Financial Crime

The *mens rea* for knowing receipt

by John Breslin

When a bank or other financial institution handles or receives the proceeds of crime or other wrongdoing, it faces the prospect of liability to the victims under a number of headings. These include liability in tort for negligence (*Barclays Bank plc v Quincecare* [1988] 1 FTLR, [1992] 4 All ER 363), breach of fiduciary duty, and constructive trusteeship. Liability can be either personal or proprietary. Constructive trusteeship, until recently, involved two distinct alternative elements: liability for knowingly assisting in a dishonest breach of trust; and liability for knowing receipt of trust property, knowing its transfer to be in breach of trust (*Barnes v Addy* (1874) 9 Ch App 244). The traditional thinking on knowing assistance has been excoriated by the Privy Council (*Royal Brunei Airlines Sdn Bhd v Tan* [1995] 3 All ER 97). The preference is now to concentrate on the dishonesty of the accessory rather than the state of mind of the original perpetrator of the wrong. That case has left the law on knowing receipt in something of a state of disarray. However recent Commonwealth decisions point to some trends growing in the courts' approach to the issue.

THE BADEN FORMULA

The key question in the debate has been 'What state of mind is required of the knowing assistant/recipient to fix him with liability?' Or, to adopt the vocabulary of the criminal law, 'What *mens rea* is required?' In the *Baden* case counsel adopted a formula to grade possible states of mind along the spectrum of culpability. As is well known, the nuances of *mens rea* were identified as follows:

(1) actual knowledge;

(2) wilfully shutting one's eyes to the obvious;

(3) wilfully and recklessly failing to make such enquiries as an honest and reasonable person would make;

(4) knowledge of circumstances which would have indicated the facts to an honest and reasonable man; and

(5) knowledge of circumstances which would put an honest and reasonable man on inquiry.

The formula has not provided a useful touchstone for the attribution of liability; the courts' approach has been inconsistent. Indeed as regards liability for knowing assistance Millett LJ has said that the formula serves no useful purpose. The proper approach, in that context, is to treat the matter as a 'jury question': would a jury regard the assistant as having acted as an honest person would have done? (*Agip (Africa) Ltd v Jackson* [1992] 4 All ER 385). The Privy Council has embraced this and has pointed out the inherent limitations in the *Baden* formula.

One would have thought that, given the complexity of the subject matter, abandoning the *Baden* formula could be criticised for oversimplifying the test. It is thought, however, that these shades of state of mind complicate what is essentially a basic value judgment. Did the defendant act as an honest person would? Honesty is stated to be an objective criterion to be judged in the light of commercial circumstances. However, in so reformulating the test in the context of accessory liability, the Privy Council has defined dishonesty as 'commercially unacceptable conduct' (*Royal Brunei Airlines Sdn Bhd v Tan* [1995] 3 All ER 97). This lowering of the threshold leaves banks and other financial intermediaries wide open to liability.

The rejection of the *Baden* formula by the Privy Council in *Tan* has not been universally followed even in the UK (see *Brinks Ltd v Abu Saleh (No 3)* [1995] 3 WLR 640. However, it has strong academic and judicial support (Birks (ed) *Frontiers of Liability* Oxford: OUP, 1994).

MEGARRY v MILLETT

The courts have not found it easy to decide upon a firm test of the proper standard of culpability to justify liability for knowing receipt. Megarry VC in *Re Montagu's Settlement Trusts* [1987] Ch 264, [1992] 4 All ER 308, at p. 409, favoured a test which evaluates (perhaps in a somewhat benign fashion) the effect of receipt on the conscience of the recipient. Accordingly only where a want of probity is shown will the recipient be held liable. However, Millett LJ, writing extra-judicially (*Tracing the Proceeds of Fraud* (1991) 107 LQR 71), sharply criticised this approach. His view was that liability is receipt based, not fault based, although he stops short of suggesting that liability is strict. So classified, the action based on liability for knowing receipt is an element of the law of restitution – thereby making available the defence of change of position (*Lipkin Gorman v Karpnale* Ltd [1991] 2 AC 548; South *Tyneside Metropolitan BC v Svenska International plc* [1995] 1 All ER 545; *Kleinwort Benson Ltd v Birmingham City Council* [1996] 3 WLR 1139; *Svenska Handelsbanken v Sun Alliance* [1996] 1 Lloyd's Rep 519; *Friends Provident Life Office v Hillier Parker May & Rowden* [1997] QB 85).

Millett also takes the view that there can be no liability for knowing receipt where the receipt is otherwise than for the recipient's own use and benefit. Where the funds are credited to an overdraft or loan account, this is receipt for the bank's own use and benefit. But this is not so in the case of receipt of funds to the credit of a bank account which does not have a debit balance. As a matter of law and fact, this is (with the greatest of respect) unconvincing. When a bank receives funds, it obtains legal title to them and can use them as it sees fit. This is the case irrespective of what type of account the bank books the receipt to: the posting or appropriation of receipts is purely a matter of record keeping (*Kinlan v Ulster Bank Ltd* [1928] IR 171).

The principal significance of a bank receiving money and recording the receipt by posting it to the credit of an overdrawn account is that in such a situation the bank obtains a commercial benefit (in the reduction of the credit risk inherent in the customer's liability to it). In these circumstances the courts have, rightly, been more ready to impute to the bank actual or constructive knowledge of

a breach of trust or fiduciary duty by the customer (*Cunningham v Northern Banking Co Ltd* [1928] NI 113; *Lankshear v ANZ Banking Group (New Zealand) Ltd* [1993] 1 NZLR 481). Accordingly, where money is received and the receipt results in a reduction of the fiduciary customer's liability to the bank, it may well be easier to fix the bank with liability than if the customer has an overall credit balance with the bank so that the effect on the bank's risk profile is neutral (the comments here apply equally where the bank exercises its common law (or in Ireland implied contractual) right of set-off). But this distinction does not depend on the nature of the bank's proprietary interest in the money; rather it goes to the surrounding circumstances which ought to put the bank on a higher state of alert, given that it will derive commercial benefit from the breach of trust or fiduciary duty.

RECENT COMMONWEALTH CASE LAW

There have been two significant cases reported in the post-*Tan* era which imply that the *Baden* formula has a continued function in the assessment of knowing receipt liability, if not in the context of accessory liability.

The first is the judgment of Smellie J in the New Zealand High Court in *Equiticorp Industries Group Ltd v The Crown* [1996] 3 NZLR 586. The case concerned a complex financing arrangement which amounted to unlawful financial assistance by a company in respect of a purchase of its own shares. A central question was whether the Crown, having received the purchase money, was liable as a knowing recipient. Smellie J held that knowledge in any of the first three of the *Baden* criteria would suffice to ground liability. These are actual knowledge; wilfully shutting one's eyes to the obvious; and wilfully or recklessly failing to make such inquiries as an honest and reasonable person would have made. In particular, he held that it was no defence, in the circumstances, that the defendant had paid away the money received.

The second is the decision of the Supreme Court of Canada in *Citadel General Assurance Co v Lloyds Bank Canada* (1997) 152 DLR (4th) 411. In that case the plaintiff insurance company brought proceedings against the defendant bank which handled accounts for a company (Drive On) which received motor insurance premiums in trust for the plaintiff. Drive On, and its related company (also a customer of the bank) were in financial difficulty. The bank, on the instructions of the directors of those companies, transferred funds from the Drive On account (which represented funds held in trust by Drive On for the plaintiff) to the account of the related company, so as to reduce its overdraft. The Supreme Court held that the bank could not be held liable for knowing assistance: such liability could only be imposed if it actually knew of the breach of trust by Drive On, was reckless to it, or wilfully turned a blind eye to the obvious (*Air Canada v M&L Travel Ltd* [1993] 3 SCR 787). However liability was imposed on the bank for knowing receipt. The bank, by reducing the related company's overdraft with the trust funds held by it on behalf of Drive On, had received the funds to its own use and benefit. Constructive knowledge would suffice for such liability to be fixed to the bank: i.e. failing to make enquiries in circumstances where an honest and reasonable person would do so.

The Supreme Court endorsed Millett's view that liability for knowing receipt is a restitutionary remedy. The Supreme Court also preferred Millett's view (over that of Megarry V-C) that there should be two different standards respectively for knowing assistance and knowing receipt. By classifying knowing receipt liability as restitutionary, the court impliedly incorporates the possibility of the defence of change of position.

CONCLUSION

Ever since the much criticised decisions in *Selangor United Rubber Estates Ltd v Cradock* [1968] 2 All ER 1073 and *Karak Rubber Co Ltd v Burden (No 2)* [1972] 1 All ER 1210 the courts have grappled with the difficulties involved in creating a benchmark for liability in this area (see Goode, *Commercial Law* (Penguin Books, 1982), at p. 514; *Paget's Law of Banking* 9th edn: ed Megrah and Ryder (Butterworths, 1982), at p. 225). The task is to identify a standard of misconduct sufficient to warrant the imposition of personal or proprietary liability, while at the same time taking into account business realities. For example, as Steyn J pointed out in *Barclays Bank plc v Quincecare* [1992] 4 All ER 363 at p. 380, banks are not required to be amateur detectives. However, they cannot also claim merely to be automatic handlers of customers' money so that they are always under an absolute duty to deal with customers' money as they are mandated, irrespective of suspicious circumstances (Per Brightman J in *Karak Rubber Co Ltd v Burden (No 2)* [1972]).

It is not entirely clear if the *Tan* criterion of dishonesty as 'commercially unacceptable conduct' affords enough scope to banks and other financial intermediaries to carry on business reasonably free from legal risk. Equally, it is not clear if pigeonholing knowing receipt liability into the (as yet) relatively amorphous category of restitutionary liability is going to be universally workable.

What is clear is that both these developments do nothing to alleviate the concerns of banks and other financial institutions, or their advisers. Furthermore, there is a discernible trend to contemplate concurrent liability in contract and tort, and in tort and fiduciary law (*Henderson v Merrett Syndicates* [1995] AC 145: see, respectively, the judgments of Lords Goff and Browne-Wilkinson). The taking of a risk which the judge ultimately deems to be unacceptable may well mean that all these various forms of liability rain – like missiles – from aggrieved third parties on the bank.

The great American judge, Mr Justice Holmes, said the following about the law of contracts:

'The law is always approaching, and never reaching, consistency... It will become entirely consistent when it ceases to grow' (quoted by Hughes Parry in *The Sanctity of Contracts in English Law* (London: Stevens & Sons Limited, 1959) at p. 77).

While accepting that the law, dealing as it does with human behaviour, will never achieve mathematical equilibrium, nonetheless the law in the area of constructive trusteeship has a long way to go before one can say that it has achieved even an acceptable level of consistency.

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