned third party

**Protecting unsecured creditors in a blanket way effectively provides some ‘security’ and thus elevates the interest held by an unsecured creditor**

It is trite to say that an unsecured creditor has no direct right to any specific asset within the insolvent pot. While a creditor may (if they have sufficient resources) make enquiries about the level of assets held by a debtor at the time they extend credit, there is no guarantee that a debtor will hold those same assets at the time of insolvency. Conversely, and equally tritely, a secured creditor’s interest is more protected because they have direct recourse to whichever asset or assets their interest is secured to.

Therefore, what can be unfair about an unsecured creditor being limited only to whatever assets are legitimately within the pool at the time of insolvency? By definition, that is precisely the interest they bargained and contracted for. An unsecured creditor will normally have no means of monitoring (let alone controlling) assets as they move in and out of a debtor’s control. Since an unsecured creditor cannot claim a direct right to any legitimately acquired asset, it follows that they cannot claim a direct right to an illegitimately acquired asset.

What can be unfair about an unsecured creditor being limited only to whatever assets are legitimately within the pool at the time of
Insolvency? By definition, that is precisely the interest they bargained and contracted for.

It might be argued in response to this that unsecured creditors are generally ‘small and poor’, and would prefer to have security but probably do not have the bargaining power to obtain it. While that is unfortunate, the response cannot be to artificially bring illegitimately acquired assets into the insolvent pot, thereby elevating the interest that the unsecured creditor has bargained for. I say that this approach would ‘elevate’ the interest held by an unsecured creditor because it essentially guarantees that ill-gotten fiduciary assets would form part of the available pot, whereas normally an unsecured creditor has no assurance that any particular asset (legitimate or otherwise) will be in the pot when it comes to enforcement.

The criticism above is aimed only at a rule that approaches unsecured creditors in a blanket and hypothetical manner. There may of course be situations in which a prudent unsecured creditor has extended credit on the assurance that an asset (which is in fact an ill-gotten fiduciary asset) is the legitimately owned property of the debtor, and while they have not had sufficient bargaining power to obtain security, they may extend credit in reliance on the strength of that asset. In such a case, the detriment to the individual unsecured creditor if a proprietary remedy were granted might be so great that a court might be persuaded that a proprietary remedy would be inappropriate. The factsensitive nature of the inquiry demonstrates why third-party interests cannot be effectively catered for by an all-encompassing and inflexible rule. They are much better dealt with on a discretionary basis.

Finally, there is an inherent inconsistency in attempting to treat concerns about unsecured creditors within the general rule (as a factor which supports denying proprietary relief at the outset) while relegating concerns about other third parties, with stronger proprietary rights, to a separate secondary inquiry. BFP are owners of assets and therefore should have stronger proprietary rights than unsecured creditors. It would be peculiar if the lesser interest (that of unsecured creditors) were permitted to influence the default rule in two-party cases when the more substantial BFP interest only acts as a limitation on tracing in three-party cases.

Ignoring other third parties worthy of protection

In addition to the issues outlined above, the fixation with protecting the interests of unsecured creditors is problematic because it overlooks the interests of other deserving third parties. Unsecured creditors are not the only third parties who might be affected by a proprietary remedy, but they are the consistent focus of commentary and case law.

For example, as set out above, the Full Federal Court of Australia in Grimaldi was concerned about the effect of the decision on existing third-party shareholders and stakeholders. The effect of a proprietary remedy would have been to force those third parties into unwanted commercial relationships for which neither party had bargained and for which the wronged principal had not invested any capital nor taken on any initial risk. The significant disadvantage that would have been caused to those parties was sufficient for the court to depart from the general rule, and exercise its discretion to refuse to award a constructive trust. That example demonstrates that the singular focus on hypothetical unsecured creditors risks overlooking the prejudice or advantage that might be caused to other equally innocent third parties.

Despite the emphasis the Supreme Court in FHR placed on ‘harmonising the development of the common law round the world’, and citing the Grimaldi case with apparent approval, it did not engage with the fact that an English court confronted with the Grimaldi facts would be bound by FHR to award a constructive trust, whereas the Australian court was persuaded by third-party concerns to refuse one.


11. Grimaldi (n 5) [672]–[681].
Remedial absolutism

The issues outlined above suggest that courts should take a more nuanced approach to the interests of third parties in cases involving fiduciary wrongdoing. Such an approach would sit comfortably alongside the discretionary principles applicable to other equitable remedies, such as specific performance and injunctions. In those cases, the Court is unashamed about the important role played by discretionary factors. The inflexible approach taken by the Supreme Court in FHR is therefore an anomalous one in the wider context of equitable remedies.

In support of the FHR approach it has been said that remedial discretion is inappropriate because ‘there must at least be a serious argument that judges should not go around altering property rights and property ownership’. That concern seems to disregard the fact that equitable remedies such as specific performance and injunctions often do alter or impact on established property rights. One example is the constructive trust imposed on a vendor in a contract for the sale of land, where that contract is capable of being specifically enforced. Another example arises in the context of proprietary estoppel where a defendant causes a claimant to believe they would acquire an interest in property, and the claimant has acted on that representation to their detriment, the defendant is estopped from denying that interest. In such a case, the court has a discretion to grant proprietary relief. In addition, there have been suggestions that a constructive trust might be available in response to a breach of confidence and that such relief might be discretionary. In the statutory context, there are many examples of the courts power to vary property rights. Although it is acknowledged that the same objections might not apply where the power to vary property rights is ‘sanctioned by statute’, the fact remains that the courts are familiar with remedies that alter property rights, and judges are well equipped to deal with fact-sensitive inquiries and discretionary considerations.

It has been noted that equity attempts to ‘do more perfect and complete justice’ than would result if parties were left to their remedies at common law. This guiding principle permeates considerations about equitable remedies generally, and it is suggested should apply equally in the fiduciary gains context.

The FHR rule is a blunt instrument in the remedial sphere and lacks the agility to respond to the many and varied situations in which unauthorized fiduciary gains can occur. In addition, the rule sits uncomfortably with the discretionary nature of many other equitable remedies. A better approach would be to start with proprietary relief as the general rule, but permit a limited equitable discretion to refuse proprietary relief where it would be inappropriate in the circumstances.

Elizabeth Houghton is a barrister at Wilberforce Chambers, London. Her practice includes a wide range of trust, fiduciary, commercial, regulatory and property disputes. E-mail: ehoughton@wilberforce.co.uk

13. See Lord Neuberger ‘The Remedial Constructive Trust – Fact or Fiction’ (Banking Services and Finance Law Association Conference, Queenstown, delivered 10 August 2014) [27].
17. For example, s 14 of the Trusts of Land and Appointment of Trustees Act 1996 (UK) (property settlements in de facto relationships); s 24(1)(c) Matrimonial Causes Act 1973 (variation of ‘nuptial settlements’), see also BJ v MF [2011] EWHC 2708 (Fam) and Ben Hashem v Al Shayif [2009] 1 FLR 115 [290] describing the court’s discretion under s 24(1)(c) as ‘both unfettered and, in theory, unlimited’.
18. Lord Neuberger (n 13).