EQUITABLE REMEDIES — RECENT DEVELOPMENTS

Commentary

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INTRODUCTION

Tony Oakley's paper clearly and concisely discusses and summarises the law in Australia (such as it is), and in England and New Zealand, relating to the categories of liability in equity known as "knowing receipt", "knowing assistance" and "inconsistent dealing". It is not the primary purpose of my paper to re-examine this law and, accordingly, only a brief summary is included. The purpose of this paper is to take the Australian law as it stands and to discuss its practical application in the context of Australian banking practice.

In particular, this paper considers:

(a) the nature of risk management procedures which may be adopted by banks to reduce exposure to liability for knowing assistance, knowing receipt and inconsistent dealing; and

(b) the steps which can be taken in the event that a bank finds itself in a position in which it is committed to assist a customer who is a fiduciary in what it suspects may be a breach of fiduciary duty.

Whether the risk of liability justifies the costs associated with the implementation of the procedures and systems recommended in this paper is a matter for separate analysis and is a matter on which this paper makes no comment.

SUMMARY OF THE LAW IN AUSTRALIA

The state of the law in Australia in relation to the equitable categories of liability the subject of this paper can be summarised as follows:

1. Knowing assistance

The scope of liability for knowing assistance in Australia is uncertain. In particular, the uncertainty is in:

(a) whether the requirement of a "dishonest and fraudulent design" on the part of the fiduciary demands more than a simple breach of fiduciary duty; and

(b) whether the requisite degree of knowledge on the part of the assistant is limited to actual, or deemed actual, knowledge and, if not, to what type of constructive knowledge it extends.

The uncertainty stems from the fact that High Court authority in *Consul Development v DPC Estates*[1] has aged and reassessment in Australia of the basic principles is now well overdue given the pace of development in other jurisdictions. However, it remains authoritative law in Australia, the relevant aspects of that case having recently been expressly confirmed in the New South Wales Court of Appeal by Kirby P (in dissent) in *Equiticorp Finance v Bank of New Zealand*.[2]

As a result, it would appear that the mere negligent assistance (ie assistance with constructive, but not actual, knowledge) of a fiduciary in a simple breach of fiduciary duty (ie irrespective of any dishonesty on the part of the fiduciary) may well attract liability for knowing assistance in Australia.

2. Knowing receipt and inconsistent dealing

Similarly, scope of liability for knowing receipt in Australia is uncertain.

In this case, however, the uncertainty lies solely with the requisite degree of knowledge on the part of the recipient, it being quite clear that a dishonest and fraudulent design on the part of the fiduciary is not an element required to establish liability.

Once again, the relevant High Court authority is *Consul Development v DPC Estates*.[3] Dicta in this case, together with dicta of Kirby P in *Equiticorp Finance v Bank of New Zealand*,[4] indicates that liability may be imposed in the absence of actual, or deemed actual, knowledge of the misappropriation of property in breach of fiduciary duty. The recipient need only have constructive knowledge (the type of which remains uncertain) of the misappropriation.

Liability for inconsistent dealing does not appear to have been specifically considered in the Australian courts. However, it is submitted that, logically, the degree of knowledge appropriate to liability for knowing receipt (whatever that may be) should apply given that liability in each case is dependent upon beneficial receipt (as opposed to mere assistance).

It should also be kept in mind that the rapid development of the law of restitution (ie the law relating to the reversal of unjust enrichment) has the potential to overtake and consume liability in equity for knowing receipt and inconstent dealing. Restutitionary models suggest that liability in the event of beneficial receipt of property should be strict. That is, the state of mind of the recipient should not be relevant to a determination of prima facie liability to make restitution. Although relevant to the establishment of certain defences, the knowledge of the defendant recipient would not constitute an element of the prima facie case required to be made out by the plaintiff.

Accordingly, the approach of banks to dealing with the risk of liability within the three categories the subject of this paper should reflect the strong possibility that in Australia liability may be imposed where:

(a) there is a simple breach of fiduciary duty by the fiduciary/customer;

(b) in which the bank assists, or by virtue of which it beneficially receives trust property; and

(c) irrespective of whether the bank has actual, or deemed actual, knowledge of the breach of fiduciary duty.

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1 (1975) 132 CLR 373.

2 (1993) 32 NSWLR 50.

3 (1975) 132 CLR 373.

4 (1993) 32 NSWLR 50.

DETECTING SUSPICIOUS TRANSACTIONS

I now turn to consider the nature of risk management procedures which may be adopted by banks to reduce exposure to liability for knowing assistance, knowing receipt and inconsistent dealing.

Prima facie, such procedures may be based on one of two mutually inconsistent philosophies:

(a) restricting the level of knowledge obtained by the bank in relation to its customers who are fiduciaries with a view to later arguing that any improper assistance, receipt or dealing by the bank was given, accepted or undertaken in ignorance of any breach of fiduciary duty and, as a result, without the requisite degree of knowledge for liability; or

(b) reducing the probability of improper assistance, receipt or dealing by actively seeking specific knowledge relating to the powers and duties of customers who are fiduciaries and then using such knowledge to detect suspect proposed transactions involving the bank which may result in improper assistance, receipt or dealing by the bank.

The two approaches are mutually inconsistent because the first relies on lack of certain knowledge whereas the second requires the accumulation of that knowledge.

Unfortunately, it would appear that current banking practices in Australia (which do not appear to be directed towards reducing exposure towards liability within the categories the subject of this paper) dangerously leaves banks somewhere between the two alternative approaches.

To effectively minimise the risk of liability for knowing assistance, knowing receipt and inconsistent dealing it is my submission that banks must develop and maintain procedures that reduce the probability of providing improper assistance, accepting improper receipts or undertaking improper dealings (the second approach referred to above) as opposed to procedures merely designed to restrict the level of knowledge obtained by the bank (the first approach referred to above).

However, it appears to me that this view is not universally held. For example in Bright, *Banking Law and Practice in New Zealand*[5] it is said that "in order to reduce the possibility of being held responsible in the event of some misappropriation of trust funds, a banker should not make himself aware of or record the conditions of the trust, except only those that govern operations on the account".

The reasons why taking the first approach (and the approach advocated in Bright) is dangerous in practice are as follows:

(a) "Actual knowledge" is not a pre-requisite of liability

As set out above, there is a strong possibility that in Australia liability in all three categories may be imposed in situations in which "actual knowledge" is absent but circumstances are such that the bank "ought to have known" of the relevant breach of fiduciary duty.

In the context of traditional banking practice, where a customer is known to be a trustee of an express trust, and a written trust instrument exists, even if the bank officer does not obtain a copy of, or obtains a copy of but does not read, the trust instrument, there is a strong possibility that the banker/customer relationship will automatically cause the bank to be in a position in which it "ought to have known" of the contents of the trust instrument. This is supported by the New South Wales Court of Appeal decisions in *Story v Advance Bank Australia Limited and Anor*[6] and *Bank of New*

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5 2nd ed, p 67.

6 (1993) 11 ACLC 629.

Zealand v Fiberi Pty Ltd[7] being cases dealing with the concept of constructive knowledge of banks in the context of section 68A(4)(b) of the *Companies Code* (now section 164(4)(b) of the *Corporations Law*).

In the result, even if successfully implemented, a procedure designed to restrict the level of knowledge obtained by a bank can only restrict "actual knowledge" and, thus, may well put the bank in a false position. In my submission, it is preferable to actually know than to be deemed to know, as it is possible to take action on actual knowledge but not on the fiction of deemed knowledge.

(b) In practice it is very difficult to restrict the attainment of actual knowledge

Even if constructive knowledge was not an issue, to successfully implement procedures to prevent the attainment of the relevant actual knowledge, it would be necessary to strictly divide the information necessarily required by the bank to open the account of, or conduct the relevant transaction with, the fiduciary/customer from information as to the conditions of the trust. Such a division is unlikely to be possible in reality.

For example, there is a strong risk that in the sighting and reading of an instrument of trust by a bank officer for the purpose of extracting limited information, the bank will be fixed with actual knowledge of all of the matters contained in it including the conditions of the trust, any express restrictions on the powers of the trustee and any procedural requirements.

In addition, information may be volunteered to bank officers, or may otherwise come into the possession of bank officers without having actively sought it, resulting in the fixation of the bank with actual knowledge as to those matters. Controlling the attainment of such information is not practical.

I now turn to consider the nature of procedures which may reduce the probability of providing improper assistance, accepting improper receipts and undertaking improper dealings (the second approach referred to above, and my preferred approach).

It should be realised that to be adequate, such procedures must be comprised of two essential elements:

(a) procedures and information systems to obtain and record specific knowledge relating to the powers and duties of customers who are fiduciaries; and

(b) procedures and information systems to ensure that such knowledge is used to identify proposed transactions involving the bank which may constitute improper assistance, receipt or dealing.

The second essential element involves the identification that a proposed transaction may involve a breach of fiduciary duty by the customer/fiduciary.

Clearly, the nature of the relevant breach of fiduciary duty will impact on the ability of the bank to identify it. A breach may be constituted by action which is ultra vires the parameters of the trust or, alternatively, it may be constituted by mere lack of authority on behalf of the individual(s) dealing with the bank purportedly on behalf of the trustee(s). Further, the breach of fiduciary duty may be constituted by the actual activity with which the bank is involved (eg where a trustee purchases a bank bill with a term of greater than 200 days in circumstances in which the trust instrument restricts the power of investment to bank bills with a term of no more than 200 days). Alternatively,

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7 (1994) 12 ACLC 48.

the breach of fiduciary duty may result from the activity with which the bank is involved as opposed to being constituted by the activity (eg where moneys lent to a company are used to purchase shares in that company in breach of section 205 of the *Corporations Law*).

In this regard, it should be understood that failure to identify a proposed breach of fiduciary duty should not result in liability in the event of such breach in circumstances in which the bank has acted reasonably in its endeavour to collect and apply knowledge regarding the fiduciary relationship. Failure to identify a breach of fiduciary duty means that the bank did not actually know of it and there is little scope for the application of constructive knowledge where reasonable steps have been taken to acquire all relevant information.

In summary, my enquiries of banks indicate that current bank procedures are designed towards collecting limited information in relation to customers who are fiduciaries which information directly relates to operations on accounts, or to specific powers to transact, but are deficient in that:

(a) in fact, the procedures result in the collection of a greater degree of information than is specifically sought and utilised (for example, standard banking practice is to obtain a copy of the trust instrument); and

(b) there are very few formal procedures and information systems designed to record and apply the collected information to ensure that the bank does not engage in improper conduct (the labelling of each trust account as "Trust Account" is an example of a standard procedure that is directed towards this end).

Unless procedures and information systems are developed and maintained whereby information in relation to customers who are fiduciaries is collected and utilised to prevent improper assistance, receipt or dealing, banks run a serious risk of engaging in improper conduct and, through the concept of constructive knowledge, of satisfying the "knowledge" element of the liability categories the subject of this paper without, in fact (and somewhat confusingly), actually knowing it.

UNWINDING SUSPICIOUS TRANSACTIONS

I now turn to consider the steps which can be taken in the event that a bank finds itself in a position in which it is committed to assist a customer who is a fiduciary in what it suspects may be a breach of fiduciary duty.

The equitable categories of liability for knowing assistance, knowing receipt and inconsistent dealing do not exist in a vacuum. These categories of liability were developed outside of the development of law specific to banking. Accordingly, it is not surprising that they do not sit easily with all banking specific principles.

In the context of traditional banking practice, there is an apparent tension between such categories of liability and the implied terms of the banker/customer contract.

Once a bank knows, or is deemed to know, that its customer owes fiduciary duties in operating an account, or conducting a transaction, there is the potential for a practical dilemma to arise. The dilemma turns on the fact that the implied terms of the banker/customer contract demand compliance by the bank with the instructions of the customer/fiduciary whereas the equitable categories of liability the subject of this paper may demand that, in certain circumstances, the bank refuse to comply with such instructions or risk liability to the beneficiaries.

For example a bank may find itself in a practical dilemma where:

(a) it has contractually committed itself to provide a service to a customer/fiduciary (eg to pay cheques drawn by the fiduciary); and/or

(b) it is in possession of, or otherwise controls property ordinarily to be dealt with in accordance with the instructions of a customer/fiduciary (eg the funds in a trust bank account),

and the bank then (subsequent to contractually committing or taking possession or control) suspects that it is, or will be (if it acts in accordance with the terms of the contract or the instructions of the customer/fiduciary), assisting in a breach of fiduciary duty.

A contractual obligation to assist in a breach of fiduciary duty would not be enforceable. However, the bank's suspicion may prove to be incorrect. If the bank refuses to perform its contractual obligations (eg refuses to pay a particular cheque), and hence refuses to assist the fiduciary, and the suspicion of the bank proves to be incorrect, the bank risks liability to the fiduciary for breach of contract.

In addition, where the bank has been vested with possession or control of property which, in the ordinary course, would be dealt with in accordance with the directions of the customer fiduciary, and it is decided to not act in accordance with those directions, the bank will also need to decide to whom the property should properly be relinquished. In this regard, relinquishing the property into the wrong hands is likely to result in liability to the beneficiaries and/or the fiduciary.

In the alternative, the bank may decide to continue to perform its contractual obligations or to act in accordance with the instructions of the customer/fiduciary despite its suspicions. However, if the suspicions prove to be correct, the bank risks liability to the beneficiaries for knowing assistance.

How does a bank protect itself from liability in these situations? To my mind, none of the alternatives are entirely satisfactory nor necessarily available in all circumstances. They appear to me to be as follows:

(a) Application to the court for directions or declaration

Virtually all Australian jurisdictions contain Supreme Court Rules which provide for the application by a trustee or other fiduciary to the Supreme Court for directions in relation to powers, rights, and obligations (eg South Australian Supreme Court Rule 63.04). Pursuant to this procedure it is possible to obtain the sanction of the court as to a course of conduct.

It should be carefully noted, however, that an application for directions may only be made by a trustee or certain other fiduciaries. Unless an underlying trust is involved in which the applicant is trustee (eg in *Finers (a firm) and others v Miro* [1991] 1 All ER 182) the procedure is not available. In the ordinary course, a bank will not be a fiduciary - the bank will merely be a party to a contract and, probably, a debtor or creditor. As a result, and for example, the procedure would not be available in the case of a bank seeking directions as to the appropriateness of certain proposed dealings with funds in a bank account.

It should also be realised that, even if available, an application for directions does not constitute a simple procedure. An application for directions can be both time consuming and costly.

In addition to the directions procedure, most Australian jurisdictions contain Supreme Court Rules which provide for application to the Supreme Court for a declaration as to the rights of a person under, and the interpretation of, a written document (eg South Australian Supreme Court Rule 63.01). However, once again, such procedure may be of little assistance to banks. More often than not, the interpretation of a written document will not be involved as the relevant contract will be the unwritten banker/customer contract.

(b) Consent of the beneficiaries

A trust, or other fiduciary relationship, is for the benefit of the beneficiaries. Accordingly, they can by unanimous consent extend the powers of the trustee/fiduciary. Thus, where power is doubtful, ratification by unanimous consent would protect both the fiduciary and the bank. This would not, of course, be a practical solution in relation to a large discretionary trust.

(c) Contractual protection

In the case of a written contract (eg a loan contract), some thought could be given to incorporating an express right on behalf of the bank to terminate its contractual obligations in the event that the bank has reasonable grounds to suspect that the performance of the contract would constitute, or cause or assist in, a breach of fiduciary duty. Such an express provision would overcome the problem that, generally, a mere suspicion that the performance of a contractual obligation would assist in a breach of fiduciary duty does not give the right to terminate. Of course, it may not be acceptable for all contractual arrangements to contain such a broad right to terminate.

In summary, a bank which becomes aware that it may well be assisting in the breach of a fiduciary duty is in a very difficult position. The obvious solution would be to obtain the consent of all parties concerned (ie the fiduciary and the beneficiaries) before proceeding further. However, in many cases (eg in relation to a large discretionary trust) this will not be possible. The bank may be forced to take its chances. There is no doubt, however, that if the wrong decision is taken and loss is suffered, even in the absence of commercial dishonesty, the bank will more likely than not be held liable to account to the party that suffers such loss.

CONCLUSIONS

1. The current law in Australia relating to "knowing assistance", "knowing receipt" and "inconsistent dealing" imposes serious risks on banks in dealing with customers who are fiduciaries.

2. To reduce these risks, banks could (although, admittedly, at a significant cost) implement procedures and information systems to obtain information relating to the powers and duties of their customers who are fiduciaries and to use such information to identify potential improper assistance, receipt or dealing. Alternatively, banks could refuse to deal with persons who are fiduciaries. While neither of these options may seem commercially acceptable, banks should understand that restricting the accumulation of information regarding their customers who are fiduciaries will not protect them, and indeed may expose them, to risks of liability in equity.

3. When faced with the practical dilemma of, what appears to be conflicting duties to the customer/fiduciary and to the beneficiaries, the remedial options open to banks are severely limited. Only the implementation of the procedures and systems referred to in the preceding paragraph, or a refusal to deal with persons who are fiduciaries, would assist in ensuring that banks are not placed in such difficult situations.