

THE UNIVERSITY OF ZAMBIA
SCHOOL OF LAW

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Entitled:

BANKER CUSTOMER RELATIONSHIP VIS-A-VIS THIRD PARTY VICTIMS OF
FRAUD

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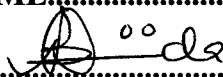
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DECLARATION

I NAKASAMBA T. BANDA, COMPUTER NUMBER 28076222 hereby declare that the contents of this directed research are entirely based on my own findings and it has not previously been submitted for a degree at the University of Zambia or any other University. All other works referred to in this essay have been duly acknowledged. I bear absolute responsibility for all errors, defects or any omissions herein.

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ABSTRACT

Recent times have witnessed a mounting number of elaborate fraudulent schemes through banks. This paper recognises that the banker customer relationship is based on contract to which the third party is a stranger and is generally owed no duty of care. Thus, the question to be addressed is whether banks may be civilly liable to third party victims of the fraudulent activities of the bank's customer. Chapter one provides the backdrop of the entire research, describing the nature of the relationship between banks, customers and third parties. Chapter two ascertains the basis on which banks may be liable to third parties. It establishes liability based on common law and equity rather than statute, and the difficulties encountered in establishing liability given the lack of duty of care are acknowledged. In addition, the chapter ascertains alternative non judicial mechanisms of establishing liability and their viability given the obligations of the bank to its customer. Chapter three looks at the Zambian legal regime and its provision for liability of banks and the willingness of the courts in imposing such liability. This includes a critical analysis of the *Elpe Finance Ltd v Brymum Ltd and Stanbic Bank (Z) Ltd case* which indicates the unwillingness of the courts. For a deeper insight of the issues being grappled with, a comparative analysis of judicial developments as practiced around the world is presented. After considering the foregoing, this paper concludes that establishing a duty of care, knowledge of the fraud on the part of the bank and the willingness of the courts to impose liability is vital in finding the bank liable. It is then recommended that if a duty of care is to be owed, third parties must expressly enter contracts with the bank; knowledge is to be imputed on the bank by a *mareva* by letter; and the willingness of the judges to impose liability can only be achieved by their exercise of judicial activism. Further, 'Know your customer' policies and increased accountancy professional responsibility will assist in the prevention and detection of fraud through banks.

DEDICATION

To my mother, whose life long struggles and sacrifices have been aimed at making a better life for her children. Your love and support made it possible for me to pursue my LLB.

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The conclusion of this work is the result of what has been a difficult yet satisfying journey, as it were, in the school of law. With God's grace I am done!!! Well... not technically, but I will be in 3weeks. Many thanks to my supervisor, Mr Mumba Malila, I can't even begin to imagine the stress you had to undergo, given that both the president and I had your number on speed dial, but you still left him on call waiting. In the end, what you have approved, no man can certainly disapprove. My family-Dad, Mum, Christine Witinala, Chabota and Chipego, always reliable and supportive beyond measure. My 'fyonse', I told you I gat this. I can't even begin to imagine what I would do without you. Your constant concern as to my meeting deadlines and taking care of everything else in my life so I can concentrate on school is beyond your job description, but because you're you, you did it....madluv.

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GLOSSARY OF ACRONYMS

AML	Anti Money Laundering
BFSA	Banking and Financial Services Act
BOZ	Bank of Zambia
CDD	Customer Due Diligence
DPP	Director of Public Prosecution
FIC	Financial Intelligence Centre
FPC	Forfeiture of Proceeds
KYC	Know Your Customer
KCM	Konkola Copper Mines
PPML	Prohibition and Prevention of Money Laundering
STR	Suspicious Transactions Reporting
UK	United Kingdom
USA	United States of America

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CHAPTER ONE

SETTING THE SCENE

1.1 Introduction

With the escalation of fraudulent activities occurring through bank services, it is becoming increasingly incumbent on financial institutions to pursue with reasonable diligence not only their own clients' protection against fraud, but potential non-customer victims as well¹. On the other hand, some bankers have forcefully argued that commercial reality militates against any doctrine under which a bank is put on enquiry as to suspicions of fraudulent activity². Thus this research paper investigates the basis on which banks may be liable to third party victims of the fraudulent activities of banks' customers and whether or not it is in itself adequate and effective so as to serve the interest of both parties.

This chapter principally provides the backdrop of the entire research which is presented in the title 'A Critical Analysis of the Banker- Customer Relationship vis-a-vis Third Party Victims of Fraud'. It therefore introduces the study by establishing and describing the nature of the relationship between banks, customers and third parties and goes on to highlight the problem that is to be addressed in this paper.

¹ Lincoln Caylor, et al... "Emergence of the Mareva by Lettter: Bank's Liability to Non-Customer Victims of Fraud" *Business Law International*. Vol 12, No.2. (May, 2011) p.2

² Kennedy Luwisha, Corporate Banker- Standard Chartered Bank, New York interviewed by Nakasamba Banda 04/11/11

1.2 The nature of the relationships between the bank, their customer and a third party.

The law of banking proper is the law of the relationship between a bank and a customer³.

According to the Banking and Financial Services (Amendment) Act No.18 of 2000, a bank is defined as a company conducting banking business. Banking business is further defined as;

- (i) The business of receiving deposits from the public including chequing account and current account deposits and the use of such deposits, either in whole or in part for the account of and at the risk of the person carrying on the business, to make loan advances or investments
- (ii) Financial services; and
- (iii) Any custom, practice or activity prescribed by the bank of Zambia as banking business

As this relationship is enjoyed by no one but a bank with reference to a customer, it is thus necessary to know what a customer is in law. This is probably impossible to define with exactness. It is true that there is no statutory definition of the term, but it is a well known expression that there must be some sort of an account or similar relation to make a man a customer of a banker⁴. It was at one time thought that the account had to be of some duration before the status of customer could be achieved, but this view no longer holds⁵. In *Taxation Comrs v English, Scottish and Australian Bank Ltd* it was held that duration of the relationship was not of the essence. The decision was to the effect that a man was a customer whose only connection with the bank at the material date was the payment in of a single cheque for collection, a typical case of a first transaction⁶. A course of dealing not distinctly related to banking business is therefore not sufficient to create the relation of banker and customer. For instance, where a man had for some years been in a habit of getting crossed

³Mark Hapgood. *Pagets Law of Banking*. (London and Edinburgh: Butterworths,1989), 131

⁴Great Western Railway Co v London County Banking [1901] AC 414

⁵Hapgood, 131

⁶[1920]AC 683

cheques exchanged for cash at a bank where he had no account, and which charged him nothing for the service, it was held that he was not a customer⁷.

The banker customer relationship has long been held to be based on a contract between the parties. According to Hapgood⁸ it consists of a general contract which is basic to all transactions, together with special contracts which arise only as they are brought into being in relation to specific transaction. Basically the relationship is that of mandator (the customer) and mandatory (the bank), but it is nonetheless a relationship which embraces mutual duties and obligations and offers privileges to both parties.

In its banking business, a bank may come into contact with various persons besides its customers. Such third parties can be referred to as non-customers as opposed to a customer as defined above. The connection between the bank and a third party arise in a number of ways. For instance, victims of predicate offences to money laundering may attempt to sue the bank for damages in connection with the bank's breach of a duty to raise red flags⁹. Further, the connection may be instigated by the customer; for instance, were a customer uses the banking facilities so as to defraud a third party. A specific example of the creation of such a connection can be seen in the case of *Elpe Finance Limited v Brymum Limited and Stanbic Bank Limited*¹⁰.

In this case, by loan agreements entered into on diverse days, the plaintiff⁶ defendant financial facilities and other accommodation on terms to be defined in the facility agreement. The securities provided by the plaintiff⁶ defendant

⁷ Great Western Rly Co v London and County Banking Co.

⁸ Hapgood, 132

⁹ Most jurisdictions provide for a statutory obligation on bank, breach of which amounts to criminal liability for money laundering.

¹⁰ HCJ 2009/HPC/0155

vehicles and assignment of the proceeds of all contracts it had with Konkola Copper Mines (KCM) Plc. Pursuant to the said security, the first defendant's account was designated as a collection account and the plaintiff was made signatory to the account so as to afford it control over the funds. This was done by delivering to the second defendant (the bank) a resolution of the Board of Directors of the First Defendant containing an instruction on the signing mandate on operations of the collection account. As can be deduced from these facts, the plaintiff was not a joint account holder of the collection account. They did not hold an account with Stanbic Bank but were merely appointed as signatory to the account, hence regarded as third parties.

The general rule is that a bank owes no duty of care to non-customers,¹¹ its primary concern being its customer's interest. Usually, a bank need not concern itself with rights of third parties, namely persons with whom it does not have a contractual relationship. To pursue a claim of negligence against the bank, one must prove: (1) a legal duty to use due care; (2) a breach of such legal duty; and (c) the breach as the proximate or legal cause of the resulting injury¹². However, the lack of a general duty of care makes proof of a negligence claim against a bank problematic.

However, the once prominent concept that a bank owes a duty of care only to its customers has been significantly eroded in various jurisdictions in recent years. This recognition of a duty financial institutions have to third party victims when it is put on notice of fraud can be seen in decisions emanating from Canadian, American, English, and Swiss courts. These judicial decisions have established that banks owe a duty of care to non-customers who are

¹¹ Ross Cranston. *Principles of Banking Law*. (Oxford: at the University Press, 1997), 378

¹² W.V.H Rogers. *Winfield and Jolowicz on Tort*, 17th Ed. (London: Sweet and Maxwell, 2006) , 272

defrauded by the bank's customer once it has actual knowledge of, or is wilfully blind to, the use of its services for fraudulent purposes. Depending on the circumstances, the possibility is still open that a bank may owe such a duty even where it does not have actual knowledge (wilful blindness or recklessness) of the fraud. The nascent principle was recently restated in *Dynasty Furniture Manufacturing Ltd v Toronto Dominion Bank*¹³, an American case which arose in an effort to compensate victims of the Allen Stanford Ponzi scheme. In its decision, the Ontario Superior Court of Justice held that if a bank has actual knowledge of a customer's fraudulent activities, or is wilfully blind to or recklessly disregarded the existence of such activities, the third party victim would have a reasonable cause of action against the bank.

Equity recognises this liability on the basis of constructive trust theories¹⁴. Clearly, banks commonly act as trustees appointed as such under an express trust set up by the customer. In this event the bank is subject to all general law concerning powers, duties and liabilities of trustees. Liability to third party beneficiaries is therefore straightforward if the express and formally appointed bank is found to be in breach of trust. However, according to Cranston¹⁵, constructive trust is a general principle which arises when a person who has not been appointed to act as a trustee becomes involved in the affairs of the trust and thus becomes liable to the beneficiaries of the trust in the same way as an appointed trustee who acts in breach of trust. This can also arise when there is no formal trust but a fiduciary duty is owed, for instance, by a partner to his partner.

¹³ 2010 ONCA 514

¹⁴ Haggood, 231

¹⁵ Cranston, 415

In the seminal case of *Barnes v Ardy*, Lord Selbourne stated that,

“Strangers are not to be made constructive trustees merely because they act as agents of trustees in transactions within their legal powers ...unless those agents received and became chargeable with some part of the trust property or unless they assist with knowledge in a dishonest and fraudulent design on the part of the trustees”¹⁶.

1.3 The problem, objective and significance of the study, and research methodology employed.

Knowledge seems to be the crux of the bank’s potential liability. At first sight, the analysis of ‘knowledge’ seems simple¹⁷. However, the issue of what constitutes ‘knowledge’ in imposing a duty of care or in the context of dishonest assistance brings much confusion. There is no simple answer as to what the degree of knowledge for constructive trusteeship should be. For instance, in *Selangor United Rubber Estates v Cradock (No.3)*¹⁸ Ungood-Thomas J concluded that the knowledge required to hold a bank liable as constructive trustee in a dishonest and fraudulent design was ‘knowledge of circumstances which would indicate to an honest and reasonable man that such design was being committed or would put him on enquiry whether it was being committed’. This test seems questionable. It suggests that a negligent failure by a bank to recognise a transaction as dishonest is sufficient. The touchstone for the imposition of a constructive trust is want of probity. This want of probity cannot be derived from a state of mind that is negligent but honest. This test clearly disregards the emphasis of dishonesty on the part of the bank.

In addition, most jurisdictions seem to be reluctant to find the existence of a duty of care owed by banks to third parties. This is easily achieved given the stringent test for liability and

¹⁶ 1874 9 Ch App 244

¹⁷ Haggood, 237

¹⁸ [1968] 2 All ER

difficulties in establishing knowledge as set out above. As will be shown in the paper, American and British standards of liability are more stringent than courts in Canada as well as Switzerland. There is a pertinent need to analyse the case of *Elpe Finance v Byrmum and Stanbic Bank Limited*,¹⁹ so as to establish the extent to which the judicial system in Zambia is willing to find a bank liable to a third party for the fraudulent acts of its customers.

Furthermore, the desirability of imposing liability on a bank that turns a 'nelsonian' eye to the fraudulent activities of its customer cannot be denied. Various decisions have tried to clear some of the ambiguity that results in the law. However it would seem a more direct approach is necessary to traverse the uncertainties encountered in establishing liability. Given the technicalities involved in successfully asserting a claim in assistance or receipt, some scholars posit the view that liability for tainted funds is better achieved by simply putting the bank on notice by means of an unambiguously phrased letter referring to the underlying and necessary facts of an apparent fraud, and covering a bundle of supporting evidence²⁰.

Legal professionals with experience in this area have opined that the issuance of a letter to a bank that provides sufficient particulars and evidence of fraud can, in certain situations, give rise to a de facto mareva injunction²¹. This has been referred to as the mareva by letter. It originates from a victim and basically puts the bank on notice of its customer's potential or actual fraud. A duty of care as regards a non-customer would then arise. Accordingly, with the growth of fraudulent activity occurring through bank services, financial institutions ought to be prepared to investigate and be proactive in their assessment of the merits of such a letter as an evidentiary foundation for knowledge of fraud and preserve the assets held by the

¹⁹ HCJ 2009/HPC/0155

²⁰ Caylor, et al., 16

²¹ Caylor et al., 20

fraudster pending further information or direction. This actual knowledge of a fraud will necessitate a bank to take certain positive actions, and an intentional disregard of these responsibilities will likely give rise to a cause of action by a third party victim.

However, even this comes with its own problem. A bank is but a mere mandatory, with obligations imposed by contract to its customer. Given these obligations, liability may be incurred for any loss occasioned to a customer while the bank tries to mitigate the fraud effects pursuant to the *mareva* by letter with actions such as freezing of accounts.

Given the hurdles that may be encountered in establishing liability such as the imposition of knowledge on the bank as to the fraudulent acts, and the court's attitude in such imposition, the general objective of this study will be to critically evaluate the basis of liability of banks to third party victims. This is so as to establish whether or not the principles on which liability is based are in themselves adequate and effective and whether or not they serve the interest of both parties. In addition, the legal basis and viability of extra judicial mechanisms such as the *mareva* by letter is considered in light of the contractual obligations of the bank to the customer.

The specific objectives will be;

1. To highlight the nature of the banker-customer relationship.
2. To determine in what circumstances a bank may be held liable to non customers and consider the difficulties encountered in establishing such liability.
3. To ascertain whether the basis of such liability provides an appropriate balance between the interest of both the bank and the non customer

4. To examine the extent to which various common and civil law jurisdictions have shifted towards finding banks liable to non customers for the fraudulent acts of their customers, with special reference to the Zambian situation as shown in the case of *Elpe Finance v Brymum Limited and Stanbic Bank Ltd.*
5. To explore the viability of extra judicial mechanisms such as the mareva by letter and escrow agreements in establishing banks' liability for fraudulent and dishonest acts of their customers

The theoretical significance of this study arises from the fact that the growth of fraudulent activity occurring through bank services requires financial institutions' involvement in the protection of their customers and non customers alike. On balance, a bank with actual knowledge of such activity is often best suited to intervene to prevent further fraudulent transactions and the dissipation of the misappropriated funds so as to reduce the ultimate harm caused to the victim. Given the onerous duty involved in putting a bank on its enquiry for every transaction that may seem fraudulent lest they incur liability as constructive trustees, or the difficulties encountered by third parties in trying to establish any form of liability, this work will endeavour to explore alternative principles of imposing such liability which consider interests of both parties.

The research problem in question came to light through facts arising in the case of *Elpe Finance v Brymum Ltd and Stanbic Bank Ltd.* It was further discerned through personal direct observations and experiences whilst conducting ordinary banking activities. Unlike the old days where only the wealthy upper class of society could open accounts with banks²², anyone can open an account regardless of their wealth or social standing in society, thus becoming a

²² Cranston, 343-345

customer of the bank. Since it is not only a significant part of the population but also a cross section of demographics that may interact with such customers and banks in turn, the findings are bound to be of relevance to any of these specially affected people in society, if not all highlighted. Anybody engaging in any form of financial transaction could be a victim of fraud. The practical value of this discourse would therefore appear to be self evident given the emerging businesses in the country and the rise in fraudulent activities occurring through financial services. With the mounting legal responsibility expected of everyone to prevent fraud, the apparent benefits to potential plaintiffs or fraud victims is unquestionable.

As is typically with the case of legal studies, the method of data collection will be based on both primary and secondary information. The primary information will include open ended, in- depth, non structured or scheduled interviews which will be qualitative in nature. These will be conducted with bankers and professionals from various banking institutions in Zambia and abroad. The secondary information will be obtained from a number of authorities that have systematically analysed issues relating to the bank's relationship to third parties. These include information from textbooks, journals, paper presentations, and scholarly articles. In addition, this study will refer to the plethora of decided cases on the matter, and attention will be given to the law as it applies in various jurisdictions. It will also attend to the internet with a view to disseminating current information.

1.4 Conclusion

This chapter has introduced the study. It has drawn attention to the parties involved in discussing this paper; these include the bank, customer and third parties. Further, it has established and described the nature of the relationship between the bank and customer, and the bank and third parties, giving *Elpe Finance Limited v Brymum Limited and Stanbic Bank*

Limited as an appropriate example. In addition, the basic aspects of the research such as statement of the problem, purpose or objective of the study and methodology have been addressed.

CHAPTER TWO

ESTABLISHING BANKS' LIABILITY TO THIRD PARTY VICTIMS OF FRAUD

2.1 Introduction

In recent years, we have seen a growing number of highly publicized frauds, money laundering and other related financial scandals. In response, governments and other legal authorities in various jurisdictions have accelerated their issuance of new legislation, regulations, programs and cooperative actions, pronouncements and enforcement steps focused on combating fraud, money laundering, terrorist financing and other related financial crime¹. However, the principal focus of recent legislation has been criminalisation of such acts rather than compensation of the victims of the criminal activity. If a person is a victim of fraud he will wish to recover the money that he has lost. In such cases, it will be scant comfort that the fraudster is apprehended and tried by a criminal court. Neither will it help him if a bank, through which for instance funds were successfully laundered, is fined or prosecuted for its failure to carry out proper identity checks or to report suspicious transactions to the appropriate authorities as required by its national statutes. He is out of pocket and wants his money back. There will be a claim against the original wrongdoer –the bank's customer. However, in practice, fraudsters tend to be impecunious, or else disappear taking their gains with them. Hence, victims of fraud often tend to recover their money from parties alleged to be implicated in the fraud, or to have facilitated it in some way. Banks are prime targets for such claims chiefly because they have fixed locations and 'deep pockets' thus worth pursuing for large sums involved.

¹Ben Kingsley and Ruth Fox . 'Civil liability for Money Laundering'. *Slaughter and May* (April, 2009) p1. <http://www.slaughterandmay.com/media/7> Accessed 02/04/2012

Therefore, despite the profusely reiterated principle that the bank owes no duty of care to third parties, this chapter analyses the banker customer relationship in relation to third parties. It focuses on the basis on which banks may be liable to third party victims of fraud. This will include analysis of the effectiveness of the basis of such liability in achieving their intended purpose. It further ascertains alternative non judicial mechanisms of establishing liability and whether these mechanisms are viable given the bank's obligation to its customer. Particular aspects of the area of law considered in this chapter are fully discussed and analysed in Hapgood's *Pagets Law of Banking*² and in the article entitled 'Emergence of the *Mareva* by Letter: Banks' Liability to Non-Customer Victims of Fraud'³. This chapter owes a considerable debt to these works.

2.2 Civil liability generally

In terms of money laundering, surprising to many, criminal liability for financial institutions in most jurisdictions is likely to be more easily incurred than civil liability though financial consequences of civil liability will be greater. This is simply because unlike criminal liability, there is no single coherent and developed civil remedy. Instead, traditional legal concepts have been adapted to impose civil liability on those who provide assistance. It should be remembered that in terms of money laundering, this paper refers to proceeds of fraud rather than proceeds of other crimes for the latter do not provide victims that can sue in civil law.

A victim of fraud has a wide range of potential claims open to him, depending on what happened to his money and the involvement of persons alleged to have participated in swindling him. These include common law claims; in contract; in tort for conversion, aiding

² Mark Hapgood. *Paget's Law of Banking*, 10th Ed. (London: Butterworths, 1989)

³ Lincoln Caylor, et al., 'Emergence of the *Mareva* by Letter: Banks' Liability to Third Party Victims of Fraud'. *Business Law International*. Vol 12 No. 2. (May 2011)

and abetting, conspiracy, deceit, unlawful interference in trade, money had and received or negligence. However, it should be stated from the outset that apart from aiding and abetting, money had and received and negligence, these tort claims are mainly relevant against the original wrong doer as opposed to the bank. For instance, a claim in deceit only lies against parties to the fraud. A bank used by fraudsters will not be liable unless the institution itself has made fraudulent statements or was a willing party to the fraud⁴. Therefore, there will be no need to consider these claims here, suffice to say liability of a bank is normally predicated on the existence of wrong doing by the primary offender.

In addition, equity provides personal remedies against third parties that interfere with trust property. These include liability based on constructive trust theories and tracing. These are discussed in turn.

2.3 Common law claims

2.3.1 Liability based on contract

The relationship of the banker and his customer is one of contract⁵. It consists of a general contract which is basic to all transactions, together with special contracts which arise only as they are brought into being in relation to specific transactions or banking services.

In accordance with the general principles of contract, a third party will not be able to sue on this contract as they are not privy. The doctrine of privity in the law of contract provides that a contract cannot confer rights or impose obligations arising under it on any person or agent except the parties to it⁶. Therefore, a victim of fraud will only be able to sue the bank for the duty of care that arises from the contract with its customer if the third party falls within the

⁴ Kingsley and Fox, 3

⁵ *Foley v Hill* [1848] 2 HL Cas 28

⁶ Joseph Chitty and Hugh Beale. *Chitty on Contract*. 6th Ed. (London: Sweet and Maxwell, 2008), 346

exceptions to privity of contract. These include; collateral contracts between the third party and one of the contracting parties; trusts (the beneficiary of a trust may sue the trustee to carry out the contract); land law (restrictive covenants on land are imposed upon subsequent purchasers if the covenant benefits neighbouring land); agency and the assignment of contractual rights; third-party insurance (a third party may claim under an insurance policy made for their benefit, even though that party did not pay the premiums); and contracts for the benefit of a group where a contract to supply a service is made in one person's name but is intended to sue at common law if the contract is breached. There is no privity of contract between them and the supplier of the service⁷.

2.3.2 Liability in tort

(a) Negligence;

Due to lack of a contractual relationship, third parties may therefore wish to sue the bank in tort for negligence. The elements of such a claim are: (1) a legal duty to use due care; (2) a breach of such legal duty; and (3) the breach as the proximate or legal cause of the resulting injury⁸. However, the general rule is that a bank owes no duty to non-customers.⁹ Various recent decisions¹⁰ have determined this lack of a general duty of care owed by banks to noncustomers, thus preventing successful third party actions against banks for negligence.

(b) Money had and received (Restitution);

Where money is stolen the victim may be able to recover from a third party by bringing a personal claim at common law for money had and received, the name given to common law

⁷Chitty and Beale, 357

⁸ W.V.H Rogers. *Winfield and Jolowicz Tort. 17th Ed.* (London: Sweet and Maxwell, 2006), 272

⁹ Ross Cranston. *Principles of Banking Law.* (Oxford: at the University Press,1997), 378

¹⁰ Customs and Excise Commissioners v Barclays Bank [2004] 2 All ER 789,

tracing. More typically, such a claim is made where money has been paid for consideration that has wholly failed. The claim exists to reverse a defendant's or third parties unjust enrichment. Unjust enrichment is a legal term denoting a particular type of causative event in which one person is unjustly enriched at the expense of another and an obligation to make restitution arises, regardless of liability for wrongdoing¹¹. Thus, person will be liable if; (1) he has been unjustly enriched (2) enrichment was at the expense of the plaintiff (3) there is no legal reason for the defendant to retain the enrichment and (4) no defence is available. In this way, it is possible to recover money from a bank that beneficially receives stolen funds and it will be liable unless it can rely on a relevant defence. It is therefore a significant potential source of liability for banks. This applies as much to a bank because (stolen) money paid in becomes property of the bank.

In practice this form of claim is unlikely to be widely used in relation to money laundering. This is because, at common law money can only be followed into and out of a bank account and into the hands of a subsequent recipient provided it does not cease to be identifiable by being mixed with other money derived from other sources as this destroys the claim. Further there is a defence if the recipient is a bona fide purchaser for value. Thus in most instances, banks will not be liable for money had and received since money would have been mixed or the institution would have provided full consideration by applying those monies in discharge of a loan or reduction of an overdraft and thus constituted itself a bona fide purchaser for value unless it can be shown otherwise¹².

¹¹ Peter Birks. *Unjust Enrichment*. (New York; Oxford University Press, 2005), 198

¹² Toby Graham, et al. *Money Laundering*. (Wiltshire: Cromwell Press, 2003), 155

In addition, a bank may be able to invoke the defence of 'ministerial receipt'. This defence is available to an agent that has received money in his capacity as agent, if he has paid it over to the principal before acquiring notice of a third party claim to the money¹³. The third party must then sue the principal rather than the agent who drops out of the picture. Further, the defence of change of position is available where the bank has made payments to, or to the order of a customer and the bank is no longer able to reverse those entries. Where the bank can without detriment, reverse a credit entry to reflect the fact that it has made restitution to the third party, this defence will not be available.

2.4 Equitable claims

2.4.1 Liability on the basis of constructive trust theories

The legal concept of constructive trusteeship has been prominent in providing victims with a remedy against those involved in an indirect capacity. Although the trust may be the most important invention of equity, it has proved resistant to a precise and exhaustive definition. It is therefore safer to describe what a trust is rather than go in pursuit of a definitional chimera. Trusts are generally described as relationships in respect of property under which one person, known as a trustee, is obliged to deal with property vested in him for the benefit of another person, known as a beneficiary.¹⁴

Trusts may either be express or implied¹⁵. Express trusts are said to arise where a settler expressly creates a relationship of trustee and beneficiary. There are two types of implied trusts: the resulting trust and the constructive trust. A resulting trust takes its name from the fact that it operates to ensure that beneficial title 'results back' to a transferor. For instance,

¹³ Kingsley and Fox, 11

¹⁴ A.J Oakley. *Constructive Trusts*, 2nd Ed. (London; Sweet and Maxwell, 1987), 1

¹⁵ Micheal Haley and Dr Lara McMurtry. *Equity and Trusts* (London. Sweet and Maxwell, 2006), 16

where one party transfers legal title of property to another in return for no consideration presumption of a resulting trust is raised. The equitable interest will result back to the transferor. Or where property is purchased by X with financial assistance from Y, Y may acquire an interest in the property by virtue of a purchase money resulting trust.

A constructive trust is a form of implied trust that arises by operation of law rather than deliberate acts or intention of the parties¹⁶. No formalities are required for its creation. The circumstances in which the constructive trust will be encountered are many and varied. These include constructive trusts imposed as a result of; fraudulent, unconscionable or inequitable conduct; dishonest assistance in breach of trust; knowing receipt of trust property; breach of fiduciary duty; disposition of trust property in breach of trust; secret trusts and mutual wills; those imposed upon a vendor who has entered into a contract of sale which is capable of being specifically enforced; and those imposed to give effect to incomplete transfers.

It follows that the constructive trust is notoriously difficult to define. As Edmund Davies L.J. admitted in *Carl Zeiss Stiftung v Herbert Smith and Co.*, “English law provides no clear and all embracing definition of a constructive trust. Its boundaries have been left perhaps deliberately vague so as not to restrict the courts by technicalities in deciding what the justice of a particular case may demand.”¹⁷

In recent times, an increasing number of decisions emanating from the Court of Appeal (United Kingdom) impose constructive trusts not only as a result of fraudulent and unconscionable conduct but also as a result of conduct which the individual judges are prepared to classify as merely as inequitable. It is therefore clear that the general trigger activating the constructive trust is unconscionability. In the words of Costello J., “the

¹⁶ Haley and McMurtry, 20

¹⁷ [1969] 2 Ch. 276 at 300

principle is that where a person who holds property in circumstances which in equity and good conscience should be held or enjoyed by another he will be compelled to hold property in trust for another¹⁸.” Equity acts in *personam* to ‘construe the defendant to be trustee of property when he has knowledge of some factor that affects his conscience in respect of specific property.

In relation to a bank, where it has notice, however received or information which would lead it to understand that an account is affected with a trust, express or implied or that the customer is in possession or has control of money in a fiduciary capacity, it must regard it strictly in that light and avoid being party to breach of that trust. This may include wrongfully paying away or otherwise dealing with the trust moneys. The difficulty often lies in their inability to know the nature of an account in this connection. Of course where there is no notice, the mere fact that unknown to the banker, moneys are held by the customer in a fiduciary capacity in no way affects the banker’s right to treat them as the absolute property of the customer.

Also, a bank may be an express and formally appointed trustee, liable in breach of trust to make restitution to the trust like any other express trustee. However, there may not always be an express trust. The law may nevertheless impose upon it the liability of a trustee. The bank is then said to be a constructive trustee. This may occur in two distinct situations. Firstly, although the bank is a stranger to the trust, it may take upon itself the responsibility to act on behalf of the beneficiary without authority to do so. By this unauthorised intermeddling, the bank may be held to have usurped the role of trustee and constituted itself a ‘trustee *de son tort*. For a bank, this situation is unusual. It is well established that the predominant relationship between a bank and its customer is that of debtor and creditor, not trustee and beneficiary. Therefore a court will not readily infer that a bank has voluntarily assumed the

¹⁸ *Rouchefoucauld v Boustead* [1897] 1 Ch. 296,206

role of trustee¹⁹. Secondly, a constructive trust may be imposed in circumstances where a bank has acted with such degree of complicity in a breach of trust that it is fair that the bank should make restitution to the trust. It is this degree of complicity required which is a matter of controversy in case law. Unlike trustee *de son tort*, the bank's liability needs no voluntary assumption of responsibility as trustee prior to the breach of trust. It is this second form of constructive trusteeship which is of most relevance to this paper as banks are especially vulnerable to having the liability of such trusteeship imposed upon them.

Where there has been a breach of trust or fiduciary duty the key target of subsequent litigation will often not be the fiduciary, but third parties who have received assets or their proceeds from the fiduciary or who can be said to have knowingly assisted in the breach. The seminal statement of liability of a stranger to a trust as a constructive trustee appears in the judgement of Lord Selbourne LC in *Barnes v Ardy*²⁰.

...Strangers are not to be made constructive trustees merely because they act as agents of trustees in transactions within their legal powers, transactions perhaps of which the court of equity may disapprove, unless those agents receive and become chargeable with some part of the trust property or unless they assist with knowledge in a dishonest and fraudulent design on the part of the trustees.....and I apprehend those who create trusts do expressly intend, in the absence of fraud and dishonesty to exonerate such agents of all classes from the responsibilities which are expressly incumbent, by reason of the fiduciary relation, upon the trustees.

As a result of Lord Selbourne's statement, the law as to liability of an agent to a trust as constructive trustee in the second situation has been split between; agents who receive and become chargeable with some part of the trust property, and agents who assist with knowledge in a dishonest and fraudulent design on the part of trustees. These can be abbreviated as 'knowing receipt and dishonest assistance'. Most of the case law on banks as

¹⁹Hapgood, 231

²⁰(1874) 9 Ch App 244 at 251

constructive trustees has concerned Lord Selbourne's second category of dishonest assistance.

(a) Knowing receipt

A bank may become liable as constructive trustee under this head if it receives trust property with the knowledge that the transfer to it is in breach of trust, or else it deals with the property in a manner inconsistent with the trust after acquiring knowledge of the trust. Based on Lord Selbourne's formulation, there is no need for a dishonest design on the part of the trustee to establish liability under this head. However, it has been suggested that there is no relaxation of the need for a want of probity as a condition of liability.²¹

In addition, the bank must have received the money beneficially. There is thus no cause of action in knowing receipt against a person who holds trust property merely as agent for a third party. The difficulty lies in determining whether the bank has received money beneficially or as an agent of the customer. It is well established that the relationship between a bank and its customer is that of debtor and creditor²². It follows that where money is deposited into an account, it becomes the bank's own. It could therefore be argued that in all cases where money is paid into a bank account, the bank receives the money beneficially with the result that the bank is potentially liable if it turns out that the money was misappropriated. However, courts have refused to endorse such an approach because it would impose extensive potential liability on banks. In most cases, the courts have drawn a distinction between money paid into an account in credit and money paid into an overdrawn account. Millet J explained the distinction as follows '... In paying or collecting money for a customer the bank acts only as an agent. It is otherwise however if the bank uses the money to reduce or discharge the customer's overdraft. In so doing, it receives the money for its own

²¹ *Carl Zeiss Stiftung v Herbert Smith and Co.*, [1969] 2 Ch. 276 at 300

²² *Hapgood*, 164

benefit'²³. Thus, a bank will receive money paid into an account as agent when the account is in credit and the third party victim can only sue the account holder (though the bank may be liable for dishonest assistance). However, where the account is overdrawn, the bank is said to receive money beneficially and thus potentially liable.

(b) Knowing assistance/Dishonest assistance

Four elements must be established to hold a bank liable as constructive trustee for assisting with knowledge in a dishonest and fraudulent design on the part of the trustees (i) the existence of a trust, express or implied. It is sufficient that there be a fiduciary relationship between the trustee and the property of another legal person, (ii) a dishonest and fraudulent design on the part of the trustee, (iii) assistance of the bank in that design. This is a question of fact and (iv) knowledge by the bank of the trust, the dishonest and fraudulent design and of its own assistance in that design.

The general principle underlying this form of liability is that a stranger to a constructive trust will also be liable to account as a constructive trustee if he knowingly assists in the furtherance of a fraudulent and dishonest in breach of trust. It is not necessary that the party sought to be made liable as a constructive trustee should have received any part of the trust property, but the breach of trust must have been fraudulent. The basis of the stranger's liability is not receipt of trust property but participation in a fraud.

Clearly, a constructive trusteeship so imposed can be described as a fiction which provides a useful remedy where no remedy is available in contract or in tort²⁴. In the banking context, this category of liability can encompass a situation where, for example, a bank

²³ *Agip (Africa) Ltd v Jackson* [1991] Ch 547

²⁴ David J Hayton (1985) 27 *Malaya Law Review*, 313, 314

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²³ *Agip (Africa) Ltd v Jackson* [1991] Ch 547

²⁴ *David J Hayton (1985) 27 Malaya Law Review, 313, 314*

somehow facilitates transactions involving a breach of trust or fiduciary duty. The decision in *Agip (Africa) Ltd v Jackson*²⁵ illustrates that assistance that could result in criminal liability for money laundering will be sufficient for such civil liability.

The consequences of the imposition of such a trust is that not only will the third party beneficiary necessarily be entitled to proprietary rights in the subject matter of the constructive trust; the constructive trustee will also by virtue of the constructive trust, be personally liable to account to the beneficiary for his actions as such.

2.4.2 Effectiveness of liability based on constructive trust theories

Knowledge seems to be crux of the bank's potential liability. At first sight, this analysis seems simple. However, what constitutes 'knowledge' brings much confusion as there is no simple answer as to what the degree of knowledge for constructive trusteeship should be. In *Selangor United Rubber Estates v Cradock (No.3)*²⁶, Unged Thomas J concluded that the knowledge required to hold a bank liable as constructive trustee in a dishonest and fraudulent design was knowledge of circumstances which would indicate to an honest and reasonable man that such design was being committed. This test seems questionable. It suggests that a negligent failure by a bank to recognise a transaction as dishonest is sufficient. The touchstone for imposition of a constructive trust is want of probity. This cannot be derived from a state of mind that is negligent but honest. The test clearly disregards the emphasis of dishonesty on the part of the bank.

²⁵ [1991] Ch 547

²⁶ [1968]2 All ER 634

The most detailed exposition of the requisite degree of knowledge for knowing assistance was provided by Gibson J in *Baden, Delvaux and Lecuit case*²⁷, who stated that the knowledge relevant for the purposes of constructive trusteeship can comprise one of five different mental states- (i) actual knowledge, (ii) wilfully shutting one's eyes to the obvious (iii) wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make (iv) knowledge of circumstances which would indicate to an honest and reasonable man and (v) knowledge of facts which would put an honest and reasonable man on inquiry.

According to Haggood²⁸ and as can be deduced by any reasonable legal professional, this intriguing but complicated analysis of knowledge seems questionable. Firstly, a 'wilful shutting of eyes' under category (ii) is not a lesser degree of knowledge than actual knowledge, but evidence from which the court may infer actual knowledge. Secondly, categories (iii), (iv), and (v) can not by any ordinary meaning of the word constitute 'knowledge'. However, category (iii) is distinguishable from (iv) and (v) because it does at least connote through the words 'wilful' and 'reckless' a degree of subjective awareness. It is suggested that (iii) must have been meant to catch an accessory to breach of trust who believes he is participating in a breach but deliberately shuns the inquiry which might convert his belief into knowledge. To believe means more than to suspect, it means at least to consider that a breach of trust is a probability. A bank cannot possibly be rendered liable as constructive trustee from awareness that a breach of trust is a possibility otherwise potential liability would arise in almost any instance where a bank allowed trustees to draw on a trust account. It may be dishonest for a bank to shun inquiries despite its belief, but it is hard to see how any dishonesty can arise out of the negligent states of mind portrayed in (iv) and (v).

²⁷ *Baden, Delvaux and Lecuit v Societe General pour Favoriser le Developement du Commerce et de l'Industrie en France SA*[1983] BCLC 325

²⁸ Haggood, 235

The issue of what constitutes knowledge was authoritatively settled in *Royal Brunei Airlines v Tan*²⁹. The House of Lords held that dishonesty was a necessary ingredient. Lord Nicholls put forward his interpretation of the necessary standards of behaviour that will suffice for dishonesty to be found. In addition he found that this standard was not subjective. He stated that ‘honesty is not an optional scale, with higher or lower values according to the moral standards of each individual. If a person knowingly appropriates another’s property, he will not escape a finding of dishonesty simply because he sees nothing wrong in such behaviour.’ The House of Lords’ decision in *Twinsectra Ltd v Yardley*³⁰ led to considerable uncertainty regarding the test for determining whether a third party should be accountable to a victim in equity for dishonest assistance. It found that the subjective approach must be taken to the question of dishonesty. Lord Hutton stated that ‘it must be established that the defendants conduct was dishonest by the ordinary standards of reasonable and honest people and that he himself realised that by those standards his conduct was dishonest.’ This created an ambiguity and gave rise to academic debates over whether the effect was to result in departure from the law on dishonest assistance as previously understood or whether there was now a need to inquire into the defendant’s views about generally acceptable standards of honesty³¹.

Subsequently in *Barlow Clowes International Ltd (in liquidation) v Eurotrust International Ltd*³² the Privy Council considered that the House of Lords had not intended to reach such a conclusion. Their Lordships accepted that there was an element in those remarks which may have encouraged a belief expressed in some academic writing that the *Twinsectra* case had departed from the law as previously understood. But they did not consider that this is what Lord Hutton meant. The reference to ‘what he knows would offend normally accepted

²⁹ [1995] 3 W.L.R 64

³⁰ [2002] 2 All ER 377

³¹ Haley and McMurtry, 275

³² [2005] UKPC 37

standards of honest conduct' meant only that his knowledge of the transaction had to be such as to render his participation contrary to normally acceptable standards of honest conduct. While this decision is a welcome clarification, it is nonetheless a Privy Council decision and not of the same persuasive authority as the House of Lords.

Further, although the Privy Council in *Barlow Clowes International* sought to clarify the law, the Court of Appeal's decision in *Abou-Rahmah v. Abacha*³³ demonstrates that until the House of Lords has to decide on this issue again, the uncertainty is bound to prevail. The majority opinion in *Abou-Rahmah* is that untargeted, speculative or general suspicions that are not sufficiently connected with the specific circumstances of the breach of trust or fiduciary duty will not suffice to establish dishonesty, either on the basis of actual knowledge of sufficient facts to render one's participation dishonest or on the basis of wilful blindness (sometimes called 'blind-eye knowledge').

Quite what this new test will mean in practice is not clear, and it is doubtful that this will prove to be the last word on the subject. From the foregoing, it would seem only actual knowledge, recklessness or wilful blindness will render a bank liable. Mere constructive knowledge will not suffice.

2.4.3 Tracing in equity

As was seen in section 2.3.2 of this paper, common law tracing is traditionally subject to a number of important limitations. As these restrictions do not apply to equitable tracing, a plaintiff will only rarely seek to trace at common law. A person may wish to trace in equity in order to assert an equitable ownership of or lien over property held by the defendant. Unlike common law, equity will permit a person to trace through a mixture. However, equitable tracing has one major limitation. This is the requirement that there must be a fiduciary

³³ [2005] EWHC 2262(QB)

relationship. This may be readily satisfied in cases of corporate fraud as the theft of a company's money will almost inevitably involve a breach of fiduciary duty on the part of its employees or agents. For banks, equitable tracing then becomes a potent source of liability as they frequently receive money beneficially which becomes mixed with their own property, bringing the equitable tracing rules into play. If the original money was subject to a third party equitable interest, the bank may be at risk of a claim for knowing receipt or dishonest assistance. If the claimant's original property is held by the bank, then it may be at risk of a proprietary claim for a constructive trust over that property

2.5 Alternative non-judicial mechanisms of establishing liability

2.5.1 The *mareva* by letter

It is beyond the scope of this paper to give detailed consideration of a *mareva* injunction. However, a summary may be helpful in understanding the basis of a *mareva* by letter.

A *mareva* injunction is an order of the court restraining a party to proceedings from removing from the jurisdiction of the court or otherwise dealing with assets located within the jurisdiction, and in more limited circumstances from dealing with assets outside the jurisdiction³⁴. The words 'otherwise dealing with' are not to be construed *ejusdem generis* with 'removing from the jurisdiction'; they are to be given wide meaning and include dissipation of assets within the jurisdiction. The first *mareva* order was made on an *ex-parte* application by the Court of Appeal in *Nippon Yusen Kaisha v Karageorgis*³⁵ and later in the eponymous *Mareva Cia Naviera SA v International Bulkcarriers SA*³⁶.

The foundation of the *mareva* jurisdiction is to prevent judgments of the court from being rendered ineffective whether by removal of assets from the jurisdiction or by dissipation

³⁴ Hapgood, 332

³⁵ [1975] 3 All ER 282

³⁶ [1980]1 All ER 213

within the jurisdiction thereby abusing court process. It is not the purpose of the *Mareva* injunction in any way to improve the position of claimants in insolvency. In particular, a *mareva* injunction is not a pre-trial attachment, but a relief in *personam* which prohibits certain acts in relation to assets in question. Also it is not the purpose of the *mareva* jurisdiction to freeze a defendants assets to ensure that there are funds available from which the plaintiff will be able to satisfy a judgement regardless of the defendants need to draw on the funds to meet his debts as they fall due. Further, it is neither security³⁷ nor a means to pressure a judgment debtor³⁸, nor does it confer a proprietary interest in the assets of the judgment debtor³⁹.

In cases where the victim of fraud is dealing with a dishonest sophisticated obligor with the propensity to transfer and conceal assets, the time taken to prepare and finalize a set of pleadings to ground a series of urgent *ex parte mareva* injunction or asset-freezing applications to courts may well turn out to be time spent in vain. There is a strong possibility that by the time a freezing order is issued, the assets are no longer at the bank previously identified. Given the circumstances in which injunctive relief is usually sought within the context of complex, commercial fraud cases, immediate action is generally required.

In addition, as recent judicial decisions have established that a bank owes a duty of care to non-customers once it has actual knowledge of, or is wilfully blind to the use of its services for fraudulent purposes, liability on banks is better achieved by directly imposing knowledge of the fraud on the bank.

A relatively new development in complex fraud litigation is that of the '*mareva* by letter'⁴⁰.

³⁷ Jackson v Sterling Industries Ltd [1989] 5 BCC 214

³⁸ Camdex International Ltd v Bank of Zambia (No. 2)[1997] C.L.C 714

³⁹ Cretanor Maritime Co Ltd v Irish Marine Management Ltd [1978] 3 All ER 164

⁴⁰ Caylor, et al., 24

A *mareva* by letter involves placing a third party holder of assets, namely a bank, on notice that those assets are imposed with a constructive trust in favour of someone other than the party who the holder was previously led to believe is the true owner; or that the accounts in issue are being used to further a fraudulent scheme. The purpose of the letter would generally be to request that the bank prevent activities such as the transfer of assets from any suspected accounts pending courts orders or further clarification of the facts surrounding the potentially fraudulent activity. This tends to counter the speed with which funds are transferred and the prospect of the fraudster becoming aware of situation

Accordingly, the imposition of actual knowledge of a fraud will necessitate a bank in any jurisdiction to take certain positive actions. This is because an intentional disregard of these responsibilities will likely give rise to a cause of action by a third party victim. The duty of care owed by a bank to a non-customer would arise after and as a result of the third party's presentation to the bank of evidence of fraudulent activity. Thus, once the fraud becomes known to a bank, beyond having its statutory obligations to report suspicious behaviour, a civil action against the bank may arise if it wilfully or negligently fails to preserve the assets held by the fraudster pending further information or direction.

Exposing a bank or fiduciary holder of assets to actual knowledge of an apparent fraud also destroys the defence of good faith or the defence implicit in the absence of knowledge of fraud to an action for assistance with knowledge in a dishonest and fraudulent design on the part of the trustees. Furthermore, it might expose officers and employees of the bank or any other capital market intermediary to criminal sanctions under anti-money laundering laws. Thus, the utterance of a '*mareva* by letter' can invoke public law duties on the relevant bank or fiduciary holder of wealth

A bank in receipt of a private letter is therefore prone to investigate further and freeze its customer's assets if sufficient information is provided that would give rise to actual knowledge of the fraud. Of course, a private letter is not the only way through which a bank may acquire the requisite knowledge of fraud to become liable, but it is a highly effective and quick mechanism. It further provides any number of victims of the fraud the ability to rely on a letter sent by another victim, which put the bank on notice, in arguing for bank liability - effectively "piggybacking" on the bank's acquired notice from the other party's letter.

However, this brilliant initiative comes with its own hurdles. When the banker is fixed with the fiduciary nature of the account, he has to bear in mind two somewhat conflicting influences. He has to consider the interests of the persons beneficially entitled and also recognise the right of his customer to draw cheques on the account and have them honoured. For instance, it is not business or right of a banker to whom a cheque is presented to set up a claim of any third person against the mandate of his customer. At the same time he cannot shelter behind his character of banker to cover complicity in a fraud. Mere suspicion does not justify him in refusing payment of a cheque. A bank that complies with a freezing request without a court injunction risks being held liable to its customer in the event that any attempted transactions are blocked and it is later revealed that the basis for the blockage was faulty or non-existent.

Therefore, legal professionals with experience in this area have opined that to have the desired effect, a letter to the bank should provide sufficient detail to demonstrate a prima facie case of fraud⁴¹. At the very least, evidence presented should provide comfort that the conclusion being urged upon regarding the provenance of the assets is in fact a reasonable one to be drawn in the circumstances. This way the bank will feel justified in temporarily refusing to relinquish control over the customer's assets. The letter should disclose the basis

⁴¹ Caylor, et al., 32

for the belief that certain accounts maintained by the bank contain the proceeds of fraud and the foundation for the claim that the bank is a constructive trustee of the funds in the account. The recent trend in the case law indicating the bank's dual obligations in circumstances where it has actual knowledge of fraud should also be raised in the letter. Also, advise the bank of its potential accessory liability in the event of any transfer or disposal of the assets in question. An aptly-worded notice will ensure the letter is given its due consideration and would protect the bank from liability on both fronts, ensuring greater bank acquiescence with non-customer requests.

The stronger the evidential basis put forward the more comfort is provided to the asset holder and the more likely they are to comply swiftly and without raising a series of questions often entailing unwelcome delays. Letters of this nature, even those evidencing all possible indicators of fraud, used to be disregarded by banks. Financial institutions generally saw its duty to its customers as paramount. More often than not, this approach could have been taken with the bank suffering little to no adverse effects. Now, a bank will have to weigh the risks of ignoring a letter that outlines a case for fraud as well as the potential liability of the bank if nothing is done to mitigate the fraud's effects.

2.5.2 Escrow agreements

Escrow is an arrangement made under contractual provisions between transacting parties whereby an independent trusted third party receives and disburses money and/or documents for the transacting parties, with timing of such disbursement by the third party dependant on the fulfilment of contractually agreed conditions by the transacting parties⁴². If the escrow is entered between the bank on one hand and its customer and a third party on the other, this provides the third party with a basis of liability if he were later defrauded by the customer.

⁴² <http://www.escrow.com/> accessed 24/03/12

This is because the bank would have contractually undertaken responsibility of securing both its customers interest and that of a non customer to whom it initially owed no duty.

2.6 Conclusion

From the foregoing, it is clear that a victim of fraud has a wide range of potential claims open to him, depending on what happened to his money and the involvement of persons alleged to have participated in swindling him. In reference to a bank in which the money may have been placed these include; common law claims; in contract; and in tort for money had and received or negligence. In addition, equity provides personal remedies against third parties that interfere with trust property through constructive trust theories and tracing.

Further, due to the difficulties encountered in ascertaining such liability after the fact, this chapter has advanced certain mechanisms which assist victims of fraud in establishing the bank's liability. These non-judicial mechanisms include the *mareva* by letter and escrow agreements. The former places a bank on notice that its institution is being used to further fraudulent activities, and therefore opening the bank up to various public and private law duties to prevent any further misappropriation of funds. The latter (escrow) basically provides a contractual basis of establishing liability between a bank and non-customer which would otherwise not have been possible under the banker customer contract due to privity of contract.

CHAPTER THREE

A COMPARATIVE ANALYSIS...

3.1 Introduction

The preceding chapter outlined the potential claims for the recovery of money that might be brought by third parties against intermediaries who become involved directly or indirectly in fraud. As has been established, the civil law in this area originated and developed in the courts. Thus various jurisdictions around the world are imposing such civil liability on banks at varying degrees. This chapter analyses the *Zambian* legal regime and its provision for liability of banks for the fraudulent acts of their customers and the willingness of the courts to impose such liability. This will include a critical analysis of the *Elpe Finance Ltd case* to determine the judicial position. In addition, the position in other jurisdictions such as Switzerland, United States of America (USA), Canada and the United Kingdom (UK) are considered as they have increasingly found banks liable in recent years.

3.2 The *Zambian* legal framework

Various provisions of the Penal Code¹ provide for the criminalisation of fraudulent acts. Persons who do or omit to do any acts for the purpose of enabling, aiding or abetting another to commit the offence are also guilty of the offence². Once the bank is found guilty of aiding and abetting the customer in committing fraud, it is then open to criminal liability. As established in the preceding chapter, this does not help a victim recover his property.

¹ Cap 87 of the Laws of Zambia

² Penal Code, Cap 87 of the Laws of Zambia. s.21

However, fraud is a crime. The Forfeiture of Proceeds (FPC) Act³ provides for the confiscation of the proceeds of crime; deprivation of persons of any proceed, benefit or property derived from the commission of any serious offence⁴; and facilitates the tracing of any proceed, benefit or property derived from the commission of any serious offence. By section 4 of the FPC Act, the Director of Public Prosecution (DPP) may apply to court for a forfeiture order⁵ against property that is tainted in respect of an offence, or a confiscation order against the person in respect of benefits derived from the commission of an offence⁶. However, third parties with interest in the property are protected as they may apply to the court for an order declaring the nature, extent and value of their interest before the forfeiture order is made⁷ or before the end of the period of six months commencing on the day on which the forfeiture order was made⁸. In considering whether such order should be made, the court will have regard to rights and interests of such third parties in the property⁹ if it is satisfied that the third party does have an interest in the property and was not involved in the commission of the offence¹⁰. Therefore, a victim of the offence of fraud may recover his property in this way.

³ No. 19 of 2010. preamble.

⁴FPC Act, No. 19 Of 2010. s.2 defines 'serious offence' as an offence for which the maximum penalty by law is death or imprisonment for not less than 12 months.

⁵ FPC Act No 19 of 2010. s.2,s.10(1) An order made by the court that property tainted in respect of a serious offence be relinquished to the state as a consequence of the offence.

⁶ FPC Act, No. 19 of 2010. s.10

⁷ FPC Act, No.19 of 2010. s.12

⁸ FPC Act, No. 19 of 2010. s.12 (3)

⁹ FPC Act, No.19 Of 2010. s.10 (4)

¹⁰ FPC Act, No. 19 of 2010. s. 12 (2)

Further the Prohibition and Prevention of Money Laundering (PPML) Act¹¹ provides that any property which is in possession or under the control of a person convicted of a money laundering offence and which property is derived or acquired from proceeds of the crime shall be liable to forfeiture by the court. Thus, a claim may be made in writing by any person who is lawfully entitled to the property and the commissioner may order the release of such property to the claimant¹²

From the above statutory provisions, it can be seen that recovery of property by a victim is dependent on whether ‘a person is convicted of a serious offence’¹³ or money laundering offence respectively. Even where section 9 of the FPC Act provides that a forfeiture order can be made if a person absconds in connection with a serious offence it assumes that the tainted property in relation to the offence that must be forfeited still exists. However, this paper works on assumptions such as; a lack of existence of property that may be forfeited, impecunious perpetrator, the perpetrator running away with the property or in cases of money laundering, successful laundering of proceeds through the banks services. Thus protection to the third party victims of the fraud is not provided by the above statutory provisions in such instances and the third parties may then seek to sue the bank as persons implicated in the fraud.

Clearly, these Acts aim to criminalise and deprive wrongdoers of the benefits of crime rather than compensate the victims. Third party claims against the bank as set out in chapter two are

¹¹ No. 14 of 2001. s.17

¹² PPML Act, No. 14 of 2001. s. 18(3)

¹³ FPC Act, No.19 of 2010. s.4

nonetheless available under the Zambian legal regime. This is because by virtue of the English Acts (Extent of Application) Act¹⁴ common law and doctrines of equity shall be in force in the republic subject to provisions of the constitution and any other written law.

However, the uncertainties encountered in the use of common law (and equity) as opposed to statute must be acknowledged. There is a lack of jurisprudence in Zambia as regards liability of banks to third parties; thus despite the doctrine of judicial precedent as a cornerstone of common law legal system, the court is only bound to follow an applicable decision of the same jurisdiction, and acknowledge as a minimum that it is very much persuaded by applicable decisions from sister jurisdictions. However, no two cases are completely the same. What renders one case analogous to another and the degree of factual similarity required before one case can be considered influential in the resolution of the other have always defied precise abstract description. The reality of the common law method can be much more flexible in the hands of the individual judges¹⁵. Thus despite the availability of the civil claims, the extent of liability of banks in Zambia can only be determined by the willingness of judges to impose liability on banks. Despite the lack of jurisprudence, the following analysis of the case may help provide the position taken by the courts, though the overall position cannot be determined based on a single judgment.

¹⁴ Cap 11 of the Laws of Zambia

¹⁵ Margaret M. Munalula Legal Process: Zambian Cases, Legislation and Commentaries (Lusaka; UNZA Press, 2004) p212-216

3.2.1 The courts' willingness to impose liability on banks: a critical analysis of the *Elpe Finance v Brymum Ltd and Stanbic Bank (Z) Ltd*¹⁶.

On the 12th of August, 2010 the High Court of Zambia had an opportunity to consider the question of whether or not a bank should be held liable to a non customer for assisting with knowledge in fraudulent and dishonest acts by its customer in the *Elpe Finance Case*.

The facts of the case were that by loan agreements entered into on diverse days, the plaintiff availed to the first defendant financial facilities and other accommodation on the terms and conditions set forth in the facility agreement. The securities provided by the first defendant were charges on its motor vehicles and assignment of the proceeds of from all contracts it had with Konkola Copper Mines (KCM) Plc (who effected payments due to the first defendant's account). Pursuant to the said security, the signing mandate on this account held by the first defendant with the second defendant, herein referred to as the 'bank', was changed to include the plaintiff as signatory thus providing them with part control of the account. A resolution of the Board of Directors of the first defendant including an instruction on the signing mandate on operations of the account, co-signed by the two initial signatories and the plaintiff was then delivered to the bank. The first defendant subsequently sent another board resolution and instruction, signed only by the 1st defendants, removing the plaintiff as signatory and replacing him with their own representative. The plaintiff then wrote to the bank purporting to instruct it not to allow the second defendant to unilaterally change the initial signing mandate without his signature, an event that had already occurred. However, the defendant ignored the letter and argued that its duty was to honour its customer's mandate, thus could not receive instructions from the plaintiff who had previously been

¹⁶2009/HPC/0155

removed as signatory. The plaintiff thus brought a claim against the bank for breach of contract and duty of care and for knowingly assisting the first defendant in the commission of a fraud and dishonesty against the plaintiff. The honourable judge emphatically held that the bank could not be held liable on all the grounds advanced by the plaintiff thus dismissing the application. The reasoning of the judge will be considered in the critic of the case below.

It must be first be accepted that the judgment is commendable in that given their already existing responsibilities; it would be a burden to expect banks to look out for every other person's interest, lest they be imputed with liability. Clearly, commercial reality militates against any doctrine under which a bank is put on enquiry as to suspicions of fraudulent activity. Establishing such liability would open up a Pandora box, to which banks will be liable to any person that walks into a bank.

However novel and commendable as this decision is, it is not without shortcomings. The judge stated that there was no contract between the bank and the plaintiff and thus no duty of care arose. However, duty of care can be a non-contractual obligation. Therefore, the plaintiff's attempt to establish breach of duty of care was because it was not privy to the banker customer relationship. The general principle is that a bank owes no duty of care to non-customers. However a board resolution was delivered which stated that "at the meeting held it was resolved that Elpe Finance Limited be retained as financiers for the orders and in order to facilitate the same, an official from the company is to be a signatory on Brymum Limited Account". This put the bank on notice of the financing contract between the plaintiff and first defendant. In addition, the first letter of instruction to the bank was co-signed by the plaintiff as a non-customer and first defendant as the customer. When the bank accepted the

letter of instruction, it clearly altered the existing relationship it had with the plaintiff as it took upon itself the duty to secure both the plaintiff and first defendant's interests at least for the period that the plaintiff and defendant had a contract. The relationship created resulted in a duty of care owed by the bank to the plaintiff. This is unlike the relationship that may exist between the bank and a third party who merely walks into the bank. To this third party the general rule applies. In addition, in considering the test of liability, policy issues should have been taken into consideration in determining whether any factors exist which justify denying liability. These include, among other things, the effect of recognizing the duty of care on legal obligations generally, the impact on the legal system and any general societal effect of imposing liability. With fraudulent activities through banking services on the rise, it is doubtful that public policy can go against a requirement that banks should be liable if they choose to turn a blind eye to fraudulent acts committed using their services.

In addition, the Honourable Judge held that the claim against the second defendant was not founded in negligence because the endorsement claimed damages for 'breach of duty of care' rather than 'negligence'. He stated that "the authorities that the plaintiff relied on in establishing liability based on duty of care namely *Caparo Industries Plc v Dickman and Others*¹⁷, *Donoghue v Stevenson*¹⁸, *Hedley Byrne and Company Limited v Heller and Partners Ltd*¹⁹ and *Home office v Dorset Yacht*²⁰, demonstrated the principle of duty of care at play; but the authorities were in relation to a claim for damages in negligence and they do

¹⁷ [1990] 1 All ER 568

¹⁸ [1932] AC 562

¹⁹ [1963] 2 All ER 575

²⁰ [1970] 2 All ER 294

not relate to claims as endorsed in the writ of summons for payment of a liquidated amount or damages for breach of contract. Duty of care is therefore not a standalone obligation that leads to damages but rather one of the ingredients used to establish the tort of negligence and should be considered where there is a claim for damages in negligence. As there was no such claim in the pleadings, the plaintiff's claim failed".

This paper posits the view that, a notion to the effect that failure to claim damages for 'negligence' in the pleadings must result in the dismissal of the plaintiff's claim is narrow and has no support of the law. This is because under the law of tort, negligence is itself defined as a breach of a legal duty to take care which results in damage to the claimant²¹. Quite apart from the semantics and presentation of the wording in the pleadings, a claim for 'damages for breach of duty of care' is exactly the same as 'damages for negligence' when one considers the legal definition of the tort of negligence. There is simply no known rule of civil procedure that requires that for a claim in negligence to be tenable the word 'negligence' must be used in the pleadings or the endorsement on the writ²².

Further, in *William David Wise v E F Hervey*²³, Ngulube CJ referred to *Letung v Cooper*²⁴ and cited with approval the meaning assigned to the phrase "cause of action" by Lord Diplock when he said the words meant "simply a factual situation the existence of which entitles one person to obtain from the court a remedy against another person". It basically

²¹ W.V.H Rogers. *Winfield and Jolowicz Tort. 17th Ed.* (London: Sweet and Maxwell, 2006) , 271

²² KMG Chisanga of KMG Chisanga Advocates, advocate for the plaintiff in *The Elpe Finance Case*, interviewed by Nakasamba Banda 13/04/2012

²³ (1985) ZR 179

²⁴ [1965] 1 Q.B 232

refers to every fact which it will be necessary for a party to prove, if traversed, to support his right to the judgment of the court. In addition, the points a plaintiff must prove to win a given type of case are called the "elements" of that cause of action. In this instance, the elements of a claim of negligence are: the existence of duty, breach of that duty, proximate cause, and damages²⁵.

Given that the plaintiff's endorsement amounted to a cause of action in itself, it should not have been dismissed solely on the basis that they claimed damages for breach of duty of care rather than negligence. Considering that is exactly what negligence is, the judge should not have dismissed the claim. Such dismissal based on trivial technicalities begs the question of whether or not the claim would have succeeded had the plaintiff claimed negligence anyways.

The second limb argued by the plaintiff in establishing liability was that the second defendant was complacent to the commission of the fraud and dishonesty by the first defendant. The judge proceeded to highlight the relationship between the banker and the customer and its effect. Quoting Lord Hailsham of Marylebone, the court held that the receipt of money by a customer constitutes him debtor of the customer, liable to repay only the person from whom he received the money. The banker is not trustee for the customer and has no right to inquire into, or question the use of the money by the banker. The judge reiterated the facts stating that the account was opened by the first defendant and it did not make provision for the plaintiff to be beneficiary under the account.

²⁵ www.law.cornell.edu/wex/cause_of_action accessed 24/03/12

This position is not denied. However, chapter two of this paper has established that constructive trusteeship is a fiction and provides a useful remedy where no remedy is available in tort or contract. Its purpose is to imply a trust where none exists by operation of law rather than deliberate acts of the parties. The resolution and the signing mandate were delivered by the plaintiff and first defendant to the bank for the purposes of the plaintiff benefitting from its financing. This was categorically stated in the resolution. The bank was thus fixed with knowledge of the interest the plaintiff had in the funds held by the first defendant in an account maintained with the bank. As the bank held property in circumstances in which equity and good conscience should have been enjoyed by the plaintiff, this gave rise to a constructive trust by operation of the law. Consequently, the actions of the bank in allowing the first defendant to unilaterally alter the signing mandate to the detriment of the plaintiff brought it sharply into context of liability connected with the breach of the constructive trust. The second defendant failed to act as a prudent banker in circumstances where it had been placed on notice of the requisite arrangement between the plaintiff and the first defendant. Despite the bank's duty to follow its customer's instructions, this should not absolve the bank from liability if it knew that to act would amount to assistance in a fraudulent design on the part of the first defendant. A bank has the duty to ensure that its services are not used to further fraudulent acts. It is not expected that the bank be an amateur detective, but given that on the balance, a bank with knowledge is better equipped to prevent fraudulent activities, the least the bank should have done was inquire into the second defendant's unilateral instruction to remove the plaintiff as signatory, in light of the fact that the first instruction included the plaintiff as signatories by virtue of being financier.

Basically, it is felt that the outcome of this case presented the law generally but was unsatisfactory to both parties as it neglected to consider exceptions to rules and emerging

trends in banking practice. Its narrow and untailored approach showed an unwillingness of the court to find the bank wanting simply because it had to follow its customer's mandate. Its duty to the customer should not provide a bank with a cloak of invisibility as against other obligations.

3.2.2 Civil liability of banks for money laundering specifically

Civil liability for money laundering must be considered because perpetrators of fraud may seek to launder the fraudulently acquired proceeds through the bank. A number of issues must thus be considered in order to determine the courts willingness to impose liability on banks as against third parties in cases of money laundering.

The principal law governing money laundering in Zambia is the PPML Act²⁶. In exercise of the powers contained therein, Bank of Zambia as supervising authority²⁷ has issued Anti Money Laundering Directives to banks and financial institutions. In addition the recently enacted Financial Intelligence Centre (FIC) Act²⁸ provides for the prevention of money laundering, terrorist financing and other serious offences. This Act creates the Financial Intelligence Centre (FIC) which has taken over some of the responsibilities of the Anti-Money Laundering Unit (AMLU) such as receiving suspicious transaction reports (STR). However at the time of writing this paper, FIC was not yet operational²⁹.

²⁶ No 14 of 2001

²⁷ PPML Act, No.14 of 2001. s.12(4)

²⁸ No 46 of 2010, Part III s.15-41.

²⁹ Dr Leonard Kalinde, Legal Counsel, Bank of Zambia Secretariat interviewed by Nakasamba Banda 25/04/2012

Any person who attempts, aids, abets, counsels, conspires or procures the commissioning of the offence of money laundering is guilty of the offence³⁰. Provided the bank is alive to its obligations to report suspicious transactions or suspicions that any property is the proceeds of crime as provided by section 29 of FICA, it should avoid criminal proceedings being taken against it. As the case of *Agip (Africa) Ltd v Jackson*³¹ illustrates, assistance that could result in criminal liability for money laundering will be sufficient for civil liability. Therefore, the disregard of the duty to report will not only impose criminal liability but will make it easier for a third party victim to claim as against the bank. It should be noted that despite the bank's duty to maintain confidentiality³² of their customer's information obtained in the course of service, no liability arises for breach due to the report since section 32 of FICA provides that no secrecy or confidentiality provision in any other law shall prevent a reporting entity³³ from fulfilling its obligations under the Act. Further, section 35 exempts banks from any civil, criminal, disciplinary or professional secrecy or contract liability that, in good faith submit information or provide information in accordance with the Act itself. Therefore, the bank can carry out its duty to report without incurring liability as against its customer.

However, banks tend to face a number of dilemmas in connection with money-laundering rules. While the law provides for STRs, there are no clear guidelines as to what happens when the report is made or while it is being processed. There are no provisions as to how long the bank should wait before it is given approval by FIC to allow or freeze transactions.

³⁰ PPML Act, No 14 of 2001. s. 9(1)

³¹ [1991]Ch 265

³² Cap 387 of the Laws of Zambia. s. 50.

³³ FIC Act No 46 of 2010. s.2; defines reporting entity as 'an institution regulated by a supervisory authority and required to make a suspicious report under the Act'

And even if consent is given, FIC will not be liable to any claimant if the bank pays out monies and a third party sues. This leaves the bank with conflicting obligations. On one hand, the bank is constrained to comply with the mandated payment instructions of their customers. However, if a payment is made out, a victim may sue the bank in an assisting offence (if not reported or consent was not given by reporting authority) and constructive trustee (with or without consent). On the other hand, if it denies mandated instructions of its customer, it risks civil liability for breach of mandate and a tipping off offence³⁴. What reason is the bank to give its customer for denial of instructions without tipping off the customer? The bank cannot reveal the difficulty it faces because that in itself could amount to tipping off. Thus the banks are 'damned if they do, damned if they don't'.

As no jurisprudence exists on these matters, positions advanced in common law jurisdictions especially the United Kingdom must be resorted to. However, it should be borne in mind that these sources are only of persuasive value.

3.3 Legal developments in other jurisdictions

3.3.1 English judicial developments

Recent English decisions have determined that there is no general duty of care owed by banks to noncustomers, thus preventing successful third party actions against banks for negligence³⁵. However, the law does recognise liability on the basis of constructive trust theories money had and received and conspiracy³⁶ as provided in chapter two. In addition, a third party may trace the monies in equity.

³⁴ FIC Act , No 46 of 2010. s. 33

³⁵ Customs and Excise Commissioners v Barclays Bank [2004] 2 All ER 789

³⁶ Toby Graham, Evan Bell and Nicholas Elliot. *Money Laundering* (Wiltshire: Cromwell Press,2003), 143-157.

Further, the UK Proceeds of Crime Act, 2002 has addressed the conflicting obligations of banks as regards money laundering³⁷. The absence of a time table for consent following a STR has been addressed by section 335. It provides for a time table of seven working days and a thirty one day moratorium. Thus hardships are limited to forty days after which consent to allow transactions is deemed to be given. It should be noted that there is no equivalent to deemed consent in the context of the bank's ability to disclose to the customer its reason for non payment. However the JMLSG³⁸ Guidance has recommended steps to be taken by a financial institution faced with the question of whether and if so what to disclose.

In addition, recent rulings on obligations of banks are helpful in suggesting the likely view as regards the conflict between mandatory nature of the banker customer relationship and the bank's desire to escape third party claims. In *K v National Westminster Bank*³⁹ it was stated that the banks contract with the customer was suspended whilst the moratorium period was in place. Longmore LJ said that the "temporary illegality" of performing the mandated transaction "suspended" the bank's obligations:

"If the law of the land makes it a criminal offence to honour the customer's mandate in these circumstances there can, in my judgment, be no breach of contract for the bank to refuse to honour its mandate."

3.3.2 Emergence of a duty of care owed by banks to non-customers under Canadian law

The once prominent concept that a bank owes a duty of care only to its customers has been significantly eroded within various Canadian jurisdictions in recent years⁴⁰. In its 2001

³⁷ Graham, 173

³⁸ Joint Money Laundering Steering Group

³⁹ [2006] EWCA Civ 1039.

⁴⁰ Lincoln Caylor, et al., 'Emergence of *Mareva* by Letter: Banks' Liability to Third Party Victims of Fraud'. *Business Law International*. Vol 12 No. 2. (May 2011), 9

decision in *Semac Industries Ltd. v. 1131426 Ontario Ltd.*⁴¹, the Ontario Supreme Court determined that a bank which knows of a customer's fraud in the use of its facilities, or has reasonable grounds for believing or is put on its inquiry and fails to make reasonable inquiries, will be liable to those suffering a loss from the fraud. Numerous subsequent cases have developed this principle, and it is now well established that in certain situations, a bank will owe a duty of care to a third party who is defrauded by the bank's customer⁴².

3.3.3. United States of America (USA) judicial developments

With fraud on the rise and courts unwillingness to impose liability on banks, a *mareva* by letter has become not only a useful tool for plaintiffs, but perhaps the key piece of evidence used to hold American banks liable for investors' losses in a fraudulent scheme⁴³. As stated in *Fine v Sovereign Bank*⁴⁴ 'knowledge' can be (1) actual knowledge; (2) constructive knowledge following "red flag" warnings, or (3) deliberate ignorance. Therefore the contents of a *mareva* by letter advising a bank of fraud or suspicious activity is the basis upon which to establish that a bank had actual knowledge of a breach of fiduciary duty or the underlying fraud itself or, alternatively, could be deemed a "red flag" sufficient to place the bank on constructive notice of a problem. If a bank chooses to ignore such a letter, it runs the risk that liability will be imposed for all activity taking place after that point in time.

Further, other primary areas under which bank liability may be found are negligence, and aiding and abetting fraud or breach of fiduciary duty. For the most parts, courts do not appear eager to extend liability to noncustomers under a negligence theory but will do so

⁴¹ 2001 CanLII 28375 (ON S.C.)

⁴² *A & A Jewellers Ltd. v. Royal Bank of Canada*, 2001 CanLII 24012 (ONCA),

⁴³ *Caylor, et al.*, 14

⁴⁴ 634 F.Supp.2d 126, 137 (D.Mass. 2008).

under certain circumstances. For example in *Lerner v Fleet Bank*⁴⁵, the court let stand a claim of negligence against a bank brought by a noncustomer of the bank where the customer had deposited its funds in the debtor's bank accounts with an assurance that the debtor was an attorney and where it was alleged that the bank knew the accounts were to be maintained as trust accounts for client funds.

Also, courts in New York have increasingly recognized that "a bank may be held liable for its customer's misappropriation where (1) there is a fiduciary relationship between the customer and the non-customer, (2) the bank knows or ought to know of the fiduciary relationship, and (3) the bank has 'actual knowledge or notice that a diversion is to occur or is ongoing. Both actual knowledge and constructive knowledge have been found sufficient to impose liability on a bank for breach of fiduciary duty to noncustomers. As held in *Chaney v. Dreyfus*⁴⁶, "Requisite knowledge can be established through the doctrine of deliberate ignorance. Deliberate ignorance exists where there is 'a conscious effort to avoid positive knowledge of a fact which is an element of an offense charged so the defendant can plead lack of positive knowledge in the event he should be caught.'"

Fraud victims may also pursue banks for compensation through a claim of aiding and abetting fraud. Knowledge is also a key element for aiding and abetting theories of liability, claims for which may also be brought against a bank by a noncustomer. These theories provide exposure for banks even if the bank did not financially gain from the tort, or owe the *corporate debtor an independent duty*.

⁴⁵ 459 F.3d 273, 281 (2d Cir. 2006).

⁴⁶ [1997] C.L.C 714

3.3.4 Swiss legal developments

Under Swiss law, as is the case in most civil law jurisdictions, non-contractual liability exists in the presence of an illicit act, which through the fault of the perpetrator, caused damage to a third party. Further, the Federal Law on the Prevention of Money Laundering in the financial sector (SLML), introduced in 1998, requires financial intermediaries to immediately file a report with the Money Laundering Reporting Office Switzerland (MROS) of suspicious activity. Upon reporting, the financial intermediary must immediately freeze the assets that are connected with the report, until it receives a freezing order from the competent prosecution authority, but at the most for five working days from the time at which the report has been filed, and may not inform the person affected or third parties until such delay has elapsed

Whoever professionally accepts, keeps safe, or assists in investing or transferring assets belonging to a third person without checking with due diligence the identity of their beneficial owner shall be liable of an offence. However, in cases of money laundering, such liability only exists if the acts were committed intentionally within the meaning of the Swiss Penal Code, and not by negligence. Based on recent decisions of the Federal Court - Switzerland's Supreme Court, a breach of the criminal money laundering provision entails the liability for damages under article 41 of the Penal Code towards the victim of the predicate offence if the money laundering activity prevented the criminal forfeiture of the assets (which is essentially deemed to favour the interests of the victim, who, under Swiss law would have been entitled to be allocated the forfeited proceeds *per se entail civil liability (dolus eventualis)*⁴⁷).

⁴⁷ Caylor, et al., 18

3.4 Conclusion

The Zambian legal system provides for recovery of property by third party victims when such property is liable for forfeiture through the FPC and PPML Acts. However, the law overlooks situations in which the perpetrator of the fraud has not been convicted or no property exists that may be forfeited. In such instances actions may be brought against intermediaries (banks) who directly or indirectly become involved in the fraud. These may be civilly liable to third parties based on traditional legal concepts of common law and equity by virtue of the English Acts (Extent of Application) Act. As these principles develop in the court, the lack of jurisprudence on the matter makes it difficult to determine to what extent the courts will be willing to impose such liability. The *Elpe Finance Case* suggests the unwillingness of the courts to impose liability but a conclusive position cannot be given based on an analysis of one case. However, the unwillingness portrayed can be distinguished from various jurisdictions like the UK, USA, Canada and Switzerland that are increasingly establishing a duty of care to third parties whilst Switzerland has expressly provided, in its written law, for civil liability of the bank to a third party once it is found guilty of the criminal offence of money laundering. In relation to money laundering specifically, conflicting obligations are faced by the bank in its effort to avoid criminal liability and civil liability from both the customer and third parties. Reference to decisions in other common law jurisdictions helps resolve this though it should be remembered that they are only of persuasive value.

CHAPTER FOUR

CONCLUSION AND RECOMMENDATIONS

4.1 Introduction

The objective, in the preceding chapters, has been to outline the concern surrounding liability of banks to third party victims of fraudulent activities committed by the bank's customers using the banking services. This chapter therefore recapitulates previous chapters with a view to elucidate findings made along the way that tend to answer the question as to banks liability to third party victims of fraud and thus achieving the objectives of this paper as provided in chapter one. It then uses the findings to suggest remedies to the imperfections so as to strengthen the principles protecting third parties without imposing too excess a burden on banks.

4.2 Findings

Recent times have witnessed a mounting number of elaborate fraudulent schemes through banks. In response, governments including Zambia have enacted legislation to combat these activities. However, the principal focus of this legislation has been the criminalisation of fraudulent acts rather than the recompense of victims of the criminal activity. With regards to Zambia, it was observed that though the Penal Code merely criminalises fraudulent activities, legislation such as the FPC¹ and PPML² Acts have provided the means by which third party victims may recover property that is subject to forfeiture if they have an interest in it. However, such forfeiture and recovery is dependent on whether the perpetrator is convicted of a serious offence or money laundering offence respectively. In addition, it assumes that the tainted property in relation to the offence that must be forfeited still exists. This means that if

¹ No.19 of 2010

² No. 14 of 2001

the perpetrator successfully launders the proceeds, runs off with the property or otherwise becomes impecunious, the third party has no remedy at law.

Third parties may thus seek to sue a bank whose action or inaction prevented the criminal forfeiture of the assets which would essentially have been deemed to favour the interests of the victim. The preceding chapters have established that there is no single coherent and developed civil remedy. Rather, traditional legal concepts have been adapted to impose liability on those who provide assistance to perpetrators of fraud. It is clear that a victim of fraud has a wide range of potential claims open to him, depending on what happened to his money and the involvement of persons alleged to have participated in swindling him. Those provided in chapter two encompassed common law and equitable claims.

The availability of these claims under the Zambian legal regime was ascertained by chapter three. It was found that by virtue of the English Law (Extent of Application) Act³ common law and doctrines of equity shall be in force in the republic subject to provisions of the constitution and any other written law, thus enabling the application of the forms of liability established in chapter two. However, chapter two also examined a number of difficulties encountered in establishing these forms of liability. These encumbrances included; the doctrine of privity in efforts to establish liability in contract as third parties are not privy to *the banker customer relationship*; *the lack of a general duty of care, making proof of a negligence claim against a bank problematic* and; *most importantly, establishment of knowledge on the part of the bank in order to find it preclude it from using the defence of good faith in a number of claims.* An interview with a Pumulo Akapelwa, financial expert of

³ Cap 11 of the Laws of Zambia

Bank of Zambia's Financial Intelligence Unit revealed that despite the theoretical possibilities, the practicality of it is that knowledge cannot be easily established.

In addition, the uncertainties encountered in the use of common law (and equity) as opposed to statute were acknowledged. It was found that there was a lack of jurisprudence in Zambia as regards liability of banks to third parties. Thus despite the doctrine of judicial precedent being a cornerstone of the common law legal system, decisions from sister jurisdictions are persuasive rather than binding on the Zambian courts. It was further established that the reality of the common law method can be much more flexible in the hands of the individual judges⁴. Thus the judges' willingness to impose liability on banks had to be determined. The analysis of *Elpe Finance Case* provided the position taken by the courts, though not representative of the entire legal system. The case indicated a clear unwillingness on the part of the courts. This is probably because it is felt that it would be too onerous a responsibility to place on banks a duty of care to third parties lest they be considered as assisting⁵.

On the other hand, it was found that recent Canadian judicial decisions have established that a bank owes a duty of care to non-customers once it has actual knowledge of, or is wilfully blind to, the use of its services for fraudulent purposes. The law in other common and civil law jurisdictions appeared to be following the trend of placing a share of the risk of fraud onto the bank's shoulders when it was put on notice of fraud.

⁴ Margaret M. Munalula. *Legal Process: Zambian Cases, Legislation and Commentaries* (Lusaka; UNZA Press, 2004), 212-216

⁵ Pumulo Akapelwa, Financial Expert-Tax, Financial Intelligence Unit, Bank of Zambia interviewed by Nakasamba Banda 25/04/2012

Finally, the total lack of jurisprudence as regards civil liability of banks to third party victims for money laundering left the question as to willingness of judges in Zambia unanswered. Until cases on these issues has been litigated on, the way in which lacunae in the law, the conflicting obligations of banks and the complex requirements of AML laws as expounded in chapter three will be resolved can only be surmised by reference to similar provisions in other jurisdictions especially England.

4.3 Recommendations

4.3.1 'Know your customer' policies

Every business has its mantras. In real estate, brokers say “location, location and location.” In the construction business, the carpenters say, “measure twice, cut once.” Lawyers are inclined to admit, under pressure, “when you don’t have the law, argue the facts, and when you don’t have the facts, argue the law.” Bankers have a simpler maxim, “know your customer (KYC).” “If you know your customer,” the bankers say, “you won’t get hurt.”⁶

Therefore, the first solution would be the prevention of money laundering and fraudulent activities through banking services. This entails the adoption of a robust system for fraud detection and its prevention. KYC principle help facilitate this as their primary objective is to enable effective identification and reporting of suspicious activity. The underlying assumption is that, unless you truly know your customer well enough to understand and anticipate that customer’s business behaviour, you can neither reasonably nor effectively distinguish unusual and possibly suspicious activity from usual and customary behaviour. KYC guidelines require or recommend developing a thorough understanding, through appropriate due diligence, of the true beneficial parties to transactions, the source and intended use of funds and the appropriateness and reasonableness of the business activity and

⁶Toby Graham, Evan Bell and Nicholas Elliot. *Money Laundering* (Wiltshire: Cromwell Press,2003) , 99

pattern of transactions in the context of the business. There is no doubt that enhanced due diligence, enhanced scrutiny and related guidelines for strengthening and further promulgating KYC principles and STR will go a long way in the prevention of money laundering and other fraudulent activities⁷.

In order to promote the reporting of suspicious activities, there should be established safe harbour for protection and indemnification of banks and their employees who report such activities as against their customers. Further the law should provide clarity as to STR through the provision of models as an essential guide. Specifically, the law should provide for a maximum time frame within which they are to respond to suspicious transaction reports and give their consent to the bank whether to proceed with transactions on the account or freeze them, for it is this time period that the bank is susceptible to liability due to its conflicting obligations

4.3.2 Establishing an epistemic community and the move towards principle based regulations.

Given the uncertainties of common law as opposed to statute and the reluctance of judges to establish a duty of care in instances that justify it, the codification of the rules of establishing liability seems like the way forward⁸. This move will create more legal certainty in an ever-increasingly complex world of financial markets and regulation. However, Braithwaite⁹ advances another theory of legal certainty stating: “the iterative pursuit of precision in single rules increases the imprecision of a complex system of rules”. Therefore, rather than the need to codify the rules on which liability is based, it would be more appropriate for the financial

⁷ Graham, et al., 101

⁸ Graham, et al (2003), 143-157.

⁹ J Braithwaite, “Rules and Principles: A Theory of Legal Certainty” *Australian Journal Legal Philosoph*, Vol. 27 (2002), 47

community to develop into an epistemic community. This, as characterised by Haas¹⁰, is a network constituted by experts in a particular area, recognised for their competence in that area. Although the professionals are from a variety of disciplines and backgrounds, they have; (1) a shared set of normative and principled beliefs, which provide a value-based rationale for the social action of community members; (2) shared causal beliefs, which are derived from their analysis of practices leading or contributing to a central set of problems in their domain and which then serve as the basis for elucidating the multiple linkages between possible policy actions and desired outcomes; (3) shared notions of validity – that is, inter subjective, internally defined criteria for weighing and validating knowledge in the domain of their expertise; and (4) a common policy enterprise – that is, a set of common practices associated with a set of problems to which their professional competence is directed, presumably out of the conviction that human welfare will be enhanced as a consequence.

Haas develops the concept further and states that if the financial services regulated community becomes an epistemic community as described above, then its level of maturity will surpass or transcend the need to rely purely on specific rules. Banks would have internalised their analysis of whether or not they are compliant with rules and regulations. A shared understanding will be the product of such a community. The supervisory authorities can then move towards principle based regulation, which tends to increase the financial sector's duties in making sure that their firms abide by the principles thus creating liability towards third parties to which no duty was initially owed.

Further, the maturity of this approach is critically important because there is a limit to what rules or guidance can do and so problems which may have occurred because of lacunae in the

¹⁰ P Haas, "Introduction: Epistemic Communities and International Policy Coordination" *International Organisations*, Vol 3 (1992), 46

law, conflicting obligations and complex requirements as provided in chapter three are superseded because there has been a “development of shared understandings between the supervisory authority and regulated institutions as to the role and purpose of principles in the regulatory regime. There is, no doubt, an enormous amount still has to be done in order to achieve this. Clearly, two changes must occur: (i) the development of consensual theoretical knowledge and (ii) regulation would have to be based on this knowledge.

4.3.3 Accountancy professional responsibility

Until relatively recently, the battle against money laundering and related financial crime was the exclusive domain of law enforcement, and for good reason. Approximately fifteen years ago, forensic accountants started to contribute their skills to detecting possible money-laundering activity buried in the books and records of victimized financial institutions¹¹. Now, governments and businesses increasingly look to the profession, not only to aid in their monitoring and detection efforts, but also to establish and strengthen controls and safeguards against money laundering, its perpetrators and their accomplices in organized financial crime. The accountancy profession around the world is increasingly involved in both arenas. Therefore, there should be promotion of awareness of important money laundering issues and of the related professional obligations imposed on accountants. This could be further qualified by imposition of specific duties by national AML laws.

4.3.4 Judicial activism

Judges should be urged to approach the law purposively especially where the law is unjust. It is only then that the law will remain relevant to new challenges. In the *Elpe Finance Case*, no doubt the judge saw his role as limited merely to the application unreservedly of banking law as he understood it. This is judicial restraint typical of conservative judges. Judges should

¹¹ IFAC. Anti Money laundering. 2nd Ed. (March,2004) <http://www.ifac.org> Accessed 24/03/2012

realise that the rise in fraudulent activities through banks is a problem that should be addressed by placing some risk on the bank itself so that it feels the need to prevent such fraud. Through judicial activism, judges will increasingly impose a duty of care on banks in cases that warrant it.

4.3.5 Individual safeguards

As prevention of fraud may not always be successful, third parties must take steps to guard themselves against fraud. In cases such as that established in the *Elpe Finance Case*, this can be done by expressly entering into a contract with the bank and its customer so that a contractual duty is imposed on the former to safeguard the interest of such non customer. This contract will obviously not amount to creating a banker customer relationship as no account is intended to be open. These arrangements include escrow agreements in which the bank may hold a financial instrument on behalf of the other two parties in a transaction. The funds are held by the escrow service until it receives the appropriate written or oral instructions or until obligations have been fulfilled.

The value of the *mareva* by letter has been established. It serves as an effective asset-preservation tool for victims of fraud. Its viability marks a significant advancement in the remedial framework against losses occasioned by fraud. This is a new concept and applies in financially developed countries. As it has been established the bank's mandate cannot be used as a cloak of invisibility to escape liability when it has actual knowledge of the fraud, its application to Zambia seems possible as it does not go against any established principles or law. Therefore, as a result of its practicality, victims of fraud would be wise to add such a

letter to the arsenal of weapons available to combat the potentially devastating effects of fraud in all circumstances that warrant it¹²

4.4 Conclusion

This research paper has established that in as much as the principles of liability exist, there still exists an imbalance between the interests of the bank and that of third parties due to the difficulties in establishing liability and the unwillingness of the courts to impose liability. In order to remedy this, this chapter has provided a number of recommendations. The first step entails prevention of fraud by banks through KYC principles so that the issue of liability does not arise to begin with. Further, the accountancy professions should be more involved in the fight against fraud and money laundering. In addition, rather than codification of the rules as a solution to the uncertainties of common law and unwillingness of the courts in establishing liability, an alternative requires the creation of an epistemic community so that the move to more principle based regulation can be successful. In addition, despite the lack of a duty of care owed, judicial activism would enable a judge establish such duty in cases that warrant it rather than sticking to the strict letter of the law. Individual third parties must also take steps to safeguard themselves rather than await the inevitable difficulties. This would involve expressly placing a duty of care on the bank by entering into an agreement with the bank and the customer, such as an escrow, so that the bank has a duty towards a third party. Finally *mareva* by letter can be used to impose knowledge on a bank so that the defence of good faith is precluded.

¹² Lincoln Caylor, et al., 'Emergence of the *Mareva* Injunction', *Business Law International*. Vol 12 No. 2. (May 2011)

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