

CLEANING UP AFTER BREACHES OF FIDUCIARY DUTY - THE LIABILITY OF BANKS AND OTHER FINANCIAL INSTITUTIONS AS CONSTRUCTIVE TRUSTEES

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Introduction

For lawyers interested in the commercial applications of equity the events of 19th and 20th October 1987 ('Black Monday and Tuesday') still hold a morbid fascination. Among many other consequences the meltdown in the world's stockmarkets brought down many of the paper-shuffling entrepreneurs who had risen to a synthetic prominence in the 1980s. Many whose wealth was held in publicly quoted shares found themselves unable to meet contractual commitments and resorted to transactions of dubious legality, or in some cases of patent illegality, in order to meet their obligations.¹ Not all the principal wrongdoers were dishonest and high-handed; some were genuinely victims of unforeseen economic circumstances. Nevertheless, the fall of these shakers and movers of papers spawned a considerable amount of litigation as liquidators, administrators and secured creditors tried to salvage what they could from the financial wreck. Although statute and common law liability naturally had their place in this litigation, equitable principles played a central role. Company directors may be liable in equity as well as under the Corporations Act for their defaults. This paper is not concerned with direct fiduciary liability. Equitable constructive trusteeship could also, however, have been imposed on those to whom money was passed or who, perhaps as financial advisers to a fallen entrepreneur, furthered the enterprise in some way. Banks are the natural defendants to this secondary litigation. They are, for the most part, solvent and inescapably within the jurisdiction of the court. Moreover, banks are often the unsuspecting facilitators of the movement of the proceeds of fraud. For these reasons they have been increasingly drawn into hindsight inquiries as to the effectiveness of their procedures for preventing financial fraud.

The revitalisation of equitable causes of action in this area is harder to explain. It does appear that technology has to some extent altered legal classification. In the first part of this century commercial fraud was usually

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1 *Eagle Trust plc v SBC Securities Ltd* [1992] 4 All ER 488 and *Equiticorp Industries Group v Hawkins* [1991] 3 NZLR 700, together with other, mainly unreported, *Equiticorp* cases, are clearly traceable to the events of October 1987. So, though more indirectly, is *Cowan de Groot Properties Ltd v Eagle Trust plc* [1992] 4 All ER 700.

litigated at common law, conversion of cheques being a typical allegation. The replacement of physical documents by electronic transfers has meant that conversion, which presupposes the existence of physical property such as a document, is increasingly viewed as unsuitable for this form of litigation, whereas equitable fiduciary principles may follow the configurations of elections from the malfasant company directors into the bank accounts of others who have received the fruits of the breach of duty. Commercial fraud of the late 1980's was less a matter of 'paper shuffling' as of taking advantage of more efficient techniques of electronic transfers.

The focus of this article will be upon the liability of banks and other financial institutions as constructive trustees. Other sources of secondary or accessory fiduciary litigation should, however, not be overlooked. Recent years have seen a rapid expansion, and hence occasional abuse, of schemes of collective investment. The eighteenth and nineteenth century private trust was a form of 'family collectivity'. Some family trustees would inevitably manipulate the trust for private advantage, wittingly or unwittingly assisted by solicitors who found themselves caught up in a battle for the control of the trust.² The essentially domestic collectivity of the trust has largely given way to a variety of commercial collective schemes. The recent report of the Australian Law Reform Commission and Companies and Securities Advisory Committee on Collective Investments³ has documented both the proliferation of the number and variety of schemes and, in many cases, the absence of effective regulatory machinery. They range from multi-million dollar unit trusts to small scale pooling arrangements between friends. A steady flow of constructive trust cases can already be traced to the abuse or mismanagement of collective investment schemes.⁴

Statute may also play its part in increasing the exposure of institutions and professional advisers to the risk of secondary liability for a breach of fiduciary obligation. The *Superannuation Industry (Supervision) Act 1993* affords a recent example. The Act of 1993 makes provision for a number of non-excludable covenants which purport to codify in some respects, and extend in others, some of the equitable obligations affecting superannuation entities.⁵ Contravention of a covenant is not an offence, though someone who suffers loss or damage as a result of conduct of another person engaged in a contravention may recover 'against that other person or against any person involved in the contravention'⁶ Following the statutory trail, we learn that being involved in a contravention includes a case where a person 'has been in any way, by act or

2 *Barnes v Addy* (1874) LR 9 Ch App 244; *Williams v Williams* (1881) 17 Ch D 437, *Re Blundell* (1888) 40 Ch D 370.

3 Australian Law Reform Commission/Companies and Securities Advisory Committee (no 65) *Collective Investments: Other People's Money*, ch 3.

4 *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22; *Re Goldcorp Exchange Ltd* [1994] 2 All ER 806; *Nimmo v Westpac Banking Corp* [1993] 3 NZLR 218; *Murphy and Allen v Lew* 13 (1993) ACSR 10.

5 *Superannuation Industry (Supervision) Act 1993* (hereinafter 'SIS') s 52. The covenant requiring trustees to act honestly (s 52(2)(a)) is an example of the former, the covenant to formulate and give effect to an investment strategy in a specified way (s 52(2)(f)) may be an illustration of the latter.

6 SIS ss 55(2), (3).

omission, directly or indirectly, knowingly concerned in, or party to, the contravention'.⁷ Will superannuation trustees be required to remedy a loss on the basis of the generous principles applicable to equitable compensation, which may not be subject to considerations of remoteness of damage or mitigation of loss?⁸ More pertinently for the purposes of this paper, will persons who 'knowingly' assist in a statutory contravention be liable on the basis of the degree of knowledge required of those whom it is sought to hold liable for knowingly assisting in breach of trust or other fiduciary duty? In other words, are these statutory obligations designed to operate within the framework of existing fiduciary law, or should the statute be viewed as an opportunity to recognise and enforce new norms of conduct? The problem of applying statutory obligations within the fabric of established common law and equitable principles is not new: courts have been wrestling with this issue in the evolving case law under the *Trade Practices Act* 1974 (Cth). But for advisory committees of professional advisers who are commonly appointed to assist and provide specialist advice for superannuation trustees ascertainment of what precisely is meant by being 'involved in a contravention' assumes rather more than theoretical significance.

If a breach of an equitable or statutory fiduciary obligation has been committed, why does the victim of the breach sue a receiver of the assets from the fiduciary, or a party who assists in the breach, rather than (or as well as) the fiduciary? Obvious reasons, already adverted to, are the insolvency of the fiduciary or the escape of the fiduciary 'to some Shangri La which hides bribes and other corrupt moneys in numbered bank accounts'⁹ beyond the reach of the civil processes of justice. If the third party recipient still possesses fiduciary assets or their proceeds the principal will want to recover them, if necessary by employing tracing techniques. The claim to a constructive trust of assets which are actually in the hands of the recipient may then compete with the claims of secured lenders to the fiduciary. The facts of *Linter Group Ltd v Goldberg*¹⁰ are typical of this sort of priority dispute. A less obvious explanation for suing secondary parties is the existence of personal inhibitions which prevent the initiation of proceedings against the principal wrongdoer but which would not restrain an action against a recipient or an accessory. These reasons include the strength of family blood ties or the loyalty which may endure between business associates in spite of the breach of duty. Beneficiaries of nineteenth century family trusts might feel inhibited by ties of kinship from suing the family members who acted as trustees; such considerations would not prevent proceedings being brought against outsiders who had become implicated in the trust administration. In *Re Barney*,¹¹ a leading case on the liability of third parties as trustees de son tort, the children beneficiaries prosecuted the case against outsiders who had assisted in carrying on a business in breach of trust

7 SIS s17(c).

8 See WMC Gummow, *Compensation for Breach of Fiduciary Duty*, in TG Youdan (ed), *Equity, Fiduciaries and Trusts*.

9 *Attorney-General of Hong Kong v Reid* [1994] 1 AC 324, 339, Lord Templeman.

10 (1992) 7 ACSR 580.

11 [1891] 2 Ch 265. Mrs Barney, although nominally a defendant, gave evidence in support of the plaintiff's case.

more vigorously than the action against their mother who as executrix was the principal wrongdoer.

The modern counterpart of the family beneficiaries who pursue third parties more actively than the family trustees is the company which does not sue a director for breach of fiduciary duty because the other directors have personal or business reasons of their own for not litigating against the principal wrongdoer. Instead, the directors discharge what they conceive to be their duty to the company by bringing proceedings against a secondary party who may have received company assets or have been implicated in some way in the breach of duty. Some recent decisions which appear to have restricted the liability of recipients and assisters may have been influenced by an unstated judicial perception that a significant cause of fraud in these cases was the tacit acquiescence of the co-directors in the principal wrongdoer's transgression. But the policy of suing secondary parties while leaving the defaulting fiduciary untouched is usually misguided. A fiduciary does not escape liability simply because the victim of the breach elects to sue a secondary party. The secondary party may seek contribution from the fiduciary, compelling the latter to pay a proper share of the compensation payable upon breach and thereby defeating the victim's election of a defendant. There are indications that the relevance of contribution principles to the law of constructive trusts is beginning to be recognised.¹²

Since *Barnes v Addy*¹³ it has been convenient, if inaccurate, to distinguish cases brought against third parties on the ground of 'knowing receipt' of property from a fiduciary from those founded on 'knowing assistance' with a breach of fiduciary duty. There are in fact numerous varieties of equitable secondary liability. This was an area of equity which prior to *Barnes v Addy* displayed considerable conceptual richness,¹⁴ with some mingling of fault based liability for participation in a breach of fiduciary duty with the strict liability to repay imposed upon the wrongful recipients of a trust funds following a mistaken distribution made by a trustee. Lord Selborne's judgment in *Barnes v Addy* was a magnificent specimen of Victorian self confidence: apparently axiomatic propositions were formulated with no case law citation and without any appreciation of the conceptual peculiarities of the constructive trust imposed upon secondary parties. The diverse strands of authority on secondary liability were effortlessly reduced to the dichotomy of 'knowing receipt' and 'knowing assistance'. Although some of the earlier lines of authority have occasionally resurfaced in later analysis by English judges¹⁵ courts have mostly been content to accept the dual scheme of 'knowing receipt' and 'knowing assistance' without providing a rationale for it. Australian and New Zealand judges have, if anything, been even more acquiescent in the

12 *Equiticorp v Hawkins* (No 4), Wylie J, NZHC, 18 Feb 1992, unreported.

13 (1874) LR 9 Ch App 244.

14 See the more detailed classification adopted by Charles Harpum, 'The Stranger as Constructive Trustee' 102 (1986) *LQR* 114, 267. His scheme is followed by M Cope, *Constructive Trusts*, (1992) ch 8, 9. See also C Harpum, 'The Basis of Equitable Liability' (1993), SPTL seminar on Equity.

15 *Arip (Africa) Ltd v Jackson* [1992] Ch 265, 291-293, Millett J.

receipt/assistance distinction than their English counterparts.¹⁶ They have uncritically adopted this division of the field of equitable secondary liability and confined their creativity to exquisite analyses of the degree of knowledge required to hold a defendant liable in each of these categories.

An unfortunate consequence of this over-absorption with the question of knowledge is that other important issues tend to be neglected. One, the meaning of 'receipt' for the purposes of constructive trusteeship based on knowing receipt, can be crucial where a bank is the defendant. This problematic issue has been considered elsewhere.¹⁷ Other issues explored in recent cases, which perhaps deserve closer examination than they have so far received, include the liability of co-constructive trustees to make contribution¹⁸ (important given the multiplicity of defendants in many commercial fraud cases) and the standing of new trustees to sue former trustees, recipients and assisters for breach of trust¹⁹ (important given the multiplicity of plaintiffs, and the problems of instituting class actions in some cases of failure of collective investment schemes). The complexity of litigating commercial fraud cases has demonstrated that more is required of judges today than the construction of a taxonomy of degrees of knowledge.

Nevertheless, while the scholastic debates about the meaning of 'knowledge' for the purpose of imposing constructive trusteeship liability can be deplored they cannot be ignored. The degree of knowledge possessed by those who receive assets in breach of fiduciary duty, or who assist in a breach, remains the principal forensic issue in most constructive trust litigation. The process of elucidating the facts in a 'paper shifting' fraud case is lengthy and complex, and the need to ascertain the precise type of knowledge possessed by the principal actors adds another layer of complexity, with its attendant costs, to this type of case. There is no shortage of judicial and academic opinion as to what the 'right' answer to the knowledge question is, but the profusion of 'right' answers has served only to confuse more thoroughly judges who have to adjudicate a constructive trust issue. This is an area of equity which has been over-theorised with very little practical benefit.

The purpose of this article is not to add to the confusion by proposing some new theoretical approach to secondary liability. Its aim is modest and descriptive. It is to examine and to organise the principal approaches to imposing constructive trusteeship in cases of 'knowing receipt' and 'knowing assistance'. 'Receipt' has attracted the most thoroughgoing academic attention. In determining the degree of knowledge expected of recipients of fiduciary assets, who are most frequently banks these days, judges make implicit assumptions as to the role that this form of equitable obligation plays. The older cases rest on a proprietary basis: a recipient of property should be liable to return it or pay for its value, on the same basis and subject to the same exceptions as any other recipient of trust

16 But see *Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 32 NSWLR 50, 105, Kirby P.

17 Michael Bryan, 'When Does a Bank Receive Money?' *Journal of Business Law* (forthcoming).

18 *Equiticorp v Hawkins (No 4)*, above n 12.

19 See *Murphy v Allen and Lew*, Victoria Full Court, 27 June, 1994.

property. In these cases the language of actual or constructive knowledge (or even notice, in some of the older cases) is employed. Other cases see the receiver as a sort of 'substitute fiduciary' who should be subject to the same considerations of 'conscience' as the original fiduciary wrongdoer. 'Conscience' has here been roughly translated into a requirement of actual knowledge. Finally, some writers and fewer judges characterise the receipt-based constructive trust as essentially restitutionary, in the sense of being the functional equivalent in equity of the action for money had and received at common law. Here the superficially radical suggestion has been made that liability should be strict.

The constructive trust based on 'knowing assistance' more readily lends itself to the 'conscience' approach since the transfer of wealth which is the hallmark of the 'property' and 'unjust enrichment' approaches will not necessarily be present. The assister may in some cases have not received fiduciary assets; in other cases there will be no beneficial receipt.²⁰ The principal dispute here concerns the nature of the principal wrong to which secondary liability attaches. Does assistance in a 'dishonest and fraudulent design' imply that the initial breach of fiduciary obligation must be more than, say, a technical breach of an investment clause in a trust deed? Or must a plaintiff discharge the heavy and uncertain burden of proving fraud on the part of the fiduciary? The problem is not inherent in this form of secondary liability but derives from Lord Selborne's proposition in *Barnes v Addy* that strangers were not to be made constructive trustees unless:

they assist with knowledge in a dishonest and fraudulent design on the part of the trustees.²¹

This offhand reference to 'dishonest and fraudulent' design has acquired significance in the light of recent cases, including a recent decision of the Canadian Supreme Court, which controversially attempt to confine liability to cases of deliberate wrongdoing by fiduciaries.

The Meaning of Knowledge

The receipt-based constructive trust abounds in unresolved issues but none has exercised so much judicial fascination, or provoked so much casuistry, as the question of the degree of knowledge required to hold a defendant liable.

The High Court has never pronounced directly on the question and settled approach has emerged from decisions of State Supreme Courts. Since the confusion is not confined to Australian law, however, but extends to the rest of the common law world the problem may be traceable to a deeper fault-system within the law of constructive trusts for knowing receipt. The chaos in

20 See *Lankshear v ANZ* [1993] 1 NZLR 481 for a recent example of a receipt which was in part not a beneficial receipt.

21 (1874) LR 9 Ch App 244, 252.

the state of authorities seems to reflect a philosophical disagreement as to the role that this type of constructive trust is supposed to play in the arsenal of remedies available for breach of fiduciary duty. Three distinct approaches to the imposition of liability can be identified in recent cases. Each rests on assumptions which are rarely discussed openly by judges. Moreover, each emphasises a feature of knowing receipt liability which is overlooked, or minimised, by the other approaches. The three approaches are the property approach, the conscience (or substituted fiduciary) approach and the unjust enrichment approach.

The Property Approach

The term 'property approach' is used advisedly. It does not necessarily mean that the plaintiff seeks the return of specific property, although if property is traceably in the hands of the defendant a proprietary constructive trust may be imposed. More often, though, the constructive trust is imposed upon a defendant through whose hands the property has passed; such a defendant is personally liable for the value of the property. Nevertheless, the analogy with property is strong, and judges readily make the connexion between a recipient through whose hands the property has passed and one who is in actual receipt of property. The connexion was recognised by Stephen J in *Consul Development Pty Ltd v DPC Estates Pty Ltd* where the origins of this form of constructive trust were said to lie:

perhaps ... in the equitable doctrine of tracing, perhaps in equity's concern for the protection of equitable estates and interests in property which comes into the hands of purchasers for value.²²

Although the links to property law have been acknowledged courts have been careful to distinguish knowledge under this head of constructive trusteeship with the doctrine of notice developed in the law of real property. Recipients will not be liable on the basis of actual or constructive notice.

It seems to me that one must be very careful about applying to constructive trusts either the accepted concepts of notice or any analogy to them. In determining whether a constructive trust has been created, the fundamental question is whether the conscience of the recipient is bound in such a way as to justify equity in imposing a trust on him.²³

A feature of recent English constructive trust decisions has been the identification and isolation of five types of knowledge, possession of which by the defendant may justify the imposition of liability. The typology was developed by Peter Gibson J in *Baden v Société Générale pour Favoriser le Développement de Commerce et l'Industrie en France SA*.²⁴ The categories are

22 (1975) 132 CLR 373, 410. See also *Agip (Africa) Ltd v Jackson* [1992] 4 All ER 385, 403-404, Millett J.

23 *Re Montagu's Settlement Trusts* [1987] Ch 264, 277, Megarry VC.

24 [1992] 4 All ER 161.

as follows:

- (i) actual knowledge;
- (ii) wilfully shutting one's eyes to the obvious;
- (iii) wilfully and recklessly failing to make such enquiries as an honest and reasonable person would make;
- (iv) knowledge of circumstances which would indicate the facts to an honest and reasonable person;
- (v) knowledge of circumstances which would put an honest and reasonable person on inquiry.²⁵

This classification has been criticised on the ground of over-refinement.²⁶

It has not so far provided the framework of analysis in Australia, although there have been few recent cases in which it might have been applied. It has, however, won a measure of acceptance in New Zealand.

Some Australian authority has applied a test of liability based on the defendant's 'actual or constructive' knowledge without clarifying what these terms might mean. A recent illustration is the Victorian case of *Linter Group Ltd v Goldberg and others*.²⁷ The facts are complex but for present purposes it is sufficient to state that Goldberg, who controlled Linter Corporation, transferred \$205 million to a shelf company, Arnsberg, in order to enable the latter to make a takeover bid for Brick and Pipe Industries Ltd. Various other financial institutions also provided money for the takeover, which succeeded. Arnsberg received Brick and Pipe shares worth about \$290 million. Shortly afterwards both Linter and Arnsberg went into liquidation. Southwell J held that the advance of \$205 million by Linter to Arnsberg constituted a breach of the fiduciary obligations owed by Goldberg to Linter since the loan was inadequately secured and offered no real benefit to Linter. Arnsberg was held liable as constructive trustee for knowing receipt of Linter's money which it had received as a direct result of Goldberg's breach of duty. Since Goldberg controlled both Linter and Arnsberg it was easy, perhaps automatic, to attribute Goldberg's knowledge of his own fiduciary defaults to Arnsberg. Nevertheless, Southwell J, relying substantially and perhaps uncritically on the earlier English decision of *Belmont Finance Corp v Williams Furniture Ltd (No 2)*,²⁸ held that the correct test was whether the stranger to the trust, Arnsberg in this case, had received the assets with actual or constructive knowledge of the breach of duty. Like the Court of Appeal judges in the *Belmont* case he did not explain how precisely a recipient was fixed with 'constructive knowledge'. Presumably, following *Re Montagu's Settlement Trusts*,²⁹ constructive knowledge differs from constructive notice in that the former does not impose a general duty of reasonable inquiry upon a recipient of assets.

25 Ibid at 235.

26 See, in particular, *Agip (Africa) Ltd v Jackson* [1992] 4 All ER 385, 405, although here and in other cases the application of this taxonomy has been criticised in connexion with knowing assistance liability, rather than knowing receipt.

27 (1992) 7 ACSR 580.

28 [1980] 1 All ER 393.

29 [1987] Ch 264.

Linter is typical of many receipt-based constructive trust cases in that Arnsberg would have been liable on *any* plausible test of knowledge applied by the court.³⁰ Where money has been moved through a network of associated or subsidiary companies effectively controlled by the principal fiduciary, then, however complex the network, it is a straightforward matter to attribute the knowledge of that fiduciary to a company further down the money chain. The evidential problems of following the money trail may be considerable but the ascription of knowledge in these 'paper shifting' transactions usually presents no problems. The *Linter* case also demonstrates that courts are perhaps most likely to emphasise the proprietary features of this form of constructive trust where the trust itself is genuinely proprietary and not just a basis for accounting for the value of the property received. *Linter* successfully claimed proprietary rights over the proceeds of sale of the Brick and Pipe shares by virtue of the constructive trust, ahead of the claims of other lenders who had assisted Goldberg in the takeover venture. When the role of the constructive trust is to confer beneficial interests as part of 'the battle of priorities' a test of liability posited on actual or constructive knowledge may appear to judges to be a reasonable adaptation of the doctrine of actual or constructive notice which defines the limits of equitable tracing principles.

New Zealand has, more firmly than Australian law, committed itself to the proprietary approach for the receipt-based constructive trust. In contrast to *Linter Group* case the New Zealand courts have defined actual and constructive knowledge in terms of the *Baden* taxonomy while remaining sceptical about the over-elaboration inherent in its divisions of knowledge. The leading case is *Westpac Banking Corporation v Savin*.³¹ Two boat owners, Savin and Boyle, authorised Aqua Marine Ltd to sell their boats. Aqua Marine was to receive a commission for the sales, related to the price it obtained for the boats. Both boats were sold and the proceeds of sale paid into Aqua Marine's trading account with Westpac, which was overdrawn. Shortly afterwards Aqua Marine went into liquidation without either owner having been paid. Evidence was adduced that the bank knew that on average about three out of four boats sold by Aqua Marine were sold on behalf of the boats' owners and not out of the company's own stock. It had also been keeping Aqua Marine's trading account under constant supervision in view of the company's precarious solvency. The bank used the proceeds of boat sales to reduce the company's overdraft. This constituted a 'beneficial receipt' and the New Zealand Court of Appeal held Westpac liable as constructive trustee. Given the close involvement of Westpac with Aqua Marine's activities, the court had no difficulty in concluding that the bank had actual knowledge of the company's breach of fiduciary duty. Like Arnsberg in the *Linter Group* case the bank would have been held liable on almost any test of knowledge that the court might have enunciated.

30 *Stephens Travel Services International v Qantas Airways* (1988) 13 NSWLR 331, *Westpac Banking Corp v Savin* [1985] 2NZLR 41 and *Powell v Thompson* [1991] 1 NZLR 597 are other recent cases where the recipient possessed actual knowledge, and where the precise test adopted by the court was immaterial to the decision reached.

31 [1985] 2 NZLR 41.

The judgment of Sir Clifford Richmond contains a careful and scholarly review of the authorities, placing special emphasis on cases where claims had been brought against banks. But it is in the judgment of Richardson J that discussion of the *Baden* taxonomy is found. 'Constructive knowledge' was equated to the fourth and fifth types of *Baden* knowledge:

In principle I cannot see any adequate justification for excluding categories (4) and (5) [of *Baden* knowledge] at least in the 'knowing receipt' class of case and I tend to favour for that class of case the comprehensive approach of Peter Gibson J which now has the endorsement of *Halsbury*.³²

Although the judgments in *Westpac v Savin* have been criticised on the ground that they are not always careful to distinguish 'knowledge' from 'notice'³³ the case itself has long been regarded as the controlling authority in New Zealand on 'knowing receipt'. Apart from a mild and eccentric flirtation with restitutionary analysis, to be discussed later in this paper, New Zealand cases have remained loyal to a proprietary approach. The 'five degrees' of *Baden* knowledge are recognised as falling short of imposing a 'duty of inquiry' on banks to investigate the source of money received, and are not considered to impede the flow of money transfers. In one of the latest cases it has been asserted that the dictum of Richardson J cited above:

... preserves the ability to discourage abuses of fiduciary position, with a flexibility which allows normal commerce. The dictum has not caused apparent commercial difficulties. Whatever trends may be apparent in England, it rather seems the (occasionally different) needs of commerce in New Zealand are satisfied.³⁴

As later discussion will show, the proprietary approach constitutes a compromise position between a conscience framework, which has tended to protect later recipients of the proceeds of fraud, and a restitutionary analysis which favours the initial fraud victim.

The Conscience Approach

The avoidance of unconscientious conduct is an abiding concern of modern courts of equity, and its influence has been felt in the receipt and assistance based constructive trusts as it has elsewhere. Underlying some of the recent case law has been the notion that the moral assumptions informing the fiduciary's liability in equity should as far as possible govern the liability of a recipient of assets from the fiduciary. The considerations of 'conscience' which form the basis of the fiduciary's liability should also apply to the recipient as 'substituted fiduciary'. The idea of the stranger as 'substituted fiduciary' is well expressed by Ford and Lee:

32 Ibid at 53.

33 *Stronge v ANZ Banking Group*, McGechan J, 11 Oct 1994.

34 Ibid.

Where a stranger, having received trust property or improperly participated in a breach by the trustee, is liable to pay compensation for losses arising from her or his breach, the equation of liability to that of an expressly appointed trustee owes something to an idea that the stranger is subject to the same rights and remedies that were enforceable against the trustee expressly appointed and is treated as being subject to the same fiduciary obligations.³⁵

Judges who locate equitable liability in conscience prefer to base constructive trusteeship on actual knowledge. While the first three categories of the *Baden* typology provide a reasonable conceptualisation of an honesty approach some reservations have been expressed about the appropriateness of knowledge within the fourth and fifth categories. A significant cause of instability in this area of constructive trusteeship, though, has been the failure of judges who consider that a test of liability extending to constructive knowledge is over-broad to develop an alternative formulation which might command general acceptance.

The genesis of the 'conscience' approach to knowing receipt constructive trusteeship, at least in recent times, is the English Court of Appeal decision in *Carl Zeiss Stiftung v Herbert Smith and Co*³⁶ where Sachs L J underlined the need for 'dishonesty or a consciously acting improperly'³⁷ and Edmund Davies L J insisted upon 'want of probity'.³⁸ The judgments are ambiguous as to whether knowing receipt or knowing assistance was being discussed. But in *Re Montagu's Settlement Trusts*³⁹ Megarry V-C recast 'want of probity' into the *Baden* classification and considered that it was 'at best doubtful'⁴⁰ whether types (iv) and (v) knowledge applied.

Neither case concerned receipt-based constructive trusteeship in the context of commercial fraud. Both have been criticised by proponents of proprietary and restitutionary approaches on the grounds that they run counter to established authority and are inconsistent with basic principles which should govern the law of knowing receipt. The criticisms are convincing, at least given the standpoints of the critics. The conscience approach has, however, attracted increasing support in recent cases and instead of viewing this line of authority as a judicial aberration it seems worthwhile examining why an approach based on the recipient's honesty has become popular. The appeal to 'conscience' has been particularly strong in cases involving company directors as fiduciaries. In

35 HAJ Ford, WA Lee *Principles of the Law of Trust*, 2nd ed, 1990, para [2216]. The whole section on knowing receipt in this text is firmly grounded on the notion of a stranger as substituted fiduciary, whose liability should be based on actual knowledge. See in particular para [2219]: 'It is one thing to say that a person who has legal title to property should be postponed to a prior equitable interest because that person was careless though honest. It is another to say that a person who has received property should be personally liable to pay compensation for loss, or to account for gains, and to base that liability on an original failure to make inquiries that was negligent but not dishonest'.

36 [1969] 2 Ch 276, criticised D M Gordon QC (1970) 44 *ALJ* 261, Charles Harpum, n 14 at 285-287, Peter Birks 'Misdirected Funds: Restitution from the Recipient' (1989) *LCMLQ* 296, 324-325.

37 *Ibid* at 298.

38 *Ibid* at 299-301.

39 [1987] Ch 264, criticised by Peter Birks, above n 36, at 329-332.

40 *Ibid* at 285.

some of these cases courts appear to be motivated by 'clean heads' considerations: the plaintiff is a small company whose officers have failed to monitor closely the activities of the principal wrongdoer. In other cases a 'conscience' approach has been judicially regarded as the most sensitive to policies of promoting negotiability and speed of commercial transactions. Transactional speed is crucial on banks, and even if a distinction can be drawn between constructive notice and constructive knowledge, the line between them is fine. Although courts have consistently denied that a duty of inquiry rests upon banks to investigate the source of money they receive, the recognition of types (4) and (5) *Baden* knowledge in practical terms comes very close to the imposition of such a duty. Both these concerns could be allayed by a sensitive application of the proprietary and restitutionary approaches. There is, however, a clear judicial perception that a 'conscience' approach may provide the most suitable framework for the sort of fine tuning with which courts of equity are familiar in exercising remedial discretion. The fine tuning consists of either confining liability to actual knowledge or reformulating the fourth and fifth categories of *Baden* knowledge so as to reflect more faithfully standards of commercial honesty.

Typical of the 'conscience' approach is the English Court of Appeal decision in *Eagle Trust plc v SBC Securities Ltd*.⁴¹ In October 1987 Eagle Trust made a takeover offer for the shares of the Samuelson group of companies. Under the terms of the offer, which was accompanied by a rights issue, the shareholders of Samuelson were offered new shares in Eagle or a cash alternative. The defendants agreed to underwrite the cash alternative and the rights issue. They proceeded to sub-underwrite their liability, using for this purpose a list of sub-underwriters introduced by Eagle's chief executive, Ferriday. Ferriday himself agreed to underwrite 25.5 million shares. The October 1987 stock market crash occurred just before the offer documents had been sent out. Most of Ferriday's wealth was tied up in Eagle and, needing £13.5 million in order to satisfy his sub-underwriting obligations, he misappropriated money from Eagle for this purpose. The money was paid to the defendants as principal underwriters. Eagle sought to hold the defendants liable to account as constructive trustees on the basis of knowing receipt, for the £13.5 million misappropriated by Ferriday. The defendants applied to have the action struck out.

It is clear from the tone of Vinelott J's judgment that he did not regard the action as meritorious. The other directors of Eagle could as easily have prevented the misapplication of company money as the defendants; the defendants, as underwriters, were not well placed to confront Ferriday with any suspicions they might have entertained as to the source of his money; finally, Eagle's arguments that the defendants should have made further inquiries of Ferriday were tainted by hindsight and an after-knowledge of the misuse of the company's money. This last consideration is an important factor in commercial constructive trust cases. It is almost always possible for a recipient of money

41 [1992] 4 All ER 488.

to probe more deeply into the sources of money, but it is not always reasonable to expect such probing. As Vinelott J remarked, 'it would hardly have been open to [the defendants] to invite Eagle to play detective and investigate their own chief executive'.⁴² A conscience-based approach is designed to prevent an inappropriate use of hindsight in fixing the degree of knowledge required.

In ordering Eagle's claim to be struck out Vinelott J confined knowledge to the first three categories of *Baden* knowledge, or to where:

an honest and reasonable man would have inferred that the moneys were probably trust moneys and were being misapplied, and would either not have accepted them or would have kept them separate until he had satisfied himself that the payer was entitled to use them in discharge of the liability.⁴³

Later cases have gone further in applying the 'conscience' approach in a way that affords greater protection to good faith recipients of fiduciary assets than the proprietary approach. In *Cowan de Groot Properties Ltd v Eagle Trust plc*,⁴⁴ also a case arising from the events of October 1987 and involving the same fiduciary, Ferriday, implicated in the earlier *Eagle Trust* case, Knox J declined to hold that a purchaser of properties sold (in effect) by Ferriday in breach of fiduciary obligation was liable to Eagle Trust as constructive trustee. His conclusion was that:

[the purchaser] did not in my judgment have the knowledge in any of the categories (i), (ii) or (iii) of the *Baden* classification of the facts that constituted the breach of fiduciary duty in the sale at the figure and on the terms on which it was effected. That is fatal to Eagle's claim In my judgment it may well be that the underlying broad principle which runs through the authorities regarding commercial transactions is that the court will impute knowledge, on the basis of what a reasonable person would have learnt, to a person who is guilty of commercially unacceptable conduct in the particular context involved.⁴⁵

If the phrasing is different from that of Vinelott J in *Eagle Trust plc v SBC Securities* the formulation of liability in terms of commercial conscience is even clearer. Both cases manifest a commitment to protecting a purchaser's security of transaction, a policy possibly reinforced by the original title holder's failure to safeguard its own assets.

A similar preoccupation with security of transaction informs the Court of Appeal decision in *Polly Peck International v Nadir (No 2)*.⁴⁶ Asil Nadir was the chief executive of Polly Peck International, a public limited company which carried on business as the holding company of a group of over two hundred subsidiaries. An administration order was made against the company in 1990.

42 Ibid at 511.

43 Ibid at 509.

44 [1992] 4 All ER 700.

45 Ibid at 761.

46 [1992] 4 All ER 769.

The administrators alleged that Nadir had transferred £142 million of Polly Peck's money to the account of IBK at a London clearing bank. IBK was a bank incorporated in Northern Cyprus and controlled by Nadir. Some £45 million of the £142 million was transferred by IBK from its London account to the Central Bank of Northern Cyprus's account at the same branch of the London bank in exchange for a corresponding sum of Turkish lire. The Central Bank acted as the supervisory bank for Northern Cyprus. Millett J imposed a Mareva injunction on the Central Bank's assets in England in support of the administrator's claims which included a constructive trust claim. The Court of Appeal allowed the Bank's appeal against the injunction. The judgment of Scott LJ illustrates the problems of forcing a conscience-based approach into the straitjacket of the *Baden* typology,⁴⁷ but it also shows a concern to sustain the flow of ordinary banking transactions, unimpeded by equitable duties of inquiry. In particular, the judgement rejected the argument that the Central Bank should have been put on inquiry by the very large amounts of money involved in the transfers.

The test is not satisfied by the inference of no more than curiosity. It is important in this regard to bear in mind that it is common ground, for present purposes at least, that at the relevant time Mr Nadir was a man of unblemished commercial reputation and integrity. He had achieved quite staggering commercial success over a relatively short period. He loomed, in Northern Cyprus, like a colossus over the local economy and over the commercial prospects and fortune of the country. Why should the Central Bank have suspected impropriety because of the scale of the funds being transferred into Northern Cyprus?⁴⁸

Authority for a conscience based approach in Australia is slight. Obiter dicta can be found in the leading authority on knowing assistance in a breach of fiduciary duty, *Consul Development Pty Ltd v DPC Estates Pty Ltd*,⁴⁹ on liability for knowing receipt which would restrict this form of constructive trusteeship to cases of proven dishonesty. The judgment of Stephen J comes closest to a conscience approach.

Two features emerge [from a review of the cases], they are all cases in which property passed through the defendant's hands and in all of them in which the plaintiff succeeded it did so because the defendant was held to have had actual knowledge of facts constituting the relevant fraud or breach of trust; thus constructive notice arose out of the defendant's failure to recognise fraud when he saw it, not from a failure to pursue inquiries.⁵⁰

47 Scott LJ accepted that category (v) knowledge (knowledge of facts which would have put an honest and reasonable person on inquiry) would suffice for the imposition of liability, but had some doubts about category (iii) knowledge (wilfully and recklessly failing to make inquiries that an honest and reasonable person would have made): [1992] 4 All ER 769, 777. Most attempts to establish a conscience-based approach accept the inclusion of the third category but exclude or redefine the fifth category: see *Eagle Trust plc v SBC Securities* [1992] 4 All ER 488; *Cowan de Groot Properties Ltd v Eagle Trust plc* [1992] 4 All ER 700.

48 [1992] 4 All ER 769, 778-779.

49 (1975) 132 CLR 373. D Heydon 'Recent Developments in Constructive Trusts' (1977) *ALJ* 635.

50 *Ibid* at 411. See also Gibbs J at 398.

But this is thin straw with which to build bricks of conscience. An indigenous Australian version of the conscience-based constructive trust would have to draw upon the recent High Court revitalisation of unconscionability doctrines: in the rules relating to the avoidance of unconscientious transactions, estoppel, the rules relating to relief from penalties and forfeiture, and in the constructive trust based upon failure of a joint endeavour, exemplified by *Muschinski v Dodds*⁵¹ and *Baumgartner v Baumgartner*.⁵² In addition, the principal weakness of the conscience-based cases - the failure to settle authoritatively the degree of knowledge required for the imposition of the constructive trust - must be eliminated. Finally, a court must avoid a 'drift into conscience' (a very real danger in the present state of equity jurisprudence) and articulate clearly why a conscience based approach should be adopted. Convincing policy reasons are not hard to find. In an area of law dominated by money and share transactions the twin policies of ensuring negotiability and minimising transactions costs will be most effectively promoted by legal rules which minimise the inquiries required of a bank or other recipient of assets and which place the onus of unsettling concluded transactions firmly on the plaintiff. In short, the 'conscience' approach goes further than the alternative in protecting security of transaction. But the relevance of security of transaction to a given case needs to be clearly demonstrated and not drowned in the rhetoric of unconscionability.

New Zealand law has one eccentric exception apart, never embraced the conscience approach. The authority of *Westpac v Savin*⁵³ has ensured fidelity to the proprietary approach. The exception is the judgment of Thomas J in *Powell v Thompson*.⁵⁴ As the ground of liability identified by Thomas J was unjust enrichment the decision will be considered in the next section. But, as will be shown, unjust enrichment was construed in the judgment as being essentially synonymous with the avoidance of unconscionable conduct, and there is a great deal to be said for treating the case as an application of the unconscionability principle.

The Restitutory Approach

Lawyers have been slow to recognise unjust enrichment as a possible basis for the receipt-based constructive trust. In contrast to the constructive trust imposed on property in cases of relationship breakdown, where Canadian⁵⁵ and some other courts have eagerly subscribed to a version of unjust enrichment, restitutory analysis has rarely infiltrated the case law on 'knowing receipt'. One reason has been the judicial preoccupation with the limits of commercial knowledge, which may be antithetical to a restitutory approach. Another has been the ignorance of some judges as to what is meant by a restitutory

51 (1985) 160 CLR 583.

52 (1987) 164 CLR 137.

53 See n 30 above.

54 [1991] 1NZLR 597.

55 *Pettkus v Becker* (1980) 117 DLR (3d) 257; *Sorochan v Sorochan* (1986) 29 DLR (4th) 1; *Peter v Beblow* (1993) 101 DLR (4th) 621; *Gillies v Keogh* [1989] 2 NZLR 327. See A Burrows, *The Law of Restitution* (1993) 38 for a criticism of this line of authority.

approach. 'Unjust enrichment' is sometimes crudely equated by judges to 'conscience' or 'balancing the equities'. This occurred in *Powell v Thompson*⁵⁶ where Thomas J's application of unjust enrichment was loose and unstructured. Mrs Powell and her two daughters, the plaintiffs, owned a house as tenants in common. When the daughters went overseas they conferred a power of attorney on Mrs Powell which they forgot to revoke on their return. Mrs Powell worked as an accountant for the defendant's butchery business. Between 1979 and 1987 she systematically embezzled \$289,482 from him. Upon discovery of the fraud the defendant did not go to the police but demanded full repayment. As part of the process of making restitution she agreed to transfer the house to the defendant. Her daughters knew nothing of their mother's fraud or of the later transfer. The defendant was aware that she was using a power of attorney in order to complete the transfer. After completion she was allowed to continue occupying the house. When the daughters discovered what had happened they claimed that the defendant held the house on constructive trust for them. They argued that the mother's abuse of the power of attorney amounted to a breach of fiduciary duty and the defendant had received the home with knowledge of the breach.

Thomas J held the defendant liable as constructive trustee. As in many other cases, the requisite degree of knowledge was almost beside the point. 'His actual knowledge was extensive',⁵⁷ since he was aware that the power of attorney was held and exercised on behalf of the daughters. Not content with this simple finding Thomas J embarked upon a wide-ranging inquiry into the juristic basis of this form of constructive trusteeship. In the opinion of his Honour:

In the 'knowing receipt' class of case the underlying basis of the defendant's liability is the unjust enrichment of the defendant at the expense of the plaintiff. The defendant gains the trust property; the plaintiff is deprived of it.⁵⁸

Unjust enrichment was invoked, as it has been in the Canadian family home cases, as a synonym for unconscientious conduct:

However, whether the juristic basis has been expressed in terms of unconscionability, constructive or equitable fraud, unjust enrichment, imputed intention, denial of reasonable expectations, or proprietary or promissory estoppel, the outcome is the same; the courts will declare the defendant to be a constructive trustee of the property in question whenever, in all the circumstances of the particular case, it is perceived that it would be unjust or unfair not to do so.⁵⁹

Modern restitution scholarship insists that a recognised 'unjust' factor

56 See above n 54.

57 Ibid at 616.

58 Ibid at 607.

59 Ibid at 606.

should be clearly identified: recognised factors include mistake, compulsion and failure of consideration.⁶⁰ Thomas J's judgment nowhere identifies the 'unjust factor' except on 'an unusably vague plane'⁶¹ as 'manifest unjustness' or 'inequity'. These are so nebulous that his analysis has been almost completely ignored in later New Zealand cases. In spite of the judge's criticism of *Re Montagu's Settlement Trusts* the decision in *Powell v Thompson* really belongs to the 'conscience' family of constructive trust cases and not to the law of unjust enrichment.

At one point, however, Thomas J briefly touched on an issue which has been more fully developed in modern restitution writing. He suggested that the defendant might have been accountable even if he had been unaware of the abuse of the power of attorney by Mrs Powell:

For the purposes of the present case I can accept that such knowledge is required, but I would not preclude the possibility that in certain circumstances a Court of Equity could be persuaded to examine the equities of the competing claims where the defendant was not aware that he or she was receiving or dealing with the property in a way which was inconsistent with a trust. Because liability in this class of case stems from equity's unwillingness to accept the enrichment of the third party at the expense of the beneficiary, and not any particular conduct or misconduct on the part of either the trustee or the third party, such knowledge may not be necessary in order to activate equity's jurisdiction with the objective of ensuring a result which is consonant with good conscience.⁶²

Although the point is obscured by the reference to 'examining the equities' Thomas J may be suggesting that a defendant could be held strictly accountable for receipt of fiduciary property. The proposal coincides with the view of Professor Peter Birks developed in a series of articles.⁶³ Drawing on recent decisions on constructive trusteeship he has proposed a 'five point programme,' the most significant of the points being that a recipient's personal restitutionary liability should both at law and in equity be strict.

The argument for strict liability is based both on authority and on the need to maintain consistency with the common law actions of conversion (applicable to chattels and documents including cheques) and for money had and received (for money claims). The precedents are equivocal but the arguments from principle are more compelling. Liability for conversion is imposed on a recipient of a chattel who deals with it in a manner inconsistent with the person entitled to possession. Liability is strict.⁶⁴ The exceptions to the rule of *nemo dat quod non habet*, however, constitute a defence to an action for conversion. Some of these exceptions are special statutory defences applicable

60 Peter Birks, *Introduction to the Law of Restitution*, 18-19.

61 CEF Rickett, 'Strangers as Constructive Trustees in New Zealand' 11(1991) *OJLS* 598, 601.

62 [1991] 1 NZLR at 608.

63 Peter Birks, 'Misdirected funds: restitution from the recipient' [1989] *LMCLQ* 296; 'Persistent problems in misdirected money: a quintet' [1993] *LMCLQ* 218. See also A Burrows, *The Law of Restitution* (1993), 150-156.

64 [1993] *LMCLQ* 218, 228.

to banks and other financial institutions, and enacted in order to promote negotiability and to facilitate commercial dealings.⁶⁵ They may in fact as we will see, reflect longstanding policy objections to a thoroughgoing regime of strict liability. But, subject to these exceptions, a receiver of a chattel from a thief who fails to deliver it up on demand or who deals with it in a manner injurious to the rightful possessor's title will be strictly liable in detinue (in those jurisdictions which retain the tort) or conversion. Given the stringency of these common law actions, how can a fault-based equitable action for receipt be justified? Or, expressing the same point more emotively, why should someone who receives a stolen radio in a hotel bar, and who later disposes of it, be strictly liable in conversion when a receiver of stolen money from a company director who has acted in flagrant disregard of fiduciary obligation be accountable only upon proof of the requisite degree of knowledge, an issue which may take many days of intensive and costly litigation to resolve?

In the case of money, the argument that the action for money had and received can extend to third party recipients is more complex. Acceptance depends, first, on the proposition that the common law tracing rules are more efficacious, particularly as they apply to money mixed in bank accounts, than orthodox analysis has so far recognised.⁶⁶ It also depends on acceptance of the notion elaborated by Lord Goff in *Lipkin Gorman v Karpnale Ltd*⁶⁷ that entitlement to money generates a chose in action which in turn confers title to sue subsequent recipients of the money.⁶⁸ Even if the plaintiff's title to sue and a link between that title and the defendant's can be established with the assistance of common law tracing techniques, a plaintiff must also demonstrate an 'unjust' factor for the purposes of the law of unjust enrichment. The rival claims of 'ignorance'⁶⁹ and 'property'⁷⁰ have been canvassed in the literature as possible 'unjust' factors, although courts are at present hardly aware of the debate, still less participating in it. Finally, as in the case of conversion, the significance of commercial negotiability must not be overlooked: a recipient of money who takes by way of bona fide purchase for value without notice will have a good defence.⁷¹

Although the logical case for strict liability is strong it has not so far attracted a great deal of judicial interest. Dicta of Thomas J in *Powell v Thompson* fortuitously coincide with conclusions reached by Birks but they are not based on an understanding of modern restitutionary scholarship. In *El Ajou v Dollar Land Holdings plc Ltd* Millett J who is, after Lord Goff, perhaps the English judge most responsive to restitutionary arguments, asserted that:

65 See generally part VI of the *Cheques and Payment Orders Act 1986* (Cth).

66 RM Goode, 'The Right to Trace and Its Impact in Commercial Transactions' 92 (1976) *LQR* 401, 528.

67 *Lipkin Gorman v Karpnale Ltd* [1991] 2AC 548, 573-574.

68 Peter Birks, *Trusts in the Recovery of Misapplied Assets: Tracing, Trusts and Restitution* in (McKendrick ed) *Commercial Aspects of Trusts and Fiduciary Obligations* 149, 161-163.

69 See Birks, above n 63, and 'Misdirected Funds Again', 105 (1989) *LQR* 528.

70 Andrew Burrows, 'Misdirected Funds: A Reply', 106 (1990) *LQR* 203, *The Law of Restitution* (1993), Ch 13.

71 FA Mann, *The Legal Aspects of Money* (4th ed), 8-10. A Burrows, *The Law of Restitution* (1993), 472-475.

I do not see how it would be possible to develop any logical and coherent system of restitution if there were different requirements in respect of knowledge for the common law claim for money had and received, the personal claim for an account in equity against a knowing recipient and the equitable proprietary claim.⁷²

But this observation led to no reassessment of the principles of equitable liability. The holding by Millett J that the defendant was not liable for knowing receipt in that case followed an entirely predictable analysis of the authorities discussed in the previous two sections of this article.

Why has the case for strict liability so far failed to arouse judicial interest? The obvious answer is that it is new and little known outside the narrow, predominantly academic, circle of restitution lawyers. The process of osmosis by which academic ideas enter judicial discourse is a slow one, and the hour of the strict liability constructive trust may be a long time coming. Dissatisfaction with the knowledge-based constructive trust may speed the process, but dissatisfaction is not for the time being so strong or universal as to motivate a search for new solutions.

Policy reasons may also delay the recognition of strict liability. Banks are the perennial defendants in this type of litigation, and the history of attempts to impose strict liability on bankers is not a happy one. When it became clear in *Robarts v Tucker*⁷³ that a bank which paid money out of customer's account on a cheque bearing a forged indorsement could be held strictly liable to the customer in assumpsit or conversion, the British parliament moved swiftly, in response to considerable pressure exerted by the financial community, to effect a legislative reversal of the decision, so that protection was conferred upon banks who had paid out 'in good faith' and 'in the ordinary course of business' on a forged indorsement.⁷⁴ This was the precursor of a formidable array of defences available to paying and collecting bankers, most applying where the bank had acted 'in good faith and without negligence'.⁷⁵ Fault expelled from the common law or equity has a habit of re-entering by legislation. The logical arguments for strict liability are not, of course, invalidated by the fact that a class of defendants may successfully assert statutory immunity from liability. The hiving off by legislation of cases necessitating special fault-orientated policy treatment may enable the principle of strict liability to apply more satisfactorily to the remaining cases. Nevertheless, the story of the application of the tort of conversion to banking transactions at least shows that recognition of strict liability is unlikely to be rapid or wholehearted.

Another objection to strict liability is that its introduction will not in fact eliminate costly and time consuming inquiries into the precise nature of the

72 [1993] 3 All ER 717, 739. Overruled on other grounds: [1994] 2 All ER 685.

73 (1851) 16 QB 560. E Milnes Holden, *History of Negotiable Instruments in English Law* (1955) 222-229.

74 *Stamp Act* 1853 (Imp) s 19; *Bills of Exchange Act* 1882 (Imp) s 60. See now *Cheques and Payment Orders Act* 1986 (Cth) s 91.

75 See, generally, part VI of the *Cheques and Payment Orders Act* 1986 (Cth).

defendant's knowledge. These inquiries are certainly the bane of the modern law, and a strict liability approach might be thought to remove the need to undertake them. But strict liability is not absolute liability. Defences will be available, including change of position and bona fide purchase. Both require consideration of whether the defendant acted in good faith. Birks has argued that good faith purchase should be analysed as 'a species of change of position', and that courts should:

expound bona fides as excluded by all and any of the five species of knowledge and failure to know on the *Baden Delvaux* scale, right down to (v) (knowledge of circumstances which would put an honest and reasonable man on inquiry) but, very importantly, insist that this standard must be sensitive to context, so that circumstances which would put an honest and reasonable man an inquiry in the course of a conveyance will often not be such as would put the same person on inquiry in the course of an ordinary commercial transaction.⁷⁶

It is obviously right, indeed vital, for a court to distinguish carefully between knowledge in conveyancing and commercial transactions. The distinction now drawn between 'notice' and 'knowledge' is supposed to be sensitive to context. But if the 'five degrees' of the *Baden* knowledge taxonomy are going to define the limits of good faith the law of knowing receipt will continue to be as over-refined and convoluted as it is now. There are already indications that the doctrine of notice, as it applies to proprietary tracing remedies, is being reformulated in terms of the *Baden* 'five degrees'.⁷⁷ A restructuring of bona fide purchase and change of position, or some composite of these defences, in *Baden* terms will only have the effect that the defendant will be required to establish absence of knowledge instead of placing on the plaintiff the onus that the defendant sufficiently knew of the fiduciary's default. The principal consequence of the introduction of strict liability will therefore be to transfer the burden of proof on the 'knowledge' question to the defendant. This might be considered an advantage since the facts of money transfers are often shrouded in secrecy behind a veil of banking confidentiality, and banks are better placed than the victims of fraud to explain the circumstances of such transfers and to demonstrate their honesty in handling the laundered money. On the other hand, courts have consistently resisted attempts to impose on banks a 'duty of inquiry' into the source of money, on the grounds that it would impose heavy transactions costs on banks and would undermine the principle of negotiability which is the defining characteristic of money and instruments. Placing the onus on banks and other recipients to disprove the possession of any of the degrees of *Baden* knowledge might be viewed as an indirect imposition of a 'duty of inquiry'. The understandable reluctance of courts to apply the doctrine of constructive notice to commercial transactions may well frustrate attempts to require recipients of funds to disprove the possession of *Baden* knowledge.

76 Peter Birks, 'Persistent problems', above n 63, at 229.

77 *Polly Peck v Nadir (no 2)*, above n 46, at 782.

In summary, the case for strict liability is attractive precisely because it combines conceptual elegance with simplicity. But if it turns out that any gains in the elimination of the 'knowledge' requirement are offset by complexity in the definition of 'good faith' for the purpose of the defences of bona fide purchase or change of position, or if the result of the introduction of strict liability is to impose heavy duties of inquiry upon banks as to the sources of funds they receive, judicial resistance to this type of restitutionary reasoning can be expected and the 'property' and 'conscience' approaches will continue to provide the staple judicial tests.

Conclusions on the Knowledge Requirement for the Receipt-Based Constructive Trust

It is impossible to state, even tentatively, not only what type of knowledge, if any, must be proved before a defendant can be held liable for knowing receipt but, more fundamentally, what the knowledge requirement should be. There are several reasons for this doctrinal incoherence. In the first place, *Barnes v Addy* provided the wrong starting point for the development of this head of equitable liability. As modern scholarship has convincingly shown⁷⁸ Lord Selborne's confident generalisations ignored established authority on participatory liability and never clearly explained why receipt cases should be differentiated from liability for assistance. Strangers' liability to constructive trusteeship is not one of the more venerable, still less venerated, areas of equity so there is no reason based on settled authority why Australian courts should not discard *Barnes v Addy* and begin the painstaking work of formulating a new set of principles.

There is, though, a deeper problem which cannot be solved by an act of judicial iconoclasm. The confusion in the cases reflects different visions of the constructive trust and even differences as to what doctrinal analogies should be drawn. The 'proprietary' approach is based on the paradigm fiduciary relationship of trustee and beneficiary and, following a loose analogy with tracing, but making allowance for the fact that money and not land is the relevant property, posits liability on the basis of the defendant's actual and constructive knowledge. The 'conscience' approach draws its inspiration from the modern rediscovery of the primacy of avoiding 'unconscientious conduct'. In recent fiduciary decision the role of conscience in modifying the stringency of fiduciary obligation has been recognised.⁷⁹ This approach, which arguably is the most sensitive to issues of negotiability and security of commercial transactions, has not, however, so far succeeded in translating conscience into an agreed knowledge test. But as a general rule judges who speak the language of conscience prefer to rest liability on actual knowledge. Finally, the restitutionary approach draws its analogies from the action for money had and received and

78 Charles Harpum, 'The Basis of Equitable Liability', above n 14, who draws attention at 11 to the contribution of Lord Langdale MR in *Fyler v Fyler* (1841) 3 Beav 550, 49 ER 216 and *Att-Gen v The Corporation of Leicester* (1844) 7 Beav 176, 49 ER 1031, to the development of the principles of intermeddlers' liability.

79 *Chan v Zacharia* (1984) 154 CLR 178, 204-205, Deane J.

the tort of conversion, both of which are grounded in strict liability. Even more than the proprietary approach, the overriding concern of the restitutionary approach is to enforce the original title holder's right to restoration of the assets, or their value, where they have been misapplied. The policy of protecting security of commercial transactions is addressed through restitutionary defences rather than within the initial cause of action.

Confusion in the case law therefore mirrors confusion in the underlying philosophical assumptions. The differences between the conscience approach and restitutionary analysis are the most extreme. But although the arguments about the place of conscience and restitution in the law of constructive trusts are recent, the debate itself echoes older disputes. It simply reflects in a new setting the classic tension in sale of goods law between the competing principles of *nemo dat quod non habet* and *bona fide* purchase:

[t]he first is for the protection of property; no one can give a better title than he himself possesses. The second is for the protection of commercial transactions; the person who takes in good faith and for value without notice should get a better title.⁸⁰

In the law of sales the application of the *nemo dat* rule is subject to the various common law, equitable and statutory exceptions which protect, for example, good faith purchasers of goods without notice of the seller's voidable title.⁸¹ The *nemo dat* rule and its exceptions reflect a compromise between security of title and security of transactions. The compromise is not irrational and can be justified by reference to notions of economic efficiency.⁸² The debate on the level of knowledge, if any, required of the receipt-based constructive trust is really the rearguing of an old question as to the relative weight to be attached to security of title and security of transactions but with the argument transposed from goods to money and commercial property. Restitution lawyers accord primacy to protection of original title; the 'conscience' approach attaches greater weight to security of transaction. Both frameworks are sufficiently flexible to accommodate competing values: the law of restitution protects security of transaction through the defences of change of position and bona fide purchase, whereas a 'conscience' analysis uses equitable discretion to enforce in an appropriate case the title claims of a victim of fraud. What is missing is any assessment of the relative efficiency of these competing approaches, or any socio-legal analysis of the impact of the equitable rules on banking practice. The debate on 'title versus transaction' has been taken as far as it can reasonably be taken in formal analytical terms. The absence of any convincing appellate statement on 'knowing receipt' reflects genuine judicial uncertainty as to where the line between 'title' and 'transaction' should be drawn when money is transferred in breach of fiduciary duty.

80 *Bishopsgate Motor Finance Corporation v Transport Brokers Ltd* [1949] 1QB 332, 336-337, Denning LJ. See AJ Duggan, *Personal Property Security Interests and Third Party Disputes: Economic Considerations in Reforming the Law*.

81 See *Goods Act 1958* ss 27-31 (Vic) and equivalent legislation in other states.

82 See AJ Duggan, above n 80.

Knowing Assistance

The principles applicable to constructive trusteeship for knowing assistance based can be more readily deduced. The authorities, if not totally reconcilable, at least conform to an intelligible pattern. Australian law enjoys some High Court authority on this head of liability, although some recasting of language may be required in the light of developments elsewhere. New Zealand law has been unsettled by disagreement among first instance judges as to what a 'conscience' approach to knowing assistance actually requires. Nevertheless, the New Zealand cases reach conclusions on the knowledge question which are not out of line with decisions in other common law jurisdictions.

The legacy of Lord Selborne's dicta on knowing assistance in *Barnes v Addy* has been as dubious as his remarks on knowing receipt. His assertion that a participant must assist 'in a dishonest and fraudulent design on the part of the trustee'⁸³ has been responsible for some complex, and arguably unnecessary, analysis of the nature of the breach of fiduciary duty by the principal wrongdoer. The Australian law on 'dishonest and fraudulent design' is generally thought to have been settled by the decision of the High Court in *Consul Development Pty Ltd v DPC Estates Pty Ltd* but a recent decision of the Canadian Supreme Court may reopen the debate on some key issues.

Assistance 'in a dishonest and fraudulent design'

Breaches of fiduciary duty take many forms ranging from blatant dishonesty to a technical misreading of an investment clause in a trust deed. Must the assister have participated in a fraudulent breach of trust or will assistance in a technical breach of obligation suffice, assuming always that the defendant possesses the required degree of knowledge? In *Consul Development Pty Ltd v DPC Estates Pty Ltd*⁸⁴ Gibbs J stated that a 'dishonest and fraudulent design' includes 'a breach of trust or of fiduciary duty'.⁸⁵ No analysis was offered in support of this proposition although modern equity writers are in concurrence.⁸⁶ It would be inconsistent with the basic principles not only of related areas of equitable liability but also more generally of all forms of private law accessory liability, for example inducement of breach of contract, to insist that the primary breach of obligation should be dishonest or fraudulent.

Nevertheless, Lord Selborne's reference to a 'dishonest and fraudulent design' cannot be discounted. The weight of authority in both England⁸⁷ and New Zealand⁸⁸ favours the restriction of this head of liability to cases where the principal breach of fiduciary duty was reprehensible. The Canadian Supreme

83 (1874) LR 9 Ch App 244,251-252.

84 (1975) 132 CLR 373.

85 *Ibid* at 398.

86 See Charles Harpum, 'The Basis of Equitable Liability', above n 14, at 12-13.

87 *Belmont Finance Corp Ltd v Williams Furniture Ltd* [1979] Ch 250, 267, Buckley LJ. Cf *Selangor United Rubber Estates Ltd v Cradock* (No 3) [1968] 1 WLR 1555, 1590-1591, Ungood-Thomas J.

88 *Equiticorp Industries Group Ltd v Hawkins* [1991] 3 NZLR 700, 718-728, Wylie J.

Court has now also accepted that this is a limitation on equitable liability for 'knowing assistance'. In *Re Air Canada and M & L Travel Ltd*⁸⁹ the appellant was a director of a travel agency which sold Air Canada air tickets under an IATA agreement. The agreement provided that the proceeds of sale were to be held on trust for Air Canada until accounted for to the airline. The appellant did not pay the Air Canada proceeds into a trust account for the airline but into the agency's general operating account. The agency obtained a line of credit from a bank under an agreement which authorised the bank to remove from the general account moneys owing on the loan. Following a dispute between the appellant and his co-director about the liquidity problems of the travel agency, the bank closed the general operating account in order to meet the agency's indebtedness to the bank. Air Canada sued both directors for the money owed from ticket sales for which the agency had failed to account to the airline. The Supreme Court of Canada held that in applying the proceeds of sale of Air Canada tickets towards the general operating purposes of the travel agency, the agency had committed a breach of trust and the appellant had knowingly assisted in the commission of the breach of trust. The principal judgment of Lacobucci⁹⁰ J held that not only must the appellant have actual knowledge of the breach of trust, which he in fact possessed, but the breach of trust must amount to a 'fraudulent and dishonest design'. In this case the requirement was satisfied by the fact that the appellant had taken a risk to the prejudice of the beneficiary, Air Canada, by paying the airline's money into its general operating account.⁹¹

Iacobucci J explicitly relied on the 'conscience' approach to constructive trusteeship in imposing this additional requirement:

In my opinion, this standard best accords with the basic rationale for the imposition of personal liability on a stranger to a trust which was enunciated in *Re Montagu's Settlement Trusts* as namely, whether the stranger's conscience is sufficiently affected to justify the imposition of personal liability. In that respect, the taking of a knowingly wrongful risk resulting in prejudice to the beneficiary is sufficient to ground personal liability.⁹²

This particular appeal to 'conscience' is unconvincing. It is important, as the next section will show, to formulate a requirement of knowledge which does not impose an oppressively high duty of inquiry on solicitors and other professionals who assist in trust management or other fiduciary enterprises. But the risk of ensnaring innocent, or even careless, professionals in the web of constructive trusteeship can be averted by insisting that the plaintiff establish the defendant's actual knowledge of the breach of obligation. If the liability of

89 (1993) 108 DLR (4th) 592. For a similar Australian case, but raising issues of knowing receipt, see *Stephens Travel Service International Pty v Qantas Airways Ltd* (1988) 13 NSWLR 331.

90 McLachlin J concurred in the result but declined to decide the knowledge question or whether the breach of trust had to be fraudulent and dishonest.

91 *Ibid* at 618. The description of fraud as 'taking a risk to the prejudice of another's rights' was taken from the *Baden Delvaux* case [1988] BCLC 325, 406, which in turn was based on *R v Sinclair* [1968] 3 All ER 241.

92 *Ibid*.

accessories is strictly confined to instances of actual knowledge, including recklessness and the shutting of eyes to the obvious, the need for 'a dishonest and fraudulent design' becomes a superfluous additional requirement for a plaintiff to satisfy. There is little in the reasoning of *Re Air Canada and M & L Travel Ltd* to suggest that Gibbs J in *Consul* was wrong to ignore this part of Lord Selborne's judgment, provided always that the 'knowledge' requirement for this limb of *Barnes v Addy* is restricted to actual knowledge.

The Knowledge Test for Assisters

The leading Australian authority on knowing assistance is the High Court decision in *Consul Development Pty Ltd v DPC Estates Pty Ltd*.⁹³ A solicitor named Walton controlled a company, DPC Estates, which acquired properties with a view to renovating and reselling them. The company employed a manager, Grey, whose duties included advising the company upon the availability and acquisition of properties. Walton also employed an articulated clerk, Clowes, whose family had business connexions with Walton. Clowes was also a property developer. Grey passed on information to Clowes about a number of properties, stating that DPC had been interested in the properties but could not afford to buy them. Clowes's company, Consul, acquired these properties. Walton and DPC argued that Grey had committed a breach of fiduciary obligation in supplying Clowes and Consul with information about the properties and that Clowes had assisted and encouraged Grey to commit his breach of obligation. The High Court, McTiernan J dissenting, held that Clowes was not liable for knowing assistance and that the properties he had acquired were therefore not to be held on constructive trust for the plaintiffs.

It is difficult to relate the judgments in this case to more recent developments because the majority were concerned to reject the argument, which has never since been seriously revived in knowing assistance constructive trust cases, that the defendant could be held liable under the doctrine of constructive notice, using that term in its conveyancing sense. Stephen J, with whom Barwick C J agreed, declared that the authorities:

...did not go so far, at least in cases where the defendant had neither received nor dealt in property impressed with any trust, as to apply to them that species of constructive notice which serves to expose a party to liability because of negligence in failing to make inquiry.⁹⁴

Although the real property concept of notice was clearly held to be inapplicable, it is less easy to elicit the test actually favoured by the Court. Gibbs J was prepared to accept a test based on the accessory's actual or constructive knowledge of the breach of duty.⁹⁵ Stephen J, on the other hand, preferred to impose liability on the basis of actual knowledge, extended to

93 (1975) 132 CLR 373.

94 Ibid at 412.

95 Ibid at 396 when *Selangor United Rubber Estates Ltd v Cradock (no 3)* [1968] 1 WLR 1555 was approved.

include cases of shutting one's eyes to the obvious, or reckless failure to make inquiries.

If a defendant knows of facts which themselves would, to a reasonable man, tell of fraud or breach of trust the case may well be different, as it clearly will be if the defendant has consciously refrained from inquiry for fear lest he learn of fraud. But to go further is, I think, to disregard equity's concern for the state of conscience of the defendant.⁹⁶

This can reasonably be considered, in *Baden* parlance, knowledge of types one to three.⁹⁷ So construed, it is consistent with the trend of courts across the common law world to insist upon actual knowledge of the breach of fiduciary obligation as an essential precondition of liability.⁹⁸ Most recently, the Supreme Court of Canada in *Re Air Canada M & L Travel Ltd* held that liability should be based on actual knowledge, including recklessness and wilful blindness.⁹⁹

The dictum of Stephen J explicitly refers to equity's concern for the state of the conscience of the defendant. In *Re Air Canada and M & L Travel Ltd* Iacobucci J approved of the reasoning of Megarry V-C in *Re Montagu's Settlement Trusts* in confining liability to the defendant's possession of actual knowledge. In terms of the categorisation of cases of knowing receipt adopted by this article, 'knowing assistance' cases can be said to exemplify the 'conscience' approach. A restitutionary approach is irrelevant where the defendant will usually not receive property and no question of title arises. The proprietary approach discussed earlier, which enlarges the area of liability to include instances of constructive knowledge, is also usually considered to impose an excessively heavy burden of inquiry on those who assist in a breach of fiduciary duty but who do not share its fruits.¹⁰⁰

As long as 'conscience' is clearly understood in this context to be a shorthand term for actual knowledge, including recklessness and wilful blindness, no great harm is done by resting liability on the state of the defendant's conscience. Some confusion has been caused, however, by New Zealand authority which would equate the conscience approach to instances of constructive knowledge. A lively skirmish has developed between first instance judges in New Zealand as to what 'considerations of justice and conscience' actually require. In *Powell v Thomson* Thomas J expressed, obiter, the opinion that a defendant might be liable 'in conscience' as a constructive trustee where actual or constructive knowledge were present:

96 Ibid at 412.

97 Ford and Lee, *Principles of the Law of Trusts*, fn 35 above, para [2222] construe the *Consul* case in this way.

98 Helen Norman, 'Knowing assistance - a plea for help' 12 (1992) *Legal Studies* 332, and *Bank Tejarat v Hong Kong and Shanghai Banking Corporation (CI) Ltd* [1995] 1 Lloyds LR 239, 248.

99 (1993) 108 DLR (4th) 592, 608, Iacobucci J. McLachlin J reserved her opinion on this question.

100 But note that some judges have advocated the application of such an approach. See Helen Norman, 'Knowing assistance - a plea for help', above n 98, and *Baden Delvaux* and *Agip* decisions, n 23 and n 15 respectively.

...Again, the requisite knowledge is not confined to actual knowledge but may include constructive knowledge. The third party's failure to make an inquiry notwithstanding that an inquiry might reasonably have been expected will form part of the defendant's overall conduct which will be examined by the Court...the question will still be whether, in all the circumstances, his or her conduct was unconscionable and justifies the imposition of the obligation of the trust upon them¹⁰¹

This interpretation of the 'conscience' approach has, though, proved controversial. A riposte soon came from Wylie J in *Equiticorp Industries Group Ltd v Hawkins*. While acknowledging that liability for knowing assistance was 'a question of conscience', he went on:

We have not yet reached the stage where the conventional ingredients of causes of action can be ignored for the purpose of enabling the Courts to arrive at some ill-defined and undisciplined objective of being fair It is much easier to find unconscionable the retention of a benefit to which the defendant cannot claim a just entitlement, than it is to find unconscionable a careless but innocent failure to appreciate the probable truth behind, and the consequences of, known facts or to inquire further into these matters.¹⁰²

In other words, only participants who have actual knowledge of a breach of fiduciary duty can be said to have acted unconscionably. Later New Zealand decisions have explored both *Powell v Thomson* and the *Equiticorp* case,¹⁰³ with the views of Wylie J in the latter case winning more adherents. Perhaps the most valuable lesson to emerge from this judicial disagreement is that appeals to the conscience of the defendant are no substitute for careful analysis of the degree of knowledge required before a constructive trust can be imposed. After a period of confusion a consensus now exists in common law jurisdictions that liability to constructive trusteeship based on knowing assistance should be confined to actual knowledge, including recklessness and wilful shutting of eyes to the obvious. 'Conscience' should not be a cover for importing constructive knowledge or duties of inquiry into this area of the law.

Conclusion

Judges are becoming increasingly exasperated with the *Barnes v Addy* constructive trust. In *Equiticorp Finance Ltd (in Liq) v Bank of New Zealand* Kirby P of the New South Wales Court of Appeal in a characteristic dissenting judgment lent his support to proposals of Professor Paul Finn which would result in 'an abandonment of much of the jurisprudence of *Barnes Addy*'.¹⁰⁴ It is easy to sympathise with this dissatisfaction. Lord Selborne's judgment did set the law on the wrong path; the requirement of knowledge is over-analysed and philosophically incoherent, and courts have established bars to recovery, such

101 [1991] 1NZLR 597, 611.

102 [1991] 3 NZLR 700, 728.

103 *Marshall Futures Ltd v Marshall* [1992] 1 NZLR 316; *Lankshear v ANZ Banking* [1993] 1 NZLR 481.

104 (1993) 32 NSWLR 50, 105. The majority did not consider this issue, having taken a different view of the facts.

as the need to establish 'dishonest and fraudulent design' which rest on no very clear policy basis.

In spite of these failings of modern equity, however, it is suggested that it would be wrong to dismantle the *Barnes v Addy* constructive trust and replace it with a more broadly based form of participatory liability. Although terminology differs among jurisdictions, there is a considerable uniformity in the common law world as to the basic requirements of the constructive trust based on knowing assistance. The same cannot be said, of course, of the receipt-based constructive trust. Here no amount of linguistic tinkering can conceal the fact that courts remain very confused about the rationale of this form of constructive trust. This article suggests that the confusion reflects a basic tension between security of title, favouring equitable relief for the victims of fraud, and security of transaction, which protects the ultimate recipients of the proceeds of fraud if they have acted in good faith. The conscience and restitutionary approaches try in different ways to resolve the tension, which is functionally equivalent to the competition in sale of goods law between the *nemo dat* and *bona fide* purchase principles. What is needed is not a new analytical framework, which can only be established by imposing considerable transactions costs which will be largely borne by banks and other financial institutions, but some analysis of the existing receipt-based constructive trust in terms of efficiency or the socio-legal consequences of particular approaches to the parties to these transactions. For example, is the policy of protecting security of title as vital in cases of mistaken money transfers as it is generally assumed to be in the case of fraudulent transfers? What are the costs of imposing strict liability on banks in these cases? Economic and socio-legal approaches are not magic methodologies to be waved at intractable legal problems, and the conclusions to be drawn from such analysis will often be ambiguous. Nevertheless, traditional analytical approaches to imposing civil liability in cases of misdirected funds has not produced a coherent body of law, and we need to know more about the costs to the various involuntary participants in commercial fraud of the tests adumbrated by judges and writers. A new law of equitable participatory liability is less important than a more rigorous evaluation of the old law.