

The Fiduciary Relationship between a Bank and Customers

SESE, Atsuko

I Introduction

An argument that the obligations that a bank owes its customers include fiduciary duty has long been discussed in many of common law countries. There have been lots of issues to be examined. However, in this thesis, I will focus on the following two issues :

- (1) In which situations a fiduciary relationship between a bank and customers exists.
- (2) When a bank owes liability as constructive trustee.

Regarding (1), David Hayton's famous comment : "A fiduciary relationship cannot exist if a bank has no reason to believe that the customer is placing trust and confidence in it and relying on it to put the customer's interests above all else. Only in very special circumstances will this occur in the banking context. The relationship trustee-like obligations, -as capable of being extended to other persons holding a position where confidence is reposed in such persons by someone entitled to expect that they will act in his or her interest to the exclusion of their own interests,"¹ has been frequently argued in discussion regarding "fiduciary relationship" in common law jurisdictions for a long time.

In order to examine this statement, I shall confront the ultimate question : "In which circumstances, a fiduciary relationship shall exists

1 David Hayton, "Fiduciaries in Context: An Overview" in *PRIVACY AND LOYALTY*, (ed. Peter Birks, 1997), p283-284.

between a bank and its customer?"

While the principle of fiduciary relationship, which is applied in a wide variety of circumstances as well as trustees and agents, has been established for some 250 years², it was only half century ago that an English court for the first time applied this principle to the relationship between a bank and its customer in *Woods v. Martins Bank Ltd.*³

Therefore, in this paper, first of all, I will discuss about how the principles governing bank-customer relationship have been developed and why the principle of fiduciary relationship has evolved in this context. Secondly, "what is fiduciary relationship in general" will be analysed. Finally, I will explain the current situation regarding the fiduciary relationship in accordance with bank-customer relationship.

As to (2), William Blair's statement that "Financial institutions are inevitably caught up in other people's fraud because of the nature of their business as holders and transmitters of funds. As the nature of a bank's business is to hold and transmit funds, the burden of a bank's potential liability as constructive trustee in relation to fraud instigated by third parties is currently too onerous."⁴, really reflects the current situation regarding constructive trust in banking law context.

In order to examine this statement, first, I will refer to the general concept of constructive trust in banking law and secondly, will analyse the "Knowing Assistance" situation and finally, will discuss about "Knowing Receipt" situation.

I Fiduciary Relationship

2 Goff and Jones, THE LAW OF RESTITUTION, p730.

3 [1959] I.Q.B. 55.

4 "Secondary Liability of Financial Institutions for the Fraud of Third Parties", 30 Hong Kong L.J. 74, p91.

1. Bank-Customer Relationship

(1) Who are banks and customers ?

The question regarding what a bank-customer relationship is can be divided into two questions : i.e., “what is a bank ?” and “how is a customer defined?”.

However, as to the former question, for example, Section 2 of Bills of Exchange Act 1882 only provides that “banker” includes a body of persons whether incorporated or not who carry on the business of banking which has been criticised as the circularity of the wording by many commentators.⁵

Then, the question what “the business of banking” will arise. In *United Dominion Trust v. Kirkwood*,⁶ Lord Denning held :

“Bankers (i) accept money from, and collect cheques for, their customers and place them to their credit ; (ii) honour cheques or orders drawn on them by their customers when presented for payment and debit their customers accordingly, and (iii) keep current accounts in which the credits and debits are entered”⁷

In addition, in *Re Roe’s Legal Charge*⁸, it was held that the proportion of banking transactions must be non-negligible in comparison to the lending, in order to be called as a bank.⁹

The definition of “bank customer” is more important to clarify the fiduciary relationship.

In *Ladbroke & Co. v. Todd*,¹⁰ it was found that a person with an

5 J. Wadsley & G.A. Penn, THE LAW RELATING TO DOMESTIC BANKING (2nd ed. 2000), p91.

6 [1966] 2.Q.B. 431.

7 Supra note 5, p93.

8 [1982] 2 Lloyd’s Rep. 370.

9 Supra note 5, p95.

account, will be a customer even though his or her only connection with the bank was payment into an account opened for the purpose of collecting a single cheque (and even if the cheque has not been collected, so that the “customer” may not draw on the uncleared effect).¹¹ Where a bank performs a casual service for a customer even if the service is performed on a regular basis, unless that person maintains an account, whether a deposit or a current account, with the bank.¹²

*Woods v. Martins Bank Ltd.*¹³, in which a young and inexperienced-investment man argued that the bank gave him a wrong financial advice, however, he had not opened an account with the bank in question when the advice was given, might seem to be an exception to the well-established definition of a bank customer: who has opened and is maintaining an account with a bank. However, if analysing cases more closely, we can reach the conclusion that a person will become a bank customer when the bank agrees to open an account for him or her and that duration of relationship is irrelevant.¹⁴ If we interpret the case law regarding the definition of a bank customer as above, the holding of *Woods v. Martins Bank Ltd* is not inconsistent with the law.

(2) Contractual Relationship

(i) **What Kind of Contract?**

When a bank merely played a role of a goldsmith, the contract

10 [1914] 30 T.E.R. 433.

11 Supra note 5, p98. Confirmed by *Barclays Bank Ltd. V. Okenarhe* [1966] 2 Lloyd's Rep. 87

12 *Great Western Railway Co. v. London and Country Banking Co.Ltd.* [1901] A.C. 414 at 421.

13 Supra note 3

14 *Commissioners of Taxation v. English Scottish and Australian Bank Ltd.* [1920] AC 683. Ellinger, Lomnica, and Hooley, MODERN BANKING LAW, (3rd. ed. 2002), p89-90.

between a bank and its customer was that of bailment. However, since a bank started to accept money as deposit from a customer, a different explanation was required and *Foley v. Hill*¹⁵ established that a bank-customer relationship is not a trust but a debtor-creditor relationship in which a bank merely owes a debt to the customer and it may use the funds they hold as they see fit.

(ii) **Implied Terms of Contract**

Nevertheless, there are many problems regarding a bank-customer relationship which cannot be solved by a debtor-creditor theory only. First of all, when certain accounts are opened, a mandate is executed which gives the bank express instructions concerning operations on the account, but even in those cases no attempt is made to prepare a comprehensive list of the respective rights and duties of banker and customer¹⁶ and bank-customer relationship is not usually spelt out in a comprehensive written contract between the parties entered into and rather it has been defined over the years in the case law.¹⁷

That is why in banking law implied terms of contract are of vital importance.¹⁸ In *Joachimson v. Swiss Bank Corporation*¹⁹, the following implied terms of the contract were found²⁰:

- ① The bank undertakes to receive money and to collect bills for its customer's account, and it borrows the proceeds and promises to repay them. The bank promises to repay at the branch of the bank

15 [1948] 2 H.L. Cas. 28.

16 Milnes Holden, *THE LAW AND PRACTICE OF BANKING, VOL. 1 BANKER AND CUSTOMER*, (5th ed. 1991), p50.

17 Ross Cranston, *EUROPEAN BANKING LAW: THE BANKER-CUSTOMER RELATIONSHIP*, p12.

18 Id.

19 [1921] 3 K.B. 110.

20 Supra note 5, p105.

where the account is kept and during banking hours.

- ② The bank promises to repay any part of the amount due against the customer's written order at the branch.
- ③ The bank promises not to cease to do business with the customer except on reasonable notice.
- ④ The customer promises to exercise reasonable care in executing his written orders so as not to mislead the bank or to facilitate forgery.

Since *Joachimson v. Swiss Bank Corporation*, many decisions have added other implied terms of the contract, such as the duty to tell of known forgery (*Greenwood v. Martins Bank Ltd.*²¹), the duty to accept overdrawing when there is a clear agreement on it (*Rouse v. Bradford Banking Co. Ltd.*²²) and confidential liability (*Tournier v. National Provincial and Union Bank of England*²³).

And in *Tai Hing Cotton Ltd. v. Liu Chong Bank Ltd.*²⁴, implied term of contract that the customer's account may not be debited on a forgery superseded the written term of the contract regarding deemed confirmation of the bank statement.

(3) Fiduciary Relationship

However, the principle of implied terms of contract cannot be applied where the special circumstances that may not be attributed to the actual or implied intention of the parties, i.e., something existing outside their state of mind. That is why the principle of fiduciary relationship was introduced.

*Woods v. Martins Bank Ltd.*²⁵ for the first time admitted the fiduciary relationship between a bank and customers, justifying the protection of

21 [1932] 1 K.B.371 at 381 per Scrutton L.J.

22 [1984] A.C. 586, at 596 per Lord Herschell L.C.

23 [1923] 1 K.B. 461 (C.A.).

24 [1985] 2 All E.R. 947; [1986] A.C. 80.

the customers by the creation of a relationship of proximity and the existence of a conflict of interests.²⁶

Since then, the fiduciary relationship between a bank and its customers has been used to protect customers.

Before starting to explain the current situation, let me refer to the fiduciary relationship in general.

2. Fiduciary Relationship

(1) Background

Many scholars have tried to define or classify the concept of fiduciary relationship.

For example, Sealy classified the fiduciary relationship as follows²⁷ :

Category 1: The fiduciary who holds or controls another's property

Category 2: The fiduciary who finds him/herself in such a situation if s/he has undertaken or is under an obligation to act on another's behalf or for another's benefit

Category 3: The fiduciary who even if had renewed the partial right on the property held for another or had obtained additional rights, are deemed to hold those as an attachment to the original property.

Category 4: The fiduciary under the doctrine of "Undue Influence".

Finn also challenged this difficult problem in his remarkable work of "Fiduciary Obligations"²⁸.

However, none of them has been successful in doing so, and actually, "English judges have wisely never attempted to formulate a comprehensive definition of who is a fiduciary."²⁹ That is because the definition and

25 Supra note 3.

26 Ellinger, Lomnica, and Hooley, MODERN BANKING LAW, (3rd. ed. 2002), p102.

27 L.S. Sealy, "Fiduciary Relationships", (1962) Cambridge L.J. 69., "Some Principles of Fiduciary Obligation" (1962) Cambridge L.J. 119.

28 CUP, Cambridge 1977.

classification may limit the scope of the situations where the fiduciary relationship is used and also may deprive of flexibility.

(2) Current Approach

Pearce and Stevens classify the fiduciary relationship more realistically:³⁰

(i) Fiduciary Relationship per se

The following are non-exhaustive examples of the fiduciary relationship on its face³¹:

Trustee and beneficiary

Agent and principal

Mortgagee and mortgagor

Solicitor and client

Partners and co-partners

Director or senior management and the company

Confidential employees and their employers

(ii) Fiduciary Relationship within a Relationship Which Is Not Fiduciary in Essence

For example, on the face of it the relationship between a bank and its customers is not a fiduciary relationship³², however, special circumstances that were found in the cases such as *Woods v. Martins Bank Ltd* shall amount to make the relationship between a bank and its customers the fiduciary relationship.

(iii) Artificial Use of Fiduciary Relationships

29 Goff and Jones, THE LAW OF RESTITUTION, p730.

30 Robert A Pearce and John Stevens, THE LAW OF TRUSTS AND EQUITABLE OBLIGATIONS, (1995), p460-466.

31 Id. P462-463.

32 *Governor and Company of the Bank of Scotland v. A ltd.* [2001] Lloyd's Rep. Bank 73.

In *LAC Minerals Ltd. v. International Corona Resources Ltd.*³³, La Forest J held that “courts have resorted to fiduciary language because of the view that certain remedies, deemed appropriate in the circumstances, would not be available unless a fiduciary relationship was present. In this sense, the label fiduciary imposed no obligations, but is rather merely instrumental or facilitative in achieving what appears to be the appropriate result.”

This tendency is particularly significant in banking context, therefore, let's return to the banking law. The reason why this artificial use of fiduciary relationship is frequent in banking law is that a bank co-mingles the money in account with its own money based on debtor-creditor theory discussed above.

Regarding tracing as the process for recovery of money, there are both common law tracing and equity tracing available. Nevertheless, where tracing principles lead to money being traced into a bank account containing more money than the amount traced, then the remedy ought to be the imposition of an equitable charge whether the plaintiff's original proprietary right was equitable or legal.³⁴

That is why *Chase Manhattan Bank v. Israeli-British Bank (London) Ltd.*³⁵ was criticised for holding that the overpaid bank was the fiduciary of the paying bank. The court here referred to the fiduciary duty not by deduction from the principle of fiduciary relationship, but merely by the necessity to save the paying bank. In other words, the conclusion led to the reasoning.

3. Conclusion

33 [1989] 61 D.L.R. (4th) 14.

34 Supra. note 1, p301.

35 [1981] 61 D.L.R. (4th) 14.

As I have discussed, the concept of fiduciary relationship has been rather enthusiastically abused than precisely used and not only natural opportunism of counsel but also the availability of tracing remedy has driven this enthusiasm much too far.³⁶

However, as Lord Millet argued in *Bristol and West Building Society v. Motthew*³⁷, “the much more limited and much more precise use of the concept of fiduciary duties” is required in order to reconcile the social responsibilities inherent in the conduct of banking in a modern economy, with the commercial imperative of maintaining a financially sound and competitive business.³⁸ In this sense, the statement by Hayton is quite right.

III Constructive Trust

1. General Concept

(1) Definition

Basically, a bank bears no liability based on another’s wrongdoing, however, an important exception to this is where a bank is liable as a constructive trustee.

The concept of constructive trust in banking law context is sometimes understood to be included in the fiduciary relationship situations discussed in II. For example, some Japanese scholars explain the artificial use of the concept of fiduciary relationship found in *Chase Manhattan Bank v. Israeli-British Bank (London) Ltd.*³⁹ is one of the constructive trust remedies.⁴⁰

36 Peter Birks, “Lionel Cohen Lecture : The Content of Fiduciary Obligation” 34 *Isr. L.Rev.* 3, p6.

37 [1998] Ch 1 (CA).

38 *Supra* note 17, p11.

39 *Supra* note35.

However, while a bank's fiduciary duties are based on its proximate relationship with a given customer, the bank's liability as a constructive trustee is incurred as a result of its nexus with the trustee or agent who has committed a breach of trust.⁴¹

In addition, as a remedy, constructive trust is different from tracing in that "there would only be good reason to seek the imposition of a constructive trust if the property has depreciated in value or been dissipated while in the hands of the recipient, or if the recipient has obtained some incidental profit, which may be claimed by the beneficiary."⁴² However, the fact that such amount, which has decreased or increased is traceable in the United States law might have incurred some misunderstanding.⁴³

Furthermore, as to the interrelationship between a constructive trust claim and claims in contract and tort, Blair argues that a claim in constructive may be successful even if the bank is no in breach of its contractual duty of care in executing its customer's payment instructions.⁴⁴

(2) Classification

*Barns v. Addy*⁴⁵ classified constructive trust into the following two patterns :

40 Jun Ueda, THE PRINCIPLE OF FIDUCIARY RELATIONSHIP IN COMMON LAW COUNTRIES-FOCUSING MAINLY ON ENGLISH CASE LAW, (1997) p221. Hiroto Dogauchi, THE PRINCIPLES OF TRUST AND PRIVATE LAW, (1996), p77.

41 Ellinger, Lomnica, and Hooley, MODERN BANKING LAW, (3rd. ed. 2002), p100.

42 J. Wadsley & G.A. Penn, THE LAW RELATING TO DOMESTIC BANKING (2nd ed. 2000), p302.

43 Supra. note 40 Ueda, p231.

44 Supra. Note 4, p79.

45 [1874] 9 Ch.App. 244.

- (A) “Knowing assistance”, or “Accessory liability”, where a bank has assisted the delinquent trustee in his/her action
- (B) “Knowing receipt”, or “Recipient liability”, where a bank received the trust property from the delinquent trustee

This classification was confirmed by *Royal Brunei Airlines v. Tan*⁴⁶.

The difference between (A) “Knowing assistance” and (B) “Knowing receipt” is variously argued :

Whereas (A) is fault-based liability,⁴⁷ or participation in fraud⁴⁸, (B) is restitution-based liability.⁴⁹

(3) Mental State

In order to constitute a liability as a constructive trustee, mental state of a bank is important and *Baden Delvaux & Lecuit v. Societe General S.A.*⁵⁰ provides so-called “Baden Scale” as follows :

- ① Actual knowledge
- ② Shutting one’s eyes to the obvious
- ③ Wilfully and recklessly failing to make such inquiries as a reasonable and honest person would make
- ④ Knowledge of circumstances which would indicate the facts to an honest and reasonable person
- ⑤ Knowledge of circumstances which would put a reasonable person on inquiry

The scales ①—③ are sometimes defined as “actual notice” whereas

46 [1995] 2 AC 378.

47 Penn and Shen, *THE LAW RELATING TO DOMESTIC BANKING* (2nd ed. 2000), p300.

48 Susan Barkehall Thomas, “When Is a Stranger a Constructive Trustee? A Critique of Resent Decisions”, 39 *Alberta L.R.* 453, at 476.

49 *Supra.* note 47.

50 [1992] 4 *All.L.R.* 161 at 235.

④ and ⑤ is called “constructive notice”⁵¹, or, the former is “dishonesty” while the latter is “negligence”.⁵²

However, Privy Council of *Royal Brunei Airlines v. Tan*⁵³ held that now that the requirement of “dishonesty” for “Knowing assistance” was established, Baden Scale is no longer necessary. Nevertheless, many courts still consider this Baden Scale useful to differentiate a lack of probity (scales ① to ③) from negligent behaviour (scales ④ and ⑤).⁵⁴

2. Knowing Assistance

(1) Tough Era for Banks

In order to be liable as a constructive trustee, the following conditions must be satisfied: ⁵⁵

- (i) The existence of trust
- (ii) A breach of trust by the trustee or agent
- (iii) Assistance by the third party or bank in that breach
- (iv) The third party’s knowledge of these three elements.

Regarding the above (iv), the degree of knowledge, the courts used to make decisions that seems too tough for banks in *Selangor United Rubber Estates Ltd. v. Cradock*⁵⁶ and *Karak Rubber Co. Ltd. v. Burden (No.2)*⁵⁷, where Baden Scale ④ was used in holding the bank had owed a duty of inquiry, because it knew of circumstances from which an honest and reasonable banker would have concluded that there existed some wrongdoing.⁵⁸

51 Supra, note 42, p289.

52 Ross Cranston, PRINCIPLE OF BANKING LAW (1997), p208.

53 Supra, note 46.

54 Supra, note 42 p290.

55 Supra, note 42, p287.

56 [1968] 2 All.L.R. 1073.

57 [1972] 1 All.L.R. 1210.

58 Supra, note 42 p291.

Considerable controversy arose regarding these disastrous decisions.

(2) Establishment of “Dishonesty” Requirement

However, many decisions including *Lipkin Gorman v. Karpnale Ltd.*⁵⁹, *Royal Brunei Airlines v. Tan*⁶⁰, *Agip (Africa) Ltd. v. Jackson*,⁶¹ *Belmont Finance Corp'n Ltd. V. Williams Furniture Ltd. (No. 2)*,⁶² *Re Montagne's Settlement*⁶³, *Barclays Bank Plc v. Quincecare Ltd.*⁶⁴ have firmly established the requirement of “dishonesty”.

Although this “dishonesty” requirement is argued to be an objective standard, some argue that it is not. For example, Blair argues that honesty has such a strong subjective element that dishonesty is to be equated with conscious impropriety.⁶⁵ The word “conscious” refers to the subjective element in that courts will assess the conduct in the light of what the defendant actually knew, not what a reasonable person would have known, and will have regard to the defendant’s experience, intelligence and reasons for acting as s/he did, while impropriety indicates a violation of objective standards of not acting as an honest person would in the circumstances.

3. Knowing Receipt

(1) Current Situation

While the degree of knowledge required in “Knowing assistance” is firmly established (i.e., “dishonesty”), as to “Knowing receipt”, it is not the situation in England although there are two decisions of noteworthy-

59 [1989] 1 W.L.R. 1340 (C.A.).

60 *Supra*, note 46.

61 [1991] Ch, 547.

62 [1980] 1 All.E.R. 393.

63 [1987] Ch. 264.

64 [1992] All E.R. 363.

65 *Supra*, note 4, p89-90.

ness in Canada.⁶⁶

These are *Gold v. Rosenberg*⁶⁷ and *Citadel General Assurance Company v. Lloyds Bank Canada*⁶⁸.

They established the following principles: ⁶⁹

- ① The defendant will not be liable for knowing receipt unless the defendant has received trust property for the defendant's own use and benefit. There is no cause of action in receipt against an agent holding property for another.
- ② The nature of liability for knowing receipt and knowing assistance is quite different. Knowing assistance liability derives from the defendant's participation in a fraud. Knowing receipt liability is restitutionary.
- ③ The defendant is liable as a recipient because "the defendant has improperly received property which belongs to the plaintiff. The dispute between the plaintiff and the defendant is about "who has a better claim to the disputed property".
- ④ It is inappropriate to use a "want of probity" test for receipt liability.
- ⑤ Unjust enrichment is the basis of liability. The defendant is not unjustly enriched unless the defendant has failed to inquire in circumstances where there is a legally recognised duty of inquiry.
- ⑥ The defendant will be liable if any of categories ① to ⑤ of Baden Scale are satisfied.
- ⑦ The burden of proof is on the plaintiff to satisfy the court that the defendant was not a bona fide purchaser for value without notice.

66 Id. P81.

67 [1997] 152 D.L.R. (4th) 385.

68 [1997] 152 D.L.R. (4th) 411.

69 Supra note 48, p476-477.

⑧ Tracing and third party liability are distinct, but they share a common concept of bona fide purchase for value without notice.

(2) Criticism against Two Canada Cases

Regarding beneficially receipt requirement, it is too technical to recognise. In modern banking practice, whether a bank receive a proceed as an agent or as a repayment of overdrawn is determined as a matter of computer systems arrangements. In addition, reducing the indebtedness of a solvent customer is not necessarily for the bank's benefit since to that extent the bank does not earn interest.⁷⁰

In addition, there are logical weaknesses. "There is no distinction between the knowing receipt action and a proprietary claim consequent upon the use of the tracing mechanism. If the knowing receipt action is for the recovery of property, there is no role for restitution. Further, if the knowing receipt action is purely proprietary, why does it depend on knowledge, whereas a claim founded on tracing does not?"⁷¹ Also, the principles established here are to far from English restitution theory.⁷²

4. Conclusion

The statement is true and right in that the requirement for constructive trust must be clarified in view of the very substantial number of cheques handled daily by the banks and undue burden imposed on banks may produce economic inefficiency that must ultimately be paid by innocent depositors.

However, at least regarding "Knowing receipt", no clear and persuasive definition has been established.

70 Supra note 42, p208-209.

71 Supra, note 48, p477.

72 Id. P478.