Proprietary Remedies in Insolvency: A Comparison of the Restatement Third on Restitution and Unjust Enrichment with English and Commonwealth Law

By

Anthony Duggan *

1. Introduction

At its Annual Meeting in May, 2010, the American Law Institute approved the Restatement of the Law Third Restitution and Unjust Enrichment in its final form. The vote marked the end of a project that had run for more than ten years and that involved the progressive release and revision of seven tentative draft documents under the direction of Reporter, Professor Andrew Kull. The Restatement covers every aspect of the law of restitution, drawing together a wide range of doctrines and principles and exploring the inter-face between restitution and other parts of private law, including contract, tort, property and the law of fiduciary obligations. To borrow ALI Director Lance Liebman’s words, we can see in the Restatement “a structure that holds together – as if this were natural and not manmade – an extraordinary variety of legal disputes and legal doctrines”.1 The Restatement traverses a host of “[fascinating] legal controversies” and it sends an important message about “the continued vitality of the common law as a vehicle for applying contemporary values to provocative disputes”.2

The Restatement also serves an important educational function because as Kull himself has remarked, “scarcely anyone in the United States understands what restitution is about …most law schools gave up teaching restitution a generation ago, and many judges and practitioners are not familiar with its general principles.”3 This regrettable state of affairs

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1 Foreword to Restatement of the Law Third Restitution and Unjust Enrichment (hereafter, “Restatement”), Tentative Draft No.6 (March 12, 2008).
2 Lance Liebman, Foreword to Restatement, Tentative Draft No. 4 (April 8, 2005).
has important implications for commercial law at large and bankruptcy law in particular, because “lack of familiarity with the restitutionary elements of the background [commercial law rules] results in a predictable distortion of commercial law”. 4 Liebman predicts that “lawyers, judges and professors will use [the Restatement]”.5 He seems to have a mainly United States audience in mind, but there is also much lawyers in other common law countries could learn from the Restatement. It has become common for courts in England, Australia, Canada and New Zealand to look to one another’s case law for guidance, but reliance on United States law is much less common. In the same connection, private law scholarship in Australia, New Zealand and to a lesser extent Canada is markedly Anglo-centric in focus, and there is a tendency to overlook the wealth of United States case law and literature on nearly any given topic. In the area of restitution and unjust enrichment, this blind spot is especially puzzling, given that the now global restitution movement originated in the United States with Seavy and Scott’s ground-breaking work on the first restatement on restitution.6

One of the many topics the Restatement covers is proprietary remedies for claims in restitution and their status in the defendant’s insolvency.7 This was one of the last parts of the project to be completed. It spanned two tentative drafts – numbers 6 and 7 – published on March 12, 2008 and March 12, 2010, respectively. Coincidentally, Richard Calnan, an English lawyer, happened to be writing a book on the same topic during this very period and Calnan’s work was published around the time of ALI’s 2010 Annual Meeting.8 There is no reference to the Restatement in Calnan’s book and, likewise, the Restatement makes no reference to Calnan. This may be some confirmation of the blind spot mentioned above, though to some extent it is probably also an accident of timing. In any event, the appearance of Calnan’s book at around the same time the finishing touches were being put to the Restatement was the inspiration for this paper. My aim is to

4 Ibid.
5 Op.cit. note 1, above.
6 Restatement of the Law, Restitution (1937).
7 See Restatement, Chapter 7, Topic 2.
compare English and Commonwealth law on proprietary remedies, drawing substantially on Calnan’s account, with the American position, as found in the Restatement.

The topic raises one of the most vexing questions in the law of obligations. It involves the interplay between two fundamental principles of insolvency law: (1) the pari passu sharing principle, which establishes that unsecured creditors are entitled to equal treatment in a debtor’s bankruptcy;\(^9\) and (2) what might be called the property of the estate principle, which holds that the property available for distribution among creditors is limited to the debtor’s own property at the date of the bankruptcy and does not include assets belonging to others.\(^10\) The application of these principles, in turn, depends on the distinction between personal and proprietary rights and the problem is that, in a common law system, this is not a straightforward exercise because equity blurs the boundaries. So the positive challenge is to identify the factors which motivate courts of equity to recognize proprietary claims, while the normative challenge is to identify those cases in which it is appropriate, as a policy matter, to give the claimant a proprietary interest.

The following discussion is organized around 5 simple hypotheticals, each representing fact patterns which courts in England and other parts of the Commonwealth have found particularly troubling. My aim is to identify the likely outcome of each case under both American and English - Commonwealth law and to explore the policy implications of differences that may emerge. The hypotheticals are grouped under five broad headings:

\(^9\) See Restatement, s.60, Comment f (U.S. law); Calnan, ibid. at para.1.10:
“The pari passu sharing principle is one of the main tenets of insolvency law, and has been so for centuries. The expression (which means, literally, ‘in equal steps’) establishes that, at least as the general rule, all creditors are equal. It is normally given in its Latin form, and is rarely translated into the vernacular. Perhaps this is because a reference to ‘equal’ sharing might be misleading. Each creditor is not entitled to an equal amount. His entitlement is to be paid the same proportion of his debt as the other creditors. If creditor A is owed 100, and creditor B is owed 50, equality of treatment will require A to receive twice as much as B. It is perhaps this ambiguity in the meaning of ‘equality’ which has led us to retain the use of the Latin tag at a time when it is no longer fashionable to use them, even amongst lawyers” (English law).

\(^10\) See Restatement, s.60, Reporter’s Note on Comment b: Priority in restitution: “claims of creditors (whether voluntary or involuntary) must be satisfied from property of the debtor, not from property of someone else in the debtor’s possession (U.S. law); Calnan, op.cit. n.6 supra, para.1.62: “the pari passu sharing principle requires the assets of a debtor to be applied in discharge of his liabilities pari passu. It is a fundamental element of this principle that it is the debtor’s assets which are to be used for this purpose, not those of other persons” (English law).
mistake (Part 2, below); misrepresentation (1) (Part 3); misrepresentation (2) (Part 4); wrongful gains (Part 5); and specific performance (Part 6). Part 7 concludes.

Part 6 deserves a further word of explanation. The Restatement does not discuss specific performance in any detail because, by definition, specific performance is not a restitutionary remedy. However, specific performance is conceptually the mirror-image of rescission - in the sense that specific performance, by completing the contract, delivers to the claimant the asset he paid for while rescission, in unmaking the contract, restores to the claimant the value she parted with in the course of performance.\textsuperscript{11} Furthermore, the constructive trust remedy is commonly associated with both rescission claims and claims for specific performance and the Restatement does deal at length with the constructive trust.\textsuperscript{12} For these reasons, any discussion of proprietary remedies in insolvency would be incomplete without some reference to specific performance even if this involves straying beyond the limits of the restitution project.

Incidentally, there is a salutary reminder here. The restitution project is an exercise in what Stephen Waddams has called the “mapping of legal concepts”, namely the schematic classification of private law into discrete subject areas – contract, tort, property and so on - by reference to characteristics which unify some cases and distinguish others.\textsuperscript{13} Mapping serves an important organizational function; it assists our understanding of the law by dividing the overall mass into manageable chunks and, perhaps more importantly, by making connections that might otherwise have escaped our attention. But, by the same token, as Waddams points out, mapping carries a degree of risk because, in any classification scheme, there is a tendency to treat the divisions as exhaustive and mutually exclusive.\textsuperscript{14} In real life, legal problems commonly traverse subject boundaries and, in such cases, too rigid a classification scheme may be an

\textsuperscript{11}See Restatement, s.55, Comment \textit{e}: Recission as a remedy for breach of contract: “when rescission affords an alternative remedy for breach of a valid and enforceable contract …[it] permits the injured party to make a fundamental election, choosing to go backward (to the status quo ante) instead of forward (by enforcement of the contractual exchange).”
\textsuperscript{12}Ibid. s.55.
\textsuperscript{14}Ibid. at p.11.
obstacle to a comprehensive understanding of the issue. To avoid this risk, we must constantly remind ourselves that the boundaries we draw are not fixed; that, for example, a contract problem may also engage elements of tort law, or - returning to the subject at hand - that a remedies question may traverse any given set of legal classifications (restitution, contracts, property, equity, bankruptcy law, and so on). More specifically, while the constructive trust may be part of the law of restitution, it is not exclusively a restitutionary remedy and it may serve a contract enforcement function as well.

2. Mistake

Case 1. Bank A makes a transfer of $1 million to Bank B by mistake. Bank B goes into bankruptcy before Bank A can recover the money. The payment is still identifiable in Bank B’s hands. Can Bank A claim a constructive trust over the funds?

(a) The Restatement

Case 1 is based on Chase Manhattan Bank v. Israel British Bank. Comparable American cases include Simms v. Vick and Amalgamated Ass’n v. Danielson. The answer to the question matters because if Bank A’s claim succeeds, it will recover payment of the disputed funds in full ahead of Bank B’s other unsecured creditors. If Bank A’s constructive trust claim fails, at best it will have a personal claim for recovery of the payment which will rank pari passu with other unsecured claims in Bank B’s bankruptcy. The governing Restatement provisions are ss 6, 55 and 60, which provide, in relevant part, as follows.

15 Ibid., Chapter 2.
16 Robert Chambers, “Constructive Trusts in Canada” (1999) 37 Alberta Law Review 173. See also Restatement, s.55, Comment i: Constructive trust as specific performance
19 24 Wis.2d 33, 128 N.W. 2d 9 (1964).
s.6. Payment of Money Not Due

(1) Payment of money to one who is not the intended recipient, or payment when no payment is intended, gives the payor a claim in restitution against the recipient.

(2) Payment of money resulting from a mistake as to the existence or extent of the payor’s obligation to an intended recipient gives the payor a claim in restitution against the recipient to the extent the payment was not due.

s.55. Constructive Trust.

(1) If a recipient is unjustly enriched by the acquisition of legal title to specifically identifiable property at the expense of the claimant or in violation of the claimant’s rights, the recipient may be declared a constructive trustee, for the benefit of the claimant, of the property in question and its traceable product.

s.60. Priority

(1) Except as otherwise provided by statute and by s.61, a right of restitution from identifiable property in the hands of the recipient is superior to the competing rights of a creditor of the recipient who is not a purchaser for value of the property in question. Acquisition of a judicial lien (by attachment, garnishment, judgment, execution, or the like) does not make the lien creditor a purchaser of the property subject to the lien.

Section 6 establishes that, on the facts of Case 1, Bank A has a claim in restitution against Bank B. Section 55 establishes that, provided the disputed funds are specifically identifiable in Bank B’s hands, Bank A is entitled to constructive trust relief. Section 60 establishes that Bank A’s constructive trust claim has priority over Bank B’s trustee in bankruptcy, given that the trustee is not a purchaser for value of the property in question. The trustee acts as the representative of the general creditors and so she stands in the same position as they do relative to Bank A’s claim. The general creditors, in turn, are not purchasers for value because: (1) with the exception of judicial lien creditors (or execution creditors, as they are known in England and other parts of the Commonwealth), an unsecured creditor has no claim to any particular asset belonging to the debtor; and (2) a judicial lien creditor may have a claim to the disputed asset, but the judicial lien is an involuntary transaction and so the creditor does not qualify as a purchaser for value. 21

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20 As to which, see further text at nn 49-54, infra.
21 Restatement, s.60, Comment b.
Restatement, s.60, Illustration 1, which is analogous to Case 1, above, confirms this analysis:

Broker’s accounts indicate that Customer has a credit balance of $25,000 when the true balance is zero. Broker thereafter remits $15,000 at Customer’s request. By the time the mistake comes to light, Customer is in bankruptcy. Applying the tracing rules of s.59…, Broker is able to identify the $15,000 paid by mistake in the closing balance of Customer’s bank account.Broker asserts a right to recover the $15,000 via a constructive trust (ss 6…, 55 …, 59). Bankruptcy Trustee opposes Broker’s claim arguing that restitution to Broker would be unfair to Customer’s general creditors. Because the rights of Customer’s creditors (or of Trustee as their representative) in the property of Customer cannot exceed the rights of Customer himself, Broker is entitled to restitution of $15,000 in priority to the claims of the general creditors.22

The purpose and effect of the constructive trust remedy in cases like this is to give the claimant priority over the insolvent defendant’s general creditors. What justifies this special treatment? According to the Restatement, the main argument rests on the property of the estate principle: “claims of creditors (whether voluntary or involuntary) must be satisfied from property of the debtor, not from property of someone else in the debtor’s possession”:23 In re Berry,24 on which Illustration 1, quoted above, is based, provides support for this proposition:

It is urged that to compel restitution now will work injustice to the general creditors of the bankrupts, but this contention loses sight of the fact that the money in dispute never belonged to the bankrupts, and their creditors, upon broad principles of equity, have no more right to it than if the transaction of November 25th had never taken place. If the trustees succeed on this appeal the creditors will receive $1,500, the equitable title to which was never in the bankrupts. There can be no doubt of the fact that the payment to Berry & Co. was a mistake and that by reason of this mistake the trustees have in their possession $1,500 which, otherwise, they would not have. The proposition that Raborg & Manice, who have done no wrong, shall be deprived of their property and that it shall be divided among creditors to whom it does not fairly belong, is not one that appeals to the conscience of a court of equity.25

The trouble is that this rationalization begs the question by presupposing an equitable proprietary interest in the claimant. The passage anticipates Cardozo J.’s famous

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22 See also Restatement, s.60, Illustration 13 which is to similar effect.
23 Restatement, s.60, Reporter’s Note on Comment b: Priority in restitution.
24 147 F.208 (2d Cir.1906)
25 Ibid. at 210, quoted in Restatement, s.60, Reporter’s Note on Comment b: Priority in restitution.
A constructive trust is the formula through which the conscience of equity finds expression. When property has been acquired in such circumstances that the holder of the legal title may not in good conscience retain the beneficial interest, equity converts him into a trustee.

But this statement does not advance matters very far because it fails to specify the circumstances affecting the conscience of the legal title-holder. In relation specifically to the facts of Case 1, why is it unconscientious for Bank B’s trustee to retain the beneficial interest in the disputed funds? The answer cannot be that the funds belong in equity to Bank A, because that is the very question at issue. So if there is an answer, it must be sought outside the parameters of Cardozo J.’s statement.

A suggestion commonly advanced in the academic literature is that Bank A qualifies as an involuntary creditor, in the sense that, because it made the payment by mistake, it did not voluntarily accept the risk of Bank B’s insolvency, and this distinguishes its claim sufficiently from the claims of ordinary unsecured creditors to justify giving it priority.

Of course, there are other kinds of involuntary creditor, of which tort claimants are the most prominent example, who, as the law presently stands, do not enjoy priority in the defendant’s insolvency, and this prompts a further inquiry into the distinguishing characteristics of Bank A’s claim relative to other involuntary creditors. One possible response is that Bank A’s claim rests on the twin pillars of: (1) its status as an involuntary creditor; and (2) the fact that the disputed funds are specifically identifiable as the product of Bank B’s unjust enrichment. The Restatement appears to endorse this explanation in the following passage:

Priority in this three-way contest may be explained without reference to formal notions of title. Even if A’s suit for restitution is formally asserted against B as

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26 122 N.Y. 378 (1919)
27 Restatement, s.55, Comment a: General principles and scope; relation to other Sections.
30 Ibid. See also Kull, op.cit. note 3 at p.282.
recipient, A’s implicit claim – to justify in equitable terms the remedy of constructive trust – is that B’s voluntary and unsecured creditor C will be unjustly enriched, at A’s expense, if B’s debt to C is satisfied from assets that B obtained from A by fraud [or mistake]. The intuitive objection is that a debtor should not be allowed to rob Peter to pay Paul. Underlying this intuition is the distinction between C’s voluntary extension of credit and the defective transaction that underlies A’s claim in restitution.31

The statement is couched in terms of a contest between A and C, but it applies, mutatis mutandis, to the case where A’s dispute is with B’s trustee in bankruptcy. This version of the argument is subject to the same logical difficulty as the original argument; it rests partly on the proposition that A is an involuntary creditor, but to distinguish A from other involuntary creditors it invokes the robbing Peter to pay Paul metaphor. However, the validity of this characterization depends on the assumption that A has a proprietary interest in the first place which is independent of its status as an involuntary creditor.32

(b) English and Commonwealth law

The leading case on point in England and the Commonwealth is Chase Manhattan Bank v. Israel British Bank.33 It was common ground in the proceedings that the governing law was the law of the State of New York, but Goulding J. took New York and English law to be the same, holding that:

A person who pays money to another under a factual mistake retains an equitable property in it and the conscience of that other is subjected to a fiduciary duty in respect of his proprietary right.34

The court relied on both English and American authority in support of this conclusion, including In re Berry.35 It also quoted with approval Story’s proposition that “the recovery of money which consistently with conscience cannot be retained is, in Equity,

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31 Restatement, s.55, Comment d: Constructive trust as a means to priority (emphasis added).
34 Ibid. at p.119.
sufficient to raise a trust in favor of the party for whom or on whose account it was received”, 36 and Scott’s statement that “where chattels are conveyed or money is paid by mistake, so that the person making the conveyance or payment is entitled to restitution, the transferee or payee holds the chattels or money upon a constructive trust”. 37

In the later House of Lords decision, Westdeutsche Landesbank Girozentrale v. Islington London Borough Council 38 - which was not itself a mistaken payment case - Lord Browne-Wilkinson made some observations in passing about the Chase Manhattan Bank case, pointing out that a constructive trust could only be awarded if the payee bank’s conscience was affected which, in turn, would require proof that it was aware of the mistake. 39 He concluded by saying that, “although I do not accept the reasoning of Goulding J., Chase Manhattan may well have been rightly decided. . . Although the mere receipt of the moneys, in ignorance of the mistake, gives rise to no trust, the retention of the moneys after the recipient bank learned of the mistake may well have given rise to a constructive trust”. 40 This qualification is significant because by the time the payee bank’s conscience is affected by notice of the mistake, “the specific proceeds of the payment might have ceased to be identifiable among [its] assets” and “the constructive trust would fail unless the subject-matter which it was to bind could be identified”. 41

In summary, English case law remains unsettled: the Chase Manhattan Bank case was only a first instance decision while Lord Browne-Wilkinson’s statement in the Westdeutsche case amounts at best to qualified support for the earlier decision and it substantially limits its application. Among the more recent first instance cases, which go both ways, 42 Papamichael v. National Westminster Bank 43 is noteworthy for the following statement:

36 Joseph Story, Commentaries on Equity Jurisprudence , 2d ed, vol.2 (Boston, Little, Brown, 1839) at para.1255
39 Ibid. at pp 714-715.
40 Ibid.
42 See Calnan, op.cit. note 8, supra, at para.4.161.
Regardless of what they might actually do in practice, I fancy that most people who had been paid too much change would regard the excess as belonging to the mistaken payer. Similarly, where a bank accidentally credits an account with money not due to the account holder, (mild schadenfreude apart) most people would regard the credit as being that of the bank …[I]t is obvious that someone who pays money by mistake stands on a different footing from a supplier who knowingly takes the risk of non-payment and often obtains security against that danger. Perhaps more to the point, once one allows of the fact that assets may be subject to a constructive trust where acquired in breach of a fiduciary relationship, I cannot see a distinction in principle that would preclude a trust arising where they have been acquired in consequence of a mistake.\(^{44}\)

If this view were to prevail, English law would stand on much the same footing as the Restatement’s account of the American position. However, the English case law – such as it is – has not been free from criticism and at this point it cannot safely be predicted what direction it might eventually take. Calnan argues that the \textit{Chase Manhattan Bank} case was wrongly decided, as a matter of both law and policy, and that in disputes like Case 1, Bank A should have only a personal claim for recovery of its payment. In the first place, he points out that there are two types of case: (1) where A’s mistake is induced by B, for example by misrepresentation, duress or undue influence; and (2) cases – like the \textit{Chase Manhattan Bank} case – where A’s mistake was self-induced. In a Type (1) case, A can rescind the contract and reclaim legal or beneficial title to the disputed asset, but in a Type (2) case, as a general rule rescission is not available.\(^{45}\) An unexercised right of rescission gives the claimant “a mere equity” in the disputed asset.\(^{46}\) A mere equity falls short of beneficial title, which revests only upon rescission.\(^{47}\) In a Type (1) case, it would be inconsistent with this distinction to conclude that A retains or acquires a fully fledged equitable interest from the outset, while in a Type (2) case, creating an equitable interest

\(^{44}\) \textit{Ibid.} at pp 372-373.
\(^{45}\) \textit{Ibid.} at para.4.114.
\(^{46}\) \textit{Latec Investments v. Hotel Terrigal} (1965) 113 C.L.R. 265 (High Court of Australia).
\(^{47}\) Specifically, beneficial title can be defeated by a \textit{bona fide} purchaser of the legal estate for value and without notice of the equitable claim, whereas in the case of a mere equity, the \textit{bona fide} purchaser rule is not limited to the case where the purchaser acquires legal title: Calnan, \textit{op.cit.}, note 8, \textit{supra} at para.4.89. American law also recognizes the concept of a “mere equity” in cases involving voidable title: Kull, \textit{op.cit.} note 3, \textit{supra} at pp 281-282; but the distinction between “equities” and “equitable interests” seems to have been elided: \textit{ibid.} at p.265, where the expressions are used interchangeably.
in A’s favor “would be to give a better remedy to someone who has made his own mistake than would be given to someone whose mistake has been induced by another”. 48

Furthermore, the Chase Manhattan Bank case – like Case 1, above – involved the transfer of what Calnan refers to as “bank money”, as opposed to “chattel money”. By the transfer of “chattel money”, he means the physical delivery of bank notes or coins by the payer to the payee. By the transfer of “bank money”, he means the transfer of funds, normally by electronic funds transfer, from the payer’s bank to the payee’s bank. 49 The difference is that, in the case of a transfer of chattel money, property passes by assignment from the payer to the payee. But in the case of a transfer of bank money, the payment by the payer to the payee is effected by set-off. If the payer’s bank happens also to be the payee’s bank, the netting exercise will be a bilateral one. “Where the payer’s account is in credit, the payer authorizes the bank to pay the payee and to reduce the amount it owes to the payer by a corresponding amount. To the extent of the amount of the payment, the debt owing by the bank to the payer is extinguished, not transferred. What the payer obtains is a new direct right against the bank for a corresponding amount, not a right over a debt owing by the bank to the payer”. In other words, there is a novation, not an assignment. 50 If the parties have different banks, the netting exercise will be a multilateral one. “Multilateral netting involves a contractual arrangement between the parties whereby they agree to release claims against the others in consideration for a net claim against, or liability to, one or more of the other parties. No property passes hands.” 51

The implication of this analysis is that, in a mistaken payment case involving the transfer of bank money, B does not receive A’s asset and so, contrary to what Goulding J. said in the Chase Manhattan Bank case, there is no basis on which A can be said to have

48 Calnan, op.cit. note 8 supra at para.4.116. See also paras 4.121-4.124.
49 Ibid. at paras 4.15 et seq.
51 Calnan, op.cit. note 8 supra, at para.4.34. See also Fox, op.cit. note 41 supra, paras 5.10-5.22.
“retained an equitable property” in the money. The only basis on which A could obtain an equitable proprietary interest would be if the court were to confer one on him by imposing a remedial constructive trust. However, it is still not settled whether the remedial constructive trust is available in England, while there is authority to the effect that, whatever the answer to this question, a remedial constructive trust cannot be imposed if the defendant is insolvent. More fundamentally, while “there is no doubt that the crediting of B’s account represents value received by B which can form the subject matter of a personal claim for repayment[,] B has not received A’s asset and therefore the imposition of an equitable proprietary interest involves the establishment of a constructive trust over an asset which A has never owned”.

This aspect of Calnan’s analysis leads to the troubling conclusion that A’s rights may vary depending on whether the payment happens to have been made in bank money or chattel money. By contrast, David Fox argues that “the law should aim for functionally equivalent outcomes regardless of the payment method.” He goes on to suggest that the solution lies in applying to bank money transfers the tracing rule that property rights can be created in substituted assets which are obtained in an unauthorized exchange:

“To the extent that [A’s] decision to transfer the funds represented by the original chose in action is vitiated, it can be said that the substitution of the funds in [B’s] account for the funds originally in [A’s] account was unauthorized by [A]. [A] accordingly takes a title to the traceable proceeds in [B’s] bank account. [B’s] primary legal title to the proceeds is taken subject to [A’s competing title] arising

52 Ibid. at para.4.126. In the Chase Manhattan Bank case, the payment was made by electronic funds transfer and the question was raised whether the plaintiff could identify any particular assets to which a constructive trust might attach. Goulding J. dismissed the suggestion saying simply that “when equitable rights are in question, the court does not encourage fine distinctions founded on the technicalities of financial machinery”: [1981] Ch. 105 at p. 121 quoted in Calnan, op.cit. supra note 8 at para.4.145. As mentioned above, In re Berry 147 F.208 (2d Cir.1906) was one of the cases relied on in Chase Manhattan, but the decision in Berry proceeds on the assumption that the transfer of bank money is analogous to the transfer of chattel money: Calnan, op.cit. supra note 8 at para.4.144.

53 Re Polly Peck (No.2) [1998] 3 All ER 812, discussed in Calnan, op.cit. note 8 supra, at paras 1.89-1.92. The position is the same in other parts of the Commonwealth, with the exception of Canada which does recognize a remedial constructive trust along the lines of the American model: Pettkus v. Becker (1989) 117 D.L.R. (3d) 257 (SCC).

54 Calnan, op.cit. note 8 at para.4.126.

55 Fox, op.cit. note 41, supra at para.1.101.
through the unauthorized substitution. If [A] elects to enforce [its] title, [it] may enforce a proprietary claim to the proceeds”. 56

However, the practical significance of this proposition is limited in mistaken payment cases because the enforcement of A’s proprietary claim depends on the proceeds remaining traceable and, as Fox acknowledges:

“The consequence of the limitations imposed on the Chase Manhattan case by the House of Lords in [Westdeutsche] is that there are now likely to be insuperable obstacles to applying the reasoning in Chase Manhattan to mistaken payments made through a payment mechanism. In most instances, a mistaken payment would not be traceable unless the beneficiary realized the mistake as soon as the money was credited to his or her account.” 57

Calnan says that “the absence of a proprietary remedy should not come as any surprise. A will have a personal remedy against B for a mistaken payment, and there seems to be no reason why he should also have a proprietary remedy.” 58 As for the involuntary creditor argument, 59 Calnan points to “the difficulty of trying to rank creditors by reference to how worthy they are to receive payment from the debtor”. It is not self-evidently true, he suggests, that a person who has deliberately provided credit to the debtor should rank behind someone who has not, or that a restitutionary claimant should always take priority over a contractual one. Moreover, giving restitutionary claimants special treatment opens the door for other types of creditor to claim priority (for example, tort victims or claimants with special needs), but adjudicating such claims is likely to be expensive and time-consuming to the detriment of the creditors collectively. 60 The advantage of the pari passu principle “is not that it provides perfect justice but that it enables there to be a fair distribution of the assets of the debtor amongst his creditors in a reasonably fair and straightforward (and therefore cost-effective) way”. 61


57 Fox, op.cit. note 41, supra at para.5.144.

58 Calnan, op.cit. note 8, supra at para.4.127.

59 See text at note 29, supra.


61 Ibid. at para.1.152.
(c) Discussion

If the function of a restatement is to set out the law as it is, rather than to suggest what the law should be, it is hard to quarrel with the Restatement’s treatment of the mistaken payment question. As the Restatement itself points out, American law on Case 1-type disputes is well settled in A’s favor: the availability of constructive trust relief for mistaken payment claims and the like was a “legal commonplace” even at the time of Cardozo J.’s statement, while the constructive trust’s priority in insolvency proceedings engages a dispute which “is not decades but centuries old. [I]t is the contest between the judgment creditor and the holder of a prior equitable interest affecting the judgment debtor’s apparent title to property. As a matter of non-bankruptcy law, the outcome of this contest is not in doubt”, while Federal bankruptcy law has typically recognized state law property rights and there is nothing in the history or text of the current Bankruptcy Code to upset this tradition. “This is not to say that the choice made by the courts is self-evidently desirable as a matter of policy”, but it is up to Congress to eliminate A’s priority if it thinks necessary. Some American courts have accepted policy arguments similar to Calnan’s, denying constructive trust relief in the defendant’s bankruptcy on the ground that it violates the pari passu principle. True to form, the Restatement criticizes these aberrant case law developments, not explicitly on policy grounds but, rather, because they fly in the face of settled case law and because there is no legislative basis for them in the Bankruptcy Code.

A principal justification for the constructive trust remedy in mistaken payment cases is that the disputed funds belong in equity to the payer and so limiting the payer to a personal claim in the defendant’s bankruptcy would be “robbing Peter to pay Paul”. As discussed above, the weakness in this argument is that it begs the question concerning the

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63 Restatement, s.55, Reporter’s Note, a. General principles and scope; relation to other sections.
64 Restatement, s.60, Comment f: Restitution in bankruptcy.
65 E.g., XL/Datacomp, Inc. v. Wilson (In re Omegas group Inc.) 16 F.3d 1443 (6th Cir. 1994): “constructive trusts are anathema to the equities of bankruptcy since they take from the estate, and thus directly from competing creditors, not from the offending debtor” (at p.1452); for a critical analysis of the case, see Kull, op.cit. note 3 supra.
existence of the payer’s title. However, this feature is not unique to the mistaken payment context. Equitable proprietary interests rest on the maxim that “equity deems as done what ought to be done” and the application of this maxim inevitably results in arguments that are question-begging, conclusory or circular. Even the most familiar of equitable entitlements, such as the interest of a trust beneficiary and the mortgagor’s equity of redemption, are subject to these logical infirmities. What happens is that, with the passing of time and the accumulation of case law, the logical infirmities end up being forgotten, *stare decisis* kicks in and the accumulated case law itself becomes the basis of the claim.

The differences between the American and English positions identified above can probably be accounted for on the basis that the two legal systems are at different stages of development on this particular issue. In the United States, the availability of constructive trust relief in mistaken payment cases is long-settled and so it is probably too late now for the courts to revisit the underlying policy questions. If change is required, legislative intervention is now the only available option. English and Commonwealth courts, by contrast, are working with a relatively clean slate and so they still have room both to question the logical underpinnings of constructive trust relief in mistaken payment cases and to shape the law by reference to the doctrinal and policy issues discussed above. Ultimately, the question boils down to a choice between, on the one hand, maximizing the value of the bankruptcy estate for the benefit of the creditors collectively, even if this means doing rough justice to some types of claim and, on the other hand, striving to achieve a higher form of justice for certain individual claimants even if this means diminishing the returns to the creditors as a group. The tension between these objectives calls to mind the opposition between the economic concepts of allocative efficiency (where the concern is with increasing the size of the pie) and distributional equity (where the concern is with how the pie is sliced). There may also be a clash of legal cultures in play, between bankruptcy lawyers on the one hand and restitution lawyers on the other. It is probably fair to say that restitution lawyers are by both training and predisposition more likely to favor individual restitution claims over the collective interest of all the creditors, while bankruptcy lawyers tend to be skeptical of special claims. Calnan writes from a bankruptcy viewpoint, while the Restatement, naturally enough, is written from a
restitution standpoint. On this basis, the prospects for reforms along the line Calnan envisages may depend, at least in part, on who happens to be behind the wheel at the critical time.

3. Misrepresentation (1)

Case 2. A is induced by B’s misrepresentation to sell Blackacre to B. B becomes bankrupt before A discovers the misrepresentation. Can A rescind the contract?

(a) The Restatement

As in Case 1, the answer to the question has important bankruptcy implications. If A is able to rescind the contract, B’s bankruptcy trustee will have to re-convey Blackacre to A and, in the meantime, the trustee holds the property on constructive trust for A. The upshot is that A recovers the property in specie, pro tanto diminishing the amount available for distribution among B’s other creditors. On the other hand, if A cannot rescind, she will be limited to a personal claim for damages ranking on a pari passu basis with B’s other unsecured creditors.\(^{66}\) The governing Restatement provisions are ss 13, 54 and 60.

Section 13 provides in relevant part as follows:

s.13. Fraud and Misrepresentation: Rescission

(1) A transfer induced by fraud or by an innocent, material misrepresentation is subject to rescission at the instance of the transferor or a successor in interest.

Section 54 provides in part:

s.54. Rescission and Restitution

(1) A person who has transferred money or other property may avoid the legal effect of the transaction and recover the property transferred if

\(^{66}\) See Restatement, s.13, Comment i: Restitutionary remedies upon rescission, (4) priority vis-à-vis third parties.
(a) the transaction is invalid or subject to avoidance for a reason identified in another section of this Restatement, and

(b) the requirements of this Section may be satisfied.

The provision goes on to specify that: rescission requires a mutual restoration and accounting between the parties which involves, among other things, restoring property received from the other; a pre-condition for rescission is restoration of the defendant to the status quo ante; and rescission is a discretionary remedy, subject to “the interests of justice” and, in particular, “if rescission would prejudice intervening rights of third parties, the remedy will on that account be denied”: s.54(4)(c). Comment I: Rights of third parties, explains that this provision refers “to someone who has acquired an interest in the property, such as a mortgagee or other purchaser for value, through subsequent dealings with the original transferee”. In other words, the provision complements s.60 which, as noted above adds the rider that, for the purpose of the rule, a judicial lien creditor is not a purchaser.

Section 13 establishes that, on the facts of Case 2, A may rescind the contract. Section 54 reaffirms this proposition and also establishes that, upon rescission, A becomes entitled to a reconveyance of Blackacre. Restatement, s.54, Illustration 2 confirms this analysis:

A conveys Blackacre to B in exchange for B’s promise to pay $100,000 one year later. B fails to pay, whereupon A discovers that the transaction was induced by B’s fraud. A can enforce B’s contractual obligation to pay. Alternatively, A may choose to rescind the conveyance and recover Blackacre from B . . . . Specific relief to A might be described in terms of rescission, or cancellation, or constructive trust, or quieting title in A, or by an order directing B to reconvey to A. The language employed makes no difference to this outcome.

Section 60 establishes that A’s right of rescission has priority over a judicial lien creditor and, by extension, B’s trustee in bankruptcy. Restatement, s.60, Illustration 3 confirms this proposition:
Victim conveys Blackacre to Swindler, induced by Swindler’s fraudulent misrepresentations. . . Creditor obtains a judgment against Swindler for $50,000. By statute, Creditor’s judgment becomes a lien on all of Swindler’s interests in real property within the jurisdiction…In a contest between Victim and Swindler, Victim would be entitled to restitution of Blackacre. . . Creditor’s judgment lien attaches only to Swindler’s interest in Blackacre. Because a judicial lien creditor is not a purchaser for value, Creditor acquires no better rights vis-à-vis Victim than Swindler had. Victim recovers Blackacre . . . free of Creditor’s judgment lien.

(b) English and Commonwealth law

English and Commonwealth law is similar. According to Calnan, the cases establish the general proposition that, if A transfers title in an asset to B as a result of a vitiating factor induced by B (such as B’s fraud, misrepresentation, duress, or undue influence) then, on discovering the true facts:

- A can rescind the contract; and
- The effect of the rescission is to vest title to the asset in A. 67

Following rescission, beneficial title to Blackacre vests in A pending reconveyance of the legal estate by B’s trustee in bankruptcy. Prior to rescission, A has a lesser proprietary interest in Blackacre, which is referred to as “an equity” or a “mere equity” and which is a function of A’s as yet unexercised right to rescind the contract. A’s equity is enforceable in B’s bankruptcy. A leading case is Re Eastgate, 68 where the court said:

Now did the property at the time [of A’s rescission] form part of the estate of the bankrupt? I do not think it did, and for this reason. I think that the trustee acquired the interest of the bankrupt in the property subject to the rights of third parties. One of those rights in this case was the right of the vendors of the goods to disaffirm the contract and to retake possession of the goods. 69

Calnan suggests that if, the matter were free from authority, it would be open to question whether A should have a proprietary claim in these circumstances. It is true that B’s representation entitles A to rescind the contract, but the remedy could be

67 Op.cit. note 8 supra, para.4.76.
69 Ibid. at p.467. See also Tilley v. Bowman [1910] 1 K.B. 745.
administered on a purely personal basis, by means of an accounting between the parties. On that approach, A would obtain no advantage over B’s general creditors and would be entitled to share in the bankruptcy distribution on a pari passu basis only. However, the case law to the contrary is settled and it is too late now to wind back the clock.

(4) Misrepresentation (2)

Case 3. A is induced by B’s fraudulent misrepresentation to lend $500,000 to B. B banks the money but becomes bankrupt before disbursing any of the funds and before A discovers the misrepresentation. There are no other funds in the account. Can A rescind the loan contract with B?

(a) The Restatement

According to the Restatement, American law treats this case the same as Case 2. In other words, it makes no difference that the disputed subject-matter is money rather than land or other property. Restatement, s.60, Illustration 6 confirms this conclusion:

Customers remit $500,000 to Investment Co. for purposes of investment. Discovering thereafter that they had been defrauded, Customers bring suit for rescission and restitution against Investment Co. The court issues an order barring disbursement of the $200,000 balance of Investment Co.’s account with Bank. While Customer’s suit is pending, Creditor obtains a judgment against Investment Co. and Bank to assert the priority of his lien. The court determines that the whole of the $200,000 balance held by Bank can be traced to Customer’s most recent remittances to Investment Co.; by contrast, Creditor does not assert that any part of the balance is the product of his property. Because Investment Co. holds the $200,000 in constructive trust for Customers, the funds are not property of Investment Co. to which Creditor’s garnishment lien can attach. Bank will be directed to pay $200,000 to Customers and nothing to Creditor. For reasons previously discussed, the result would be the same if the dispute had been between Customers and Investment Co.’s trustee in bankruptcy.

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70 Calnan, op.cit. note 8 supra at para.4.75.
71 See also Restatement, s.13, Illustration 35; s.60, Illustration 14.
(b) English and Commonwealth law

There are cases suggesting that English and Commonwealth law is consistent with the position as set out in the Restatement. For example, in *El-Ajou v. Dollar Land Holdings*, Millett J. said that, if a person “has been induced to purchase … shares by false and fraudulent misrepresentations, they are entitled to rescind the transaction and vest the equitable title to the purchase money in themselves, at least to the extent necessary to support an equitable tracing claim”. However, Calnan disputes the correctness of these decisions on the ground that they overlook the distinction between transfers of chattel money and payments of bank money:

Payments of bank money do not result in A’s asset coming into the hands of B. Value passes from A to B by crediting and debiting accounts with third parties, not by the transfer of any asset by A to B. In principle, therefore, it would seem that rescission can have only a personal, and not a proprietary, effect in the case of payments of money. On rescission, an asset which has been transferred by A to B will vest in A. With a money payment, no asset passes from A to B, and there is therefore nothing which A can identify in B’s hands as being an asset which A originally owned.

Fox takes a different view, relying on the principle that “property rights can be created in substituted assets which are obtained in an unauthorized exchange”. He says:

Once the court ordered rescission of the transaction, [B] would hold his or her legal interest in the traceable credit balance in his or her account on resulting trust for [A]. If [B] were the fraudster, then [A] could also elect to assert an equitable lien over the account”.

Moreover, A would be better placed to trace and recover the payment in a misrepresentation case (Case 3) than she would in a mistaken payment case (Case 1). This is because, in Case 3 the ground for A’s rescission is B’s wrongful conduct and, if B is a wrongdoer from the outset, A can “rely from that point on the more favourable evidential presumptions to trace the value represented by his payment into [B’s] account.

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72 [1993] BCLC 735.
75 See text at note 56, *supra*.
76 Fox, *op.cit.* note 41, *supra*, at para.5.151.
[B] would not encounter the problem faced by the mistaken originator of money in the period before [B] realized the originator’s mistake.  

(c) Discussion

Calnan concedes that in a situation like Case 2, above, A has a proprietary claim which gives it priority in B’s bankruptcy, but this is only because there is settled case law on point. However, he argues that the cases are contrary to principle and that, in principle, A should be limited to a personal claim. In a Case 3-type situation, the case law is less settled and this allows him to take a more robust stance, arguing that the cases are wrong and should not be followed in future. However, Fox takes a contrary view of the English position which appears to be more in line with United States law, as represented in the Restatement. Which of these conflicting approaches is preferable from a policy standpoint?

The policy arguments in support of the United States approach are basically the same as in the mistaken payments case:

[A] prevails over the creditors because, unlike them, he has not consented to be a creditor of the debtor. Property obtained by fraud or mistake, like property obtained by theft, has not come into possession of the debtor by a voluntary transaction. To distribute it to creditors would therefore result in an involuntary transfer, accomplished in two stages, from claimant to creditors.

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77 Ibid. at para.5.152. Cf Calnan, op.cit. note 8, supra at paras 4.126 and 9.93 arguing that neither a resulting trust nor a constructive trust is appropriate in the circumstances:

“[as for the resulting trust], there is no basis on which A, having paid money to B through bank accounts, could be held to have retained a proprietary interest in his asset. The only basis on which A could obtain an equitable proprietary interest would be by the law imposing one (by way of constructive trust) over that part of its credit balance with its bank which represents the mistaken payment”.

“A constructive trust should not be imposed where the asset [A receives] is money. In such a case, the maxim that equity deems as done what ought to be done can have no application, because there is unlikely to be an identifiable asset over which a trust can be created and, in any event, what ought to be done is to pay an equivalent amount, not to transfer the money received”.

78 Kull, op.cit note 3 supra at p.282.
In other words, A deserves priority because: (1) he has a proprietary claim to the disputed asset; and (2) he is an involuntary creditor. However, the argument is contentious. The first limb presupposes that A has a proprietary claim, but that is the very point at issue. The second limb assumes that involuntary creditors deserve priority over voluntary creditors because they have not assumed the risk of the defendant’s bankruptcy. But this is not self-evidently true and, in any event, attempts to discriminate between unsecured creditors are likely to promote costly litigation which will erode the value of the estate. This is even more of a concern in misrepresentation cases than it is in the mistaken payments context. At least in a mistaken payment case, once the claimant has established the basic facts, the conclusion that he is an involuntary creditor will be relatively uncontroversial. But in a misrepresentation case, the plaintiff’s status as an involuntary creditor will often be contentious. For example, if the defendant tricks the plaintiff into a transfer of the disputed asset, it could be argued that the plaintiff is an involuntary creditor because the defendant’s conduct subverted the plaintiff’s choice. On the other hand, it could just as plausibly be argued that the risk of fraud is an incident of contracting and, while it justifies a remedy, it does not justify giving the plaintiff priority in the defendant’s bankruptcy. Emily Sherwin says that the distinction turns on a number of variables including the nature of the fraud and the plaintiff’s commercial sophistication and that “the constructive trust claimant’s position as an involuntary creditor is a question

79 At least as a matter of English and Commonwealth law, the theft analogy is open to question because, in the case of theft, the victim has no intention of transferring the disputed asset to the thief, whereas in a mistaken payment or misrepresentation case, the mistake or misrepresentation does not negative intention; it simply means the transferor’s intention was formed on a false basis: see Fox, op.cit., note 41, supra at paras 4.86-4.91 (theft of corporeal money (chattel money)); paras 5.121-5.130 (theft of incorporeal money (bank money)); and paras 6.03-6.18 (voidable transfers and rescission). In Shogun Finance Ltd v. Hudson [2004] A.C. 919, the following statement appears:

“Fraud does not negative intention. A person’s intention is a state of mind. Fraud does not negative a state of mind. The existence of a fraudulent misrepresentation means that a person’s intention is formed on a false basis – a basis, moreover, known by the other party to be false. The effect of fraud is to negative legal rights or obligations flowing from an intention to enter into a contract. . . This distinction, between negativing intention or consent and negativing the rights otherwise flowing from intention or consent, is important. It explains why the law treats a contract induced by fraud as voidable, not void. The necessary coincidence of intention, or consensus ad idem, may exist even where the intention and consent of the victim were induced by fraud. An intention thus induced is regarded by the law as sufficient to found a contract, even though the victim may repudiate the contract as soon as he discovers the fraud”: at paras [6]-[8] per Lord Nicholls.
of degree”. But answers to questions of degree are hard to anticipate in advance, and so an approach like the one Sherwin describes would increase the uncertainty of litigation outcomes. In this connection, a leading Canadian text remarks that:

all else being equal, society as a whole has an interest in a system that minimizes the costs associated with the resolution of restitutionary claims and the effects of insolvency. Consequently, a complicated regime that turns largely on judicial discretion may be undesirable insofar as it inhibits settlements and encourages litigation.

Kull’s analysis of the *Omegas Group* case illustrates the concern nicely. There the claimant paid the debtor in advance for computers the debtor was to purchase from IBM on the claimant’s behalf. The debtor became bankrupt and the claimant, arguing that its payments were induced by the debtor’s fraudulent misrepresentations, claimed a constructive trust over the disputed funds in the debtor’s hands. According to Kull, the question the court should have asked (but did not) is whether the claimant had been “so far deceived about the risks it was running that in advancing funds to the debtor it did not act voluntarily”. The question is a close call:

[o]n the one hand, late period transactions of this kind occur closer in time to the bankruptcy, inspiring the claim that the debtor has made (implicitly or otherwise) fraudulent representations of solvency. On the other hand, a late-period seller – by comparison with creditors of longer standing – is likely to have dealt with the debtor on the basis of a higher appraisal of the risk of insolvency. Any perceived decline in the debtor’s creditworthiness will have been compensated for by more favorable terms.

In the *Omegas Group* case itself, it seems there was evidence to support the latter hypothesis, but in other cases the indications may be less clear and it may not be so easy for the court to arrive at the correct interpretation of the facts or for the parties to predict in advance of the case what the court’s decision might be.

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80 *Op. cit.* note 29 *supra* at p.352. See also Kull, *op.cit.* note 3, *supra*, at p.274: “the issue of restitution in bankruptcy ultimately depends on a comparison of the respective positions of the restitution claimant and the general creditors vis-à-vis the debtor. The stronger the showing that the debtor holds property obtained in a nonconsensual transfer, the stronger the case for restitution to prevent the unjust enrichment of the general creditors at the expense of the claimant.”
81 *Oosterhoff on Trusts* (7th ed. Carswell, Toronto, 2009) at pp. 792-793.
5. Wrongful gains

Case 4. A engages B, a real estate agent, to purchase a commercial property on A’s behalf. B purchases the property for himself at a price of $500,000, concealing the purchase from A by telling him that the vendor has changed his mind about selling. B goes into bankruptcy. Can A claim a constructive trust over the property?

(a) The Restatement

Case 4 is a variation on the facts of a Supreme Court of Canada case, *Soulos v. Korkintzilas*, an important difference being that, in *Soulos*, the defendant was not insolvent. Comparable American cases include *Funk v. Tifft*, *Quinn v. Phipps*, and *H-N Ltd Partnership v. Wimmer*. The governing Restatement provisions are ss 43, 55 and 60. Section 43 provides in part that a person who obtains a benefit in breach of a fiduciary duty is accountable for the benefit so obtained to the person to whom the duty is owed. As previously seen, s.55 provides for constructive trust relief in cases where a recipient is unjustly enriched by the acquisition of property in violation of the claimant’s rights, while s.60 as a general rule gives priority to constructive trust claims and the like in the defendant’s insolvency.

In Case 4, A and B’s relationship is a fiduciary one and B’s conduct amounts to a breach of fiduciary obligation. Restatement, s.43 establishes B’s obligation to account for the benefit he has obtained, while s.55 establishes A’s right to constructive trust relief. Restatement, s.43, Illustration 10 confirms this analysis:

Purchaser retains Broker to assist him in acquiring Blackacre, offering to pay $50,000 for the property plus a 10 percent commission. Broker undertakes to locate the owner of Blackacre and to transmit Purchaser’s offer. Broker buys Blackacre himself for

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84 [1997] 2 S.C.R. 217
85 515 F.2d 23 (9th Cir. 1975).
86 93 Fla.805, 113 So. 419 (1927).
$30,000. The agreement between Purchaser and Broker, not being in writing, is unenforceable under local law, but Broker has nevertheless violated his duty of loyalty to Purchaser. Broker will be made a constructive trustee of Blackacre for the benefit of Purchaser, conditioned on payment to Broker of $30,000 without commission.

Section 60 gives A’s constructive trust priority over B’s trustee in bankruptcy.

Assume Blackacre increases in value after B acquires it and, at the date of the trial, it is worth $750,000. Restatement, s.61 provides that:

> [w]hen restitution is based on a wrongful interference with the claimant’s legally protected interests, the claimant may be entitled (as against a recipient at fault or a successor in interest) to a recovery exceeding the amount of the claimant’s loss. In such a case, however,

(a) the portion of the restitution exceeding the claimant’s loss is subordinated to the claims of the recipient’s creditors, and

(b) . . .

In the case under consideration, A’s loss is not limited to the value of Blackacre at the time of B’s wrongdoing ($500,000). It extends to Blackacre’s current value ($750,000) because, but for B’s wrongful conduct, the increase in value would have belonged to A. In short, on these facts Restatement s.61 does not limit A’s recovery.

Now assume that Blackacre drops in value after B acquires it so that, at the date of the trial, it is worth only $300,000. On these facts, A suffers no monetary loss as a consequence of B’s wrongdoing. On the contrary, he is apparently better off because B’s intervention has enabled him to avoid a bad bargain. In normal circumstances, therefore, one would expect A not to pursue his claim against B. But suppose that A has a sentimental attachment to Blackacre and wants the property regardless of its drop in value.\(^\text{88}\) If B were solvent, A would be entitled to constructive trust relief, conditional on paying B’s $500,000 outlay on Blackacre. The justification is that the function of the constructive trust remedy in fiduciary cases is not just to reverse the defendant’s unjust enrichment, but also to deter fiduciary wrongdoing and, as the Restatement points out, “to

this end, a liability in restitution by the rule of [s.43] does not depend on proof either that the claimant has sustained quantifiable economic injury or that the defendant has earned a net profit from the transaction".  

However, in the case under consideration, B is insolvent and so Restatement s.61 applies. Since A has suffered no quantifiable economic loss, the result will be to subordinate his constructive trust claim to B’s general creditors. The justification is that the deterrence rationale for constructive trust relief has no application in the defendant’s bankruptcy:

The justification of the remedy disappears if a supracompensatory award to the restitution claimant would come at the expense of a third party [the defendant’s unsecured creditors] who is innocent of the underlying wrong. . . [T]he standard justifications for a recovery in restitution exceeding the claimant’s loss –whether expressed in the language of unjust enrichment, or in terms of economic incentives – have [no] bearing on a case in which the interests opposed to the restitution claim are those of the wrongdoer’s general creditors. The creditors are not enriched in consequence of their own wrong, nor have they engaged in profitable misconduct from which a disgorgement liability will potentially deter them.  

Ironically, on the facts in question, the result Restatement s.61 leads to may not appeal to B’s trustee in bankruptcy. A’s constructive trust probably does not prejudice the unsecured creditors because they will have no special attachment to Blackacre and so removal of the property from the estate would not diminish the pool of assets available for distribution. On the contrary, given A’s undertaking to reimburse B’s outlay, the property’s removal may actually increase the asset pool by ridding the estate of a bad bargain. If so, B’s trustee will contract around his s.61 rights and admit A’s claim.

The bribe cases offer a perhaps more salient example of the problem under consideration. To adapt the facts of the famous English case, *Lister v. Stubbs*, assume B is employed by A as a purchasing officer. B accepts secret commissions from a supplier, C, in return for purchasing supplies from C. B uses the money profitably to buy

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89 Restatement, s.43, Comment b: the function of the rule.
80 Restatement, s.61, Comment a: General principles and scope: relation to other Sections.
91 (1890) 45 Ch.D. 1.
shares. However, B accumulates significant debts and ends up in bankruptcy. Can A claim a constructive trust over the shares? As in the previous examples, B’s conduct is in breach of fiduciary obligation and so B must account to A for the benefit he has obtained: Restatement, s.43. If B were solvent, A would be entitled to a constructive trust over B’s share portfolio on the basis that the shares are traceable proceeds of the bribe money: Restatement, s.55. Restatement, s.55, Illustration 30, which is based on the facts of Attorney-General for Hong Kong v. Reid, 92 confirms this analysis:

Prosecutor accepts $1million in bribes in exchange for favorable treatment of criminals. Prosecutor is liable to State in restitution for the amount of the bribes and any profits derived therefrom (ss 43 . . . , 51). To the extent that any portion of the money paid as bribes and its traceable product may be identified in Prosecutor’s bank accounts (applying the tracing rules of s.59), Prosecutor holds those funds in constructive trust for State. State establishes at trial that Prosecutor used bribe money to purchase two houses, giving one to his Wife and the other to his Lawyer (as payment for legal services). Wife had no notice of the source of the funds, but she took her house as donee. Lawyer took the house for value, but with notice that it was purchased with bribe money. Both Wife and Lawyer hold their houses in constructive trust for State.

However, since B is bankrupt, A will be limited to a money claim for the amount of his loss, secured by an equitable lien on the shares: Restatement, ss 60 and 61. Restatement, s.61, Illustration 1 confirms this analysis:

Treasurer embezzles $40,000 from Township, using these funds to acquire goods. When the theft is discovered, the goods (constituting the traceable product of the embezzled funds) are worth $50,000. In a two-party contest between Township and Treasurer, Township would be entitled to ownership of the goods via a constructive trust, despite the fact that such a remedy gives Township more than it lost. Because Treasurer is insolvent, however, restitution to Township via constructive trust would be made at the expense of Treasurer’s creditors. In these circumstances, Township’s restitution claim has its ordinary priority (s.60(1)) only to the extent of Township’s loss from Treasurer’s embezzlement ($40,000 plus interest). Correct priority is achieved by awarding Township an equitable lien on the goods in the amount of $40,000 plus interest, rather than a constructive trust.

The challenge in the bribe cases is to quantify A’s loss for the purposes of the rule in Restatement, s.61. In contrast to the Treasurer-Township example, A’s loss does not correspond to B’s gain because the bribe moneys never belonged to A. In a *Lister v. Stubbs*-type case, A’s loss is presumably the supra-competitive prices it paid for supplies as a result of the defendant’s conduct, while in *Reid’s* case, the plaintiff’s loss was the damage done to the criminal justice system. However, this amount may be impossible to measure in money terms and the implication, in the context of Restatement, s.61, is that the claimant will be denied recovery.

(b) English and Commonwealth law

There are numerous cases in England and the Commonwealth which support constructive trust relief for breach of fiduciary obligation. However, none of the cases involves an insolvent defendant and so there is no clear authority on the question at hand. For example, it is unclear what the decision in *Soulos v. Korkontzilas* might have been if the defendant was bankrupt. Canadian law recognizes the remedial constructive trust, which is a discretionary remedy. However, the discretion can cut both ways: in other words, the court could use the defendant’s bankruptcy as a reason to deny the remedy or, equally, as a reason to grant it. As suggested above, given the peculiar facts of the case, a constructive trust would probably not have prejudiced the defendant’s creditors and so it would have made sense to grant the remedy. However, not all cases are the same in this respect.

England and other parts of the Commonwealth, Canada aside, have not yet embraced the remedial constructive trust. Instead, the constructive trust is a form of declaratory relief aimed at confirming a pre-existing equitable proprietary interest. In other words, there is a tendency towards formalism in the constructive trusts case law, in contrast to the functionalism which characterizes the Restatement’s approach. In particular, since the constructive trust depends upon the establishment of a prior equitable claim, the courts

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have less room to manoeuvre depending on whether or not the defendant is bankrupt. Perhaps for this reason – and in contrast to the Restatement - English and Commonwealth law takes an all or nothing approach to the bankruptcy question. The cases proceed on the assumption that if constructive trust relief is available outside bankruptcy, it will be available inside bankruptcy, too, and on the same terms. This leads to a tail wagging the dog kind of debate, with some courts opposing proprietary remedies for breach of fiduciary obligations because of the potential bankruptcy implications, and others favoring them for deterrence reasons, even if the defendant is bankrupt. To repeat, while the English and Commonwealth courts recognize the trade-off between deterrence and bankruptcy considerations, their approach to resolving it is an all-or nothing one, in contrast to the Restatement’s more nuanced solution.

_Lister v. Stubbs_ and _Attorney-General for Hong Kong v. Reid_ are the leading cases. In _Lister v. Stubbs_, the plaintiff claimed a constructive trust over the defendant’s second generation profits, but the Court of Appeal limited him to a personal claim for the amount of the bribe money. The defendant was not insolvent at the date of the hearing, but the court was clearly concerned about what might happen if he were to become insolvent later:

[I]f Stubbs were to become bankrupt, this property acquired by him with the money paid to him by Messrs Varley would be withdrawn from the mass of his creditors and be handed over bodily to Lister & Co. Can that be right?\(^{94}\)

The decision implies that the courts should be wary about granting constructive trust relief for breach of fiduciary obligation, even if the defendant is solvent, for fear either that he may not stay solvent or that the decision will affect the outcome of other cases where the defendant is insolvent. In _Reid’s_ case, the Privy Council took precisely the opposite tack, upholding the constructive trust remedy on deterrence grounds and dismissing the bankruptcy concerns with the statement that “the unsecured creditors cannot be in a better position than their debtor”.\(^{95}\)

\(^{94}\) (1890) 45 Ch.D. 1 at p.15 per Lindley L.J.
\(^{95}\) [1994] 1 A.C. 324 at p.331 per Lord Templeman.
The trouble with the *Lister v. Stubbs* approach is that it arguably over-emphasizes bankruptcy considerations at the expense of deterrence considerations, while the objection to *Reid’s* case is the mirror-image one. However, the trend in the recent case law is clearly in favor of *Reid’s* case. For example, in *Daraydan Holdings v. Solland International*, the court said:

> [t]here are powerful policy reasons for ensuring that a fiduciary does not retain gains acquired in violation of fiduciary duty, and I do not consider that it should make any difference whether the fiduciary is insolvent. There is no injustice to creditors in their not sharing in an asset for which the fiduciary has not given value, and which the fiduciary should not have had.

This statement appears to overlook the point made in the Restatement that the objective of constructive trust relief in wrongful gains cases is deterrence, but the deterrence rationale loses its purchase if the defendant is insolvent. However, the all-or-nothing character of the English debate needs to be kept in mind: denying constructive trust relief against an insolvent defendant necessarily means denying it across the board. In any event, on the current state of the English authorities, it seems likely that, in Case 4, above, A would be entitled to the remedy and that the answer would be the same if the value of Blackacre had gone up and, also, if it had gone down.

(c) Discussion

In *Lister v. Stubbs*, the court limited the plaintiff to a personal claim for recovery of the bribe money. From a deterrence perspective, the decision is clearly unsatisfactory because it allowed the defendant to keep all his second generation gains, so that his bribe-taking ended up being a very profitable venture. The court could have done better justice to deterrence considerations, without compromising bankruptcy concerns, by awarding the plaintiff an account of profits for an amount equal to the defendant’s second-generation gains and some commentators see this solution as a way forward. However,

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96 Calnan, *op.cit. note 8 supra*, para.9.60.
97 [2005] Ch.119.
98 *Ibid.* at para.[86].
99 *E.g.*, Calnan, *op.cit note 8 supra* at paras 9.81-9.89.
even this approach may result in under-deterrence if the second-generation gains comprise an asset for which B has a special attachment or if there is a chance that the value of the property might increase after the judgment date. A constructive trust is the only sure-fire way of reaching all B’s gains.

The Restatement takes a different approach to balancing deterrence and bankruptcy objectives. On the Restatement approach, the plaintiff’s claim in *Lister v. Stubbs* should have succeeded, because the defendant was not insolvent; on the other hand, if the defendant had been insolvent, the plaintiff would have been limited to a claim for the amount of its loss secured by an equitable lien over the shares. The advantage of the Restatement’s solution is that it does not compromise the deterrence objective in cases where the defendant is not insolvent. By the same token, it avoids exposing creditors to a gains-based remedy in cases where he is. On the other hand, critics might argue that this concession in the creditors’ favor does not go far enough because the restitution claimant still has priority for the amount of its loss and so there is the same unanswered question as the one that arises in the mistaken payment and misrepresentation cases, namely what makes restitution claims different enough to warrant special treatment in the defendant’s bankruptcy?

In some situations, for example *Reid’s* case, it may not be possible to quantify the amount of the claimant’s loss and, in that event, the effect of Restatement, s.61, apparently, will be to deny the claimant any recovery at all if the defendant is insolvent. This is harsher even than *Lister v. Stubbs* which, as previously mentioned, would at least give the claimant a provable claim in the defendant’s bankruptcy for the amount of the bribe money.

6. Specific performance

**Case 5.** A and B enter into a contract for the sale of Blackacre. A pays 30 per cent of the purchase price on the signing of the contract. B becomes bankrupt and B’s trustee refuses to complete the transfer. Can A sue for specific performance?
(a) United States law

The Restatement does not address the issue Case 5 raises because specific performance is not a restitutionary remedy and so it falls outside the boundaries of the project. Instead, the answer to the question is to be found in the provisions of the Bankruptcy Code governing executory contracts. The following discussion is included for the sake of completeness, but it will be brief since it has nothing immediately to do with the Restatement, which is presently the main focus.

Bankruptcy Code, s.365 gives the trustee a right to reject, affirm and assign executory contracts, subject to court approval. The statute does not define “executory contract”, but it is generally understood to mean a contract which remains partly unperformed on both sides at the date of the bankruptcy. The contract in Case 5 is an executory contract in this sense. The trustee’s refusal to complete the transfer is tantamount to a purported rejection of the contract. The key provision is Bankruptcy Code, s.365(i) which prevents the trustee’s right of rejection from overriding the purchaser’s claim for specific performance, but only if the purchaser has gone into possession of the property. The provision gives the purchaser in possession the option of treating the contract as terminated or remaining in possession and continuing to make payments under the contract. The provision goes on to say that the purchaser may offset against the contract payments any post-rejection damages caused by non-performance of the debtor’s obligations under the contract and that the trustee must deliver title to the purchaser but is relieved of all other performance obligations. Section 365(j) applies if the purchaser is not in possession and the contract is rejected, and it gives the purchaser a lien on the debtor’s interest in the property for the recovery of any part of the purchase price the purchaser has paid. The thinking behind these provisions is that a purchaser in possession is likely to have spent money on improvements and the like, and the aim is to protect its reliance interest. (In an extreme case, failure to protect the purchaser’s reliance interest

100 Bankruptcy Code U.S.C. Title 11, s.365.
101 Or, more expansively: “a contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other”: Vern Countryman, “Executory Contracts in Bankruptcy” (1973) 57 Minn. L. Rev. 439 at p. 460.
may trigger the purchaser’s own financial crisis and this would be a high price to pay for facilitating the debtor’s bankruptcy proceedings). On the other hand, the justification for not extending the protection to purchasers across the board lies in the *pari passu* sharing principle.\textsuperscript{102}

Now assume a contract for sale by B to A of a Van Gogh painting, which is still undelivered at the date B files for bankruptcy. Outside bankruptcy, A would be entitled to specific performance: damages would be an inadequate remedy because, given the uniqueness of the contract subject-matter, there is no market in which A could find a replacement. Does A’s specific performance claim survive B’s bankruptcy? The governing provisions are Bankruptcy Code, ss 101(5)(B) and 502(c). Section 101(5)(B) provides that, for the purposes of the statute, “claim” includes the right to equitable remedies such as specific performance, and s.502(c) provides that, for the purpose of allowing a claim, equitable remedies such as specific performance are reducible to money value. One justification is that the real function of specific performance is to protect A’s interests in cases where damages are difficult to calculate,\textsuperscript{103} not to give A priority in B’s bankruptcy. Therefore, granting A specific performance in B’s bankruptcy would give her an unbargained benefit.\textsuperscript{104} An alternative justification is that s.502(c) mitigates A’s prejudice by giving the bankruptcy court a broad power to estimate claims without the constraints of state law doctrines about speculative damages.\textsuperscript{105}

**(b) English and Commonwealth law**

According to Calnan, the English position is that:

\textsuperscript{102} More or less the same considerations apply to the rejection of a tenancy agreement in the landlord’s bankruptcy and the rejection of an intellectual property licence in the bankruptcy of the intellectual property holder, and the Bankruptcy Code treats these cases on a similar footing: s.365 (h) and (n).

\textsuperscript{103} For example, because the asset is unique so that there is no market price the court can rely on as a basis for valuation, or because the counterparty places a high subjective value on the asset.


• specific performance will be available to A if he can establish that he has a proprietary interest in the asset; but
• specific performance will not be available to A if he does not have a proprietary interest in the asset. \(^{106}\)

Also:

The basic principle is that once a debtor company enters into insolvency proceedings, its insolvency officer is entitled to refuse to perform contracts entered into by the company, with the effect that the creditor will in most cases have no option but to prove as an unsecured creditor for damages for breach of contract. This is the corollary of the principle that specific performance is not available to give effect to a personal right in insolvency. \(^{107}\)

These two passages succinctly state the English position on executory contracts. The implication of the English position is that the debtor’s insolvency representative can disclaim, or reject, an uncompleted contract more or less as of right, unless the contract is specifically enforceable. The United States position, as represented by Bankruptcy Code, s.365, is at least superficially different because the provision makes rejection of contracts subject to court approval. However, most courts apply a business judgment test, which means that the court will approve a proposed rejection unless it was made in bad faith or involved a breach of discretion, and so in practice the law is not so different from the English position. Recent amendments to the Canadian *Bankruptcy and Insolvency Act*\(^ {108}\) and *Companies’ Creditors Arrangement Act*\(^ {109}\) confirm that Canadian law is to more or less the same effect.

In England, the insolvency representative’s right of disclaimer will be defeated by the contract counterparty’s (A’s) claim for specific performance and, according to Calnan, a contract is specifically enforceable in insolvency proceedings if, and only if, A can establish a proprietary interest in the disputed asset. It is commonly asserted that the availability of specific performance is itself the source of proprietary rights because

\(^{107}\) *Ibid.* at para.1.94.
\(^{108}\) 1985 R.S.C. c B-3 (new s.65.11).
equity, deeming as done what ought to be done, anticipates the decree. 110 However, if this were true, Calnán’s analysis would be circular. Calnan argues, relying on Tailby v. Official Receiver, 111 that the real basis for the recognition of equitable proprietary entitlements is “that equity will require a person who has made a promise to comply with it if it is given for good consideration”. 112

But this explanation raises the further problem that “it is not every case in which a person promises to create a proprietary interest over an identifiable asset that equity will step in and create an immediate equitable proprietary interest”. 113 For example, equity will intervene if the contract is one for the sale of land, 114 but not if the contract is one for the sale of goods. 115 Calnan’s explanation for the difference, relying in part on Re Wait, is that the rules for passing of property under a contract for the sale of goods are codified in the sale of goods legislation and the statute leaves no room for the transfer by sale of equitable entitlements. He justifies the different rule for land sales on the ground that “the rule is settled” and suggests that in all other cases, “there is much to be said for the view that beneficial title should pass with legal title.” 116 The implication is that, if the slate were clean, there should be no exception for land sales either. 117 Calnan does not address the issue of specifically enforceable contracts for the sale of goods in bankruptcy (the case of the Van Gogh painting), but, by implication, the analysis is the same as for land sale contracts. The Canadian approach to specific performance in bankruptcy is similar to the English position. 118

111 (1888) 13 App.Cas.523 (HL)
112 Calnan, op.cit. note 8 supra, para.5.56.
113 Ibid. at para. 5.59.
114 Lysaght v. Edwards (1875-76) 2 Ch.D 499 (C.A.)
115 Re Wait [1927] 1 Ch. 606 (C.A.)
116 Calnan, op.cit. note 8 supra, para.5.80.
117 Cf Tanwar Enterprises Pty Ltd v. Gauchi (2003) 217 CLR 315 (High Court of Australia), suggesting that the relationship between parties to an executory contract for the sale of land is a purely contractual one and not trustee-beneficiary.
118 Armadale Properties Ltd v. 700 King St (1997) Ltd (2001) 25 CBR (4th) 198 (Ont. SCJ). In Semelhago v. Paramadevan [1996] 2 SCR 415, the Supreme Court of Canada held that, to qualify for specific performance of a contract for the sale of land, the plaintiff must prove affirmatively that the property has special features so that damages would be an inadequate remedy. However, if, as Calnan suggests, the purchaser’s proprietary interest derives from the agreement itself and not from the availability of specific performance, the purchaser might still have a proprietary claim in the vendor’s bankruptcy even if the court were to deny specific performance on discretionary grounds. For criticism of Semelhago, see Robert
(c) Discussion

To summarize, England and the United States share a common underlying agenda with regard to specific performance, which is to strike a balance between the *pari passu* principle and the property of the estate principle. The difference is that, as in other contexts, English law relies on formal distinctions to do the work, whereas the United States approach is more openly policy-based and more nuanced.

7. Conclusion

The status of proprietary remedies in bankruptcy is a difficult topic – so difficult that, until not very long ago, it was hard even to discern the reasons for the difficulty, let alone to prescribe a solution to the problem. Thanks in substantial part to the Restatement in the United States, and to the recent contributions of scholars in England and other parts of the Commonwealth, we now do know the causes of the problem and we are well on the way to resolving it. The source of the difficulty is that there are at least three inter-related sets of considerations in play. The first is the distinction between personal and proprietary claims. The second is the interplay between two fundamental bankruptcy law principles: the *pari passu* sharing principle and the property of the estate principle. And the third is the tension between bankruptcy and non-bankruptcy policy objectives.

In common law systems, the distinction between personal and proprietary remedies is blurred by the intervention of equity. Courts of equity, under the rubric of the maxim, “equity deems as done what ought to be done”, invest certain personal claims with proprietary status, but the reasons for doing so are rarely articulated with any clarity. In the case of long-established equitable interests, such as the trust and the equity of redemption, the logical infirmities which underpin them no longer matter, given the antiquity of the supporting case law. These days, such interests are accepted without

question, supported simply by the weight of authority. The same is not true, though, of more modern attempts to apply the maxim. Claims for the recognition of new proprietary interests are bound to be scrutinized on grounds of both logic and policy so that the underlying issues are forced out into the open. To take the mistaken payment case as an example, at least in England and other parts of the Commonwealth where the case law is less settled than it is in the United States, the proprietary status of the payer’s claim cannot be supported simply on the basis of the equitable maxim. It must also be explained why the maxim should apply and this, in turn, raises the other two sets of concerns identified above.

The property of the estate principle and the *pari passu* sharing principle are both part of all good bankruptcy law courses. But they are typically taught as separate topics so that the inter-relationship between them may not be immediately obvious. The property of the estate principle is inconsistent with the *pari passu* sharing principle because it provides a basis for giving certain unsecured creditors priority over others. By the same token, the *pari passu* sharing principle is in tension with the property of the estate principle because a too rigorous insistence on equal distribution may defeat third party entitlements. The challenge for the bankruptcy lawyer is to identify where the balance should be struck. The answer cannot lie simply in an appeal to property rights as determined by non-bankruptcy law because, in the cases under consideration, the property rights are unsettled. Inevitably, therefore, the question resolves into a policy one.

At the policy level, there are competing bankruptcy and non-bankruptcy considerations at work. The relevant bankruptcy considerations are: (1) the requirement of equal treatment for creditors (*pari passu*); and (2) the importance of maximizing the size of the bankruptcy estate for the benefit of the creditors collectively. In the mistaken payment and misrepresentation cases, the relevant non-bankruptcy objective is corrective justice for restitution claimants, while in the fiduciary cases it is deterrence of wrongdoing. The challenge for the judge and the lawmaker is to identify these policy tensions and strike an appropriate trade-off. As the discussion in this paper has shown, United States law, as represented in the Restatement, though sharing many common elements with the law in
England and other parts of the Commonwealth, is also different in some important respects. The existence of these differences should not really come as a surprise because the questions in issue all turn ultimately on policy trade-offs, and it is in the nature of a trade-off that reasonable minds might differ over the point at which it should be struck.