CULPABLE KNOWLEDGE AND THE CONSTRUCTIVE TRUST

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It is clear that liability is not imposed on a constructive trustee unless he has knowledge that a trust exists although knowledge can be imputed to him from the circumstances.

In this article it is proposed to outline and defend two propositions.

(1) It is intended to show that there is only one test for liability for a constructive trustee not two as argued by Jacobs P in the Court of Appeal of the Supreme Court of New South Wales in *DPC Estates* v *Grey and Consul Development Ltd ("Consul").*[1] This is termed the test of "actual knowledge".

The same test of knowledge should apply to a trustee regardless of whether he receives the property either innocently or by way of fraud.

(2) The two inconsistent tests of knowledge are not, as they appear to be conventionally regarded the test of the subjectively honest person, on the one hand, as against the test of the objectively reasonable person on the other hand. The two inconsistent tests of knowledge are, it will be argued, the test of the objectively honest person, on the one hand, as against the test of the objectively circumspect person, on the other hand. In short, the choice to be made is not, as the conventional view would suggest, between a subjective test and an objective test, but, as the writer will attempt to show, between two differently formulated tests *bc* ɥ of which are objectively expressed.

These two propositions will be examined in turn.

I Actual Knowledge

The view which it is the purpose of the first proposition to refute was initially propounded by Jacobs P in *Consul.* His Honour said:[2]

> The point of the difference between the person receiving trust property and the person who is made liable, even though he is not actually a recipient of trust property, is that in the first place knowledge, actual or constructive, of the trust is sufficient, but in the second place something more is required, and that something more appears to me to be the actual knowledge of the fraudulent or dishonest design, so that the person concerned can truly be described as a participant in that fraudulent dishonest activity.

His Honour cited no authority for his view that there were discrete tests of knowledge for the two kinds of constructive trusts envisaged by him. This omission is not surprising. There was no such authority for his

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1 [1974] 1 NSWLR 443.
2 Ibid at 459.

Honour to cite. It is to be emphasised that although it may be trite to state that there is a clear distinction between constructive trusts based on the knowing receipt of trust property, on the one hand, and constructive trusts based exclusively on the knowing assistance in the execution of a dishonest design, on the other hand, there is no authority for the entirely different statement that the tests of knowledge are discrete for these two kinds of constructive trusts.

When *Consul* went on appeal to the High Court of Australia, Stephen J (in whose judgment Barwick CJ concurred)[3] endorsed the view of Jacobs P in these words:[4]

> It is not clear to me why there should exist this distinction between the case where trust property is received and dealt with by the defendant and where it is not; perhaps its origin lies in equitable doctrines of tracing, perhaps in equity's concern for the protection of equitable estates and interests in property which comes into the hands of purchasers for value.

Stephen J, like Jacobs P in the court below, cited no authority for his support of Jacobs P's discrete tests of knowledge. It is submitted that not only did Stephen J and Jacobs P have no authority to cite in support of their view, but that such authority as there was at the time of Jacobs P's judgment tended unequivocally to the contrary. In *Carl Zeiss Stiftung* v *Herbert Smith (No 2)*[5] Edmund Davies LJJ remarked on:[6]

> . . . that want of probity which, to my way of thinking, is the hall-mark of constructive trusts, *however created.*

His Lordship thus clearly did not take the view that there were discrete tests of knowledge for different kinds of constructive trusts.

Again, in *Karak Rubber Co Ltd* v *Burden (No 2),*[7] Brightman J held:[8]

> I respectfully agree with the explanation of the *Barnes* v *Addy* formula which I find in the *Selangor*[9] judgment. If, as seems to be established by the cases, an objective test of 'knowledge' is rightly applied in the context of the first category of constructive trusteeship . . . *I do not myself see any particular logic in denying it a similar role in the context of the second category of constructive trusteeship.*

It is thus evident that Brightman J denied the existence of discrete tests of knowledge for the two kinds of constructive trusts envisaged by him. Although Edmund Davies L J in *Carl Zeiss* and Brightman J in *Karak* were clearly disagreed on the correct test of knowledge, their Lordships were equally clearly agreed that there was only *one* test of knowledge in the imposition of liability as a constructive trustee.

However, quite apart from the lack of judicial support for the discrete

3 (1975) 132 CLR 373 at 376-377.
4 Ibid at 410.
5 [1969] 2 Ch 276 (referred to as *"Carl Zeiss"*).
6 *Carl Zeiss* at 302 (emphasis added).
7 [1972] 1 WLR 602 (referred to as *"Karak"*).
8 *Karak* at 639 (emphasis added).
9 *Barnes* v *Addy* infra n 21; *Selangor* infra n 30.

tests of knowledge favoured by Jacobs P and Stephen J in *Consul,* Stephen J himself in the same case appeared to have taken another, inconsistent, view. After concurring in the instant distinction propounded by Jacobs P in the court below, Stephen J observed:[10]

> In *Selangor* the precedent cases which led Ungoed-Thomas J to his conclusion concerning constructive notice were examined at length. Two features emerge, *they are all cases in which trust property passed through the defendant's hands* and in all of them in which the plaintiff succeeded it did so because the defendant was held to have had *actual knowledge* of facts constituting the relevant fraud or breach of trust; thus constructive notice arose out of the defendant's failure to recognize fraud when he saw it, from a failure to pursue inquiries.

It is of importance to stress that, in the passage just cited, Stephen J was asserting that *actual knowledge* of fraud was required to impose liability as constructive trustees on those defendants *who had received trust property.* With the greatest respect, it is by no means apparent how such an assertion can be reconciled with his Honour's own earlier assertion that Jacobs P was correct to confine the requirements of actual knowledge to situations where the defendant had *not* received trust property.[11] It is respectfully submitted that Stephen J's two assertions on the issue of culpable knowledge expose his Honour's judgment to self-contradiction on two points. The first self-contradiction in his Honour's judgment is his view that the requirement of *actual knowledge* of fraud *is*[12] and *is not*[13] confined to a situation where the defendant has *not* received trust property. The second self-contradiction in Stephen J's judgment is his Honour's view that knowledge of fraud in the two kinds of constructive trust envisaged by him is[14] and *is not*[15] to be tested in the same way (by proof of actual knowledge). In short, Stephen J appeared to be undecided as to (1) whether defendants who had *received* trust property could be made liable as constructive trustees where they had *not* done so with *actual knowledge*, and (2) whether, in the light of his Honour's indecision as to the issue in (1), there were in fact discrete tests of knowledge applicable to the two kinds of constructive trust examined by him.

However, can it be said that, even if one were to assume that the view of Jacobs P and Stephen J in *Consul* (that there were discrete tests of knowledge) was unsatisfactory, that this view is nonetheless authoritative? It is submitted that it cannot. When *Consul* was before the Court of Appeal (New South Wales) neither Hardie JA nor Hutley JA adverted to this posited distinction. This distinction, being supported by only one of the three Justices who sat in that court, therefore cannot be said to have been approved by the Court of Appeal. When the case went before the High Court of Australia McTiernan J[16] and Gibbs J[17] expressly re-

10 132 CLR 373 at 411 (emphasis added).
11 See n 4.
12 See n 4.
13 See n 10.
14 See n 10.
15 See n 4.
16 132 CLR 373 at 386.
17 132 CLR 373 at 396-397.

fused to accept that actual knowledge was required in a case where the defendant had *not* received trust property (as was the situation in *Consul*). Thus, in the High Court, the posited distinction was only supported by two (Stephen J, Barwick CJ concurring) of the four Justices who decided the case in that court. This means that there was not a majority in that court in favour of the posited distinction. In summary, the posited distinction in *Consul* cannot be said to be supported by the authority of either the Court of Appeal (New South Wales) or the High Court of Australia.

It is submitted that the posited distinction is also conceptually unsound in that as between a person who has received trust property and one who has not, it requires the former to have been more vigilantly innocent than the latter. Yet it appears that the mere unauthorised receipt of trust property is as innocent as the mere assistance in the execution of a dishonest design. If knowledge is requisite in either case to impose on the relevant person the burden of constructive trusteeship, then why should the test of knowledge not be the same for either case?

II Culpable Knowledge

It is suggested that essentially there are two, inconsistent, tests of knowledge or notice of fraud.[18] One test is to attribute to the defendant the perception of the *honest* person. The other test is to attribute to the defendant the perception of the *circumspect* person. It is apparent that if a person is taken to have possessed at the relevant time the alertness of a circumspect person then he will be treated as having known what such a person would, in the situation, have known, notwithstanding that an honest person similarly circumstanced would have perceived less. The contest between these two views of knowledge is confused by a factor, the presence of which has yet to be recognised and removed by the courts, which concerns the test of honest conduct. It is proposed to show that those judges who adopt the honest person as their test tend to regard him as no more than someone whose particular conscience happened to be unclouded rather than as someone, as ought to be the case, who, although not circumspect, is nonetheless informed in his conduct with that standard of integrity which the community in which he lives expects of its members.

It is suggested that the disparity between the subjectively honest person and the circumspect person is decidedly more pronounced than that between the honest person (objectively regarded) and the circumspect person. The dichotomy of the honest person (objectively regarded) and the circumspect person is, in principle, preferable to the dichotomy of the subjectively honest person and the circumspect person because there appears to be some incongruity in regarding the circumspect person as a hypothetical phenomenon but failing to regard the honest person as just as much illustrative of a *standard* of conduct. The circumstance that the perception of the honest person is less keen than that of the circumspect person is no ground for denying that both of these persons are

18 Throughout this article, the word "fraud", when used, will simply denote whatever element it is which has to be known about to create a person a constructive trustee.

objectively compounded phenomena. On the other hand, to concentrate on the particular conscience of a person by, for example, asking whether he had been "*consciously* acting improperly"[19] is, with respect, to fail to apply *any* moral standard at all.

It is respectfully submitted that while the test of the circumspect person is incompatible with equity's essential concern to prevent unconscionable conduct,[20] the test of the honest person must, if it is not to become equally inappropriate, free itself from its present preoccupation with the particular conscience of the person whose conduct is being scrutinised. The writer agrees with those judges who prefer the test of the honest person to that of the circumspect person, but he would respectfully suggest that the conduct of the defendant should be *tested* against the *standard* of the honest person.

It is proposed to commence the examination of some of the case law with the decision in *Barnes* v *Addy*.[21] In this case, D1, the sole trustee of a fund, had requested his solicitor, D2, to execute a deed whereby a moiety of that fund would be transferred to B as the sole trustee thereof. B's solicitor, D3, later approved the deed prepared by D2. B subsequently misappropriated the transferred moiety, and the beneficiaries of the latter moiety sought recovery from D1 for breach of the original trust in that D1 had made B the trustee of the subsequently misappropriated moiety. The beneficiaries also sought to recover from D2 and D3 (the two solicitors engaged in the transaction) on the ground that the latter were constructive trustees of the allegedly improperly transferred moiety of the original trust fund in that they had assisted in the preparation of the deed of transfer. At first instance, the Vice-Chancellor had ordered recovery against the estate of D1 (the latter having died in the course of the litigation), but had exonerated D2 and D3 from liability for constructive trusteeship. The administratrix of D1's estate did not appeal against the Vice-Chancellor's decision, but the beneficiaries brought an appeal against the dismissal of their case against D2 and D3. The Court of Appeal dismissed the appeal by the beneficiaries on the ground that neither D2 nor D3 had known, or had reason to suspect from the circumstances, any dishonest element or other impropriety in the transfer of the moiety to B. In the course of his judgment, Lord Selborne LC observed:[22]

> Now in this case we have to deal with certain persons who are trustees, and with certain other persons who are not trustees. That is a distinction to be borne in mind throughout the case. Those who create a trust clothe the trustee with a legal power and control over the trust property, imposing on him a corresponding responsibility. That responsibility may no doubt be extended in equity to others who are not properly trustees, if they are found either making themselves trustees *de son tort,* or actually participating in any fraudulent conduct of the trustee to the injury of the *cestui que trust.*

19 *Carl Zeiss* at 298 per Sachs LJ (emphasis added).

20 In *Jones* v *Smith* (1843) 1 Ph 244; 41 ER 624, Lord Lyndhurst LC emphasised at 256-257 that constructive notice was to be the perception of the honest person, and was not to be that of the prudent person.

21 (1874) 9 Ch App 244.

22 At 251.

It is submitted that when Lord Selborne alluded to "others who are not properly trustees"[23] but who bring upon themselves the responsibility of trusteeship his Lordship was referring to persons who so interfere in the execution of a trust that equity would make them constructive trustees to the extent of their officious or fraudulent intervention. Thus his Lordship was simply distinguishing between express trustees and constructive trustees, the latter being those who so involve themselves in the business of the trust that they cease to be strangers to the trust and take upon themselves the liabilities of trustees. But, having said that, Lord Selborne was at pains to emphasise that not just any kind of involvement in the administration of a trust would attract the burden of constructive trusteeship. Hence his Lordship hastened to add that certain kinds of involvement by strangers did *not* expose them to the exacting duties of constructive trusteeship. His Lordship elaborated thus:[24]

> But, on the other hand, strangers are not to be made constructive trustees merely because they act as the agents of trustees in transactions within their legal powers, transactions, perhaps of which a 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*[25] on the part of the trustees.

So, strangers to a trust remain strangers (i.e., remain free from the burden of constructive trusteeship) even though they may act as trustees' agents so long as such strangers scruple to avoid undertaking the administration of any part of the trust property (i.e., so long as they do not "receive and become chargeable with"[26] any part of the trust property), and so long as they avoid giving knowing assistance to fraudulent trustees (i.e., so long as they do not "assist with knowledge"[27] in the trustees' commission of fraud).

Applying Lord Selborne's observations to the facts in *Barnes* v *Addy*[28] it is obvious that neither of the two defendant solicitors had either undertaken to administer any trust assets or had any suspicion that the second trustee was planning to misappropriate the property that was being transferred to him or that the original trustee was involved in any fraudulent scheme with the second trustee. No doubt the two defendant solicitors had enabled the second trustee to perpetrate his fraud in the sense that the instrument of transfer had been prepared and approved by them, but even if their conduct could have been described as providing assistance to the second trustee's fraudulent conduct there was no question that, on *any* test of knowledge, they did not provide such assistance *with knowledge* of its consequences.

23 Ibid.
24 Ibid at 251-252 (emphasis added).
25 In *Belmont Finance Corporation Ltd* v *Williams Furniture Ltd* [1979] 1 Ch 250 (referred to as "Belmont Finance"), the Court of Appeal held that "dishonest" and "fraudulent" in this context denoted the same thing. See at 267 per Buckley LJ, at 270 per Orr LJ and at 273 per Goff LJ.
26 (1874) 9 Ch App 244 at 251-252.
27 Ibid.
28 (1874) 9 Ch App 244.

Because *no* test of knowledge could have rendered the defendant solicitors liable as constructive trustees of the designated moiety, Lord Selborne's judgment *left entirely open* the question of what precisely was denoted by "knowledge" in his expression "assist with knowledge".[29] As Ungoed-Thomas J noted in *Selangor United Rubber Estates Ltd* v *Cradock (No 3),*[30] Lord Selborne had left *"wide open the question what knowledge is required".*[31] Ungoed-Thomas J discussed *Barnes* v *Addy*[32] thus:[33]

> It is this formulation in *Barnes* v *Addy* 'assist with knowledge in a dishonest and fraudulent design on the part of the trustee' that is the basis of the plaintiff's claim that the defendants are liable as constructive trustees. There are thus three elements: (1) assistance by the stranger, (2) with knowledge, (3) in a dishonest and fraudulent design on the part of the trustees.

His Lordship then asked the question:[34]

> What knowledge is required to satisfy the second element?

To the foregoing question his Lordship propounded the following answer:[35]

> The knowledge required to hold a stranger liable as constructive trustee in a dishonest and fraudulent design, is knowledge of circumstances which would *indicate* to an *honest, reasonable man* that such a design was being committed *or would put him on inquiry,* which the stranger failed to make, whether it was being committed.

Culpable knowledge, therefore, was regarded by his Lordship as either knowledge of circumstances which would *indicate* fraud to an "honest, reasonable man" or knowledge of circumstances which, although standing alone would *not* suffice to *indicate* fraud, would nonetheless prompt an "honest, reasonable man" to *inquire* as to the possible existence of fraud.

The crucial weakness of his Lordship's definition, however, is his use of the phrase "an honest, reasonable man". This phrase is crucially weak because it embraces two inconsistent tests of knowledge. It is clear that the percipience of an honest person cannot be expected to match that of a reasonable person.[36] Reasonableness in one's percipience denotes circumspection. But which of the two inconsistent tests can we understand his Lordship to have preferred? As a matter of strict logic we must regard his Lordship as not having propounded a coherent test. Can

29 At 252.
30 [1968] 1 WLR 1555. (Referred to as "Selangor".)
31 Ibid at 1581. Writer's emphasis.
32 (1874) 9 Ch App 244.
33 *Selangor* at 1580.
34 Ibid at 1580.
35 Ibid at 1590. (Emphasis added).
36 It is hardly necessary to emphasise that an honest person can also be a reasonable person. However, when "honest person" and "reasonable person" are used for the specific purpose of defining different standards of conduct these expressions are necessarily used as alternatives to each other.

it be suggested, however, that Ungoed-Thomas J's reference to a *duty to inquire* in appropriate circumstances is some indication that his Lordship was preferring the test of circumspection to that of honesty? It is submitted that it cannot be so suggested. The mere stipulation of a duty to inquire in appropriate circumstances offers no indication whatsoever as to the identity of the person who has to undertake the inquiry, since the honest person as well as the circumspect person may come under a duty to inquire in the respectively appropriate circumstances.

Although, as it is respectfully submitted, the test of knowledge propounded by Ungoed-Thomas J in *Selangor* was conceptually self-contradictory, this test was followed[37] by Brightman J in *Karak*.[38] In the latter decision Brightman J expressed himself to understand the test of knowledge as follows:[39]

> A person may have knowledge of an existing fact because in a subjective sense he is actually aware of that fact. In an appropriate context a court of law may *attribute* knowledge of an existing fact to that person because in a subjective sense he has knowledge of circumstances which would lead *a postulated man* to the conclusion that the fact *exists* or which would put *a postulated man* upon *inquiry* as to whether the fact exists.

Since Brightman J's "postulated man" is the same[40] as Ungoed-Thomas J's "honest, reasonable man", Brightman J's test is also self-contradictory. Even if Brightman J's test had *not* been the same as that favoured by Ungoed-Thomas J, the test of the "postulated man" would have been conceptually incomplete. It is not possible to identify the postulated man, unless some *basis* of postulation is supplied. A reference to a "postulated man" is no more instructive than a reference to a "hypothetical man". Although, in the event, Brightman J did identify his "postulated man", his Lordship unfortunately did so by reference to Ungoed-Thomas J's paradoxical "honest, reasonable man".

The test of knowledge for liability as a constructive trustee also received attention in the Court of Appeal in *Carl Zeiss*.[41] In this case, the plaintiffs were claiming, in another (the main) action, that a third party was holding the latter's assets on trust for them. The defendants were solicitors acting for the third party in the main action. In the course of acting for the third party, the defendants had received from the third party remuneration for their services in, as well as the consequential costs and disbursements of, the main action. The plaintiffs contended that, as the defendants had received the moneys from the third party with knowledge of the plaintiffs' claim that the third party's assets belonged beneficially to the plaintiffs, the defendants were therefore constructive trustees of the moneys so received by them. The plaintiffs, however, expressly conceded that the defendants had acted throughout the relevant

37 *Karak*, 639. Brightman J said "I respectfully agree with the explanation of the *Barnes* v *Addy* (1874) 9 Ch App 244 formula which I find in the *Selangor* judgment."
38 See n 7.
39 Ibid at 634. (Emphasis added).
40 See n 37.
41 See n 5.

period with complete honesty. The plaintiffs further conceded, crucially, that the defendants could not have discovered for themselves in any way the outcome of the main action.[42]

At first instance, Pennycuick J dismissed the plaintiffs' suit on the ground that it was contrary to public policy to allow claims, against solicitors acting for one party in a litigation, to be made by the opposing party in respect of moneys honestly received by such solicitors in their professional capacity, as such claims would obstruct the course of justice. The plaintiffs' appeal to the Court of Appeal was dismissed. The Court of Appeal held that the defendants could not be made constructive trustees of the moneys they received from the third party where the only relevant information available to the defendants amounted to *no more than* knowledge that the moneys came from assets which were being *claimed* by the plaintiffs to be their own, particularly as the claim in question was *unverifiable* before the determination of the main action. The Court took the view that knowledge of such an *unverifiable* claim could not be equated with knowledge of the *validity* of the claim.[43]

Strictly, therefore, the facts in *Carl Zeiss* should *not* have led to any discussion of any test of knowledge or doctrine of notice. In a situation where the claim of title is admitted to be *unverifiable* at the relevant time, it is logically impossible even to raise the question of whether or not the defendants either knew or ought to have known about the existence of the title in question. Necessarily, therefore, *Carl Zeiss* cannot be regarded as a binding authority on the issue of culpable knowledge as the basis of liability for constructive trusteeship. However, two[44] of the learned Lords Justices in that case did express the view, *obiter,* that nothing short of dishonest conduct could suffice to attract the liability of constructive trusteeship. Sachs LJ contrasted "an obvious shutting of the eyes"[45] with "mere lack of prudence".[46] His Lordship regarded knowledge of a dishonest design to be that which "would entail both actual knowledge of the trust's existence and actual knowledge that what is being done is improperly in breach of that trust — though, of course, in both cases a person *wilfully shutting his eyes to the obvious* is in no different position than if he had kept them open."[47] His Lordship was of opinion that a person's failure to investigate a possible breach of trust would be no more than "an innocent failure"[48] unless in refraining from making the investigation such a person was *"consciously* acting improperly".[49] The learned Lord Justice was thus emphatically of the view that knowledge, even where it did not have to be actual but could be *attributed,* must nevertheless be scrupulously confined to such know-

42 *Carl Zeiss* at 295.
43 *Carl Zeiss,* 290, 296, 303, and 304. Furthermore, the Court of Appeal did not find it necessary to determine the issue of public policy which formed the basis of Pennycuick J's decision in the court below.
44 Sachs and Edmund Davies LJJ.
45 *Carl Zeiss,* 298.
46 Ibid.
47 Ibid, 298 (emphasis added).
48 Ibid.
49 Ibid (emphasis added).

ledge as a person could have obtained but for his having *wilfully* shut his eyes to the obvious or but for his *conscious aversion* to the truth. It is respectfully suggested that his Lordship's test of culpable knowledge is inapt because it is compatible with exonerating the dishonest, as distinct from those who are additionally subjectively aware of their own dishonesty, from the consequences of their conduct. By insisting that a dishonest avoidance of the truth provides no ground for liability unless such avoidance be *consciously* improper, Sachs LJ appears not to have propounded any moral *standard* at all. His Lordship appears to suggest that an honest person can never be under a duty to inquire (the prohibition against a conscious aversion to the truth not amounting to such a duty). Perhaps his Lordship was of the view that only a *circumspect* person would ever come under a duty to inquire. Yet, even noting that a circumspect person is more vigilantly suspicious than an honest person, it is difficult to understand why an honest person — if suspicion of dishonesty should come his way — need never be under a duty to make inquiries, even though the scope of such inquiries would, of course, be less extensive than that of a circumspect investigator. It is suggested that between the subjectively ascertained honest person, on the one hand, and the circumspect person, on the other hand, there exists the concept of the objectively understood honest person, and that the test of knowledge should be the perceptive range of this objectively understood honest person.

In the same case, Edmund Davies L J took the view that no one should be made a constructive trustee without his having displayed a "want of probity"[50] in his conduct. His Lordship thus enunciated his view:[51]

> The concept of *"want of probity"* appears to provide a useful touchstone in considering circumstances said to give rise to constructive trusts, and I have not found it misleading when applying it to the many authorities cited to this court. It is because of such a concept that evidence as to "good faith", "knowledge", and "notice" plays so important a part in the reported decisions. It is true that not every situation where probity is lacking gives rise to a constructive trust. *Nevertheless, the authorities appear to show that nothing short of it will do. Not even gross negligence will suffice.*

It is submitted that his Lordship was correct to reject the test of the circumspect person ("Not even gross negligence will suffice").[52] Did his Lordship proceed, however, to endorse the test of the objectively understood honest person? Certainly his Lordship's concentration on the need for probity appears, without more, to be compatible with his having possibly approved the test of the objectively understood honest person. However, in the course of his judgment Edmund Davies LJ had cited with approval[53] a view expressed by Kay J in *Williams* v *Williams*[54] wherein the latter had clearly stated that *attributed* knowledge had to be confined to such knowledge as would have been available to a person but

50 *Carl Zeiss*, 300.
51 Ibid, 301 (emphasis added).
52 Ibid.
53 *Carl Zeiss*, 301.
54 (1881) 17 Ch D 437 at 445.

for his having *"wilfully* shut his eyes"[55] to it. Thus it would appear that Edmund Davies LJ, like Sachs LJ in the same case, favoured the test of the subjectively understood honest person, and that, therefore, the view of both their Lordships on this point reveals a lack of regard for the need for equity to enforce upon defendants the conscience and conduct of the kind of person whom the community generally would regard as honest.[56]

It is proposed to conclude this review of judicial authorities with the decision of the High Court of Australia in *Consul.*[57] In this case, W, a solicitor, controlled a group of companies engaged in the purchase, renovation and resale of initially dilapidated properties. DPC Estates Pty Ltd (herinafter DPC) was a member of this group of companies. W engaged G as the manager of these companies. Additionally, G was a *de facto* director (his appointment as director having been formally invalid) of DPC. One of G's functions as manager of the group was to obtain information from a variety of sources regarding properties which might prove suitable for purchase by the group. Whenever G concluded that a particular property might prove suitable for purchase he would ask another employee of the group to investigate and report on that property. G would then submit this report as well as his own recommendation regarding the property to W who, if he was interested in the purchase of the property, would then nominate a company in the group to make the purchase. The company most frequently nominated for this purpose was DPC. W also had a legal practice in which he employed C as an articled clerk. C also happened to be the managing director of Consul Development Pty Ltd (hereinafter C Co) which, amongst other interests, was in the same line of business as W's group of companies. Owing to the physical proximity between the commercial and legal offices of W, the latter's manager (G) and his articled clerk (C) soon became friends. C knew that G had certain obligations towards both W and DPC but he was unclear as to the precise nature of these obligations. Over a period of time G began, through C, to assist C Co, instead of W's group, in the acquisition of certain properties. In commending these properties to C (and hence to C Co) G allowed C to understand that W's group of companies were uninterested in them because the group were in dire financial straits, and were consequently unable to make the purchases. Although it was true that the group were experiencing severe financial stringency, it was not true that they were not interested in the purchase of the properties. C independently confirmed that W's companies were in financial difficulties but he did not proceed to confirm with W the suggestion that the latter was uninterested in the purchase of the properties. Probably to avoid social embarrassment C did not inform W that C Co was purchasing these properties. Although the various properties were

55 Ibid (emphasis added).

56 The view of Sachs and Edmund Davies L JJ in *Carl Zeiss* was followed by Goff J in *Competitive Insurance Co Ltd* v *Davies Investments Ltd* [1975] 3 A11 ER 254, at 263 and (albeit *obiter*) by the Court of Appeal in *Belmont Finance* (see n 25) at 267, 268, 270, and 275. However, the test propounded in *Selangor* and *Karak* was preferred in *Rowlandson* v *National Westminster Bank Ltd* [1978] 1 WLR 798, 805.

57 See n 3. *Consul Development Pty Ltd* v *DPC Estates Pty Ltd* (1975) 132 CLR 373.

purchased in the name of C Co there was an agreement between C and G that G and C Co were to be given equal rights and obligations in respect of the purchased properties. In short, G and C Co were to be equal partners in these joint ventures. These properties had not been resold at the time of litigation.

DPC commenced suits against G and C Co, claiming, *inter alia,* an account of profits for DPC. At first instance, Hope J dismissed the suits against both G and C Co on the ground that DPC had no *locus standi* to sue because it could not be proved that W would have nominated DPC to make the purchases. DPC then appealed to the Court of Appeal Division of the Supreme Court of New South Wales,[58] which held (1) that DPC did have *locus standi*; (ii) that DPC was entitled to an order against G for an account of profits because the latter had acted in breach of his fiduciary obligations towards W's group of companies in that G had preferred his own interest to the interests of W's companies; and (iii) that DPC — Jacobs P dissenting on this point — was entitled to treat C Co as a constructive trustee of the purchased properties because C Co had participated (through C, its managing director) in G's dishonest design against W's companies.

C Co, but not G,[59] appealed against this decision to the High Court of Australia. The High Court (McTiernan J dissenting) allowed C Co's appeal.

Stephen J, with whose judgment Barwick C J agreed,[60] preferred the test of knowledge propounded by Sachs and Edmund Davies L JJ in *Carl Zeiss* to that propounded by Ungoed-Thomas J in *Selangor.* His Honour said:[61]

> In my view the state of the authorities as they existed before *Selangor* did not go so far, at least in cases where the defendant had neither received nor dealt in property impressed with any trust,[62] as to apply to them that species of constructive notice which serves to expose a party to liability because of negligence[63] in failing to make inquiry. If a defendant knows of facts which themselves would, to *a reasonable man,*[64] tell of fraud or breach of trust the case may well be different, as it clearly will be if the defendant has *consciously refrained* from enquiry for fear lest he learn of fraud. But to go further is, I think, to disregard equity's concern for the *state of conscience of the defendant.*

Applying the foregoing proposition of law to the facts of the case, his Honour held:[65]

58 See n 1.

59 In fact, G did not defend the suit against himself. (See 132 CLR 373, at 374).

60 See n 3.

61 132 CLR 373, at 412. (Emphasis added).

62 The words in this parenthesis should be *contrasted* with what Stephen J himself said in *Consul.* 411 (see also n 10).

63 It may be respectfully doubted whether *any* species of constructive notice has ever been based on *negligence,* as distinct from omission in bad faith, to make inquiry. See n 20 supra.

64 It is submitted that in the context of the cited passage Stephen J must be taken to mean "an honest man" when he uses the phrase "a reasonable man". Furthermore, his Honour in context, was referring to the subjectively understood honest person.

65 Ibid, 413-414. (Interpolations and emphasis added).

> In my view the law, as it now stands, did not require Clowes (C) to make inquiry *once he believed that the Walton (W) Group was not in the market for the properties* here in question. He had been told this by Grey (G) and his own knowledge of the Group's financial situation, confirmed by his inquiries, supported the apparent truth of Grey's (G's) statement. In that situation, *a reasonable, honest man*[66] would not, in my view, have had knowledge of circumstances telling of breach of fiduciary duty by Grey (G). This being the farthest extent to which any possible doctrine of constructive notice may go in such a case it follows that the doctrine, even if applicable, cannot impute to Consul (C.Co.) the knowledge necessary to render it liable to the plaintiff (D.P.C.). Accordingly in my view the remedy of constructive trusteeship is not available as against Consul (C.Co.) even if D.P.C. were found to have proper standing to sue. I would, therefore, allow this appeal and I find it unnecessary to determine D.P.C.'s entitlement to sue.

Stephen J thus firmly rejected the view that a merely negligent failure to inquire as to the possible existence of fraud was enough to fix a person with notice of fraud. His Honour, therefore, rejected the test of the circumspect person. But did his Honour proceed to endorse the test of the objectively posited honest person? In the writer's view, it is to be regretted that his Honour did not do so. His Honour appeared to think that the relevant knowledge could not be attributed to a defendant unless such knowledge had been wilfully averted[67] by the defendant. This approach appears to be as exceptionable as that of Sachs and Edmund Davies LJJ in *Carl Zeiss*. Furthermore, it is submitted that Stephen J's failure to apply the test of the objectively posited honest person led his Honour to the error of exonerating the defendant. It is submitted that in *Consul* an honest person in C's position would have discovered the truth by taking the simple step of asking his employer, W, whether or not the latter was interested in the purchase of the properties. It cannot be seriously suggested that, given C's knowledge of W's general commercial interests and of G's general duties towards W and his group of companies, C had no doubt whatsoever that W was not interested in the purchase of the properties in question. And if, as must almost certainly have been the case, C did have his doubts, then why did he not promptly and simply remove them by asking W the short but crucial question: was W interested in the properties or was he not? It is submitted that C's subjectively clear conscience (i.e., his view that there was no impropriety in *not* checking G's statement with W) did not represent the conscience of an honest person. It is hoped that the judiciary will eventually recognise the objective status of the honest person, and so apply honesty as a *community standard,* and not as conduct which happens to harmonise with the conscience of a particular individual.

Although Gibbs J expressed his preference for *Selangor* over *Carl Zeiss,* his Honour did not find it necessary to decide finally between these two authorities because he was able to find in favour of C Co even on the assumption that *Selangor* (which his Honour thought to have prescribed

66 Because of the self-contradiction inherent in Ungoed-Thomas J's test in Selangor ("an honest, reasonable man"), it is to be noticed that Stephen J in *Consul* has used this phrase ("a reasonable, honest man") in a context which denotes it in *one* of its two (mutually inconsistent) aspects only, i.e., the *honest* person (omitting the other aspect — the *circumspect* person). Indeed, Stephen J went further in that his Honour used it to denote the subjectively understood honest person.

67 See n 61.

the more stringent test)[68] had propounded the correct test.[69] Gibbs J, in common with Stephen J, regarded as critical the finding that C believed that W's companies were not in the market for the properties.[70] Since Gibbs J appeared to apply the test of the circumspect person, his Honour should have asked himself whether or not a *circumspect* person would have *believed* G's statement *without verifying it with W.* His Honour, crucially, failed to ask himself this question. Instead of asking himself this essential question, Gibbs J was content to *assume* the propriety of C's belief in the unverified statement of G that W's companies were not interested in the purchase of the properties. This implicit *assumption* of the propriety of C's belief was regrettable, particularly as a circumspect person in C's position would most assuredly have verified G's statement with W. Gibbs J concluded:[71]

> It follows that *on the facts which Clowes (C) believed to exist,* Grey (G) was not acting in breach of his fiduciary duty in participating in the purchase of the properties. Therefore Clowes (C) did not knowingly participate in Grey's (G's) breach; he neither knew, nor had he *reason*[72] to believe; that Grey (G) was violating his duty, and in the circumstances *an honest and reasonable man*[73] would not have thought it necessary to inquire further.

It is not immediately apparent why his Honour chose to apply the test of knowledge *after* C's knowledge had been determined by his Honour's implicit assumption that C's belief was one which he held without impropriety.

McTiernan J dissented. His Honour thought that C Co ought to be declared a constructive trustee of the properties because, in agreeing through C to share in the properties equally with G, C Co had undermined the loyalty of G in the performance of his fiduciary obligations towards W and his companies.[74]

III Conclusion

In striving to delineate the appropriate tests for knowledge as regards constructive trusts judges have outlined three competing tests, that of the honest person (objectively regarded), the honest person (subjectively regarded) and the circumspect person.

It is contended that the test of the circumspect person should be re-

68 The writer would like to repeat his view that the *Selangor* test is self-contradictory in that it embraces both the less stringent test (the honest person) and the more stringent test (the circumspect person). Unlike Stephen J (see n 66), Gibbs J appears to have selected the more stringent of the two mutually inconsistent standards embraced in the *Selangor* test and simply regarded this standard as representing the *Selangor test.*

69 132 CLR 373, at 398.

70 Ibid at 399-400.

71 Ibid 400. (Interpolations and emphasis added).

72 It is submitted that Gibbs J's allusion to the need for reasonable conduct denotes his preference for the test of the circumspect person.

73 This hapless phrase was used by Gibbs J to describe the circumspect person, yet it was used by Stephen J in the same case to describe the subjectively understood honest person (see n 66).

74 132 CLR 373 at 385-386.

jected because, as in *Consul's* case, a mere negligent failure as to the possible existence of fraud is not enough to fix a person as a constructive trustee. The difficulty with the honest man subjectively regarded is that such a test becomes too closely concerned with the particular conscience of the person whose conduct is being scrutinised.

The proper test, it is submitted, is the honest person, objectively regarded. Such an honest person could well be under a duty to make inquiries even though they may be less extensive than a circumspect investigator. There is thus a need for equity to enforce on trustees the conscience and conduct of the kind the community would regard as honest. Such objectively would protect the community from lower standards of a particular group of individuals.