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Welcome to the February 2015 edition of Herbert Smith Freehills’ fraud bulletin.

This update has been prepared by members of Herbert Smith Freehills’ trusts, fraud and asset tracing group, across a number of our offices. We intend to issue an edition of the fraud update bi-annually.

A focus of this update is on interim relief in the English courts. Notwithstanding the wide number of forums available for claimants, the English courts remain the forum of choice for many fraud claimants. This is, at least in part, no doubt due to the wide-ranging interim relief available from the court, in particular freezing injunctions and search orders. A number of recent decisions have clarified certain aspects of these and in this update we consider these cases.

There have also been developments in substantive areas of law following decisions of the Supreme Court and Court of Appeal, in particular in relation to the ownership of bribes (an issue where, following the 2011 Court of Appeal decision in Sinclair v Versailles, English law has been at odds with the law in other common law jurisdictions) and dishonest assistance.

Additionally, the European Union has, for some time now, been engaged in a consultation in relation to European Account Preservation Orders. This is a topic Robert has a particular interest in and we include in this update a report on a recent conference on EAPOs hosted by Herbert Smith Freehills.

We would like to thank all the contributors for their assistance in producing this fraud bulletin.

We hope that you find the update useful.

Robert Hunter and Gareth Keillor
On 14 May 2014 the Court of Appeal, delivering judgment in Lakatamia Shipping1, resolved an important issue in relation to freezing injunctions which had been the subject of conflicting decisions at first instance. The Court of Appeal confirmed that the standard form freezing injunction over a defendant’s “assets” does not directly freeze the assets of a company wholly owned and controlled by the defendant. However, the company’s assets in that case were nevertheless affected by the freezing injunction. This is because the standard form freezing injunction prohibits a defendant from dealing with his assets in a way which diminishes their value. Since causing the company to dispose of its assets diminished the value of the defendant’s shareholding in the company, such disposition would be a breach of the freezing order by the Respondent.

This article considers some of the strengths and weaknesses of the Court of Appeal’s judgment from the claimant’s perspective. It also considers alternative methods of preventing dispositions of the assets of a company owned and controlled by the defendant. It seeks to demonstrate that the judgment does not provide valuable protection for claimants pending further disclosure under the order.

BACKGROUND

The Lakatamia Shipping decision dealt with the interpretation of the standard form of freezing order which is set out in the Annex to Practice Direction 25A to the Civil Procedural Rules.

Paragraph 5 of the standard form freezing order provides that the respondent must not remove any of his assets; or dispose of, deal with or diminish the value of any of his assets up to a specified value.

Paragraph 6 provides that the order applies to “all of the Respondent’s assets whether or not they are in his own name and whether they are solely or jointly owned. For the purpose of this order the Respondent’s assets include any asset which he has the power, directly or indirectly, to dispose of or deal with as if it were his own. The Respondent is to be regarded as having such power if a third party holds or controls the asset in accordance with his direct or indirect instructions.”

The Commercial Court also has its own standard form freezing order2. It is similar to the wording above save for an important additional phrase. This provides that the order applies to all of the Respondent’s assets “whether the Respondent is interested in them legally, beneficially or otherwise.” It has been held that this additional wording has the effect of extending the freezing order to assets which a defendant holds on trust for third parties ie, assets in which the defendant has legal, but not beneficial, interest3.

However, neither standard form orders make it expressly clear whether assets held legally and beneficially by a company which is wholly owned and/or controlled by the defendant are covered by the order. This is an important practical point as it is commonplace for individuals to hold assets through corporate structures either for legitimate reasons (eg, tax) or to mask ownership.

On one hand, it can be argued that such a company’s assets are caught by the freezing order as a matter of practical reality. This is because the owner of a company can “by resolution at the general meeting or otherwise, access and direct the fate of the assets of the companies which he thus owns or controls”4. Therefore, as according to the standard form freezing order, the assets of the company are assets which the defendant “has the power, directly or indirectly, to dispose of or deal with as if [they] were his own” (emphasis added). This is one of the grounds on which Mr Justice Burton in Lakatamia Shipping5 had found that the company’s assets were caught by the order.

However, to treat the company’s assets as if they were the defendant’s also seems to contradict the long held principle, established in Salomon v Salomon Co Ltd6, that a company is a separate legal person. Accordingly a company beneficially owns all of its assets, even if it is wholly owned and controlled by one person. This was the basis upon which Mr Justice Hildyard in Group Seven Limited v Allied Investment Corporation Limited and Others7 had found that the company’s assets were caught by the order.

FREEZING INJUNCTIONS
WHOSE ASSETS ARE COVERED?

Lakatamia Shipping Company Limited v Nobu Su & Ors
[2014] EWCA Civ 636

FROM TOP
Gareth Keillor, senior associate
Jade Hu, trainee
(delivering judgment on the same day as the High Court in Lakatamia Shipping) held that the assets of a company in which the respondent held shares could not be affected by the grant of a freezing order. Any dispositions of the company’s assets were therefore made by the company and the defendant acted merely as its agent. This was so even though Hildyard J in Group Seven acknowledged that it is common for defendants to control companies and use their assets as if they were the defendant’s own. Hildyard J observed that his reasoning “may dilute the efficacy of the standard CPR form of freezing order, and surprise and unsettle not a few; but to my mind, there is no escape from it.”

LAKATAMIA SHIPPING: THE COURT OF APPEAL’S DECISION

The Court of Appeal’s decision in Lakatamia Shipping resolved the conflict created by the two High Court decisions referred to above. It upheld the principle in Salomon v Salomon and concluded that the order does not directly freeze the assets of companies wholly owned and controlled by the defendant. However, the company’s assets in this case were nonetheless “covered by” the order. This is because the order prevents the defendant dealing with the assets in a way that could diminish the value of the defendant’s shareholding in the company. This does not, however, prevent the company from dealing with its assets in the ordinary course of business. This is because such dealing does not ordinarily result in a diminution in the value of the shareholdings in that company.

The judgment provides much needed clarity on the effect of freezing injunctions on the assets of companies wholly owned and controlled by defendants. The previously conflicting judgments of the High Court were likely to have been particularly problematic for banks and other institutions holding the assets of these companies. If these institutions froze the company’s assets, they risked claims by the defendant and/or company on the basis that the correct interpretation of the order did not cover those assets. However, if they did not freeze the company’s assets, they risked being in contempt of court.

The judgment also illustrates the Court’s desire to respond to the changing practices of modern fraud and ensure that freezing orders provide effective protection for the interests of claimants pre-judgment. Had the Court of Appeal held that a freezing order could not, in any circumstances, affect the assets of a defendant’s company, a defendant could seek to avoid the effect of such an order by transferring his assets to a wholly owned and controlled company. Indeed many fraudsters do hold their assets in this way so if the Court of Appeal had held this then a freezing order would have been made much less valuable in many cases.

However, whilst the judgment can be welcomed for safeguarding claimants against abusive dispositions, it only affects a non-defendant company’s assets to the extent of preventing the defendant from taking steps to diminish the value of his shareholding. It does not go as far as freezing the company’s assets and the company is free to deal with those assets in the ordinary course of business. For banks and other third parties holding the company’s assets, this might create uncertainty as to when a freezing order might be breached. Some businesses are, by nature, riskier than others and such companies might conceivably make a loss (which could affect the defendant’s shareholding) even in the ordinary course of business. Further, the effect of the standard form order in light of Lakatamia Shipping on such institutions is also unclear.

This is unsatisfactory since freezing orders should make it clear to third parties what the effects of such orders are. It would be unrealistic to expect such institutions to scrutinise business decisions to determine whether they might diminish the defendant’s shareholding in the company. In practice, banks might be inclined to permit dispositions as the prospect of being sued by a customer for breach of mandate is more immediate than liability for contempt of court. Therefore, whilst the Court of Appeal’s judgment seems to enhance the reach of freezing orders, its effect might also be to undermine their enforcement. Further, the approach in Lakatamia Shipping also appears inconsistent with the general intention of freezing orders which is to freeze assets and prevent their
disposition, rather than the perhaps more abstract objective of preserving their value.

These concerns are only likely to arise where the relevant company carries on a business. In many cases, the claimant is likely to be concerned with the assets of companies that are non-trading companies. In such cases, it is likely that any disposition of the company’s assets will breach the freezing order.

**ALTERNATIVE REMEDIES**

Given the potential uncertainty in applying Lakatamia Shipping for claimants, it might be worth considering alternative remedies to protect claimants pre-judgment.

A more effective way of controlling the assets of companies owned and controlled by the defendant is for the Court to exercise the Chabra jurisdiction. This refers to the Court’s jurisdiction to grant freezing orders against third parties against whom the claimant has no claim but who appear to hold assets on behalf of the defendant. For claimants and third parties, the primary advantage is that it effectively freezes those third parties’ assets. Therefore banks and other financial institutions holding the company’s assets can be more certain as to whether they are required to take steps to enforce the freezing order. This in turn provides greater certainty of protection for claimants.

However, to exercise the jurisdiction, the Court must be satisfied that the company’s assets would be amenable to some process, enforceable by the Court, by which they would be available to satisfy a judgment debt against the defendant. Therefore, the jurisdiction might be appropriate where, for example, the company is a creditor of the defendant or receives assets transferred by the defendant in fraud of creditors. Where there is evidence which indicates that a defendant controls the company and is able to have recourse to the company’s assets, this might be evidence from which the Court might infer that the assets are held by the company as nominee or trustee for the defendant as the ultimate beneficial owner. However, the difficulty from the claimant’s perspective is that the claimant may not have sufficient information to justify exercising the jurisdiction at the time of making its initial application. It is likely that such information will only come to light during the course of disclosure which is usually required as part of the freezing order. This is perhaps where the Court of Appeal’s judgment in Lakatamia Shipping may prove to be most valuable.

Whilst the standard form freezing order does not freeze the defendant’s company’s assets directly, it provides some interim assurance for claimants whilst further information about the company is obtained. At the return hearing, at which the Court will consider whether to continue or discharge the order, the claimant will have a clearer understanding (and a stronger case) as to which companies should be joined as defendants to the order. By this stage, it is hoped that the value of the defendant’s shareholding in the company will remain intact. As noted above; however, this is likely to be more effective in relation to non-trading companies than trading companies.

There is also another alternative solution in which the claimant could restrain dealings with the defendant’s company’s assets. However, its effectiveness appears less certain.

It was suggested in Group Seven, and endorsed by the Court of Appeal in Lakatamia Shipping, that the freezing order might be drafted “to restrain dealings in assets of bodies corporate having no or no substantial trading activities which are wholly owned and controlled by the respondent”. The advantage of this approach is that the order can be drafted to define with greater certainty the dealings which are to be restricted. Therefore, the order might impose a cap on the value of transactions that the company enters into or suspend all dealings altogether.

However, the legal justification for drafting the order in this way is unclear. Unless the company itself is made a party to the freezing order (under the Chabra jurisdiction), it is not entirely clear how such wording in the order might overcome the limits imposed by Salomon v Salomon. An alternative explanation is that the Court can restrain dealings with corporate assets by exercising its jurisdiction to pierce the corporate veil and treat the company’s assets as available to satisfy the defendant’s creditors. The purpose of the jurisdiction is to deprive the company or its owner the advantage they would have obtained by the company’s separate legal personality. However, the veil piercing jurisdiction is only exercisable where the company has been deliberately used to evade the obligations or liabilities of the defendant or to frustrate enforcement measures against him. It did not therefore apply in Group Seven or Lakatamia Shipping where there was no evidence of such dishonest use of the company structure to evade the defendants’ liabilities. Where a defendant transfers assets to a company in order to protect himself against a judgment or order that might be made against him, the veil piercing jurisdiction is also unlikely to apply. This is because it only concerns the evasion of existing liabilities rather than protection against future liabilities. In any event there appears to be strong judicial unwillingness to exercise the jurisdiction. In Group Seven, Hildyard J said that veil piercing is “rare in England”.

Further, in Petroleum Resources Ltd v Prest, it was suggested that piercing the veil would be possible only where there is no other remedy available to the claimant. In light of this, it would be unwise to rely on the Court’s jurisdiction to pierce the corporate veil. Therefore, the effectiveness of drafting the order to restrain dealings with corporate assets is uncertain.

**CONCLUSION**

The real value of Lakatamia Shipping is the interim protection it provides for claimants between the granting of the initial freezing injunction and the return hearing. It prohibits the defendant from causing its companies to make any disposition that could diminish the value of the defendant’s shareholdings in them. The claimant can then obtain further information via disclosure to decide whether such companies’ assets should be frozen directly pursuant to the Chabra jurisdiction.

However, the protection under Lakatamia Shipping is not completely satisfactory. Particularly in relation to trading companies, it can be uncertain as to whether a particular disposition should be blocked on the grounds that it may reduce the value of the defendant’s shareholding in the company. There is always the risk that such loss-causing dispositions are inadvertently permitted, hence why it is still necessary for claimants to consider joining the companies as defendants.

Whilst there is an alternative way in which a defendant’s company’s assets can be covered by a freezing order (ie, drafting the other to restrain dealings with such assets), reliance on this may be risky. The Chabra jurisdiction is therefore unlikely to be the preferred method of ensuring such assets are properly frozen.

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**ENDNOTES**

2. Appendix 5 to the Commercial Court Guide.
4. Lakatamia Shipping Company v Nobu Su and Ors [2013] EWHC 1814 (Comm), paragraph 16.
7. [2013] EWHC 1509 (Ch); [2014] 1 WLR 735.
8. Group Seven, paragraph 61.
9. Group Seven, paragraph 65.
11. Group Seven, paragraph 81.
12. Group Seven, paragraph 52.
13. [2013] UKSC 34.
A VIEW FROM HONG KONG:
TOP COURT LOOKS AT ATTRIBUTION OF KNOWLEDGE OF FRAUDULENT ACTS BY DIRECTORS TO A COMPANY


The decision last year by the Hong Kong Court of Final Appeal in Moulin Global Eyecare Trading Limited (in liquidation) v The Commissioner of Inland Revenue applied the English Court of Appeal case of Bilta (UK) Ltd (in liquidation) v Nazir and Others to whether fraudulent actions by directors leading to excess tax payments can be attributed to a company.

Objections to tax assessments
Section 64(1)(a) of the IRO allows the Commissioner to extend the one-month period for a taxpayer to object to a tax assessment, if the taxpayer was “prevented from” lodging an objection “owing to absence from Hong Kong, sickness or other reasonable cause” during that one month.

The circumstances specified section 64(1)(a) are restricted to external factors or any other physical impediment, and do not include other reasons such advice from a new tax advisor.

Corrections of tax assessments
Section 70A(1) of the IRO allows the Commissioner to correct an assessment of tax if the tax charged is excessive due to “an error or omission” in the tax return.

The word “error” means an act done incorrectly, inadvertently. It does not include a deliberate inclusion in the tax returns that a taxpayer subsequently seeks to change.

FACTS OF THE CASE
The liquidators of Moulin Global Eyecare Trading Limited (the “Company”) sought to recover HK$89 million (approximately £6.8 million) of profits tax paid as a result of inflated profits tax returns fraudulently submitted by the Company’s former directors when no taxable profit was actually made in those years. Both applications were rejected by the Commissioner for Inland Revenue (the “Commissioner”).

The liquidators sought judicial review of the Commissioner’s decision. In particular, the liquidators sought to extend the time allowed to object to a tax assessment by the Commissioner. The basis for the claim was section 64(1)(a) of the Inland Revenue Ordinance (the “IRO”). The alternative claims were to correct the Company’s profits tax returns under section 70A(1).

While the Court of First Instance quashed the Commissioner’s decision, the Court of Appeal ruled in favour of the Commissioner. The liquidators then appealed to the Court of Final Appeal.

QUESTIONS BEFORE THE COURT
The Court of Final Appeal considered whether knowledge of fraudulent acts of the Company’s former directors in respect of the tax returns should be attributed to the Company; and, if it should, whether the fraud exception would apply so that those actions would not be attributed.

The liquidators argued that the Company had been unable to file proper returns or object to the original assessment due to the fraud perpetrated by the former directors in respect of the inflated profits tax returns. These actions could not be attributed to the Company, and the Commissioner had erred in law by refusing to reconsider the tax returns and assessments in question.

The majority of the Court of Final Appeal disagreed. Lord Walker, who delivered the majority judgment, considered the history of the concepts of attribution and the fraud exception, in particular referring to the recent English Court of Appeal case of Bilta (UK) Limited (in liquidation) v Nazir and Others. The Court held that attribution was sensitive to the factual and statutory background of the relevant proceedings.

The Court went on to apply the reasoning of Bilta, and distinguished between “liability” cases – in which a company is liable to a third party for its director or employee’s fraudulent conduct (even if the company is in some sense a victim of the fraud) – and “redress” cases – in which a company takes action against its directors and employees for misconduct causing loss to the company.

The fraud exception applies in “redress” cases to prevent a director or employee from relying on his own wrongdoing as a defence – which the Court held to be the proper role of that exception. However, it cannot apply in a “liability” case, and the company must take responsibility for the conduct of its directors or employees.

The Court of Final Appeal held that the facts of this case did not fit comfortably into either a purely “liability” or “redress” case. However, the Court of Final Appeal considered that applying the fraud exception would frustrate the statutory purpose of the IRO, which allows the Commissioner to make assessments based on the tax returns submitted.
ATTRIBUTION AND THE FRAUD EXCEPTION: AN OVERVIEW

Attribution is when an agent’s (such as a director’s) action or state of mind is treated as that of the person himself for the purposes of determining civil liability. This is because companies, unlike natural persons, are unable to act on their own and require natural persons to act on their behalf.

Attribution can occur in three ways, as summarised by Lord Hoffmann in Meridian Global Funds Management Limited v Securities Commission:

1. **Primary rules of attribution:** where actions are attributable by express or implied reference to company law or the company’s own constitutional documents: for example, the board of director’s decisions or shareholders’ resolutions are characterised as actions of the company.

2. **General rules of attribution:** where actions are attributable by way of normal principles of agency, such as the principles of agency or vicarious liability. These general rules are also applicable to natural persons.

3. **Exceptional or special rules of attribution:** where actions are not attributable by general rules of attribution, but by a special rule fashioned by the court for that substantive matter. For example, special rules of attribution may apply in specific statutory regimes.

However, in cases of fraud a person may not be able to rely on attribution. For example, a director of a company may not attribute knowledge of his own fraud to the company in order to defend a claim that he was making a secret profit.

Therefore, the fraud exception would not apply, and the knowledge of the directors of their fraudulent inflation of profits should be attributed to the Company. Accordingly, the appeal was dismissed as the liquidators were not entitled to rely on either:

1. An application to extend the time for objecting to an assessment, as it was not prevented from doing so under the meaning of section 64(1)(a); or

2. An application to correct the tax assessment, since the Company was deemed to have known that the inflated profits in its returns were a “deliberate lie”, which was not an “error” for the purposes of section 70A.

Mr Justice Tang PJ dissented on the application of the fraud exception. He found that the fraud exception was based on justice and common sense, and in this case justice and common sense required the fraud exception to apply to directors’ fraudulent conduct (and therefore making section 70A(1) applicable) in order to avoid the unjust results.

**COMMENTARY**

In making its decision, the Court of Final Appeal placed significant weight on Bilta (which had not been decided when the courts below gave their decisions) and extended its reasoning to the present case involving payment of money to a tax authority.

Together, these two cases provide helpful clarification on the law of attribution and the fraud exception.

This also means that, in cases involving claims by or against third parties (apart from narrow factual exceptions), companies may have to take responsibility for fraudulent acts of their directors and employees, regardless of the loss the company itself suffers. Liquidators thus may find it more difficult to recover funds paid to third parties as a result of fraudulent acts by directors or employees.

However, the English Court of Appeal’s decision in Bilta is being appealed to the Supreme Court of the United Kingdom. It remains to be seen if the Supreme Court will uphold the Court of Appeal’s reasoning with regards to the law of attribution, or if it will apply a different analysis.

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WHO OWNS A BRIBE?

SUPREME COURT CORRECTS "WRONG TURN" IN ENGLISH LAW

Who is the rightful owner of a bribe? Is a bribe or secret commission received by an agent "held on trust" for his principal? Or is the principal’s claim against the agent a personal one for equitable compensation equal to the value of the bribe or commission?

As any practitioner will know, this issue is of critical importance. It affects everything in litigation against dishonest agents, from the nature of the injunctive relief available at the outset to the rights in his insolvency. Perhaps most importantly of all, it affects whether the bribe can be “traced” into the hands of third parties and recovered as “trust” property.

After over 100 years of judicial wrangling and academic debate, the Supreme Court has now decided that bribes and secret commissions are held on trust by an agent for his principal:

FHR European Ventures LLP and others (Respondents) v Cedar Capital Partners LLC (Appellant) [2014] UKSC 45.

In doing so, the Supreme Court overturned various well-known authorities (including Lister v Stubbs and Sinclair v Versailles) and aligned English law with several jurisdictions which long ago broadened the availability of proprietary remedies. The implications are significant. Most importantly, the principal can claim a proprietary remedy against the bribe/secret commission itself, rather than a personal one against the defaulting agent.

BACKGROUND

FHR European Ventures LLP ("FHR"), along with the other claimants in the proceedings, had purchased the Monte Carlo Grand Hotel (the "Hotel"). The Defendant and Appellant, Cedar Capital Partners ("Cedar"), had acted as FHR’s agent in negotiating the purchase price of €211 million for the sale and, as such, owed fiduciary duties to FHR. On the side, unknown to FHR, Cedar had entered into an “exclusive brokerage agreement” with the seller of the Hotel, which provided for Cedar to receive a €10 million fee (the “Brokerage Fee”).

FHR brought proceedings to recover the Brokerage Fee from Cedar. At first instance, Simon J agreed that Cedar had not given proper disclosure of the exclusive brokerage agreement to FHR and that, accordingly, Cedar was liable to FHR in the sum of €10 million (ie, the amount of the Brokerage Fee). The judge refused, however, to award Cedar a proprietary remedy to the Brokerage Fee on the basis that Cedar had received the Brokerage Fee on trust for FHR.

The Court of Appeal unanimously overturned Simon J on the question of whether a proprietary remedy was available. The court noted, however, that the case law was a mess. In conclusion, the Chancellor noted:

“If the law is to be made simpler and more coherent...then that suggests a need to...provide an overhaul of this entire area of the law of constructive trusts in order to provide a coherent and logical legal framework...If that can be done at all by the courts...it can only be accomplished by the Supreme Court”.

A BRIEF HISTORY OF THE ISSUE

To understand the position in English law, you have to go back to the Court of Appeal decision in Lister v Stubbs (1890) LR 45 Ch D 1.

The appeal concerned an application for injunctive relief against three properties owned by Mr Stubbs. Stubbs had bought the properties with secret commissions obtained in the course of his employment with Lister. The Court of Appeal dismissed Lister’s appeal, holding there was no basis in law or policy which justified granting it a claim to the properties. Their claim against Stubbs was a personal one for compensation equal to the amount of the original commissions. Lister established (or confirmed, depending on how you interpret the preceding cases) the proposition that a principal has no proprietary claim to his agent’s bribes or secret commissions.

The court in Lister seemed most concerned by the policy implications of granting a proprietary remedy. If Lister could assert title to Stubbs’ properties, it would not only get a windfall (through any increased value in the properties) but it would also take the properties as secured creditors of Stubbs to the prejudice of any unsecured creditors on Stubbs’ bankruptcy.

To its detractors, Lister represented a “wrong turn” in English law, unsupported by prior authority (bar another Court of Appeal decision in Metropolitan Bank v Heiron (1880) 5 Ex D 319) and cutting across the 19th century theory of fiduciary duties. To its supporters, however, Lister confirmed an important breakwater between the scope of liability founded upon fiduciary obligations and the “hard-nosed rights” central to the English law.
of property. In no sense could bribes or secret commissions – originating from a third-party - be considered a principal’s “property”, so why should a principal be able to claim them as his own?

This more conservative view grew unfashionable in the late 20th century. While several English cases upheld the rule in Lister, there was growing dissent outside the courts. One of the most vocal critics was Sir Peter Millett (writing ex-judicially), who argued that it is integral to the law of fiduciary duties that equity will not allow an agent to keep a bribe/secret commission received in violation of duty.

Further noises off came from other common-law jurisdictions, including Singapore, Canada and Australia all of which rejected Lister and Heiron. Most notably, in Attorney General v Reid [1994] 1 A.C. 324 - a Privy Council case involving a Hong Kong public official – Lord Templeman refused to follow Lister, holding that the availability of proprietary remedies was essential in the fight against bribery, “an evil practice which threatens the foundations of any civil society”.

**Sinclair v Versailles**

Despite this trend, when the issue arose again before the English Court of Appeal in Sinclair v Versailles [2011] EWCA Civ 347, Neuberger LJ (as he was then) criticised the reasoning in Reid, and roundly rejected submissions that it should be followed in preference to Lister. In defining the scope of proprietary remedies, he set down a two-category test. A principal would have a proprietary claim against an agent where:

- the bribe/secret commission is or came from the principal’s own property (Category 1); or
- the bribe/secret commission was derived from some “opportunity or right” which was “properly” or “beneficially” that of the principal (Category 2).

If the bribe/secret commission did not fall into Categories 1 or 2, then the principal would be left with only a personal claim against the agent.

The problem with this formulation (as subsequent courts discovered) was that it proved exceptionally difficult to apply in practice.

With Category 1, a proprietary claim might turn on the narrow and arbitrary factor of how the bribe/secret commission was accounted for. For example, if the bribe came to the agent directly from the principal (eg, the agent took money from the principal, pocketed his share and passed on the remainder to a third party), the principal would have a proprietary claim. If, however, the agent passed all of a payment from his principal to a third party, who then transferred a bribe to the agent, the claim would be merely personal.

In respect of Category 2, the test was even harder to apply. First of all, what did it mean? An agent may be charged with obtaining various opportunities for his principal as part of his office. In FHR European Ventures itself, Cedar was appointed to obtain the “benefit” of the Hotel for FHR. However, was it not also part of that benefit (or an “opportunity” within that benefit) that FHR should obtain the lowest possible price? If the seller was prepared to pay €211 million for the Hotel, on the basis it would have to pay the Brokerage Fee to Cedar, then surely it would have been prepared to pay less for the Hotel if no Brokerage Fee had been payable?

As the Court of Appeal in FHR European Ventures concluded, following the “very considerable difficulties” of applying the test, the effect of Sinclair had been to make the law “more complex and uncertain...dependant on very fine factual distinctions”. An overhaul was clearly in order.

**SUPREME COURT DECISION**

If ever a close-run decision, with several dissenting judgements, was to be expected, it was on this issue. The Supreme Court doubtless acknowledged, however, that after so many years of confusion, certainty in the law was required. The clear, unanimous and concise judgment provides a conclusive final chapter to the debate (at least, as far as the courts are concerned).

The Supreme Court started by identifying the basic proposition that in some cases where an agent acquires a benefit coming to his notice as a result of his fiduciary position or pursuant to an opportunity resulting from his position, the equitable rule is that he is to be treated as having acquired the benefit on behalf of his principal so that it is beneficially owned by the principal (“the Rule”). The question was whether, as a matter of authority and policy, the Rule applied (or should apply) to bribes/secret commissions.

After reviewing the case law, the Supreme Court concluded “it was not possible to identify any plainly right or plainly wrong answer to the issue...as a matter of pure legal authority”. Instead, the conclusion was necessarily one which must be based on principle, practicality and policy.

The Justices rejected what might have been two middle-ground alternatives. There would be no revisiting the “remedial constructive trust”, a feature in some common law jurisdictions (eg, Australia), but long-ago rejected by the English courts. Similarly overlooked was the suggestion that the problem could be bridged simply by extending the scope of equitable accounting to allow personal claims against an agent equal to the value of the original bribe/secret commission and the value of any investments made with it.

Rather, FHR’s argument that the Rule should encompass bribes and secret commissions had the merit of simplicity, and avoided the painstaking factual enquiries as to ownership which the test in Sinclair had provoked. Further, and echoing the views of Lord Templeman in Reid, it was appropriate that the law should be particularly stringent when it came to bribes/secret commissions, which “undermine trust in the commercial world”. Accordingly, FHR’s proprietary claim to Cedar’s Brokerage Fee was allowed.

**COMMENT**

The judgment marks a watershed moment in the law governing proprietary remedies and signals a significant departure from a position in English law which - while widely criticised and somewhat unclear - had a line of continuity in the Court of Appeal. The decision overrules that authority, placing English law in line with other common law jurisdictions, and also endorses the Privy Council decision in Reid. There is also the intriguing personal sub-text of Lord Neuberger effectively overruling himself in Sinclair.

**The practical implications are significant**

Firstly, the rule is not confined to agents and principals. It encompasses all manner of fiduciary relationships, including employer-employee (eg, Lister v Stubbs), company-director (eg, Sinclair v Versailles), some categories of public official (eg, AG v Reid) and - of course - trustee-beneficiary.

Secondly, the availability of a proprietary claim to a bribe/secret commission provides a claimant principal with a nuclear weapon in any litigation against a corrupt agent. Granting a proprietary base in bribes/secret commissions will enable the principal to trace into the agent’s assets (and into the assets of any third-party knowing recipients) and claim any fruits of the fraud (eg, lucrative investments). If, of course, the agent’s investments have tanked, the principal can elect to pursue a personal claim against the agent equal to the amount of the original bribe/secret commission instead.

Thirdly, the bolt-on to these proprietary missiles will be an extended arsenal of ancillary relief. In addition to any freezing injunction against an agent, the principal may
also be able to obtain proprietary injunctions to freeze bribes/secret commissions and their traceable proceeds. Chabra relief may also be available against third parties holding bribes/secret commissions for the agent.

Fourthly, proprietary claims to bribes/secret commissions are not to be timed barred. Because the fiduciary holds the bribe/secret commission “on trust” for the beneficiary, any proprietary claim to it may amount to an action “to recover...trust property or the proceeds of trust property in the possession of the trustee” (within the meaning of s.21(1)(b) of the Limitation Act 1980).

Fifthly, the ruling will further shift the emphasis in civil bribery cases towards factual enquiries concerning the circumstances surrounding secret payments. It will be more important than ever for agents to ensure any conflict of interest or side deal which might compromise their duty of loyalty are properly disclosed and approved in writing by their principals.

Finally, and perhaps most significantly, the availability of proprietary remedies has the potential to pose problems for insolvency practitioners. As claimant-principals will now be able to assert title to bribes/secret commissions in their agent’s hands, unsecured creditors may lose out. While this was one of the primary reasons for the reluctance of the courts since Lister to the extent of the scope of proprietary remedies, the Supreme Court considered the concerns were outweighed by the arguments in favour of granting enhanced relief to the principal.

There will certainly be critics of the decision. Lister and Sinclair had their supporters, particularly among property lawyers. There will be concerns that, with no discretion to avoid “the Rule” in relation to bribes/secret commissions, it has the potential to prejudice creditors on the insolvency of an agent/trustee, or unduly penalise unscrupulous agents whose principals may not in fact have suffered at all from their breach of duty. All this remains to be seen. What can be said for now is that – at long last - the position in English law is certain.

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FREEZING INJUNCTIONS

THE CROSS-UNDERTAKING IN DAMAGES

This article focuses on the cross-undertaking in freezing injunctions. However, a cross-undertaking in damages can be required in relation to any injunction, not just a freezing injunction and the same principles will apply.

A freezing injunction is a powerful weapon for a litigant, often described as the nuclear weapon of English litigation. When it is deployed appropriately it can provide a significant tactical advantage; in converse, if a freezing injunction is not obtained when it should have been, assets may be dissipated, rendering any judgment extremely difficult to enforce and therefore of little value.

However, given the dramatic power which a freezing injunction grants to an applicant, there is a price to pay: the Court expects the party seeking the freezing injunction to be ready to compensate the other side if the injunction is later found wrongly to have been granted, the so-called “cross-undertaking in damages”. This article considers some issues in relation to the cross-undertaking arising from recent case law, as well as some practical points for applicants and respondents.

CROSS-UNDERTAKING IN DAMAGES

The standard form of cross-undertaking appears at B1 of the standard form freezing injunction. It reads as follows: “if the court later finds that this order has caused loss to the Respondent, and decides that the Respondent should be compensated for that loss, the Applicant will comply with any order the court may make”.

A separate undertaking in favour of third parties is also included in the standard form freezing injunction at B7:

“The Applicant will pay the reasonable costs of anyone other than the Respondent which have been incurred as a result of this order including the costs of finding out whether that person holds any of the Respondent’s assets and if the court later finds that this order has caused such person loss, and decides that such person should be compensated for that loss, the Applicant will comply with any order the court may make.”

The effect of this, in simple terms, is that if the court later finds (commonly at trial) that the freezing injunction should not have been granted, then the party who obtained the injunction can be ordered to compensate the respondent (and any third parties) for any losses they have suffered as a result of the injunction. The cross-undertaking can therefore have far reaching implications.

There are issues for both the applicant and the respondent, and we consider these each in turn.

APPLICANT

A first starting point is whether the applicant needs to offer an undertaking at all. In the ordinary course it will be necessary to do so as the price for obtaining the injunction. There are, however, some (albeit few) applicants who may be exempt from giving the undertaking. FSA v Sinaloa Gold established that in the case of public authorities seeking a freezing injunction, the starting point is that they should not have to offer an undertaking – in contrast to the usual position where the presumption is that an undertaking will be given – on the basis that these are parties under a duty to pursue action. However, the Supreme Court in Sinaloa Gold also held that in special circumstances even a public authority may have to give a cross undertaking.

It is also relevant to note that the Court cannot require a party to give an undertaking, although the court can refuse to grant the injunction (or to discharge an existing injunction) if a party declines to do so. It is for the party to give the undertaking to the Court.

Assuming an undertaking does have to be given, what then are the consequences? For an applicant they are potentially far reaching. The undertaking comes into play only if the injunction is ultimately discharged or found not to have been properly granted (most commonly if the claimant/applicant fails in its substantive claim). However, at the time of applying for the freezing injunction there may only be a limited understanding of the merits of the underlying claim; yet the applicant is assuming a risk that could come back to bite it.

However, the significance of the cross-undertaking can be overlooked, not least because often a freezing injunction is embarked upon on short notice under real pressure. For example, a company may have discovered that it has been defrauded and it needs to obtain an injunction against the suspected fraudster, or it may become aware that a defendant is about to transfer monies out of the jurisdiction. It is therefore often a decision taken quickly and at a time of uncertainty. However, the significance of the cross-undertaking is an issue on which legal advice should be given to the applicant (and which the applicant should ensure it fully understands) before seeking injunctive relief.

The applicant should therefore consider whether the benefits of obtaining injunctive relief outweigh the potential risks of assuming a liability to the respondent (and third parties) and potentially having to pay damages under the cross-undertaking.

If there is a concern about exposure under the cross-undertaking, an applicant may wish to include modifications to the usual form of order to seek to protect from later claims. If, for example, the business is a trading business then the order could confirm that the business is permitted to trade. This would ordinarily be the case in any event, providing the trading is in the ordinary course of business and not an attempt to dissipate, but to protect the applicant the point could be made explicit in the order. Other transactions could also be carved out from the order if the applicant is aware of an imminent transaction.

RESPONDENT

From the respondent’s perspective, the first thing to do is check that the freezing injunction contains the cross-undertaking. If it does not, then you will wish to press for it immediately – you will have no recourse for any losses suffered until there is an undertaking in place.

Even if an undertaking has been given, is it fortified (ie, are there any assets there to back
up the promise? Whilst the undertaking is a promise to the Court to compensate for losses caused, that promise is only as a good as the person giving it. The applicant will usually be required to provide evidence as to its ability to satisfy any order made under the cross-undertaking. You will want to scrutinise this evidence to ensure that there really are assets available, and that those assets are ones that can easily be enforced against. In particular you will want to ensure that there are assets within the jurisdiction.

If there is any doubt as to the credit worthiness of the applicant, a respondent will want to ensure that security is provided, commonly by way of a bank guarantee, to ensure that there is an asset against which to have recourse in the event the undertaking is called upon. If the undertaking is not then properly fortified then this can be a reason why the injunction should be discharged.

Even if it is fortified, is it fortified to an adequate level? You will need to consider what potential losses might be suffered as a result of the injunction - do they exceed the level of security for the cross-undertaking? If so, then you will want to consider increasing the level of security provided. It will, however, be necessary to demonstrate to the court, with evidence and on the standard of good arguable case (1) the level of likely loss; (2) that there is a risk of loss to require fortification and (3) that the loss is likely to be caused by the injunction. This can be an important tactical step as if the applicant is unable to offer an appropriate level of fortification then the injunction could be discharged. Alternatively, providing the security will tie up assets of the applicant, or incur costs (eg, fees for a guarantee).

Whilst the cross-undertaking provides a respondent with some level of comfort, it is important to remember that it will still require the respondent to demonstrate that he suffered loss as a result of the injunction. That will require clear evidence and it is important that a respondent ensure that any losses suffered are evidenced.

Moreover, the respondent has a duty to mitigate its losses. Therefore it is not open to a respondent simply to sit on its laurels and, for example, allow a corporate opportunity to be lost in the expectation that a claim can be made under the cross-undertaking for any loss suffered. The respondent should carefully consider whether to ask the applicant to consent to a variation to allow any corporate opportunities to be pursued. Not only does this address the mitigation point, but it will also assist in later evidencing that there was such an opportunity. If the respondent does not ask, it will inevitably be said that there was no such opportunity, or that it was not a genuine business opportunity, and this will be held against the respondent.

It is also important to remember that a freezing injunction does not prevent a party from conducting its ordinary course of business. A respondent should not assume that it cannot continue to operate its business because there is a freezing injunction against the company, or against a shareholder of the company. The respondent should not therefore simply allow the business to run to ruin believing all losses can be placed at the door of the applicant.
CLAIMS UNDER THE CROSS-UNDERTAKING

What types of loss might then be recoverable under the freezing injunction? Clearly much will turn on the particular facts, but common types of loss in a commercial scenario (in addition to legal costs) are likely to be increased financing costs and the loss of corporate opportunities.

The relevant legal principles were considered recently by the Court of Appeal in Hone v Abbey Forwarding. The Court of Appeal made clear that the general principle is that “the court is not awarding damages for breach of contract. It is compensating for loss for which the defendant ‘should be compensated’ (to apply the words of the undertaking). … The court is compensating for loss caused by the injunction which was wrongly granted. It will usually do so by applying the useful rules as to remoteness derived from the law of contract, but because there is in truth no contract there has to be room for exceptions.” [Paragraph 63]. The Court characterised its role as being to award damages for breach of a notional contract rather than contract damages.

To be recoverable the loss must not be too remote and a loss must be of a type which the applicant giving the undertaking should reasonably have foreseen was of the type. It is not necessary for the applicant to have foreseen the particular loss. However, as noted by the passage above, the rules on remoteness are not as strict as in usual contractual cases and the fact that something was unforeseen by the claimant does not necessarily mean that the losses will not be recoverable.

The court will, however, still apply its own test and in particular will need to be satisfied that the injunction was the cause of the loss rather than anything else. Accordingly, it is very important for any respondents to give careful thought as to whether it is the injunction that is the cause of the loss, or something else (such as simply an opportunity).

The Court of Appeal in Abbey Forwarding made it clear that a respondent will be expected to seek variations of the injunction to avoid losses. However, the Court of Appeal recognised that there can be issues for defendants in trying to operate under a freezing order and that it is not always possible to apply for a variation to the order, particularly where a defendant is put under real pressure, as they are in the early stages, and when they are likely just to have been served with a claim.

Similarly, if an applicant is faced with a request for a variation, then unless there is a very good reason the applicant will likely wish to agree to that variation: a refusal to agree significantly increases the prospects of a claim under the cross-undertaking. Moreover, if the business opportunity is genuinely a good one then the interests of the applicant and the respondent are largely aligned. If an applicant is not willing to consent, then good reasons will need to be given to demonstrate the applicant is not simply acting unreasonably. In Abbey Forwarding the Court was critical of the way in which the applicant in that case dealt with the administration of the freezing order and in particular what amounted to a blanket refusal to agree or even consider requests for monies to be released/variations agreed to. As a further warning, the Court in Abbey Forwarding seems to have felt that the applicant’s conduct was relevant to the question of loss: “An unjustified freezing order is one thing; an unjustified freezing order, unreasonably policed is another.” [Paragraph 121]

The Court can also award general damages for unidentified losses in addition to losses for specific damage. Vos LJ stated that “general damages can in an appropriate case be awarded on a cross-undertaking in respect of an inappropriately obtained freezing order for any or all of these elements: upset, street, loss of reputation, general loss of business opportunities, and general business and other disruption including adverse effects of the inappropriate policing of the injunction on injunctees.” [150]

Whilst this is of some benefit to respondents, the quantum of damages for this general category is likely to be relatively low; in Abbey Forwarding the Court of Appeal ordered damages of £750 per month for each defendant. Moreover, the facts of Abbey Forwarding were somewhat extreme and therefore may have made the Court more willing to award general damages.

CONCLUSION

In conclusion, therefore, the cross-undertaking in damages is an important consideration for both applicants and respondents. Abbey Forwarding serves both as a reminder that applicants do have real exposure under the undertaking, and also clarifies the applicable principles for parties seeking to recover under the cross-undertaking.

The main lesson for respondents is the importance to ensure that requests for variations are made. A failure to do so may seriously undermine the party’s ability to recover compensation for losses. The wording for applicants is that they need to act reasonably, as unreasonable or unprincipled refusal to agree to variations to allow corporate opportunities to be pursued may result in financial consequences for the applicant in due course.

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A NEW FREEZING INJUNCTION IN THE UK? THE EUROPEAN ACCOUNT PRESERVATION ORDER

INTRODUCTION

On 9 October 2014, Herbert Smith Freehills hosted an event to discuss whether the UK should seek to opt in to the new EU regulation establishing a European Account Preservation Order procedure (EAPO) Regulation (EU) 655/2014 (the Regulation). The new procedure will allow a creditor to freeze a debtor’s EU bank account up to a specified amount. The UK has currently opted out of the Regulation. All major commercial firms and chambers were invited and almost all sent at least one representative.

The event followed a similar one in 2011, held by Herbert Smith Freehills and attended by the Ministry of Justice, at which attendees had voted overwhelmingly to vote out of the proposed regulation. The Ministry of Justice described the feedback as “helpful” and subsequently opted out. After three years of negotiation the draft regulation has changed dramatically and the Ministry of Justice was seeking feedback as to whether to seek to opt-in in light of the changes.

The panel included Robert Hunter, Mona Vaswani, partner at Allen & Overy LLP, and Eral Knight, Head of Civil Justice Team, EU Division, Ministry of Justice. Eral Knight took points raised in the discussion to the Secretary of State to inform any future decision of the UK to seek to opt-in to the EAPO regime.

WHAT IS AN EAPO?

The Regulation seeks to establish a Union procedure which allows creditors, in cross-border cases, to obtain a protective EAPO which prevents transfers or withdrawals from a debtor’s bank account up to a specified amount. The Commission has estimated that the EAPO procedure will increase cross-border debt recovery in the EU by up to 600 million euros each year, although these figures have been the subject of dispute.

The EAPO procedure applies to both civil and commercial matters, subject to exceptions in Article 2(2), such as arbitrations.

A creditor must have a “cross-border case” to successfully apply for an EAPO (Article 3(1)(a) and (b)). A cross-border case arises where the bank account(s) to be preserved are maintained in a Member State other than:

a) the Member State of the court entitled to hear the application for an EAPO pursuant to Article 6; or
b) the Member State in which the creditor is domiciled.

Unlike the Brussels Regulation, it is the domicile of the creditor rather than the debtor which is immediately relevant to the application.

A creditor can make an application before he initiates proceedings against the debtor in a Member State, at any point during those proceedings or after he has obtained an enforceable judgment against the debtor. There are two different tests for obtaining an EAPO under Article 7. If a creditor has obtained a judgment he must present sufficient evidence to the court to satisfy it that there is an urgent need for an EAPO because there is a real risk that without it the subsequent enforcement of the creditor’s claim will be impeded or substantially more difficult (Article 7(1)). Where a creditor has not attained a judgment it must also satisfy court that it is likely to succeed on the substance of the claim against the debtor (Article 7(2)).

A creditor will not be able to preserve a UK bank account if the UK fails to opt-in to the Regulation.

ANALYSIS OF THE REGULATION

Robert guided the attendees through the Regulation drawing particular attention to those articles which have either undergone significant amendment since 2011 or continue to pose problems for any future UK opt-in.

Robert reminded delegates that, pursuant to Recital 48, creditors domiciled in the UK will not have the benefit of the EAPO procedure if the UK fails to opt-in. This could give rise to an anomalous situation where, for example, a UK partner in a banking syndicate cannot initiate EAPO procedure against a debtor in Germany.
whereas its Spanish co-partner can. There is some concern that this could damage the strong position of London syndicates in the European banking industry.

Amendments to the definition of ‘bank account’ (Article 4) mean that only bank accounts, in the traditional sense of the word, are covered by the EAPO procedure. Robert said that this is a significant improvement upon the position in 2011 where nearly all transactions between banks and their customers came under the definition.

Amendments to Article 14, which allows a creditor to request information about a debtor’s bank accounts, limit the creditor’s ability to carry out ‘fishing expeditions’. Article 14(1) now requires creditors to comply with a three stage test before they can obtain account information. Creditors must prove that:

a) the amount to be preserved is substantial;

b) there is an urgent need for account information because there is a risk that without such information the enforcement of the debtor’s claim will be jeopardised; and

c) that this would lead to a substantial deterioration of the creditor’s financial situation.

Robert said that this was far stricter than the position in the previous draft. Recital 21 provides a further layer of debtor protection by ensuring that any account information released by the bank is given to the court, not the creditor. The amendments raise the bar for creditors seeking to obtain account information and provide more adequate protection for debtors.

Articles 16(1) and (2) restrict a creditor’s ability to apply for parallel EAPO applications and force a creditor to declare if it has made any applications for an equivalent procedure in national courts. However, there remain significant gaps in the drafting of Article 16. The term “parallel” suggests that creditors need only declare EAPO applications occurring at the same time rather than sequentially. A creditor can also apply for an EAPO without disclosing previous failed EAPO applications. This unsatisfactorily allows a creditor to attempt to obtain a debtor’s account information numerous times without disclosing its approach.

Robert drew particular attention to Articles 8 and 11 and the issue of full and frank disclosure. One attendee noted that the reason English freezing orders are respected globally is the requirement for full and frank disclosure. In contrast EU Member States do not generally recognise this requirement. The issue of full and frank disclosure is not resolved by the text of the Regulation and delegates debated whether the UK should take a chance on how other Member States may interpret their disclosure obligations. It was generally thought that no such duty arose under the current draft. The UK exercises trust in the way Member States implement cross-border regulations and it remains to be seen how disclosure requirements under Article 8 will be interpreted.

The Regulation contemplates a situation where the funds subject to the EAPO are greater than the balance of the debtor’s bank account. Delegates expressed concern that the text of the Regulation failed to clarify how the creditor would pay for legal advice in this event. Eral Knight confirmed that legal costs or travel expenses are a matter for national law. This could give rise to an unsatisfactory situation where a debtor is granted permission to use funds, subject to an EAPO, for legal representation in one state but not another. A similar disparity in national experiences could arise in relation to a bank’s ability to set-off. The rules on set off are not dealt with under the Regulation and are reserved for national law leaving considerable scope for conflict.

The EAPO procedure is directed by the courts with, for example, any account information provided under Article 14 being supplied directly to the court. There were concerns that a court-led administration could lead to a slow and inefficient process. Furthermore, the creditor will not have access to account information (Recital 21) which could lead to mistakes, by either the bank or the court, remaining undisclosed. It remains to be seen what forms and procedures develop to facilitate the EAPO procedure.

The attendees discussed the UK’s options going forward with some suggesting that a sensible approach may be to ‘wait and see’ how the Regulation is implemented before committing to opt-in. This would facilitate understanding of how certain problematic articles will be interpreted and whether this has a positive impact on debt recovery across the EU. Eral Knight confirmed that this was a viable option as there is no deadline for a UK opt-in. He also alleviated concerns that a UK opt-in in 2014 would tie the UK to future changes to the Regulation. The Commission will revisit certain elements of the Regulation, particularly the potential for including financial instruments within the definition of ‘bank account’ (Article 4). Any additions or deletions from the Regulation require a new proposal and therefore further approval from the UK.

THOUGHTS AND CONCLUSIONS

At the close of the evening there was a vote on the question ‘Should the UK opt-in to the EAPO Regulation?’ There was an overwhelming result of 60 ‘no’ votes and 4 ‘yes’ votes indicating continued concerns about the EAPO regulation. Eral Knight concluded that the EAPO creates a complex procedure and it remains to be seen how often it will be used in practice.

The Regulation has been watered down significantly but there remain concerns from the UK legal community that the position of debtors is not adequately protected. There appears to be little appetite for a UK opt-in in the immediate future.

As at 1st December 2014 there was still no news as to whether the Ministry of Justice will recommend to the Secretary of State that the UK should seek to opt in to the EAPO regime.

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ENDNOTES

COURT OF APPEAL CONFIRMS AN ACCOUNT OF PROFITS IS AVAILABLE AS A REMEDY FOR DISHONEST ASSISTANCE

Some trustees are appointed at the outset of a trust. Some are appointed to the role at some later stage. And some have trusteeship trust upon them. Within this third category are strangers to a trust who “dishonestly assist” an express trustee in a breach of his fiduciary duties.


Through his dishonest assistance, the stranger will be liable to the injured beneficiary, even though no fiduciary relationship exists between them. Although they are not sued as fiduciaries, they can be held liable to account in equity as if they were a trustee of the beneficiary. Commonly, for convenience (which more often leads to confusion), the stranger is called a “constructive trustee”.

Previously, there was some uncertainty as to the scope of the remedies available for dishonest assistance: specifically, whether the claimant-beneficiary could obtain an account of profits against the dishonest assistant, even though no loss was suffered. The unanimous decision of the Court of Appeal in Novoship v Nikitin confirms the availability of the remedy in claims against third parties for dishonest assistance and also the circumstances in which the remedy will be available, namely where there is a sufficient causal connection between the dishonest assistance and the profit and where it would be not disproportionate to grant the remedy.

BACKGROUND AND FIRST INSTANCE DECISION

The appeal stemmed from a classic case of fraud carried out by an agent, charged with the responsibility of negotiating contracts for the benefit of his principal.

Mr Mikhaylyuk (M) was a former General and Commercial Manager of the first respondent, Novoship (UK) Limited (NOUK), hold co of a group of ship-owning companies. One of M’s responsibilities was to negotiate the charter of vessels owned by companies in the NOUK group (together with NOUK, the “NOUK Companies”). In breach of his fiduciary duties to the NOUK Companies, M orchestrated a series of dishonest schemes, whereby bribes were paid to him in connection with the chartering of the NOUK Companies’ vessels.

The Rupert Scheme
One such scheme involved chartering five vessels, purportedly to the national oil company of Venezuela. In reality, however, the vessels were chartered to companies owned and controlled by Mr Ruperti (R), a Venezuelan shipping magnate, who in turn sub-licensed the vessels at a huge profit (the Rupert Scheme). It was this scheme which involved the First and Second Appellants in the appeal – Mr Nikitin (N) and Amon, a Nevis company owned and controlled by N.

As part of the Rupert Scheme, M directed R to make substantial secret payments both to himself and to Amon. Clarke J at first instance concluded that these secret payments were commissions, paid by R on the hire of vessels as part of the Rupert Scheme. This was plainly a serious and dishonest breach of M’s duties as director and agent of NOUK and its group companies.

As regards N’s involvement in the Rupert Scheme, the judge concluded that:
- N knew that the commissions coming to Amon (his company) were coming from R at M’s direction;
- N knew that the charters in respect of which the commissions were being paid were charter’s to R’s companies; and
- the likely reason for the payments to Amon was that N had provided some benefit or advantage to M (or might provide some such benefit in the future).

All in all, the judge concluded that M and N were parties to a dishonest arrangement whereby M, in breach of his fiduciary duties as director/agent, secured secret payments from a third party (R), which might otherwise have accrued to the benefit of his principals (the NOUK Companies), in connection with the making of contracts on behalf of his principals.

The Henriot Charters
At exactly the same time that M, R and N were carrying out the Rupert Scheme, M and N also negotiated long-term charters of NOUK vessels to the Third Appellant, Henriot, another Nevis company owned and controlled by N (the Henriot Charters, also incidentally the subject of the long-running Fiona Trust litigation). The Henriot Charters were at commercial rates and not – in and of themselves – disadvantageous to the NOUK Companies. However, because M was negotiating the Henriot Charters with N at the same time as carrying out the Rupert Scheme (which involved secret payments for the benefit of N), Clarke J concluded that there was a realistic possibility of a conflict between M’s duty of loyalty to NOUK and M’s personal interest in favouring N in negotiating the Henriot Charters. M’s failure to seek NOUK’s consent – fully informed with knowledge of what was occurring under the Rupert Scheme – to negotiate the Henriot Charters with N was a further breach of M’s fiduciary duties to the NOUK Companies.
As for N, Clarke J held that he was liable for dishonestly assisting M’s breach. This was because N negotiated the Henriot Charters with M when:

- he knew that Amon (his company) had dishonestly received secret payments under the Ruperti Scheme, and had thereby dishonestly assisted M’s breaches of duty in respect of the Ruperti Scheme; and
- by negotiating the Henriot Charters with M, N was “continuing a relationship which was corrupt at inception and had not been cleansed” (ie, M had not disclosed the secret commissions under the Ruperti Scheme to NOUK).

As a third party benefiting under a fraudulent scheme against NOUK orchestrated by its agent, N must have known of M’s conflict of interest and that M could not be trusted to act with loyalty to his principal in negotiating deals with N.

GROUND OF APPEAL: AVAILABILITY OF ACCOUNT OF PROFITS

There were 12 grounds in the appeal, including several concerned with the judge’s findings of fact in relation to M’s breaches of duty and N’s dishonest assistance (all of which were dismissed by the Court of Appeal).

The most notable ground, however, concerned the scope of the claimant’s remedy. For his role in dishonestly assisting M’s breaches in respect of the Henriot Charters, Clarke J had held N personally liable to account to the NOUK Companies for the profits of around $109 million that he and Henriot had made from the Henriot Charters. The respondents appealed on the question of whether an account of profits was available as a remedy for dishonest assistance. If the remedy was available, further issues were:

- whether some causal connection was needed between N’s dishonest assistance and the profits which NOUK was seeking to claim; and
- whether, in the circumstances, it would be right to order the account of profits on the circumstances of the case.

THE COURT OF APPEAL’S DECISION

The appellants’ first argument was that an account of profits should not be available against a third party who had never voluntarily assumed fiduciary obligations to the claimant: a dishonest assistant is not a fiduciary, and has not promised expressly or inferentially to subordinate his interests to a beneficiary. N sought to rely on the recent Supreme Court decision in Williams (Respondent) v Central Bank of Nigeria (Appellant) [2014] UKSC 10
(see our blog post on the decision), in which the court held that dishonest assistants and knowing recipients should be treated in line with common law fraudsters (rather than with defaulting trustees) for the purposes of limitation. Similarly, N argued, as the common law does not strip a fraudster of his gain, the remedy for dishonest assistance should be limited to what is necessary to compensate the claimant for his loss.

The Court of Appeal unanimously rejected this submission. Judicial and academic authority supported the view that an account of profits was available as a result of the dishonest assistant being “accountable in equity” and “liable to account as a constructive trustee”. These expressions could not mean that the extent of the remedy should be limited to the beneficiaries’ losses. If a dishonest assistant is liable to account “as if he were” a trustee, then it followed that he must be liable both (i) to make good the beneficiary’s losses; and (ii) to give an account of profits (Cook v Deeks [1916] 1 AC 554 approved).

This conclusion was justified as a matter of policy, both in order to deter dishonest third parties from compromising the high standards of conduct expected from fiduciaries, and simply as a matter of equity. If a defaulting fiduciary should have to disgorge the fruits of his fraud, why not also a third-party accessory?

Further, and mirroring the decision in respect of limitation in Williams v Central Bank of Nigeria, there was no reason to differentiate between knowing receipt and dishonest assistance for the purposes of deciding whether an account of profits was an available remedy. Relief was “found on fraud” and ought not to turn upon whether or not the third party accessory had received trust property (although it may of course be relevant to whether or not a proprietary claim is available).

A causal connection required

As for causation, the position of a dishonest assistant was different to that of a fiduciary. A fiduciary’s liability to account for a profit does not depend on causation at all; it is sufficient that the profit received falls within the scope of the fiduciary’s duty of loyalty. Where a dishonest assistant was concerned, however, in the absence of duty of loyalty owed to the claimant-beneficiary, the common law rules of causation, remoteness and measure of damages should be applied by analogy to determine the scope of liability. This meant that a simple “but for” test of causation was not appropriate: there needed to be a sufficiently direct causal connection between the dishonest assistance and the profit made (approving Snell’s).

In N’s case, the Court of Appeal held that the causal connection was insufficient. While it was true that “but for” entering into the Henriot Charters, N would not have made a profit, the “real or effective cause” of N’s profit was an unexpected change in the market which allowed him to sub-charter the vessels at a higher rate. N had made a profit by playing the market, not by his dishonest assistance. Discretion where the remedy is “disproportionate”

Finally, the Court of Appeal noted that even if a causal connection had been made out, the decision whether or not to award an account of profits against a non-fiduciary was ultimately a matter for the court’s discretion (with reference to Attorney General v Blake [2001] 1 A.C. 268). An order to account was not an automatic consequence, in the way that it would be for a fiduciary. The remedy could therefore be withheld on the grounds that it would be disproportionate, as was appropriate in the case of N and Henriot.

COMMENT

The decision provides clarity on what was an uncertain issue. There was a growing body of case law at first instance recognising the court’s power to order an account of profits even where the claimant-beneficiary had suffered no loss (see for example Ultraframe (UK) Limited v Fielding [2005] EWHC 1638 (Ch)), and the principle is supported in key textbooks, including Snell’s and Underhill and Hoyton. Until the decision in Novship, however, there was no Court of Appeal authority on the point and, given that the judgment confirmed the court’s general discretion to refuse the remedy in appropriate circumstances, the issue is unlikely to be referred to the Supreme Court any time soon. More generally, the decision is the latest in a line of authority unifying the principles governing knowing receipt and dishonest assistance (see Williams v CBN).

There does seem to be some tension between the basis on which a dishonest assistant is liable and availability of the remedy of account. A trustee’s liability to account for a secret profit arises on the basis that he owes a duty of loyalty to his beneficiary which compels him to account for the profit. It is his failure to perform this duty - and account to his beneficiary immediately upon receiving a bribe or commission - that gives rise to the remedy of account: equity enforces performance of the duty by making the trustee pay-over his ill-gotten gain (see in this regard the recent Supreme Court decision in FHR European Ventures and ors v Cedar Capital Partners [2014] UKSC 44). By contrast, a dishonest assistant (or knowing recipient); never owes such a duty. Their liability to account only arises as a result of their dishonest involvement in another’s breach of duty. Liability is therefore founded on a wrong, rather than a duty. To some extent, this gap between a positive duty to account and the liability to pay it over is bridged by the requirement for a causal connection between the dishonest assistance and the profit, but this simply serves to link the defendant’s actions with the remedy. It does not provide a substitute for a duty which the defendant never owed. As the Court of Appeal concluded, however, the availability of the remedy is consistent with the overarching principle that dishonest assistants/knowing recipients are liable to account “as though they were trustees”.

Further, if relief really is to be “founded on fraud”, it is not clear as a matter of policy why the common law fraudster should be in a better off position for the purposes of relief than a dishonest assistant. Punishing a third party accessory seems a rather indirect way to uphold the high standards expected of fiduciaries (far more effective to this end is the Supreme Court’s recent decision in FHR European Ventures LLP and ors (Respondents) v Cedar Capital Partners LLC (Appellant) [2014] UKSC 45 regarding bribes received by fiduciaries). The court’s general discretion to withhold the remedy of account should help to ensure that it is not used oppressively in dishonest assistance cases. The confirmation of its availability, however, sends out a significant deterrent to would-be fraudsters contemplating schemes with fiduciaries.

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ENDNOTES

HIGH COURT RULES THAT AN ORDER FOR DISCLOSURE SHOULD INCLUDE THE INTERESTS OF THE RESPONDENT UNDER A DISCRETIONARY TRUST

SUMMARY

In the recent Pugachev case1 the High Court upheld a disclosure order, which included assets held by the respondent under numerous discretionary trusts, in order to identify the true extent of his control over trust assets.

The court’s recognition of a disclosure order which includes the respondent’s interests under a discretionary trust is welcome clarification and has practical consequences for those applying and responding to freezing orders. For applicants, this interpretation is helpful given the uncertainty that frequently exists when a freezing order is granted, especially where opaque corporate and trust structures are involved. For respondents, the decision may serve as a warning to those who might seek to rely on discretionary trust structures to shield their assets from the effect of freezing orders.

THE FACTS

The Defendant, Mr Pugachev, was the owner of JSC Mezhdunarodniy Promyshlenniy Bank (the Bank) which, in 2010, was placed into insolvent liquidation. The State Corporation “Deposit Insurance Agency” (the DIA) was appointed as the Bank’s liquidator and brought proceedings against the Defendant in Russia alleging that he had schemed to extract money from the Bank for his own benefit. In support of the Russian proceedings, the DIA obtained a worldwide freezing order (the Freezing Order) in the English courts against the Defendant.

The Freezing Order restricted assets up to a value of £1,171,490,852 and included an order for disclosure of assets. Following the Defendant’s disclosure that he was one of a class of discretionary beneficiaries of five New Zealand based trusts, the DIA sought, and obtained, a further order requiring the Defendant to disclose:

- the identity of the trustee(s), settlor(s), any protector(s) and the beneficiaries of the trusts; and
- details of the trust assets, including their value and location.

This order (the Disclosure Order) also contained a provision allowing “anyone who is served with or notified of this order…to apply to the court to vary or discharge [it]”. In reliance on this, the trustees of the five discretionary trusts sought to discharge, or alternatively, to vary the disclosure order. They argued that:

- as discretionary trust beneficiaries have no proprietary interest in trust assets against which a judgment debt can be enforced (as such beneficiaries only have a right to be considered for distribution), the court had no jurisdiction to make the Disclosure Order unless the trusts were shams. There was no reason to suppose that to be the case here;
- there was no reason to believe that the trust assets might be dissipated;
- the risk of injustice to the trustees if disclosure of the assets was ordered outweighed the risk of injustice to the Claimants if disclosure was not ordered. There was a risk of dissemination of the disclosed information within Russia and a consequential risk of “hostile action” against the assets; and
- if there was to be an order for disclosure, there had to be a cross-undertaking in damages to compensate the trustees for any loss they may suffer if the order was wrongly granted.

THE DECISION: ASSETS TO BE INCLUDED WITHIN THE SCOPE OF A DISCLOSURE ORDER

Mr Justice Richards dealt with each argument of the trustees in turn, providing extensive and helpful commentary on the first issue (ie, as to whether the Disclosure Order should include the respondent’s interests under discretionary trusts). The trustees submitted that the Freezing Order could only be enforced against “his (Pugachev’s) assets”; ie, those assets which were beneficially owned by Pugachev, those assets which he did not own but had some legal right of recourse over or assets for which there was a good reason to believe would fall within these preceding two categories, see SCF Finance v Masri2 and JSC BTA Bank v Kythreotis3. The trustees submitted that an interest under a discretionary trust provided only a right to be considered on distribution of the trust assets rather than a proprietary interest. The trustees pleaded that the purpose of a disclosure order was to “police the freezing injunction” and therefore it should be limited to those assets covered by the Freezing Order.

The judge disagreed with the trustees’ narrow interpretation of the assets to be included in the Freezing Order. He drew on the judgment of Lord Justice Patten in Kythreotis to conclude that the parameters of freezing orders, and by extension the disclosure orders designed to facilitate their enforcement, have been extended in recent case law to include those assets held legally, beneficially or otherwise by the respondent. This has been achieved via the inclusion of “standard form” sentences in freezing orders, as found at paragraph 6 of the Freezing Order issued against Pugachev.

The judge held that the evidence there were good grounds for supposing that the defendant was in a position to control the discretionary trust assets. For example, one of the trusts indirectly owned the Defendant’s principal residence in London in relation to which it appeared that the Defendant could “dictate or at the very least influence when, and even perhaps if, [rent] is paid”.

The court held that on the evidence there were good grounds for supposing that the defendant was in a position to control the discretionary trust assets.
Mr Justice Richards upheld the wide scope of the Disclosure Order and asserted that the court is able to exercise its discretion to order disclosure in relation to trusts for the purpose of ascertaining the true position as to who controls the assets. He stated that the court may be able to cross-examine a defendant who is subject to a freezing order (obiter), as to his possible ownership or control of assets, where there is a good reason to do so.

On alternative facts, the court may consider it inappropriate to identify third party assets as belonging to the respondent. In Masri, Lord Justice Lloyd stated that where third party assets appear, on their face, to belong to a third party, the court should only consider that they form part of a freezing order if there is “good reason” for supposing that the assets belong to the defendant. In that case, Lord Justice Lloyd held that evidence that the respondent was trading in London by using blank cheques drawn from his wife’s bank account was not a good reason to vary the freezing order to include the third party bank account. The court is not obliged to accept assertions that third party assets are within the control of the respondent and can undertake further enquiry if it deems it appropriate.

THE DECISION: RESPONSE TO THE TRUSTEES’ FURTHER SUBMISSIONS

Mr Justice Richards concluded that the second argument of the trustees (ie, that there was no risk that the assets would be dissipated) was not relevant to the order for disclosure. He held that this point was misdirected and was most relevant to the consideration of whether to grant the freezing order itself. He also noted that, if discretionary trust assets fall within the definition of “assets” under the Freezing Order, a transfer to any beneficiary would constitute a gratuitous transfer, and so would constitute dissipation.

With regard to the third argument (ie, that the disclosure of certain assets could provoke “hostile action” against those assets in Russia), Mr Justice Richards proved sympathetic. He concluded that the disclosed information must be kept within the “confidentiality club”, whose members had been chosen at an earlier date.

Further, Mr Justice Richards did not order the applicants to provide a cross-undertaking in damages. He confirmed that it is not the court’s usual practice to require undertakings in relation to disclosure orders and clarified that this would only be appropriate if there was evidence of real loss.

CONCLUSION

The Pugachev decision illustrates that the court is likely, in appropriate circumstances, to interpret disclosure orders widely to include assets held under discretionary trusts. The court can, and will, exercise its discretion to determine the true nature of relationships between respondents and the trusts to which they are associated.

The decision builds upon case law, such as Atlas Maritime Co SA v Avalon Maritime Ltd (The Coral Rose) (No. 3), wherein it is well established that the court has discretion to investigate the assets of the respondent, including those in other arms of its corporate structures. In that case, the court found that it had discretion to “peep behind” rather than pierce the corporate veil in order to consider the true nature of the relationship between the Respondent and its parent company.

As noted at the outset, the Pugachev decision has important practical consequences for those applying for and responding to freezing orders. It may prove difficult in future for respondents to obscure their assets in complex trust structures, particularly those trusts held outside of the jurisdiction.

It also remains open to applicants facing complex trust structures to apply for an injunction against the third party itself (see TSB v Chabra). This method may be appropriate where the respondent has created a “sham” trust and it is therefore necessary for the court to make an order against a third party.