Cambridge Law Journal, **57(2),** July 1998, pp. 391–405
Printed in Great Britain

CONSTRUCTIVE NOTICE AND KNOWING RECEIPT: AN ECONOMIC ANALYSIS

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THE equitable doctrine of constructive notice developed to resolve priority conflicts among interests in real property. Before the new system of land holding introduced in the Law of Property Act 1925, notice was the test which determined whether a person purchasing a legal estate in good faith would take priority over the holder of an earlier equitable interest which encumbered the vendor's title.

In contrast to transfers of land, the courts have adopted a long-standing policy against extending constructive notice to so-called "commercial transactions".[1] The classical statement of the policy appears in Lindley L.J.'s judgment in *Manchester Trust* v. *Furness,*[2] which was decided by the Court of Appeal in 1895. Rejecting an argument that a simple reference in a bill of lading to a charterparty was sufficient to give the consignors notice of all the terms of the charterparty, Lindley L.J. said:

> [A]s regards the extension of the equitable doctrines of constructive notice to commercial transactions, the Courts have always set their faces resolutely against it. The equitable doctrines of constructive notice are common enough in dealing with land and estates ... but there have been repeated protests against the introduction into commercial transactions of anything like an extension of those doctrines, and the protest is founded on perfect good sense. In dealing with estates in land title is everything, and it can be leisurely investigated; in commercial transactions possession is everything, and there is no time to investigate title; and if we were to extend the doctrine of constructive notice to commercial transactions we should be doing infinite mischief and paralyzing [sic] the trade of the country.[3]

Manchester Trust is now accepted as authority for a policy which applies to many forms of liability arising out of so-called "commercial" dealings. The term "commercial" is a convenient label for referring to these transactions but it hardly describes the real

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[1] For explanation of this term, see p. 392 below.
[2] [1895] 2 Q.B. 539.
[3] *Ibid.*, p. 545.

https://doi.org/10.1017/S0008197398000087 Published online by Cambridge University Press

substance of the policy. Transactions have been held to be commercial in the *Manchester Trust* sense when goods, money or negotiable instruments are transferred in return for some valuable consideration,[4] or where they are used as collateral to secure a loan.[5] The term "commercial", however, creates the misleading impression that notice can have no place in any transaction where the parties are commercial actors, rather than consumers or private sellers. For example, a bank taking a mortgage over customer's home may be fixed with constructive notice of an equity affecting the transaction even though the purpose of the transaction is to secure a loan to the customer's business.[6] It is more relevant to ask whether in that type of transaction there is, or ought to be, a recognised practice of inquiring into the transferor's title. As we shall see, it is the comparison between that standard and the transferee's actual conduct which becomes the basis of a finding of notice.[7] "Commercial" transactions are typically contrasted with transfers of interests in real property where the courts have long used the doctrine of notice to enforce rigid standards of inquiry. Equally important is the distinction between gratuitous transfers of property and those where a person transfers property in return for consideration. An underlying aim of the policy is to protect people who have parted with consideration, and so have a stronger entitlement to be sheltered from liability. Their identity as commercial actors is almost incidental to that purpose.[8]

This article concentrates on a specific area where the courts have recently relied on the *Manchester Trust* policy. This is where a fiduciary—most often a company director or an agent—misapplies funds which he holds on behalf of his principal.[9] If he passes the money to a third party, like a bank or a different company under his

[4] *E.g., Greer* v. *Downs Supply Co.* [1927] 2 K.B. 28 (sale of goods; whether the buyer has notice that the seller contracts as agent rather than as principal); *Panchaud Freres S.A.* v. *Etablissements General Grain Co.* [1970] Lloyd's L.R. 53, 60 *per* Winn L.J. (whether a party knows or has notice of facts founding a breach of contract so that it could be taken to have waived the breach); *By Appointment (Sales) Ltd.* v. *Harrods Ltd.,* unreported, (Court of Appeal, 1 December 1977) (sale of goods; whether the wording of sales documents gives the buyer notice that the true seller is not the person whom the buyer pays).

[5] *E.g., Joseph* v. *Lyons* (1884) 15 Q.B.D. 280 (registration of a bill of sale is not notice to a later pledgee).

[6] *E.g., Barclays Bank* v. *O'Brien* [1994] 1 A.C. 180 where a husband exerted undue influence to make his wife agree to the bank's taking the family home as security for a loan to the husband's business. The House of Lords held that the bank could not enforce the agreement against the wife if it had constructive notice of the undue influence.

[7] See p. 394 below.

[8] Hence some judges have expressed the rule by saying that constructive notice is not an appropriate standard of liability if the defendant received the trust money to discharge a debt, or if the money was payment for professional services that it had provided. See, for example, *Thomson* v. *Clydesdale Bank* [1893] A.C. 282, 289 *per* Lord Watson, and *Re Blundell* (1888) 40 Ch.D. 370.

[9] *E.g., International Sales and Agencies Ltd.* v. *Marcus Ltd.* [1982] 3 All E.R. 551; *Westpac* v. *Savin* [1985] 2 N.Z.L.R. 41; *Polly Peck International plc* v. *Nadir (No. 2)* [1992] 4 All E.R. 769.

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control, then the recipient may be liable in an equitable action for "knowing receipt". Liability is based on the recipient's fault.[10] At the extreme end of the scale, the third party is liable if there was any dishonesty or improbity about the way it received the funds. The most obvious instance would be where it actually knew the money was misappropriated or deliberately chose not to inquire whether this was the case. Dishonesty has recently been interpreted as indicating an objective standard, one where the defendant's conduct is compared with that of an honest person handling a transaction of the type in question.[11] It seems to be accepted that the recipients should generally be liable for knowing receipt if they took the money with constructive notice that it was derived from a breach of duty. An exception is made, however, where the defendant received the money in a commercial transaction. There is a cluster of recent English authorities holding that in this situation dishonesty is the only fault element which triggers liability.[12] The courts have relied on *Manchester Trust* to justify their conclusion.[13]

This article considers the reasons against extending constructive notice to equitable liability arising out of commercial transactions. It is argued that the reasoning in *Manchester Trust* makes the mistake of equating the entire doctrine of constructive notice with the paradigmatic application of it found in land transactions. It attempts a simple economic analysis to elucidate the reasoning in *Manchester Trust.* The article proposes that the policy rests on the courts' assumption that to expect a commercial recipient to inquire into the origins of money it received, or the propriety of the dealings from which the money derived, would be economically inefficient. However, once notice is understood as a principle which is wider and more flexible than the conveyancing standard, there are no clear economic reasons why it should not be a ground of liability in knowing receipt.

[10] For a general discussion of knowing receipt see C. Harpum, "The Stranger as Constructive Trustee" (1986) 102 L.Q.R. 114 and 267; S. Gardner, "Knowing Receipt and Knowing Assistance: Taking Stock" (1996) 112 L.Q.R. 56.

[11] *Royal Brunei Airlines* v. *Tan* [1995] 2 A.C. 378, 389–391 *per* Lord Nicholls (a case on equitable liability for dishonest assistance in a breach of fiduciary duty but the statements on dishonesty would apply equally to knowing receipt).

[12] *Eagle Trust plc* v. *S.B.C. Securities Ltd.* [1992] 4 All E.R. 488, 509 *per* Vinelott J.; *Cowan de Groot Properties* v. *Eagle Trust plc* [1992] 4 All E.R. 700, 759–761 *per* Knox J.; *Polly Peck International plc* v. *Nadir (No. 2)* [1992] 4 All E.R. 769. The main 19th century authority is the speeches of Lord Herschell L.C. and Lord Watson in *Thomson* v. *Clydesdale Bank* [1893] A.C. 282, 287–289. See also *Re Montagu's S.T.* [1987] 1 Ch. 264 where Sir Robert Megarry V.-C. proposed that liability in knowing receipt should depend upon dishonesty, whether a transaction was commercial or not.

[13] See especially *Eagle Trust plc* v. *S.B.C. Securities Ltd.* [1992] 4 All E.R. 488, 507 *per* Vinelott J.; and *Polly Peck International plc* v. *Nadir (No. 2)* [1992] 4 All E.R. 769, 782 *per* Scott L.J.

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Constructive Notice and the Perceived Disadvantages of Notice in Commercial Dealings

The doctrine of constructive notice reached its most refined form in dealings with real property. Purchasers of land were expected, simply as a matter of routine, to inquire into the history of their vendor's title and any rights which could be enforced against it.[14] There was a battery of case precedents, textbooks and conventional practices indicating the sorts of facts that would put the reasonable purchaser on inquiry about a possible encumbrance and the rigour of the investigations that he was expected to pursue.

This conveyancing standard, however, is just one expression of a wider principle which can apply to other kinds of transaction.[15] It does not define the doctrine exhaustively. A finding of constructive notice generally begins with the primary facts actually known to the transferee of the property in question. They are said to put the transferee "on inquiry". This a formula for saying that a reasonable person who knew the same facts as the transferee would be alerted to the possibility that there was an equity affecting the property he wished to acquire. He would feel bound, as a matter of prudence, to make further inquiries to resolve those suspicions. The court would impute the transferee with notice of whatever fact or interest he could have discovered if he had followed these investigations. In this way the transferee would effectively be bound to inquire into any third party's interest which may qualify the transferor's title. Otherwise he would run the risk of finding himself bound by an equity that he would know nothing about.

The judgment of Lindley L.J. in *Manchester Trust* gives the standard objections to extending duties of inquiry to commercial recipients. Crucial, in his mind, was the comparison between commercial transactions and land conveyances. To repeat his own words: "In dealing with estates in land title is everything, and it can be leisurely investigated; in commercial transactions possession is everything, and there is no time to investigate title; and if we were to extend the doctrine of constructive notice to commercial transactions

[14] For a discussion of the standards of inquiry followed in conveyancing practice, see J.S. Anderson, *Lawyers and the Making of the English Land Law 1832–1940* (Oxford 1992), pp. 274–280; *Cheshire and Burn's Modern Law of Real Property,* 15th ed. by E.H. Burn (London 1994), pp. 60–64; *Pilcher* v. *Rawlins* (1872) 7 Ch. App. 259; and *Hunt* v. *Luck* [1901] 1 Ch. 44 (Farwell J.), [1902] 1 Ch. 428 (C.A.).

[15] The following explanation of notice is adapted from the two leading land law cases on the doctrine, *Bailey* v. *Barnes* [1894] 1 Ch. 25, 34–36 *per* Lindley L.J.; and *Hunt* v. *Luck* [1902] 1 Ch. 428. See also J.N. Pomeroy, *Equity Jurisprudence,* 4th ed. (San Francisco and Rochester N.Y., 1918), vol. 2, para. 591 ff.; R.P. Meagher, W.M.C. Gummow and J.R.F. Lehane, *Equity: Doctrines and Remedies,* 3rd ed. (Sydney 1992), para. 854.

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we should be doing infinite mischief and paralyzing [sic] the trade of the country."[16]

Lindley L.J.'s comparison with land dealings is important. It assumes, quite unnecessarily, that constructive notice always entails the same detailed level of inquiry that purchasers of land were expected to observe. If notice meant only this, then there would indeed be compelling reasons against introducing it into commerce. But the objection is too simple. It is not a plain choice between admitting notice at the full conveyancing standard and excluding it altogether. There is no reason in principle why the standard of inquiry should not vary from one kind of transaction to another. The recipient of the property is only expected to act reasonably, given the exigencies and the customary practices of the situation in which he works. Notice can be sensitive to the demands of commercial dealing where speed and security of transaction are important. Recent authority supports this more flexible view.[17] The conduct of a bank receiving a deposit of misappropriated trust money should be measured against the standard of inquiry that could reasonably be expected of a banker, not a purchaser of land. Likewise the facts that raise the duty of inquiry may differ from one kind of property transfer to another. Outside land transactions inquiries need not be made as a matter of routine. A commercial recipient may only be put on inquiry if the facts immediately known to him make it glaringly obvious that some impropriety is afoot. So in *Westpac Bank* v. *Savin*[18] the New Zealand Court of Appeal held that a bank had constructive notice that it was using trust money to clear its customer's overdraft. It had been supervising its customer's account so closely that it knew the details of its business. The bank's conduct indicated a "clear suspicion, if not awareness on its part" that the customer was dealing with money in breach of trust.[19] If this line of authority is correct, then in commercial transactions the duty to

[16] [1895] 2 Q.B. 539, 545.

[17] Millett J. has argued strongly for this interpretation in *El Ajou* v. *D.L.H.* [1993] 3 All E.R. 717, 739 (affirmed [1994] 2 All E.R. 685 (C.A.)); and *MacMillan* v. *Bishopsgate Investment Trust (No. 3)* [1995] 1 W.L.R. 978, 1000. The point has been well put by Charles Harpum in "The Stranger as Constructive Trustee" (1986) 102 L.Q.R. 114, 125: "The mere fact that a transaction is a commercial one, does not suffice to exclude the duty of inquiry from arising in any circumstances, regardless of ordinary business practices". See also S. Moriarty, "Mixing, Laundering and Tracing" in P.B.H. Birks (ed.), Laundering and Tracing (Oxford 1995), pp. 88 ff.

[18] *Westpac* v. *Savin* [1985] 2 N.Z.L.R. 41, see also *International Sales and Agencies Ltd.* v. *Marcus Ltd.* [1982] 3 All E.R. 551.

[19] [1985] 2 N.Z.L.R. 41, 53–54 *per* Richardson J. There are other cases where claims based on constructive notice have failed because the fraud was not so obvious that it was apparent on the face of the transaction. The facts were not clear enough to take the transaction out of the ordinary course of business and so put the recipient on inquiry. See for example: *Thomson* v. *Clydesdale Bank* [1893] A.C. 282, 292–293 *per* Lord Shand; *Coleman* v. *Bucks and Oxon Union Bank* [1897] 2 Ch. 243; *Corporation Agencies Ltd.* v. *Home Bank of Canada* [1927] A.C. 318.

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inquire may only arise from facts which point so strongly to the impropriety that they could support an inference that the recipient was dishonest. The duty may only arise at the point where failure to make reasonable inquiries verges on dishonesty. This argument finds support in recent dicta saying that once it is proved that the recipient has not made reasonable inquiries, it bears an evidential onus to adduce evidence that it acted with an honest motive. Otherwise, the judge will infer that it was dishonest.[20]

Once it is understood that notice implies a variable standard of inquiry then the reasons against extending notice to commercial dealings become far less compelling. The real objection should not be to notice as such but rather to extending a land law standard of notice to commercial dealings, or at least, a standard of inquiry which is significantly more demanding than that expected of an honest recipient. As Millett J. has explained, the judges who have warned against extending constructive notice to commercial dealings "were obviously referring to the doctrine in its strict conveyancing sense with its many refinements and its insistence of a proper investigation of title in every case".[21] The same objections do not necessarily apply to an appropriately adjusted commercial standard of notice. Economic analysis bears out this point.

Economic Analysis of the Manchester Trust Policy

Underlying the *Manchester Trust* policy is the supposition that to reform the present law by introducing constructive notice into commercial transactions would be economically inefficient. The same view is implicit in the cases which have declined to accept constructive notice as the fault element in knowing receipt in instances where the money is received in a commercial transaction. The account which follows attempts to elucidate these reasons using the concepts commonly applied in the economic analysis of law. The conclusion reached, however, is that the presupposition which *Manchester Trust* makes is unsound. Once the standard of inquiry is adjusted to meet the exigencies of commercial practice—and there is no argument of principle to prevent this—then the economic reasons against extending notice to commercial dealings are far from certain.

According to the proponents of the economic analysis of law, the end which a legal rule should promote is the maximisation of wealth by the most efficient means. An efficient rule is one where the societal wealth which it generates or preserves is greater than the social costs

[20] *Eagle Trust plc* v. *S.B.C. Securities Ltd.* [1992] 4 All E.R. 488, 509 *per* Vinelott J.
[21] *MacMillan* v. *Bishopsgate Investment Trust (No. 3)* [1995] 1 W.L.R. 978, 1000.

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of administering it and the combined costs incurred by private individuals in complying with it.[22] The criteria for evaluation are narrow from the outset. Social cost in this context is measured solely in terms of wealth. It does not take into account broader forms of harm to society, nor personal hardship to individuals except in so far as these bear directly or indirectly upon aggregate societal wealth. It follows that any proposed reform of the law would be inefficient if it would generate less wealth than the existing rule, or if it would be less successful in minimising social costs. Economic theory assumes that individuals act out of self-interest.[23] The state of the law has a bearing on the amount of a person's wealth so it is assumed that when a legal rule changes the rational economic actor will modify his behaviour. He will weigh up the costs and benefits of his activity in the new legal environment and take that new course which will allow him to maximise his wealth.

From the point of view of a commercial institution, the chance of incurring liability for knowing receipt is just one of the risks attached to receiving money in the course of its business. Theoretically, that risk would increase if the fault element for liability were extended beyond dishonesty to include constructive notice. The *Manchester Trust* policy assumes that the commercial institution is averse to the risk of incurring liability for knowing receipt. It presupposes that the recipient would modify its conduct by taking reasonable steps to inquire into the origins of the money it received so as to minimise the risk of incurring liability. By following this course, it would either avoid being fixed with notice of a breach of fiduciary duty or refuse to handle any money that it found was misappropriated.[24] The analogy is with the reasonable purchaser of land. The purchaser is averse to the risk that his proposed purchase may be encumbered by an adverse equity. The purchaser follows whatever standard of inquiry is necessary to prevent himself from being fixed with notice of an unknown equity, or, having discovered the real state of the vendor's title, he renegotiates the deal to minimise his losses. In the case of a commercial institution handling money, it would probably carry insurance so that it would be indemnified against the risk of liability. Even so the terms of its policy would generally require it to take

[22] R. Posner, *Economic Analysis of Law,* 4th ed. (Boston and Toronto 1992), Chapters 1–2; W.Z. Hirsch, *Law and Economics* (London 1974), Chapter 1.

[23] R. Posner, *Economic Analysis of Law,* 4th ed. (Boston and Toronto 1992), p. 3; W.Z. Hirsch, *Law and Economics* (London 1974), p. 3.

[24] There is an analogy here with the economic analyses of the standard of care in negligence. A person whose conduct could potentially damage the plaintiff's property may reduce the risk of liability by incurring the expense of precautions. It will pay for the level of precaution that brings its conduct within the standard of reasonable care prescribed by the law of negligence. See further R. Posner, *Economic Analysis of Law,* 4th ed. (Boston and Toronto 1992), pp. 163 ff.; and "A Theory of Negligence" (1972) 1 *Journal of Legal Studies* 29, pp. 32 ff.

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reasonable care in running its operations.[25] It could not act regardless of the risk, leaving its insurers to make good any liability which it might incur. Moreover the institution's insurance cover would be subject to a heavy excess and would have a fixed upper limit of recovery. In the end, therefore, insurance would only screen out the middle range of the institution's liabilities. The incentive to minimise liabilities would remain strong.

The standard of "reasonable" inquiry would serve as a criterion for collecting the facts relevant to appraising the recipient's conduct. These would include such things as the recipient's knowledge of the customer's background, whether the payment was typical or out of the ordinary, and whether the recipient observed the procedures which were the common practice among bankers.[26] At the very least it would need to comply with its statutory duties in handling payment transactions, most notably the procedures required by the Money Laundering Regulations.[27] These require financial institutions to maintain procedures for scrutinising payment transactions with a view to detecting money laundering. The recipient would have to make precautionary inquiries even in transactions which turned out to be legitimate, and it might also incur the expense of making inquiries which were more stringent than the legal standard actually required.

These precautions against liability would increase the recipient's direct costs of handling payment transactions. Those who would oppose the extension of constructive notice to commercial transactions must contemplate that the recipient would need to adopt internal procedures for scrutinising transactions beyond those already required by the Money Laundering Regulations. Otherwise the objection would be superfluous. They contemplate, for instance, that the institution would have to employ more staff, or spend more money in teaching the new procedures to them. It would have to increase its insurance cover against the greater risk of liability to an equitable claimant, and it would incur the expense of considering claims

[25] See M.A. Clarke, *Law of Insurance Contracts,* 3rd ed. (London 1997), section 20-5A. The insured's continuing obligation to take care reduces the problem of "moral hazard", that is, the risk that a person who carries insurance cover has less incentive to take precautions to minimise the risk of loss. See W. Wils, "Insurance Risk Classifications in the EC" (1994) 14 O.J.L.S. 449, 452–453.

[26] For a gathering of the facts that might put a reasonable bank on inquiry about the risk of fraud, see *Lipkin Gorman* v. *Karpnale Ltd.* [1989] 1 W.L.R. 1340, 1353–1359 (C.A.), reversed on other grounds [1991] 2 A.C. 548 (H.L.); *Cigna Life Insurance New Zealand Ltd.* v. *Westpac Securities Ltd.* [1996] 1 N.Z.L.R. 80, 88–89 *per* Grieg J.; and *Polly Peck International plc* v. *Nadir (No. 2)* [1992] 4 All E.R. 769, 776–781 *per* Scott L.J. (discussion of facts from which dishonesty could be inferred).

[27] S.I. 1993/1933. Financial institutions must maintain procedures to verify their customers' identity and more generally "such other procedures of internal control and communication as may be appropriate the purposes of forestalling and preventing money laundering": Regulation 5(1)(a)(i). The regulations apply only to payments of more than 15,000 ecus, approximately £10,000.

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brought against it which turned out to be unsuccessful. The added expense of providing its service would be passed on to its customers in the form of higher charges. Customers, so the argument runs, would also find that their dealings with the institution took longer to conclude since the checking procedures would on average increase the time necessary to complete payment transactions. These results would follow even though most of the money which the recipient handled would derive from entirely legitimate transactions. Once the fault element of liability was extended to include constructive notice, there would be a "chilling" effect on the recipient's handling of all payment transactions, even those which were in no way tainted.[28] All customers of the institution would ultimately pay for the added protection given to the equitable claimants who took the benefit of the recipient's more stringent checking procedures.

If the *Manchester Trust* reasoning is correct, the heaviest costs of extending constructive notice would be represented by externalities. These are the secondary costs imposed on third parties who are not involved in the payment transaction in which the money is received.[29] Recall that the effectiveness of the law reform depends on an assessment of the gain or loss to society as a whole, not just the immediate parties to the transaction. *Manchester Trust* assumes that the external consequences of the higher transaction costs and the slower turnover of dealings would be socially expensive. They would make the commercial and the financial sectors less effective at generating wealth. In the exaggerated scenario which Lindley L.J. contemplated any reform of the present law would do "infinite mischief and [paralyse] the trade of the country".[30] Actually to quantify these external costs would be impossible. *Manchester Trust* simply assumes that the combined value total of all externalities and the increased transaction costs borne by commercial institutions and their customers would inevitably exceed any benefits that might be gained by extending the doctrine of constructive notice.

What, then, might those benefits be? Here the distinction must be drawn between gains accruing to an individual and net benefits to society. It is true that individual equitable claimants would benefit if notice were made the fault element in knowing receipt. They would

[28] Compare recent judicial statements about extending the duty of care in negligence. It is said, for instance, that the risk of civil liability may cause public agencies to be unduly defensive in carrying out their statutory functions. See *Rowling* v. *Takaro Properties Ltd.* [1988] A.C. 473, 502 *per* Lord Keith; and *X.* v. *Bedfordshire County Council* [1995] 2 A.C. 633, 750 *per* Lord Browne-Wilkinson.

[29] In its simplest sense an externality means a cost or benefit imposed on a third party who has not bargained to receive it. See R. Cooter and T. Ulen, *Law and Economics,* 2nd ed. (Reading, Mass., 1996) pp. 38–40; and, with criticisms, D. Kennedy, "Cost-Benefit Analysis" (1981) 33 Stanford L. Rev. 387, 393 ff.

[30] [1895] 2 Q.B. 539, 545.

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stand a better chance of getting restitution of the funds which the fiduciary misappropriated. Their individual loss would be made good, wholly or in part.[31] Likewise, if commercial institutions were bound to be more vigilant in handling money, they might deter fiduciaries from misapplying the funds in the first place.[32] They may prevent some of the general losses caused to society by crime and money laundering. There must also be some special economic value in having wealth belong to a certain class of people, such as legitimate companies or private investors, rather than have it in the hands of anyone at all, thieves and money launderers included. For example, the societal benefits accruing from keeping the Mirror Group pension fund secure for the beneficiaries of the scheme were probably more valuable than the uses to which the late Robert Maxwell put the money when he plundered the fund to support his group of ailing companies. This is to say nothing, moreover, of the moral advantage of deterring fraud, and the sense of personal security that individual investors enjoy in knowing that their funds will be held for them intact. Whatever the dictates of positive economic theory, a court would hardly overlook these matters when it decided where the net societal benefit lay.

However, from the point of view of strict economic analysis, the difficulty remains that gains accruing to individual claimants by extending the grounds of restitution would not *necessarily* increase the net wealth of society. It is societal gain rather than individual gain, which is the economic criterion for assessing whether the reform is efficient. When the fiduciary misapplies money and transfers it to a third party it cannot automatically be assumed that he causes loss to society. Value simply passes from the claimant to the third party, and, in the short term at least, society's aggregate wealth may remain unchanged.[33] A misappropriation leading eventually to restitution does not necessarily reduce aggregate wealth in the same way that tortious damage caused to the plaintiff's property does.[34] The

[31] The claim for knowing receipt allows restitution of the benefit which enriched the third party at the claimant's expense. However, since the recipient's gain is obtained "by subtraction" from the claimant, awarding restitution indirectly compensates for the loss which the claimant suffered when the fiduciary misapplied the money. On enrichment by subtraction, see further P.B.H. Birks, *Introduction to the Law of Restitution,* revised edition (Oxford 1989), pp. 22–27.

[32] A similar reason explains why financial institutions are required to monitor payment transactions with a view to detecting, and deterring, money laundering. See p. 398 above. Simon Gardner "Knowing Assistance and Knowing Receipt" (1996) 102 L.Q.R. 56, 79–85 details recent instances where financial institutions and professional agents have been given a role in detecting fraudulent dealings.

[33] This assumes, of course, that the thief does not dissipate the money or transfer it out of the country as was the fate of some of assets of the Polly Peck group of companies. See *Polly Peck International plc* v. *Nadir (No. 2)* [1992] 4 All E.R. 769.

[34] See further R. Sutton, "Mistaken Payments: an Inner Logic Infringed?" (1987) 37 *University of Toronto Law Journal* 389, 395–396 who argues that a mistaken payment of money may cause individual loss to the payer without necessarily reducing the aggregate wealth of society. The

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standard criteria for the economic analysis of the law do not take into account the moral question whether restitution ought to be allowed. They confine themselves to the narrower question whether it is costly in a financial sense to allow restitution. It follows that when assessing the total social costs associated with misappropriations a large part of the sum must represent the expenses of precautions taken by equitable claimants and commercial institutions to deter misappropriations from happening. The most efficient legal arrangement is one which deters fiduciaries by the strongest, least costly means. A thorough analysis of the full social cost would need to set the financial institutions' expenses in taking precautions against their effectiveness in deterring the social costs of crime and the value of keeping wealth in legitimate hands.

One further component of social cost should be mentioned. This represents the costs of adjudication and the comparative costs of complying with different legal tests of liability.[35] Litigation to resolve knowing receipt claims is socially expensive. The question arises whether a rule where liability depends on notice would be more expensive to administer than a narrower rule where liability turns only on dishonesty. Arguments can be brought either way. In the end, the more convincing view is that a notice standard would probably not cause higher adjudication costs than a dishonesty standard. Much depends on how precise the rule is that defines the fault element. In principle, a "bright line" rule that renders a commercial recipient immune from liability in the great run of cases may reduce the social expense of litigation. Claimants would know in advance that it would be pointless to sue the recipient for restitution and they would not waste money in the attempt. Any court would be in a position to determine promptly whether liability was established.[36] On the other hand, an open-textured standard of liability turning on whether the recipient had made reasonable inquiries may be said to encourage speculative litigation. The court would be forced into a detailed evaluation of the recipient's conduct. It would need, for example, to receive evidence of the standards of care commonly observed in practice and hear argument on which was the most appropriate to adopt as the legal standard. Difficult

facts giving rise to an action in restitution do not necessarily reduce net social wealth in the same way that the facts giving rise to an action in negligence do.

[35] On which, see generally I. Ehrlich and R. Posner, "An Economic Analysis of Legal Rulemaking" (1974) 3 *Journal of Legal Studies* 257.

[36] *Ibid.,* pp. 264–265. A related example of how a standard of fault based on reasonable notice can increase litigation is the spate of cases following *Barclays Bank* v. *O'Brien* [1994] 1 A.C. 180. In this instance, however, the high number of cases might have had as much to do with the recession causing many small businesses to fail, as it did with the possibility of arguing that the bank had notice of the undue influence which the husband exerted over his wife. The author is grateful to Ms Janet Ulph, of Nottingham Trent University, for suggesting this example.

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questions of law and fact may increase adjudication costs. There may also be the risk that the uncertainty in defining the legal standard of liability may have a chilling effect on legitimate activities. Commercial institutions may take precautions that turn out to be unnecessarily stringent since any indeterminacy in the standard would mean that they could not be sure that their attempts at compliance actually fell short of or were within its requirements. They may thus incur a level of cost that exceeded the efficient minimum necessary to avoid liability. The same would be true even if they carried liability insurance since they would still need to run their business as if they were uninsured. Moreover the grounds of liability would be contentious so the costs of insurance premiums would probably be high, reflecting the greater attention which the insurer would have to take in investigating the claims. Either way, therefore, an uncertain standard of liability may increase social costs, whether the claims were settled out of court or went to litigation.

In the author's view, however, the ultimate difference in adjudication costs between a notice and a dishonesty standard may not be significant. If the length of the judgments in recent knowing receipt cases is a reliable guide, then it seems that proving that a commercial institution was dishonest in receiving money is just as tendentious, and costly in judicial resources, as proving that it acted unreasonably.[37] The Privy Council has redefined the current understanding of dishonesty in the context of equitable liability, holding that it is an objective standard which depends on a comparison between the defendant's conduct and that of an honest commercial institution in its position.[38] This surely invites a court to make similar investigations into the evidence as would be required if reasonable notice were the standard of liability.

The final element to this analysis considers the efficient distribution of risk presupposed by *Manchester Trust.* Liability in knowing receipt shifts the risk of individual loss caused by the fiduciary's misappropriation from the equitable claimant to the third party. The third party bears the loss which would otherwise have fallen on the claimant. The third party is required to give restitution of the funds received at the claimant's expense and the claimant is restored to his original position, wholly or in part. If the conditions of liability were framed narrowly, as would be the case if they were based solely on dishonesty and did not include notice, then the claimant would have a stronger incentive to supervise the fiduciary.

[37] See for instance the judgment of Scott L.J. in *Polly Peck International plc* v. *Nadir (No. 2)* [1992] 4 All E.R. 769, 776–781 which devoted over five pages to the question whether dishonesty could be inferred from primary facts.

[38] *Royal Brunei Airlines* v. *Tan* [1995] 2 A.C. 378, 389–391 *per* Lord Nicholls.

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The burden of preventing the fiduciary from causing the loss would fall on the claimant. Once notice is accepted as a further touchstone of liability, the distribution of risks shifts in the third party's direction. The claimant has less incentive to incur cost in supervising the fiduciary since it stands a better chance of recovering its money from the third party recipient. The incentive to be more vigilant in supervising the fiduciary's payments shifts to the third party recipient. Greater vigilance reduces its own chances of incurring equitable liability, while making it less likely that the fiduciary would be tempted to commit a breach of duty.

The relevant question then emerges: which of the parties—the equitable claimant or the commercial recipient—could have incurred less expense to prevent the individual loss that results when the fiduciary misapplies the claimant's money? A normative theory of wealth maximisation would require that rules of liability should be framed so that whichever party could have prevented the loss from occurring at least cost to itself should be made to bear the risk of that loss. Assuming that the *Manchester Trust* policy is consistent with this principle, it seems to favour letting the greater burden of risk lie with the claimant. Applying *Manchester Trust,* the conditions of the third party's liability are defined narrowly so the chances of the claimant having restitution from it are correspondingly slim. The premise seems to be that the steps which the beneficiary of a fiduciary relationship would take to supervise the fiduciary would be more cost efficient in preventing misappropriations than the checks which a commercial institution would have to take to inquire into the propriety of transactions where a fiduciary paid money to it. From an intuitive point of view, this premise seems correct. The beneficiary has a legal right to make the fiduciary account to it and may be able to prevent the fiduciary from misapplying money in the first place. A commercial institution, such as a bank, is only effective in deterring misappropriations if it has stringent checking procedures. Keeping a watch for defaulting fiduciaries is hardly its main purpose.

Summarising then, *Manchester Trust* stands for the view that it would be economically inefficient to introduce constructive notice to commercial transactions. This conclusion is surely true if it is assumed that notice necessarily entails the strict conveyancing standard of inquiry. Introducing that standard into all commercial dealings would increase transaction and adjudication costs enormously. It is fair to assume, without looking to any empirical evidence, that the social costs of the reform would far exceed any gain in societal wealth that it might cause.

But the conclusion only holds good given the premises that underpin the argument. This article has proposed that it is incorrect to assume,

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as *Manchester Trust* does, that notice necessarily entails the strict standard of inquiry previously observed in land transactions. Notice is a general principle and the standards of reasonable inquiry vary from one kind of property transfer to another. Once this point is understood many of the objections to extending constructive notice to commercial transactions fall away. The economic analysis provides no compelling reason why notice, pitched at a proper standard, should not find a place in commercial dealings which may give rise to liability for knowing receipt. Under the Money Laundering Regulations financial institutions already owe duties to oversee payment transactions and the cases accept that they are liable for knowing receipt if they are dishonest in handling misappropriated funds. *Royal Brunei Airlines* v. *Tan*[39] holds that dishonesty implies an objective standard of conduct. The court compares the defendant's actions with those of an honest commercial person in its situation. Morever a close reading of cases such as *Westpac Bank* v. *Savin* and *Eagle Trust* v. *S.B.C. Securities Ltd.*[40] indicates that a commercial standard of notice would not be much more onerous than the standard of dishonesty which commercial institutions are already expected to observe. Dishonesty and a commercial standard of notice shade into each other. The adjudication costs of administering one standard of liability need not be appreciably different from the other. If we accept the social costs of litigation founded on a dishonesty standard, then there is no clear reason why we should not accept litigation turning on a commercial standard of constructive notice. Moreover if financial institutions have an incentive to be more vigilant, then whatever added costs they may bear may in the end be counterbalanced by the social benefits of deterring breaches of trust and money laundering. In short, therefore, the economic analysis does not reveal a strong reason for restricting the fault element in knowing receipt to dishonesty once the traditional land law standard of notice is adjusted to meet the demands of commercial practice. There are no clear indications that extending the fault element to constructive notice would increase social cost.

Conclusion

If a commercial institution could be fixed with constructive notice, then it would have an incentive to inquire whether some unknown third party had an equitable interest in the money which it received in a payment transaction. *Manchester Trust* states the traditional

[39] [1995] 2 A.C. 378.
[40] [1985] 2 N.Z.L.R. 41; and [1992] 4 All E.R. 488.

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reasons against extending notice in this way. This article has aimed to show that those reasons are far from conclusive. The real objection should not be to notice as such but to the rigorous standards of inquiry which conveyancers used to follow in land transactions. The conveyancing standard may represent the classic application of the doctrine but it does not define the doctrine exhaustively. Good economic reasons exist against introducing the conveyancing standard of notice to commercial dealings. However, there are no compelling economic reasons why constructive notice, set at the proper commercial standard, should not become a basis of liability for knowing receipt arising out of a commercial transaction.

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