EQUITABLE REMEDIES — RECENT DEVELOPMENTS

Commentary

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INTRODUCTION

When Tony Oakley refers to the courts of New Zealand as showing both "unanimity and consistency" whilst Australian and English law is described as "uncertain" and "wholly unsatisfactory", far be it from me to criticise! I adopt his paper as the state of the art on constructive trusts (at least that branch of constructive trust that stems from *Barnes v Addy*). Rather than focusing on the detail of the law in this area, Philip Laity and I consider what strategies banks in our respective jurisdictions have adopted to stave off attack and what more they can or should do.

SUMMARY OF THE LAW IN NEW ZEALAND

First, an attempt to briefly summarise the law as it stands in New Zealand. We are talking not of direct liability of parties to a transaction. We are talking rather of the liability of third persons who owed no specific duty to those who suffered loss, but who may have benefited from or assisted in the wrongdoing. Banks or solicitors are both third person targets so we would be hard-pressed to find a subject more likely to unite the bulk of those attending this conference. The courts impose liability on these third parties by way of "constructive trust" in two rather different circumstances: first, where the third party receives trust property (paid in breach of the trust) for its own benefit and second, where the third party does not actually receive the trust property for its own benefit (other than indirectly eg by deduction of fees) but nonetheless assists the primary defaulter. In both types of case, in order to be liable, it is said that the third party needs to have some degree of knowledge of the original wrongdoing.

The above is to some extent a simplification but it is a useful and not unreliable guide for practical purposes. The two categories of constructive trust tend to be referred to as "knowing receipt" and "knowing assistance" but these descriptions are a little misleading because the "knowledge" required for the former can simply be construed from the circumstances whereas the "knowledge" required for the latter, at least according to the current majority view in New Zealand, is more in the nature of dishonesty. It is therefore dangerous to apply the terms on any literal basis.

EXAMPLES OF "KNOWING RECEIPT" AND "KNOWING ASSISTANCE" IN THE NEW ZEALAND CONTEXT

The 1992 High Court decision of *Lankshear v ANZ Banking Group*[1] affords a good practical illustration of the two different categories of claim and also of the different likely end results depending on whether as the third party bank you have "received" the proceeds or simply "assisted".

Mr Lankshear and Mr Broadley were developing an Auckland property in partnership. Mr Lankshear paid to Mr Broadley $80,000 which Mr Broadley then deposited into an account in the name of "Cobblestone Paving" which was a company owned by Mr Broadley. The $80,000 cleared an overdraft of $54,000 in the Cobblestone Paving account and the remaining credit balance of $26,000 was then withdrawn by Mr Broadley. As is usual in these cases, Mr Broadley was then bankrupted. Mr Lankshear had lost his $80,000.

Mr Lankshear sued the bank for knowing receipt of $54,000 and knowing assistance with regard to the $26,000. On discovery, the bank had been required to produce extensive notes kept by its manager which revealed the bank knew that the $80,000 was coming from a partner, knew that it was intended to be used for the development of a property and had to know that in fact any money coming in would necessarily be used to extinguish pre-partnership debts. The court had no difficulty in holding that the bank's knowledge was sufficient to alert it to the fact that Mr Broadley was in breach of fiduciary duty to Mr Lankshear and that consequently the bank was liable for knowing receipt of $54,000 and a constructive trustee of that money. (Cases such as *Westpac Banking Corporation v Savin* [1985] 2 NZLR 41, and the line of similar authorities involving overdrawn "agency" accounts, go further. It is clear that the bank does not need express knowledge that particular sums credited to such an account were trust monies or that there was a breach of trust by the customer. The bank can be fixed with knowledge by general inference.)

Returning to *Lankshear*, on the claim for knowing assistance in connection with the withdrawal of $26,000, the court said the bank should not be impressed with such an onerous duty as to enquire into the circumstances surrounding the payment of every cheque and therefore should not be liable. The court further observed that such an obligation would render the operation of current accounts unworkable in many situations.

The claim for $26,000 in *Lankshear* is a mild example of the potential quantum of "knowing assistance" cases, that quantum bearing no necessary relationship to the bank's benefit. The more frightening potential of these claims is seen in cases such as *Equiticorp Finance v Bank of New Zealand*,[2] concerning major banking transactions (in that case $44 million) authorised by directors but subsequently alleged to be unlawful. As with *Lankshear*, (but on a slightly different scale), the claim against the bank for knowing assistance was unsuccessful. Returning to home ground, in *Nimmo v Westpac Banking Corporation*,[3] Mr Nimmo endorsed and handed over his superannuation cheque for $366,000 to Kinetic Investment Services NZ Ltd. After various transfers by Kinetic through its accounts in New Zealand and Australia, one of the directors of Kinetic embezzled the bulk of the monies, using a cheque which he had tricked his co-director into signing. The bank was held not liable for knowing assistance because, whilst it had been negligent, it had not acted dishonestly or recklessly.

Interestingly, there does not appear to have been an instance, in New Zealand at least, of a bank being held liable for knowing assistance. *Nimmo* is, as we speak, being heard by the Court of Appeal, so the position may change at any moment. The lack of success of such claims to date should certainly not encourage complacency, for the true losses in an "assistance" case obviously have the potential to be far greater than in a "receipt" case, where at least in theory the bank is

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1 1993] 1 NZLR 481.

2 (1993) 32 NSWLR 50.

3 [1993] 3 NZLR 218.

only placed back where it started. (It should be noted that this is not necessarily so - on the strength of moneys paid in, the bank may for example have extended further overdraft accommodation or paused in execution of its securities such that its own position is worse than would have applied if the monies had been deposited to a separate trust account. The case of *Westpac Banking Corporation v Ancell* is an example.)

STRATEGIES TO AVOID CONSTRUCTIVE TRUST LIABILITY

Enough of the law. What of the practice? What are the concerns or exposures arising out of this area of the law and what steps can banks take to eliminate or minimise the risk?

Knowing assistance claims are a potential rather than an actual for the moment: at least in success terms. Other than running seminars on both categories of "constructive trust" the banks in New Zealand have generally not given detailed consideration to this category of claim. However, the costs of being sued in an action such as *Nimmo* or, worse still, *Equiticorp v Bank of New Zealand,* are to be avoided. As with direct customer relationships, banks need to ensure that their manuals provide the best possible safeguards against fraud on a beneficiary, that these manuals are followed and in particular that substantial transactions are checked and authorised at a senior level. In general, this is already the case. If the customer has set out to deceive its beneficiary and the bank, it will often be that fraud or breach of duty on its part will be difficult to identify. On the basis of *Nimmo* and the "knowing assistance" authorities and in the absence of any dishonesty on its part, the bank should not be implicated. If, however, a bank officer detects some potentially fraudulent or unlawful feature of the transaction, then enquiries must be made of the customer or preferably of the customer's solicitors or accountants who will normally be involved in the type of transaction where detection is possible. As Philip Laity will tell you, "Dumb and Dumber" (to borrow a literary reference) is definitely not the answer. Half of the story will emerge in any event through diary notes and other documents obtained on discovery. The bank should try to complete the picture and in the process hopefully clear itself of potential exposure (or at least gain some useful third parties for indemnification purposes).

If the answers provided by the customer or its professionals allay concerns, the matter can be left there with a careful file note made. In the rare case where there is still some reason for doubt, the bank would need to seek its own legal advice. The last resort in situations where the bank is already committed to the customer would be to seek assistance from the courts by way of declaration. (I am unaware of any such application in practice.) The bank would then be committed to losing the customer but that would be a matter of weighing the respective potential losses.

There are some obvious practical limitations to the precautions a bank can take on "knowing assistance" claims. It is difficult to investigate a customer's bona fides or the veracity of a customer's advice when the very essence of the relationship is confidentiality. Possible inquiries will generally be limited to those that can be made of the customer or its professional advisers. Secondly, trust not distrust is the basis of a bank's dealings with its customers. It has often been said that a banker is not expected to act as a detective in its relations with its customers and most customers would not appreciate their doing so. It is submitted that the courts, in New Zealand anyway, have not lost sight of the banker/customer relationship.

Knowing receipt claims are a definite issue for the banks. Although each turns on its own facts, it is relatively plain that the courts in New Zealand are generally going to distinguish between the customer's own money and a third person's money paid into the customer's overdrawn account, particularly where the customer is engaged in obvious trustee type activities. Almost inevitably there will be sufficient to construe "knowledge" on the part of the bank. Theoretically, the bank does not lose because it has only to repay funds it otherwise would not have had but, as already observed, that is a simplistic view. Often, the bank will have allowed the customer to continue to trade in reliance on unreal account levels and the bank's security position will be so much the worse on final closedown.

The answer is seemingly obvious. Banks should ensure a trust account is opened, especially for specific industry types which would include on-behalf dealers, sharebrokers, real estate agents, travel agents, insurance brokers, and so forth. The number of industries caught is potentially quite extensive. Some of the banks have written policies stipulating for the opening of separate trust accounts for specific categories of customer, which accounts are then kept in credit and not subject to a set-off code. This does not however provide an absolute solution. First, the trust account needs thereafter to be monitored to ensure it is appropriately used and there are obvious difficulties in that regard. But more importantly, customers are often not prepared to operate a separate trust account (mainly because of increased funding costs) and usually not required (eg by the Stock Exchange) to do so. In the absence of a common policy between the banks as to the running of trust accounts, the customer required to open such an account will often look to take its business elsewhere. The result: the policy is honoured more in the breach and where trust accounts are established they are often little used.

The answer so far as "knowing receipt" cases are concerned is more one of risk analysis and control. A bank approached by an "on-behalf" customer who may be a marginal credit risk is more likely to reject a loan application than otherwise. Similarly, the risk needs to be factored into the terms of any loan agreement so that the bank can move swiftly to cap its exposure in the event of any adverse movement in the account. The bank will probably also look for greater security than otherwise. The bank then sits with the knowledge that every time the customer's account dips into overdraft, the bank takes a risk.

CONCLUSION

It must be said in conclusion that the courts should strive to keep the constructive trust as it was originally intended: a means of achieving fairness. They should not be overly enthusiastic in requiring third parties to make good a loss to beneficiaries caused primarily by someone else and often facilitated by the over-trusting nature, or otherwise unsatisfactory conduct, of the beneficiary itself. Refer back, for example, to Mr Lankshear. Bankers should not end up in a position where they have to read one of Tony Oakley's papers before deciding whether to honour a cheque drawn on their own customer's account.