

Forming contracts with thieves and fraudsters

By John Tarrant

Pursuant to the theft principle when a fraudster attempts to use the institution of contract as an instrument of fraud the courts will declare the contract to be ineffective in equity.

A thief holds any property rights to stolen property on trust for the benefit of the victim of the theft.¹ This proprietary response to theft was adopted by the High Court of Australia almost a century ago in *Black v S Freedman & Co Pty Ltd*, where O'Connor J stated that where money is stolen 'it is trust money in the hands of the thief'.² The principle, described as the 'theft principle',³ applies not only to stolen money but also to stolen goods.⁴ One of the

controversial circumstances in which the principle has been applied is where property has been transferred as a result of fraudulent conduct during the formation of a contract.⁵ This development in the law of contract will be explored below after outlining the key aspects of the theft principle.

ESTABLISHMENT OF THE THEFT PRINCIPLE

In *Black v S Freedman*, Black stole cash belonging to his employer. Black deposited some of the funds into a bank

account held by his wife and also acquired some circular notes in her name, an early form of traveller's cheque. The plaintiff claimed that they had legal property rights to both the money in Mrs Black's bank account and the circular notes. In holding that Black's employer could recover from Mrs Black, O'Connor J in the High Court of Australia adopted a wide principle, not previously adopted by the courts, that where money is stolen it is trust money in the hands of the thief.⁶ The significance of this wider principle is that a trust will arise as a result of a theft, even in the absence of a fiduciary relationship. However, this principle had not previously been applied in the context of a theft.

THEFT PRINCIPLE AND CONTRACT FORMATION

In *Halley v Law Society*,⁷ the English Court of Appeal developed an identical principle to the theft principle but in the contractual context. In *Halley*, money had been paid pursuant to what the payer understood to be a validly formed contract. The payments were made by a number of persons who were persuaded to participate in various investments. However, it transpired that the transactions were entirely fraudulent. The Law Society argued that because the transaction was akin to theft, the usual position that the contract must first be rescinded to revert title should not apply. When considering this submission, Carnwath LJ opined that where 'property is stolen, no beneficial interest passes to the thief'.⁸

The traditional position – that a contract obtained by fraudulent misrepresentation is voidable and not void at both common law and equity – is well established.⁹ But Carnwath LJ opined that the traditional position did not extend to circumstances where 'the contract has been held to be the instrument of fraud, and nothing else'.¹⁰ In such circumstances, Carnwath LJ considered that it was meaningless to require rescission.¹¹ Importantly, Carnwath LJ focused on the transaction from the fraudster's point of view and noted that there was nothing to rescind because 'for practical purposes, he has parted with nothing of value and incurred no obligation'.¹² But this was not to suggest that there was no consideration or a total failure of consideration. Carnwath LJ accepted that the parties intended to create legal relations and the traditional elements required for contract formation were present.¹³ Essentially, a contract was formed, but it would not be given any legal effect. It did not need to be rescinded because it was an instrument of fraud and would not, at least in equity, have any legal effect.

Accordingly, the decision in *Halley* should be seen as a development of a new equitable principle of the law of contract, rather than a rejection of established contract law. Carnwath LJ made it clear that the facts were sufficiently different from cases of fraudulent misrepresentation to justify the development of a new principle to deal with cases where the institution of contract was being used as an instrument of fraud.

A similar position has been adopted in Australia in the contractual context where the theft principle was expressly applied. In *Orix Australia Corp Ltd v Moody Kiddell & Partners Pty Ltd*,¹⁴ a finance company, Orix Australia, entered into

a contract to acquire a number of cranes from Nelson Equipment Pty Ltd for the purpose of lending them on hire purchase to Queensland Construction Equipment Pty Ltd. However the cranes did not exist. White J held that 'Nelson Equipment held the purchase moneys [sic] paid to it by Orix on trust for Orix immediately it received the funds'.¹⁵ This was because Nelson Equipment 'obtained the funds through fraud' and stolen property 'is trust money in the hands of the thief'.¹⁶ White J directly applied *Black v S Freedman* when holding that the trust arose immediately. White J equated the fraud in the contractual context with the theft that occurred in *Black v S Freedman*. A similar position had been adopted by Hunter J in *Menzies v Perkins*,¹⁷ where his Honour held that there is 'no distinction in principle between the proceeds of theft and of fraud'.¹⁸

These cases suggest that where a contract is used as an instrument of fraud, then although there will be a contract at common law, this contract will be of no legal effect in equity. Accordingly, although legal title to goods might pass pursuant to the contract, or money may be paid under the contract, any title acquired by the fraudster will immediately be held on trust based on the application of the theft principle.

INSTRUMENTS OF FRAUD

However, in practice it is difficult to formulate a test that will provide clear guidance on the difference between a fraudulent misrepresentation giving rise to a right to rescind >>

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Fraudulent misrepresentations and contracts that are instruments of fraud are fundamentally different.

and fraudulent conduct giving rise to an immediate trust. The decision in *Halley* suggests that if the subject matter of the contract actually exists, it will be difficult to demonstrate that the entire transaction was fraudulent. It was argued in *Halley* that rescission is always required in cases of fraud, based on the decision in *Car and Universal Finance Co Limited v Caldwell*,¹⁹ where it was held that rescission was required in circumstances where a car was purchased and the purchaser paid with a cheque that was dishonoured. But Carnwath LJ held that the contract in *Car and Universal Finance* had some substance because 'ownership of a car was transferred'.²⁰ Carnwath LJ held that the 'fraud was simply in the method of payment'.²¹ But if the fraudster knew that the cheque would be dishonoured, then it could be argued that the transaction was entirely fraudulent. What appears to be relevant is the fact that legal title to the car passed because the motor vehicle actually existed, and thus the transaction had some substance. This suggests that the theft principle will be less successful in circumstances where the subject matter of the contract actually exists.

The theft principle is more likely to be applied where the only transfer made is the payment of money from one bank account to another. In such circumstances, title to the money does not pass as such. Instead, the recipient of the funds is the owner of a new asset in the form of a larger balance in their bank account.²² There is no transfer of title.

The cases therefore suggest that much will depend on the circumstances in any particular case. If some part of the transaction actually happens, such as delivery of a chattel and the passing of legal title, then the orthodox position will be that rescission is required to revest title. This position is consistent with the idea that the courts will presume that a contract is not an instrument of fraud. But if the subject matter of the contract does not exist at all, and thus no title can pass at law, or the transaction involves only the payment of money by the defrauded party, then it will be easier to show that the entire transaction is a fraud. That is, any presumption that the contract had some legitimate purpose can be rebutted by showing that every aspect of the contract from the fraudster's perspective was a fraud.

IMPLICATIONS OF THE THEFT PRINCIPLE

The difference between cases where there is a fraudulent misrepresentation and cases where the contract is an instrument of fraud are fundamental. Where the transaction is an instrument of fraud, there is no requirement to rescind the contract and the usual bars to rescission will not apply.²³ In addition, a fraudster will 'be accountable to the victim for his or her dealings with the property from the moment that he or she fraudulently appropriated it'.²⁴ This will allow tracing claims. An additional consequence is that the victim

will receive priority in any bankruptcy of the fraudster because the victim will be able to assert property rights to the proceeds of the fraud. However, if the fraud is not sufficient to make the contract ineffective in equity, then the victim will need to rescind the contract to revest title.

CONCLUSION

Although the theft principle was established almost a century ago, it has only recently been extended to the law of contract. Only a small number of cases has applied the principle in the contractual context, and the distinction in practice between fraudulent misrepresentations and transactions that are entirely fraudulent is far from clear. This area of the law is likely to develop further in the future, which should provide clarity on this important issue.

Victims of fraud should receive protection from the courts, but the application of the theft principle in the contractual context, as well as other contexts, has the ability to impact on the rights of innocent third parties. There is also the potential for considerable uncertainty, because a victim of a fraud cannot be sure whether they have property rights arising from the theft principle until a court declares that the contract was an instrument of fraud. Accordingly, victims need to be cautious when purporting to assert property rights in circumstances where they may be unsure whether a court will declare that a contract is ineffective because it is an instrument of fraud. ■

Notes: **1** *Black v S Freedman & Co Pty Ltd* (1910) 12 CLR 105. **2** *Ibid* at 110. For a discussion of property rights to stolen money, see J Tarrant, 'Property Rights to Stolen Money' (2005) 32 *UWAL Rev*, 234. **3** See *Cashflow Finance Pty Ltd (in liq) v Westpac Banking Corporation* [1999] NSWSC 671 at [408] per Einstein J. For a discussion of the theft principle, see J Tarrant, 'Theft Principle in Private Law' (2006) 80 *ALJ* 531. For a discussion of the theft principle in the banking and commercial context, see V Priskich, 'Theft, Fraud and Mistaken Payments: Personal and Proprietary Remedies in Banking and Commercial Cases' (2008) 19 *JBFLP*, 163. The validity and appropriateness of the theft principle has recently been questioned and defended: see S Barkehall-Thomas, 'Thieves as Trustees: The Enduring Legacy of *Black v S Freedman & Co Ltd* (2009) 3 *J Eq* 52; and J Tarrant, 'Thieves as Trustees: In Defence of the Theft Principle' (2009) 3 *J Eq* 170. **4** *Creak v James Moore & Sons Pty Ltd* (1912) 15 CLR 426. **5** *Halley v The Law Society* [2003] WTLR 845; [2003] EWCA Civ 97. See also TH Wu, 'Proprietary Relief Without Rescission' [2004] *CLJ* 30; and S Barkehall-Thomas, 'Proprietary Responses to Voidable Contracts: A Misconceived Analysis' (2009) 25 *JCL*, 272. **6** *Black v S Freedman & Co Ltd* (1910) 12 CLR 105 at 110. **7** [2003] EWCA Civ 97. **8** *Ibid* at [45]. **9** See *Lonrho v Fayed (No. 2)* [1992] 1 WLR 1 at 11-12; and *Daly v Sydney Stock Exchange Ltd* (1986) 160 CLR 371 at 387-90. See also D O'Sullivan, S Elliott and R Zakrzewski, *The Law of Rescission*, OUP, Oxford, 2008, pp13-20. **10** [2003] EWCA Civ 97 at [47]. **11** *Ibid* at [48]. **12** *Ibid*. **13** *Ibid* at [43] - [44]. **14** [2005] NSWSC 1209. **15** *Ibid* at [155]. **16** *Ibid*. **17** [2000] NSWSC 40. **18** *Ibid* at [9]. **19** [1964] 1 All ER 290. **20** [2003] EWCA Civ 97 at [49]. **21** *Ibid*. **22** See *R v Preddy* [1996] AC 815. **23** See D Fox, *Property Rights in Money*, OUP, Oxford, 2008, p142. **24** *Ibid*.

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