XXIV OLD BUILDINGS

ANNUAL INTERNATIONAL TRUST LITIGATION CONFERENCE
September 2010

MATERIALS

XXIV
BARRISTERS' CHAMBERS

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PROGRAMME

08:15 – 09:00	Registration	
09:00 – 09:15	**Chairman's Introduction**	**Alan Steinfeld QC** "Star of The Bar" Alan Steinfeld, is recognised for his expertise in business litigation, trust disputes and asset tracing proceedings in the UK and Internationally.
09:15 – 10:15	**Sure bets and cunning plans** Francis Tregear QC and Sarah Bayliss examine the remedies available to individuals caught up in disputes about investments, comparing the options at common law and under the Financial Services and Markets Act 2000 with an eye to future developments resulting from the creation of the proposed Consumer Protection and Markets Authority.	**Francis Tregear QC** Francis' practice includes hostile trust litigation in offshore jurisdictions including Cayman and the Channel Islands as well as related advisory work. **Sarah Bayliss** Sarah has a broad commercial Chancery practice with an emphasis on contentious trusts and probate, company and commercial, insolvency and regulatory disputes both in England and offshore.
10:15 – 10:45	Coffee	
10:45 – 11:30	**Breaking and entering: asset protection under fire** Stephen Moverley Smith QC and Edward Knight consider in an international context the practical ways creditors can defeat attempts by defaulting debtors to secrete assets and evade judgments, the availability of pre-emptive remedies and a new angle on trust-breaking soon to be considered by the Privy Council in TMSF v Merrill Lynch.	**Stephen Moverley Smith QC** Stephen practices across the breadth of international commercial litigation and arbitration. He has a particular specialisation in contentious trust and corporate disputes in England and the British Virgin Islands. **Edward Knight** Edward's practice encompasses contentious off-shore trust matters together with insolvency, commercial and company disputes.
11:30 – 12:30	**Private trust companies: is this what you want, what you really, really want?** David Brownbill QC and Elizabeth Weaver take a look at private trust companies, consider the litigation consequences of their use and how they should be structured in the light of anticipated battles for control - does the promise	**David Brownbill QC** David specialises in all aspects of contentious and non-contentious offshore and domestic trust and company matters. **Elizabeth Weaver** Elizabeth's commercial Chancery practice is centered on contentious trust and company disputes, often with an offshore or overseas dimension.

	match the reality and can PTC directors really breathe easily after Gregson?	
12.30 – 14:00	Lunch	
14:00 – 15:00	**Re the Jabberwock Trust** You are invited to come through the looking glass to the tea party that is the final hearing in the matter of the Jabberwock Trust. It's all to play for in the tale of lies, incompetence and a particularly mimsy case of conflict of interests, presided over by Mr Justice John "the Knave of Hearts" Stephens sitting in the High Court of Wonderland. Who will lose their head? And who will ultimately run away with the jam tarts? Appearing before John Stephens will be Adam Cloherty, Edward Cumming, Erin Hitchens and Andrew Holden	**John Stephens** John Stephens specialises in private client and commercial disputes, both on and offshore. He is particularly known for his expertise and experience in trust and pension litigation. **Adam Cloherty** Already recognised as a "rising star" for commercial Chancery work, Adam's expertise includes all aspects of trusts and corporate law both at home and abroad. **Edward Cumming** Edward has particular experience of both English and international trust and probate disputes which, together with corporate litigation and insolvency work, form key parts of his busy practice. **Erin Hitchens** Erin's commercial Chancery practice includes domestic and international contentious trust work, commercial and company disputes and insolvency. **Andrew Holden** Andrew has a practice encompassing traditional Chancery matters, commercial disputes, and insolvency. He has experience of international trust litigation in the Channel Islands and the Isle of Man.
15:00	Chairman's closing remarks	

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Matthew Conaglen (door tenant)

*****(will become a member on call to Bar of England and Wales)

ACCREDITATION INFORMATION

English solicitors

4 accredited CPD points can be claimed for attending this conference.

As part of XXIV Old Buildings' accreditation with the Law Society, we are required to send the SRA completed feedback forms from the delegates. Please therefore do fill in this form which can be found at the back of this brochure and return it to either Paul Matthews or Nicholas Luckman.

English barristers

Attendees will be able to claim 4 CPD hours, speakers an additional 1 CPD hour.
The seminar is accredited.

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Sure bets and cunning plans

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SURE BETS AND CUNNING PLANS

Introduction

1. In this talk we examine some of the ways in which the regulatory regime set out in the Financial Services and Markets Act 2000 ('*FSMA*') might complement other English law remedies available to individuals caught up in disputes about investments. We will concentrate on recent developments in two areas: (1) client money; and (2) claims by private individuals against investment counterparties and professionals.

2. The title of this talk reflects the position of the (more or less fictional) high net worth client, Biffo, who had a word with his brother in law, Stiffo, (in the City - worth billions) and his mate, Toffo, (Excellent Chap from School/Varsity/Borstal: property developer – worth billions) and was introduced to an opportunity that couldn't, but somehow did, fail.

3. Investment disputes involving individual investors typically involve one or both of two problems: the investment turns out not to be worth what it was meant to be worth and/or there are issues about recovery of the sums due from the investment. Another problem may arise where money is paid for the specific purpose of being invested in a particular category of investment and is misapplied. In that case it may be possible to argue that the money is held according to a purpose trust and payment away is a breach of trust.

Remedies

4. To set the scene we will run through briefly the familiar causes of action that an advisor will consider routinely when a client comes to him with this sort of problem.

5. The investor will have invested, probably, pursuant to one or more contracts. An action may lie for damages for breach of contract or an application for specific performance may be an option. The rights and obligations of an investor who has actually purchased shares in a company will be governed by the share purchase agreement, any shareholder agreement and by company law. If the investor feels unfairly treated, consideration may be given to whether an application to the court under s 994 CA2006 to have the company wound up on the just and equitable ground might be appropriate.

6. An investor in a collective investment scheme ('*CIS*') might make his investment by way of joining an LP or an LLP as a member of the partnership - as many of you will be aware, tax schemes taking advantage of rules relating to CGT capital allowances often operate in this way. Accordingly, the

investor's rights and obligations will be governed by the members' agreement and by the law of limited, or of limited liability, partnerships.

7. In circumstances where there has been misappropriation or fraud, or an entity is in liquidation and the investor seeks an advantage over unsecured creditors, his or her main interest may lie in asserting a proprietary claim either to the funds he has invested or to a fund in which he is invested. Where there is a proprietary claim the tracing process may assist in recovering investment funds paid away in breach of trust. A '*Quistclose*' trust might arise where monies have been paid over or property transferred for a particular purpose and kept segregated. On the authority of *Westdeutsche Bank v Islington* LBC [1996] AC 669 a constructive trust might arise where money has been paid away by mistake.

8. Fiduciaries and fraudsters may be liable personally to account to the investor as constructive trustees either for investment funds that have gone astray or for the balance that cannot be recovered pursuant to a proprietary claim. Dishonest assistants and knowing recipients may also be personally liable. In addition fraudsters may be liable for damages in the tort of deceit where fraudulent misrepresentations have been made inducing the investor to part with his money.

9. Where an investment agreement is void or otherwise ineffective and a proprietary or a personal claim in equity does not run, a claim for a restitutionary remedy is likely to be made to assist the investor recover at least the principal sum invested.

10. Where the investment has failed or the funds invested have been purloined and there is no chance of direct recovery, the investor needs someone to blame. Professionals associated with the investment transaction whether they be bankers, brokers, independent financial advisers or other financial services professionals, accountants or lawyers may be liable in negligence. In addition negligent misrepresentations inducing the investor to invest may have been made leading to liability under the Misrepresentation Act 1967 or for negligent mis-statement at common law.

11. The institution in which the investor has invested, or an entity associated with it, may be in administration or liquidation. If that is the case, or if the investor considers that he may have no choice but to take steps to bring about the liquidation of such an entity, then the liquidator will be in a position to investigate the company's affairs and may be able to recover company property for the creditors pursuant to the '*clawback*' provisions of the Insolvency Act 1986: fraudulent trading (s213), transactions at an undervalue (s238) and transactions defrauding creditors (s423).

12. So far, so familiar, but what about the interrelationship between these remedies and FSMA and the impact of the ever-changing rules set out in the FSA Handbook (the '*Handbook*' and the '*Rules*')? [1]

[1] The FSA has wide power to make rules pursuant to ss138 and 139 FSMA. The Rules have the force of law and impose binding obligations upon those who are subject to them. s138 FSMA provides that the FSA may make such rules applying to authorised individuals and firms as appear to be necessary or expedient to meet any of its regulatory objectives. s139 FSMA contains further provisions empowering the FSA to make rules in particular areas including the conduct of client business by

FSMA remedies

13. The regulatory regime set up by and under FSMA is designed to protect investors by regulating the investment market in two ways. First, the regime seeks to ensure that those selling and managing investments are qualified to do so (by requiring them to be '*authorised*' by the FSA to engage in '*regulated activities*'). Second, FSMA and the Rules contain detailed provisions governing the conduct of authorised persons designed to ensure that investors receive appropriate treatment and advice and are introduced only to investments that suit them. This distinction tends to be expressed as being between '*micro prudential regulation*' on the one hand and the regulation of conduct of firms and investment professionals on the other. The first is, essentially, a gate-keeping exercise: the market is regulated by letting in appropriate persons only to provide services. The second relates to regulating the conduct of the business of those persons once they are inside the regulated '*perimeter*'.

14. It follows that it is not a principal function of FSMA to give private law remedies to individuals. However, some very useful remedies and mechanisms are to be found in FSMA and the Rules, the principal of which are as follows:

    a. *Contract/partnership*: Where investment activity is engaged in or investments are sold by '*unauthorised persons*'[2], the resulting arrangements may be unenforceable against the investor who may be entitled to the return of his investment and compensation from those who sold the investment, from those with whom the investor has entered a contract or other binding arrangement and, possibly, from others (ss26-30 FSMA);

    b. *Proprietary remedies and trusts*: the rules at Chapter 7 of the Client Assets Sourcebook ('*CASS7*') of the Handbook create a statutory trust of a client's money and dictate how that money is to be dealt with in the event of a regulated institution's insolvency.

    c. *Rescission and restitution*: ss 380(2) and 382 FSMA empower the FSA to apply to the court for orders that any person who has contravened FSMA or the Rules '*take such step as the court may direct to remedy the contravention*' or for a '*restitution order*' where a person has contravened FSMA or the Rules and made a profit from, or caused a loss to, another thereby. The provisions are in wide terms: orders may be made not only for the disgorgement of profits, they may also be made for sums compensating a person for his loss or for any '*other adverse effect*'.

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authorised persons. The Handbook and the Rules are produced pursuant to the FSA's powers under these sections. Where a provision in the Handbook is followed by 'R' it creates a legally binding obligation; where it is followed by a 'G', it is guidance.

[2] Persons not authorised by FSMA to engage in regulated activities.

d. *Professional liability*: s150 FSMA introduces an action for damages by way of a statutory tort where a breach of the Rules by an authorised person has caused loss to an investor. This is a useful tool in a number of situations including where investments have been sold to investors for whom those investments are unsuitable. In addition, s90 FSMA provides that any person responsible for listing particulars is liable to pay compensation to any party who has suffered loss as a result of the particulars being untrue or misleading. In a common law context the standard of care to be expected of a financial services professional is to be determined by reference to the applicable regulatory requirements[3].

e. *Insolvency and tactical considerations*: s380 FSMA empowers the FSA to apply to the Court for an injunction to prevent a breach of FSMA or the Rules. The FSA has locus to bring and to involve itself in administration and insolvency proceedings (ss356-379 FSMA). The FSA also has wide-reaching powers of investigation and sanction including power to bring criminal proceedings (s401 FSMA)[4]. Tactical considerations as to if and when to contact the FSA arise for those advising private investors experiencing problems with investments.

15. You will have noted that some of the remedies/mechanisms mentioned above are actionable or enforceable by an individual (ss26-30 and CASS7 and other breaches of the Rules via s150 and s90 FSMA) whilst in order to benefit from others (s380, s382) the FSA needs to be involved. In more substantial cases[5], the decision as to if, when and how to involve the FSA in a dispute raises interesting tactical questions beyond the scope of this talk but it is worth noting that the FSA will on occasion give guidance in correspondence with authorised persons and persons otherwise subject to the Rules on the interpretation of FSMA and the Rules and their application to a particular dispute[6]. The Rules require authorised persons to bring to the FSA's attention anything they think the FSA might like to hear about[7] and, since it is the FSA's job to investigate breaches of FSMA and the Rules, it may find it useful to hear from an individual in investment difficulties and this may lead to action which is to that individual's benefit. The FSA's powers to intervene and to apply to the court for orders are particularly relevant in matters where there

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3 See Jackson and Powell on Professional Liability (6th Edn) at 15-020.

4 The Supreme Court has recently held that the FSA's power to prosecute criminal offences is not limited to the offences created by and/or referred to in FSMA. Accordingly, by way of example, the FSA can prosecute offences of money laundering contrary to POCA: *R v Rollins* [2010] UKSC 39.

5 Complaints to the Financial Ombudsman Service ('*FOS*') are only relevant generally where claims are less than £100,000 since this is the current limit to an award enforceable by FOS. The Financial Services Compensation Scheme ('*FSCS*') presently has a limit of £48,000 for claims in respect of '*designated investment business*'.

6 s157 FSMA.

7 Authorised and unauthorised Persons are bound by the FSA's Statements of Principle in the Handbook ('PRIN'). Principle 11 states that: '*A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice*'. The Handbook also sets out notification requirements for authorised persons at SUP 15.3. The FSA must be notified of any significant breach of a Rule (which term includes a Principle or any breach of a requirement of FSMA or an SI made under it (15.3.11)).

are a large number of small investors for whom individually it will be uneconomic or impossible to bring action to protect their rights.

16. Neither ss 26-30 nor s150 FSMA prevent in terms a claim under those sections being pursued in tandem with either taking steps to encourage the FSA to apply for orders under s380 and/or s382 or with applications by the FSA. However, we should stress that '*getting the FSA interested*' is not a formal route to redress under FSMA[8] and the FSA will very often not be interested sufficiently in your client's problem to intervene. If your client is the sole complainant and in a position to prosecute his own claim it is unlikely that the FSA will involve itself, although it may take separate disciplinary action against the firm. On the other hand, if your client is one of many investors with similar problems it may be that the FSA has already taken, or can be encouraged to take, action on behalf of all the investors. Where there are parallel proceedings by investors and by the FSA it is likely that the court will apply normal case management logic to the matter, either by consolidating or hearing together the two sets of proceedings or by staying one case pending the outcome of the other.

17. Some of you may by now be wondering what the point of talking about all this might be when the British Government has announced it intends to abolish the FSA and set up an entirely new scheme of regulation. First, the legislative changes are at least two years away[9] and, second, the new scheme might not be as different as all that conceptually so far as the detailed regulation of the investment market is concerned[10]. The FSA is referred to in FSMA as the '*Authority*'. When the proposed Prudential Regulation Authority ('*PRA*') and the Consumer Protection and Markets Authority ('*CPMA*') take over from the FSA, it is to be assumed that the PRA or the CPMA, as the case may be, will be designated the Authority in respect of the functions each is to perform.

18. It is also to be noted that the emphasis of the Government's consultation paper: '*A new approach to financial regulation*' is upon the regulatory framework; the paper makes no mention of any of the remedies which may assist the individual investor mentioned above. Although it is always possible that these remedies and the general usefulness of FSMA to a private individual with an investment problem will change substantively under the new regime, that does not appear to be the focus of the Government's interest.

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[8] Where complaints are made to the FOS or applications are made under the FSCS, the DISP and COMP modules of the Handbook dictate the relationship between the claimant's complaint/application and other remedies.

[9] Mark Hoban MP, Financial Secretary to the Treasury, in a speech on 26 July 2010 committed the Government to putting '*the necessary primary legislation in place within two years*'. The consultation period in respect of the Government's consultation paper on financial regulation runs from 26 July to 18 October 2010.

[10] The focus of political attention is upon high level or macro '*prudential regulation*' of the financial markets (particularly banking) rather than the management of firms' conduct towards their retail customers. According to the Government's risk assessment document: '*the policy objective is to reform the regulatory system for financial services to avoid a repeat of the financial crisis*'.

Client money, CASS 7 and other proprietary claims

19. If an individual investor has a problem with the treatment of their (client) money by an investment advisor, manager or counterparty, his or her route to redress is likely to be by way of an action under s150 FSMA for breach of statutory duty. We will look at s150 FSMA in more detail later but first we examine recent developments in respect of the client money rules in CASS7 of the Handbook.

The administrators' application in the Lehman case

20. Following the collapse of Lehman Brothers in September 2008 the administrators of Lehman Brothers International (Europe) ('*LBIE*') applied to the court for directions as to the application of CASS7 to the client money under their control. The amount was said to be in excess of US$3 billion. Briggs J handed down his judgment on 15 December 2009 in *Lehman Brothers International (Europe) (In Administration) v CRC Credit Fund Limited and Ors* [2009] EWHC 3228 (Ch). Several of the Judge's orders went on appeal to Lord Neuberger, Lady Justice Arden and Sir Mark Waller on 21 June 2010. The Court of Appeal's judgment in *CRC Credit Fund Limited v GLG Investments PLC* [2010] EWCA Civ 917 was handed down on 2 August 2010 (together, the '*Lehman Decisions*').

21. A preliminary point to note is that when advising a client on the application of the client money rules (or any other Handbook provision), it will be necessary to look at the Rules on the relevant date, since the Rules are subject to not infrequent change. CASS7 was modified on 1 November 2007 to comply with MiFID[11] with a view to fulfilling the UK's obligations under European law. It has been further modified since, although not in a fashion that makes the Lehman Decisions inapplicable to the present Rules. Earlier versions of CASS included client money rules and those rules (and their predecessors) included the imposition of a statutory trust but the precise application of the Rules to a client's particular problem will be a matter of construction of the Rules as they were at the relevant time (usually when the problem arose). The Lehman Decisions dealt with the law as it was in September 2008.

The CASS7 Rules

22. The principal provisions of CASS7 as it was in September 2008 considered in the Lehman Decisions are as follows:

    a. CASS7.1.1R imposed '*client money rules*';

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[11] Directive 2004/39/EC on markets in financial instruments (21/04/04) '*to provide for the degree of harmonisation needed to offer investors a high level of protection and to allow investment firms to provide services throughout the community, being a Single Market, on the basis of home country supervision*'.

b. CASS7.2.1R defined client money as '*money that a firm receives from or holds for, or on behalf of, a client...in connection with its MiFID business*'[12];

c. CASS7.4 was concerned with '*segregation of client money*' which must be paid by a firm into a '*client bank account*';

d. CASS7.4.14G permitted a firm to adopt two approaches in '*discharging its obligations under the MiFID client money segregation requirements*': the '*normal approach*' or the '*alternative approach*';

e. CASS7.4.17G stated that the '*normal approach*' required client money to be paid into a client bank account '*promptly, and in any event no later than the next business day after receipt*';

f. CASS7.4.15R required that the '*alternative approach*' may only be adopted by firms which had '*in place systems and controls which are accurate*' and entitled a firm to pay client money into a house account on the basis that it would '*segregate client money into a client bank account on a daily basis, after having performed a reconciliation of records and accounts*' (CASS 7.4.16G);

g. CASS7.7.2R stated that a '*firm receives and holds client money as trustee on the following terms: (1) for the purposes of and on the terms of the client money rules and the client money (MiFID business) distribution rules*';

h. CASS7.9 was concerned with '*Client Money Distribution*' and contained '*the client money (MiFID business) distribution rules*' aimed at facilitating '*the timely return of client money to a client in the event of the failure of a firm or third party at which the firm holds client money*' (CASS7.9.2G);

i. CASS7.9.6R provided that on a '*primary pooling event*' (which included '*the failure of the firm*' (CASS7.9.4(1)R), '*(1) client money held in each client account of the firm is treated as pooled; and (2) the firm must distribute that client money in accordance with CASS 7.7.2R, so that each client receives a sum which is rateable to the client money entitlement calculated in accordance with CASS7.9.7R*' (which contained provisions for set off); and

j. CASS7.9.8G stated that '*a client's main claim is for the return of client money held in a client bank account*' and that he or she may be able to claim for any shortfall against money held in a firm's own account for which '*the client will be an unsecured creditor of the firm*'.

The facts

23. LBIE went into administration on 15 September 2008. It had operated the '*alternative approach*' referred to above. This involved monies received from clients being paid into an account or accounts of LBIE and then segregated into client accounts each day according to a reconciliation of client monies. The reconciliation was conducted at the close of business and a balance was transferred the following day to, or from, the segregated client bank accounts held by LBIE for its clients. Client funds were not therefore paid directly into segregated client accounts as they would have been under the '*normal approach*'. LBIE carried out its last reconciliation and segregation on 12 September 2008 reflecting the position as at the close of business on 11

[12] MiFID business means the investment business and ancillary activities of a MiFID investment firm, being a '*person*' providing investment services with its head office or registered office in the EEA.

September 2008. That meant that between 12 and 15 September 2008 LBIE received client funds into its house accounts after the '*point of last segregation*' which remained there at the primary pooling event when LBIE went into administration.

The issues

24. Four questions arose for the consideration of the Court of Appeal:

a. When did the statutory trust arise?
b. Did the primary pooling arrangements apply to client money in house accounts?
c. Was participation in the pool dependent on actual segregation?
d. When did money owed by a firm to a client become '*client money*'?

When did the statutory trust arise?

25. Neither Briggs J nor the Court of Appeal had any difficulty holding that the statutory trust arose on receipt. Both Arden LJ and Lord Neuberger drew attention to the requirements in Article 13(8) of MiFID which provides that a firm holding client money must make '*adequate arrangements to safeguard clients' rights and...prevent the use of client funds for its own account*'. Arden LJ (at paragraph 86) noted that '*it would in reality undermine the protection intended to be given to investors if it were anything other than a totally immaterial period of time when the obligations in Article 13(8) did not apply*'. Accordingly, the court held unanimously that MiFID required CASS7 to contain a provision constituting a trust of client monies as from the moment of receipt and that the literal meaning of CASS 7.72R: a '*firm receives and holds client money as trustee on the following terms: (1) for the purposes of and on the terms of the client money rules and the client money (MiFID business) distribution rules*' did just that.

26. As to the next two issues before the Court of Appeal, Sir Mark Waller commented at paragraph 241: '*The very impressive judgment of Briggs J reached, to my mind, an unsatisfactory conclusion under which client money was held on trust from receipt (issue 1) but (i) only that which had been placed in segregated accounts was subject to pooling (issue 2) and (ii) the division of the pool was to be by reference to contribution and not entitlement (issue 3)*'. On the second and third issues, the Court of Appeal disagreed with the Judge and held that the primary pooling arrangements did apply to client money in house accounts as well as that in segregated client accounts and that any client for whom a firm held client money, whether it was in a house or a segregated account, was entitled to participate in the client money '*pool*' for the purposes of distribution.

Did the primary pooling arrangements apply to client money in house accounts?

27. Although a '*primary pooling event*' can arise in a number of circumstances, the most likely to occur in practice is the '*failure of the firm*'[13]. The question

[13] '*Firm*' means (with some limited additions) authorised person.

was what money was to be treated as pooled upon the failure of a firm. CASS7.9.6(1)R provided that, upon the happening of a primary pooling event, '*client money held in each client money account of the firm is treated as pooled*'. The question for determination was whether the definition of '*client money account*' extended to any account of the firm into which client money had been paid (including house accounts where the '*alternative approach*' had been adopted) (the '*wider meaning*') or whether it was limited to segregated client money accounts, i.e. client bank accounts and client transaction accounts into which client money had already been segregated (the '*narrower meaning*').

28. Winning the prize for understatement, Lord Neuberger noted, at paragraph 204, that '*the amount of textual assistance one can get on this issue from searching through CASS7 is limited*' since support for both the wider and the narrower meaning could be gleaned from the Rules. However, taking account of policy and commercial considerations it was: '*unlikely that the FSA would have intended a client who made a payment to a firm which adopted the alternative approach should, albeit for a couple of days at most, be at risk in a way in which a client who made a similar payment to a firm which adopted the normal approach would not be*' (paragraph 216).

29. Lord Neuberger also stated that the thrust both of MiFID, CASS7.7.2R and CASS7.9.6R was that the clients of a firm were '*in it together*' on a primary pooling event when client money was to be pooled and paid out to all clients on a pro rata basis. All clients who deposited money with firms for MiFID business were intended to receive a single and consistent level of protection in compliance with MiFID (paragraphs 217 and 222). In circumstances where the arguments based on textual analysis were finely balanced, policy considerations favoured the wider meaning. Arden LJ and Sir Mark Waller agreed.

Was participation in the pool dependent on actual segregation?

30. Arden LJ had expressed the third issue in this way. She asked whether participation in the pool was limited to clients who had client money in the pool (the '*participation basis*'), or whether any client with a claim to client money could participate (the '*claims basis*'). As a matter of logic, the wider application of the pooling arrangements to include both segregated and unsegregated client money favoured the wider claims basis. Further, there was a compelling textual reason to support the claims basis. CASS7.9.6(2)R required the firm to distribute client money '*in accordance with CASS7.7.2R, so that each client receives a sum which is rateable to the client money entitlement calculated in accordance with CASS7.9.7R'*. By reference to the wording of those Rules and the relevant Glossary[14] definitions, a client's '*client money entitlement*' was a reference to the client's contractual entitlement to have money segregated for him, rather than to the client's proprietary interest in the client money pool deriving from having had his money actually segregated. Accordingly, the court held that the claims basis was correct: the basis for sharing in the pool was to be determined by

[14] The extensive glossary in the Handbook.

reference to the amount which ought to have been segregated for each client, rather than the amount which had been segregated in fact for each client.

When did money owed to by a firm to a client become 'client money'?

31. The Court of Appeal agreed with Briggs J on this issue which turned upon when a firm was to be taken to '*hold*' monies for a client for the purposes of the definition of '*client money*' in CASS7.2.1R. Arden LJ summarised the Judge's decision as follows at paragraph 165:

'*...client monies could be those received by a client, or those received by a third party for a client, or funds of the firm appropriated to the client, but not monies which the firm simply owes to the client. For example, the firm may become liable to the client in respect of 'manufactured' dividends as a result of a stock lending transaction. A stock lending transaction takes place when a client makes an outright transfer of securities or their market value in cash. The third party will often be liable to pay a 'manufactured' dividend if the transaction crosses a distribution date. LBIE borrowed stock from its clients, and became liable to pay manufactured dividends to those clients. The Judge's judgment means that the amounts needed to satisfy manufactured dividends due and payable by LBIE but not yet paid into client bank accounts are not 'client money' for the purposes of CASS7.2.1R.*'

32. In summary, the Court of Appeal decided that the statutory trust of client money under CASS7 arose as soon as it was received by a firm. Should that firm fail such that a primary pooling event took place, the pool would be deemed to contain all client money held by the firm, whether actually segregated or not, and all clients for whom the firm held client money would be entitled to a pro rata distribution from the pool, whether their money had been segregated or not. In ascertaining what money was client money for these purposes, a distinction was to be drawn between monies '*held*' for the client and monies '*owed*' to the client pursuant to arrangements to which a debtor/creditor relationship applied. The latter were not client monies.

Personal and proprietary claims

33. CASS7 is of little assistance where funds have been invested in an unregulated entity or where there has been a fraud. In these circumstances reliance will still need to be placed upon personal and proprietary claims in equity, the tracing process and the tort of deceit/fraudulent misrepresentation. In these cases the work of establishing a proprietary claim will rely on analysis of the facts in the context of current authorities. Consider, by way of brief update, the torrid tales of *Langbar International Limited v Rybak and Ors* [2009] EWHC 2764 (Ch) (and *Rybak and Ors v Langbar International Limited* [2009] EWHC 2098 (Ch) and [2010] EWHC 2015 (Ch), *Bank of Ireland v*

Pexxnet Limited [2010] EWHC 1872 (Comm) and *Law Society of England and Wales v Habitable Concepts Limited* [2010] EWHC 1449.

34. *Langbar International Limited v Rybak and Ors* [2009] EWHC 2764 (Ch) gives a flavour of the procedural and practical difficulties faced by a claimant in fraud proceedings in the present day investment environment. This action represented one facet of complex proceedings by AIM investment fund '*Langbar*' against former officers, shareholders or associates, Mariusz Rybak, Jean-Pierre Regli, Abraham Arad Hockman ('*Mr Arad*') and Lambert Financial Investments Limited ('*Lambert*').

35. Blackburne J described the facts of the case as '*extraordinary and shocking*'. Langbar was incorporated in Bermuda in June 2003 and its shares were admitted to trading on AIM in October 2003. Between admission and October 2005 a number of Stock Exchange regulatory news service releases showed Langbar '*riding high*', as Blackburne J described it, with sums (apparently) on deposit with Banco do Brasil totalling some US$660 million, according to two certificates of deposit purportedly issued by the bank. As a result, Langbar appeared to be the largest investment fund on AIM. The result was that Langbar's shares attracted considerable interest among institutional and private investors.

36. In October 2005 it was discovered that the Banco do Brasil certificates were entirely fictitious and trading in Langbar's shares was suspended. It became clear that Langbar had practically no assets and its shares were worthless. Langbar had been the victim of a fraud. Langbar's board was reconstituted and appropriate recovery and insolvency expertise were brought in. Worldwide freezing orders were obtained against Mr Rybak, Mr Regli, Mr Arad and Lambert. The underlying claims against Mr Rybak, Mr Regli and Mr Arad were that they knew that Langbar was not involved in any genuine investment business and that it did not have any substantial assets.

37. Mr Regli, Mr Arad and Lambert, all based out of the jurisdiction, kept their heads down and failed to acknowledge service or take any part in the proceedings. Mr Regli and Mr Arad were committed for contempt in their absence. Judgment in default was entered against Lambert for US$350 million in respect of a promissory note it had given to Langbar which had purportedly later been replaced by one of the fictitious certificates of deposit referred to above. Mr Rybak, in contrast, defended the proceedings vigorously.

38. Disclosure by Mr Rybak in compliance with the terms of the worldwide freezing order revealed that some of the proceeds of sale of his shares in Langbar had been transferred to his wife and daughter and a Monaco based company in which they were interested. The company had purchased property there with funds received by it. Wife, daughter and Monegasque company were joined as defendants to the English proceedings (the 'Rybak Defendants'). No doubt proprietary claims were made to the Monaco property although the judgment does not mention it. Some other of the sale proceeds had gone to Singapore and proceedings were issued (and stayed pending the outcome of the English proceedings) and injunctive relief granted in that jurisdiction against Mr and Mrs Rybak.

39. The trial of the English proceedings had been on foot for 56 days when the Rybak Defendants entered into a compromise agreement and the proceedings were stayed against them by Tomlin order. Blackburne J granted summary judgment against Mr Regli, Mr Arad and Lambert.

40. Langbar's case against Mr Regli and Mr Arad was that they knew the Banco do Brasil deposits did not exist, that the certificates of deposit were fraudulent and that (in dishonest breach of fiduciary duty to Langbar in Mr Regli's case) they made deceitful misrepresentations to Langbar, its directors, shareholders, auditors, solicitors and other professional advisers and to investors in the AIM about Langbar's financial position. Langbar's case against Lambert was that it was responsible for Mr Arad's deceit as a result of misrepresentations made by Mr Arad on Lambert's behalf as its director. The same monetary relief was sought and granted against all three in the sum of around £44 million and €5 million to cover the shareholders' losses and Langbar's wasted operating costs of pursuing investment projects that the company in fact had no money in which to invest.

41. Blackburne J concluded by stating: '*these proceedings have involved an immense amount of effort, expense, hard work and investigation by those who now run Langbar and their various advisors, to which I would pay tribute*'. The interest in the case lies not in new guidance on any technical point of law, but in the forensic and procedural aspects of the case which illustrate the logistics involved in prosecuting a modern commercial fraud claim.

42. The matter did not rest there. The agreement annexed to the Tomlin order (which was later varied by consent) made provision, as varied, for the sale of the Monaco property and payment of a proportion of the proceeds of sale to Langbar. The property was sold in late 2008 for €13.44 million. Disagreement arose as to how much was to be paid to Langbar under the agreement as varied and the Rybak Defendants brought proceedings to determine the point. Langbar defended those proceedings and counterclaimed on the basis of negligent (later amended to fraudulent) misrepresentation on the part of the Rybaks in respect of the value of the Monaco property, alleging that it would not have entered into the agreement as varied had it known the true (and much higher, it alleged) value of the property. In May 2010 the matter came before Norris J who made an order on a disclosure related application that unless the Rybak Defendants delivered up certain computers by a given date, their claim and defence to counterclaim would be struck out. The Rybak Defendants did not deliver up the computers and an unsuccessful application was made to Morgan J on 9 July 2010 for relief from sanctions.

43. *Bank of Ireland v Pexxnet Limited and Ors* [2010] EWHC 1872 (Comm) ('*BOI*') concerned proprietary and personal claims in equity and a claim in deceit to recover funds misappropriated in the course of a conspiracy to defraud BOI of some €2.4 million by presenting two forged cheques and a banker's draft for €800,000 each. BOI alleged that the defendants were liable in the tort of conspiracy to defraud the bank and that individual defendants were variously liable in deceit for presenting the forged instruments, or as constructive trustees in receipt of the funds with knowledge of the fraud or as dishonest assistants for arranging the onward transfer of the funds and for assisting in putting up a false explanation of the transactions. Jonathan Hirst

QC sitting as a deputy judge of the High Court found in favour of BOI and held that all the defendants were jointly and severally liable for the bank's losses.

44. As to the imposition of a constructive trust in relation to property obtained by fraud, the Judge referred to Lord Browne-Wilkinson's '*classic modern exposition of the law in this area*' in *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669 at 714-5 where his Lordship stated: '*when property is obtained by fraud equity imposes a constructive trust on the fraudulent recipient: the property is recoverable and traceable in equity*'. In the same passage, Lord Browne-Wilkinson commented that a constructive trust may well also arise where monies paid by mistake are retained by the recipient after he has discovered the mistake. Jonathan Hirst QC also referred to the summary of the relevant law by Lawrence Collins J (as he then was) in *Commerzbank v IMB Morgan* [2004] EWHC 2771 (Ch) [2005] 1 Lloyd's Rep 298, at paragraph 36 of that judgment, as follows:

'Whether a person who has made a payment by mistake has a proprietary claim is by no means clear. But I am satisfied that in a case of this kind, where double payment was made at the request of the recipient (IMB Morgan), where there is an identifiable fund, and where the recipient has notice of the claim, it would be unconscionable for IMB Morgan (and in effect the other claimants to the fund) to retain the benefit of that payment: Chase Manhattan Bank v Israel-British Bank [1981] Ch 105 as explained in Westdeutsche Landesbank Girozentrale v Islington London Borough Council [1996] AC 669, 714-5; Virgo, Principles of the Law of Restitution (1999), pp 630-632; and see also Papamichael v National Westminster Bank plc [2003] EWHC 164 (Comm), [2003] 1 Lloyd's Rep 341 (Judge Chambers QC).'

45. Accordingly, a proprietary claim to monies paid by mistake to a bank that has knowledge of the mistake or to a bank account whose holder has knowledge of the mistake such that it was unconscionable for it/him to retain the monies may well succeed. In the BOI case it was unnecessary to rely on the mistake jurisdiction since the Judge held that the recipients had knowledge of the fraud.

46. *Law Society v Habitable Concepts Limited and Onuiri* [2010] EWHC 1449 (Ch) is a recent case on the doctrine of dishonest assistance and knowing receipt. It will be recalled that, in order to establish liability for dishonest assistance, it must be proved that a defendant has dishonestly assisted a trustee commit a breach of trust (*Royal Brunei Airlines v Tan* [1995] 2 AC 378). In order to establish liability for knowing receipt it must be proved that there has been a transfer in breach of trust of trust property (or its traceable proceeds) to the defendant for his own benefit and that the defendant receives or keeps the trust property or deals with it with knowledge of the breach of trust (*El Ajou v Dollar Land Holdings plc* [1994] 1 All ER 685 (CA) and *BCCI (Overseas) Limited v Akindele* [2001] Ch 437 (CA)).

47. Mr Udah, a solicitor practising as Okey Udah & Co (the '*Practice*') had skipped town after the perpetration of a large scale mortgage fraud as a result of which lenders had been defrauded of around £5.8 million in the course of a four week period in 2007 by the straightforward device of submission by the Practice of non-genuine mortgage applications and appropriation of the advances so obtained. The claim was for the recovery of some £450,000 of lender's funds paid out of the Practice's client account to Habitable Concepts. Applying *BCCI v Akindele*, Norris J held that since Habitable had received the funds beneficially with knowledge of the fraud (the knowledge being that of its sole director, Mr Onuiri) such as to make it unconscionable for it to retain the benefit of the payment, it was liable to account as constructive trustee on the basis of knowing receipt.

48. As to Mr Onuiri's liability, the Judge reasoned that, as Habitable Concepts' sole agent, Mr Onuiri must have assisted the transfer of the funds from the Practice to Habitable Concepts, even if only by providing the company's bank details. The question was whether the assistance was dishonest. On the application of *Barlow Clowes International Limited v Eurotrust International Limited* [2006] 1 WLR 1476, what had to be established was that Mr Onuiri's knowledge about the payment was such as to render his participation contrary to normal and acceptable standards of honest conduct. It was sufficient for these purposes if he knew that the money received by Habitable Concepts was not at the free disposal of the Practice (*Twinsectra v Yardley* [2002] 2 AC 164 per Lord Millett). The Judge found that there was no commercial relationship between the Practice and Habitable Concepts that would justify the payment and that Mr Onuiri had applied the funds for the benefit of Habitable Concepts in any event without making any enquiry of the Practice as to why the payment had been received. This was contrary to normally acceptable standards of honest conduct and, accordingly, Mr Onuiri had dishonestly assisted in a breach of trust and was jointly liable with Habitable Concepts to account as constructive trustee.

49. If neither CASS7 nor a proprietary or personal claim in equity solves the client's problem, it may be that a claim for damages or compensation under FSMA or a claim for damages at common law or under the Misrepresentation Act 1967 will assist.

FSMA claims against unauthorised persons – and a little help from the FSA

Agreements made unenforceable by ss26-30 FSMA

50. It may be that the investment, or other arrangements, into which your client has entered involved the activities of an unauthorised person in contravention of FSMA. If that is the case, the arrangements may be unenforceable against your client (while remaining enforceable *by* him) and he may be entitled to compensation pursuant to ss26-30 FSMA. In order to explain a little more about these provisions we need first to look at the '*general prohibition*' against unauthorised persons engaging in investment activities regulated by FSMA

(s19 FSMA) and the restrictions which prohibit unauthorised persons from making financial promotions (s21 FSMA).

Restriction upon engaging in regulated activities: s19 FSMA

51. s19 FSMA prohibits anyone except an authorised person or an '*exempt person*' undertaking regulated activities. This is known as the '*general prohibition*'.

52. In order to determine what is a regulated activity reference must be made to s22 FSMA which provides that an activity is a regulated activity if it is '*an activity of a specified kind which is carried on by way of business*' and either '*relates to an investment of a specified kind*' or '*in the case of an activity of a kind which is also specified for the purposes of this paragraph, is carried on in relation to property of any kind*'.

53. The specified activities and *'investments of a specified kind'* are set out in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 ('*RAO*'). Specified activities include accepting deposits, effecting and carrying out contracts of insurance, dealing in investments as principal, arranging deals in or advising upon or managing investments, establishing a CIS and various activities in relation to regulated mortgage contracts. Investments of a specified kind include deposits, contracts of insurance, shares, debentures, bonds, CFDs, units in a CIS, futures and regulated mortgage contracts.

54. The reason for the distinction between '*specified*' and '*regulated*' activities is that specified activities only become regulated activities if they are carried on by way of business. The Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order 2001 (the '*Business Order*') contains guidance as to when a specified activity is not to be considered as having been carried on by way of business.

The financial promotion restriction: s21 FSMA

55. s21 FSMA prevents unauthorised persons communicating (or causing to be communicated) an invitation or inducement to participate in '*investment activity*' '*in the course of business*' unless the communication has been approved by an authorised person or an exemption applies. The reasoning behind the prohibition is set out succinctly in Blair: Financial Services Law (2nd Edn) at 17.131:

'Section 21 imposes a general financial promotion restriction. Apart from so called 'exempt communications', which are set out in the FPO [the Financial Services and Markets Act 2000 (Financial Promotions) Order 2001]*, essentially section 21 requires the involvement of authorised persons in all financial promotions 'in the course of business'. Thus, 'exempt communications' apart, the only financial promotions that are permitted are*

those communicated by authorised persons or whose contents have been approved by authorised persons. The FSA Handbook, in its COBS Module, then regulates the communication and approval of promotions by authorised persons.'

56. In order to determine whether what is proposed to be, or has been, promoted is subject to the financial promotion restriction, it is necessary to ascertain whether it involves an invitation, made in the course of business, to participate in investment activity. '*Investment activity*' is defined by s21 FSMA in terms of engaging in a '*controlled activity*' in relation to a '*controlled investment*'. Activities and investments are '*controlled*' if they are '*specified*' as such in Schedule 1 of the FPO.

57. Although controlled activities and controlled investments for the purposes of s21 FSMA (set out in the *FPO*) are similar to regulated activities and specified investments for the purposes of s19 FSMA (set out in the *RAO*), there are significant differences. In general the exclusions set out in the RAO do not apply in relation to s21 FSMA, so, while a person may not require authorisation because he is not carrying on a regulated activity by way of business, he may find that his communications are subject to the financial promotion restriction.

58. '*Controlled activities*' include accepting deposits, dealing or arranging deals in, managing, administering and advising upon investments. '*Controlled investments*' include deposits, shares, debentures, bonds, units in a CIS, options, futures, and CFDs.

59. Accordingly (and in English), by way of example, an unauthorised person may not communicate an invitation to buy shares or units in a CIS in the course of business unless the communication has been approved by an authorised person or an exemption applies.

Unregulated CIS

60. The scope for promoting the opportunity to invest in an unregulated CIS[15] is even further circumscribed. Even authorised persons are prohibited from making promotions in respect of an unregulated CIS unless an exemption applies (s238 FSMA). This is because such products are deemed to be high risk investments unsuitable for the majority of clients.

Exemptions

61. If a relevant exemption or exclusion applies an unauthorised person will not be in breach of the general prohibition nor of the financial promotion

[15] Three classes of CIS are capable of being regulated; authorised unit trusts, OEICs set up in the UK pursuant to the detailed rules of FSMA and overseas recognised schemes. The term '*unregulated*' simply means a scheme that does not come within one of these three classes.

restriction. The RAO sets out a series of exclusions from the list of specified activities capable of constituting regulated activities. The FPO sets out a list of exempt communications to which the financial promotion restriction does not apply: for example, communications with overseas recipients, investment professionals, certified '*high net worth individuals*' or '*sophisticated investors*' (as defined). When considering entering into investments arrangements, your clients may well be asked for information or certification in relation to whether they are high net worth individuals or sophisticated investors. Those and various other exemptions may be relied upon by persons promoting investments. Where a deal has gone sour and a remedy is required, it can pay dividends to examine what exemptions were relied upon and whether they in fact applied. If not, the arrangements may be unenforceable against your client.

Application of ss26-30 FSMA

62. ss26 and 27 FSMA provide that where an unauthorised person enters into an agreement in breach of the '*general prohibition*' in s19 FSMA or such an agreement is entered into in consequence of something said or done by an unauthorised person that agreement is unenforceable against the other party (the investor) who is entitled to recover any money paid or property transferred by him under the agreement and may also be entitled to compensation. s28 FSMA provides that where an agreement is made unenforceable by ss26 or 27 FSMA the amount of compensation payable may be agreed by the parties or fixed by the court. However, if the court is satisfied that it is just and equitable in the circumstances of the case to do so, it has the discretion to permit the agreement to be enforced.

63. s30 FSMA provides that where an agreement relating to a controlled activity is entered into by a person as a result of an '*unlawful communication*', that is, a communication made in breach of the financial promotion restriction, that agreement is unenforceable against that person (the investor) who is entitled to recover any money paid or property transferred by him under the agreement and compensation for any loss he has suffered subject to the discretion of the court to permit the agreement to be enforced mentioned above.

64. In *Charles Cleland Helden v Strathmore Ltd* [2010] EWHC 2012, Mr Helden claimed that loans of about £1 million made to him by Strathmore Ltd ('*Strathmore*') contravened s19 FSMA and were accordingly unenforceable. He also claimed damages of £1.25 million to compensate him for the loss he claimed to have suffered as a result of the breach of FSMA. Strathmore conceded that it had conducted an '*activity of a specified kind*' for the purposes of FSMA but contended that because the activity had not been carried on '*by way of business*' it was not regulated and so did not infringe s19 FSMA. If it failed on that ground, Strathmore asked the court to exercise its discretion to order that the agreement be enforced pursuant to s28 FSMA. Newey J exercised the discretion of the court to allow agreements rendered otherwise unenforceable pursuant to s26 FSMA to be enforced.

65. Certain activities in respect of '*regulated mortgage contracts*', including '*entering into a regulated mortgage contract as lender*' or making

arrangements '*for another person to enter into a regulated mortgage contract as borrower*', if carried on by way of business, are regulated activities and, accordingly, cannot be engaged in by unauthorised persons. It was common ground that Strathmore was an unauthorised person.

66. The Judge had regard to the FSA's guidance in the '*Perimeter Guidance Manual*' as to the meaning of carrying on an activity '*by way of business*'. Paragraph 4.3.7 of the manual stated: '*the 'by way of business' test in section 22 could be satisfied by an activity undertaken on an isolated occasion (provided that the activity would be regarded as done by 'way of business' in all other respects)*'. Accordingly, at paragraph, 85 the Judge stated that the test in s22 FSMA (definition of regulated activities) '*cannot be intended to mean that the relevant activity should itself represent a business. Section 22 must extend to cases where an 'activity of a specified kind' is carried on in the course of a wider business, not limited to undertaking that activity*'. The Judge went on to hold that the lending to Mr Helden was carried on by way of business on the basis that:

    a. Strathmore made a sizeable number of loans, including the loans to Mr Helden;
    b. Substantial amounts of money were advanced;
    c. The loans were made with a view to profit;
    d. The loans to Mr Helden formed part of a chain of not dissimilar transactions;
    e. Strathmore was a limited company with commercial objects;

and, accordingly, the lending to Mr Helden involved a breach of the general prohibition and, as a result, the agreements were unenforceable by Strathmore unless the court granted relief under s28 FSMA.

67. As to the application for relief under s28 FSMA, the Judge held that the fact that Strathmore did not appreciate that there was any question of FSMA applying and that it was reasonable for them not to have appreciated it under the circumstances was an important factor in considering the exercise of the discretion to allow the transactions to be enforced but not, by itself, enough. The Judge exercised his discretion to allow two out of the three loan agreements to be enforced on the basis of the following additional factors:

    a. Mr Helden had benefitted from the use of the property which Strathmore's loans enabled him to buy and that property had increased substantially in value;
    b. Strathmore would have made a return on the money lent to Mr Helden had it been invested elsewhere;
    c. No advantage had been taken of Mr Helden who had experience of the property market and had paid an acceptable rate of interest. The arrangements had been to his advantage since he was able to make lump sum repayments without incurring a penalty; and
    d. Mr Helden had not identified any respect in which he would have been better placed if Strathmore had been authorised.

68. In *Re the Inertia Partnership LLP* ('*Inertia*') No 4905 of 2006 s19 FSMA was considered in a liquidation context. The case involved an application by the

FSA under s367(1)(c) FSMA to wind up Inertia (an unauthorised entity). s367(1)(c) empowers the FSA to apply to petition to wind up an entity which is carrying on, or has carried on, a regulated activity in contravention of the general prohibition. On such an application, the court can wind up the entity if it is unable to pay its debts or if the court is of the opinion that it is just and equitable that the entity should be wound up.

69. The FSA alleged that arrangements entered into by Inertia with a company called Porterland Associates Limited (‘*Porterland*’) whereby Inertia introduced Porterland to Plasma Warehouse Group Plc (‘*Plasma*’) and Police 5 Group Plc (‘*Police 5*’) and provided administration services designed to facilitate the sale of Plasma’s and Police 5’s shares by Porterland to unsophisticated investors of limited means via ‘*boiler rooms*’[16] breached s19 FSMA. The issues before the Jonathan Crow QC sitting as a deputy judge of the High Court were:

    a. Whether Inertia had been conducting a regulated activity in breach of the general prohibition (the FSA would have no locus to petition otherwise); and, if so,
    b. Whether Inertia was insolvent and/or whether it was just and equitable to wind it up.

70. Article 25 of the RAO provides that making arrangements for another person (whether as principal or agent) to buy, sell, subscribe for or underwrite an investment which is a ‘*security*’ and/or making arrangements with a view to a person who participates in the arrangements buying, selling or subscribing for securities (whether as principal or agent) are specified activities and therefore will be regulated activities for the purpose of s22 FSMA if carried on by way of business. Article 26 of the RAO excludes from Article 25 arrangements which do not, or would not, ‘*bring about the transaction to which the arrangements relate*’.

71. The Judge held that the shares in Plasma and Police 5 fell within the definition of ‘*securities*’ at article 3 of the RAO and that the introductions and administrative services provided by Inertia to facilitate the sale of Plasma and Police 5 shares were caught by Article 25 RAO and not saved by Article 26 since Inertia’s activities had been material in ‘*bringing about*’ the sale of shares. The Judge also held that Inertia was insolvent. The court would have been entitled to wind it up on that basis but, since Inertia was already in creditors’ voluntary liquidation, the Judge went on to consider whether it was in the public interest to take the additional step of putting Inertia into compulsory liquidation. He held that it was and made the winding up order for the following reasons:

    a. The FSA’s statutory objectives of maintaining confidence in the financial system, protecting consumers and reducing financial crime would be satisfied by a winding up order since that order would assist the FSA in clarifying the scope of the general prohibition, enable it to provide further publicity to protect consumers and deter others who might be tempted to break the general prohibition;

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[16] Unauthorised offshore entities which cold-call private individuals and try to encourage them to buy (generally overpriced) shares in unlisted companies. The high pressure sales techniques of boiler rooms often involve misrepresentations being made to potential customers. The Judge described their activities as ‘*pernicious*’.

b. The scale of Inertia's activities and its level of involvement in the transactions were relevant. There was evidence that it had participated in arrangements involving at least £1 million and Inertia had played a significant role in these transactions;

c. Inertia, through its sole member, Mr Shears, had known both of the use of boiler rooms to cold-call unsophisticated consumers of limited means in the UK and of the fact that some of those consumers had made complaints that misrepresentations had been made to them;

d. By making the winding up order the public would be able to see that the FSA had investigated the matter and had concluded that it was in the public interest that the business be wound up, that the court agreed with that conclusion and that the public could also be reassured that the matter was to be properly investigated by a court appointed liquidator.

72. The Judge stated that the finding that s19 FSMA had been breached enabled investors to establish the '*first element*' of a claim for compensation under s28 FSMA. The question in the Inertia case, however, is – compensation from whom? At first sight the drafting of ss 26 and 27 FSMA appears to indicate that it is the counterparty that will be liable to return monies paid and pay compensation if the investor has suffered a loss. In many cases this will be uncontroversial since the party in breach of FSMA and the party with whom the investor has entered into an arrangement will be one and the same.

73. However, in the *Inertia* case the principal counterparties were the investors and Plasma/Police 5 but Inertia and Porterland were involved in the arrangements which constituted, or led to, the breach of FSMA. The Judge may have been indicating that he was conscious of this issue when he stated, at paragraph 63: '*Whether they* [the investors] *are in reality entitled to any such compensation, and if so against whom, is not for the court on this occasion*'.

74. This isn't a straightforward point. FSMA provisions tend to be drafted in an '*open-textured way*' and '*at a high level of generality*', to borrow formulations used by Arden LJ in *The FSA v Fradley and Woodward* [2005] EWCA Civ 1183, [2006] 2 BCLC 616 to describe the drafting of s235 FSMA (definition of a CIS), and are amenable to wide interpretation. On one view, as long as there's an arrangement caught by s19 or s21 FSMA and compensation is to be paid, the provisions do not in terms limit by whom that compensation is to be paid. On the other hand, in many investment arrangements the investor will enter into a number of contracts; most commonly he will have a services contract with an intermediary which leads to a product contract with a product provider. Logically, it will be the product contract that the investors will wish to set aside enabling them to receive back their investment upon the return of their shares or, perhaps, their parcels of land in the case of a land banking scheme that turned out to be a CIS, or upon the cancellation of their membership of an LLP in which they had invested and so on. However, the blameworthy party might not be the product contract counterparty but the services contract counterparty for giving bad advice, for example. It remains to be seen how the courts will interpret these provisions and apportion liability to pay compensation.

Restitution orders: s382 FSMA

75. In *FSA v Shepherd* LTL 1/6/2009, Jules Sher QC sitting as a deputy judge of the High Court made restitution orders under s382 FSMA on the application of the FSA to compensate investors for losses made as a result of unauthorised sales of shares to them in breach of s19 and s21 FSMA. The Judge commented upon the remedies sought (at paragraph 29 of the judgment) as follows:

'These provisions enable the regulators to obtain compensation or some other form of remedy on behalf of investors who have suffered as a result of the conduct of those who have contravened the FSMA. Those investors would not, or at the least might not, have the resources to pursue such remedies in relation to the relatively small amounts involved in their individual cases. Section 382(3) provides that any amount paid to the FSA as a result of an order under subsection (2) must be paid to the investors as the court may direct. These provisions accordingly enable the FSA to act on behalf of the investors almost as if this was a representative action. The two sections cover slightly different ground, section 380(2) being concerned with something akin to statutory rescission of the transactions which have been brought about in contravention of the Act whereas section 382 is concerned with compensation for loss resulting from those transactions and disgorgement of profits made by the contraveners as a result of them.'

76. Having satisfied himself that profits had accrued to the Defendants and that losses had been incurred by the investors as a result of the breaches of FSMA, the Judge noted he had a discretion under s382 FSMA to order the Defendants to pay '*such sum as appears to the court to be just having regard to*' the profits and losses. He also noted (at paragraph 35), on the authority of *SIB v Pantell* [1993] Ch 256 and *SIB v Scandex Capital Management* [1998] 1 WLR 712 (cases decided under analogous provisions in the Financial Services Act 1986), that '*the discretion given to the court in these sections is given in extremely wide terms*'. At paragraph 36 the Judge went on to consider the question of what factors bore upon the justness of making an order:

'...this raises the question of the statutory purpose behind the powers of the court under these sections. That purpose must, it seems to me, include protection of the investing public consistent with the regulatory objective of the protection of consumers under section 5 of the FSMA. The main form of protection of investors, who have been drawn into investment as a result of contravention of section 19 and 21 of the FSMA, is rescission or compensation. Disgorgement of profits acquired by the contravener is a further protection to the investing public because such disgorgement

discourages future contravention. But the order of the court is required to be just, and that, to my mind involves an awareness of the gravity of the conduct of the contravener. The exercise of the court involves, it seems to me, a balancing of the interests of the investors against the culpability of the contravener. There may be cases in which the contravention of the FSMA was technical or inadvertent and this may temper the judgment of the court as to what it would otherwise be minded to order. It is incumbent upon the court to consider all the circumstances that bear upon the fairness of the order it makes.'

77. The guidance given in *Shepherd* was considered recently in *FSA v Anderson and Ors* [2010] EWHC 599 Ch and 1547 Ch. The case concerned a scheme whereby unauthorised persons had engaged in the regulated activity of accepting deposits by way of business. The deposits were to be repaid with interest after a specified period of time. The evidence before the Court was that the amounts paid to the defendants pursuant to over 750 transactions had exceeded £42 million between February 2007 and December 2008 and resulted in a liability to repay of in excess of £72 million. Following summary judgment granted by Lewison J, Vos J considered what orders should be made pursuant to s380(2) FSMA and/or s382(2) FSMA. The FSA did not press for an order under s380(2) FSMA requiring the defendants to take steps to remedy their contraventions of s19 FSMA since it doubted that the transactions engaged in by the defendants were capable of being unwound, instead seeking restitution orders pursuant to s382(2) FSMA. Endorsing the guidance given in *Shepherd*, the Judge assessed the amounts the defendants should pay under s382(2) as the losses caused to the investors and the profits made by the defendants, the two sums being co-extensive.

Claims against investment counterparties and professionals under FSMA

78. If a remedy is required against an authorised person, s150 FSMA gives a private person[17] a right of action for damages against an authorised person for loss suffered as a result of a breach of the Rules subject to the defences and other incidents applying to actions for breach of statutory duty[18].

79. In *Spreadex Limited v Sekhon* [2008] EWHC 1136 (Ch), [2009] 1 BCLC 102 Dr Sekhon had run up a debt of some £695,000 between October 2005 and the end of November 2006 on spread betting transactions through Spreadex when the company closed out his open positions. Dr Sekhon complained that

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[17] Defined in Article 3 of the Financial Services and Markets Act 2000 (Rights of Action) Regulations 2000 (SI 2001/2256) as any individual, unless he suffers the loss in question in the course of carrying on a regulated activity and any person who is not an individual, unless he suffers the loss in question in the course of carrying on business of any kind.

[18] The FSA has power to prevent private actions by making rules specifying that particular provisions do not give rise to a right of action if breached. Rules have, for example, been made removing private rights of action in respect of certain high-level rules in the Handbook such as PRIN and SYSC. Similarly, breaches of the Listing Rules are not actionable under s150 FSMA.

Spreadex ought to have closed his open positions against his will some two months earlier. If it had done so consistently with its obligations under the Conduct of Business Rules ('*COBR*' now '*COBS*') in the Handbook, argued Dr Sekhon, he wouldn't have owed it any (or if some, much less) money. He claimed the deterioration in his account with Spreadex between September and November 2006 was loss and damage recoverable pursuant to s150 FSMA. The section provides as follows:

150 Actions for damages.

(1) A contravention by an authorised person of a rule is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty.

(2) If rules so provide, subsection (1) does not apply to contravention of a specified provision of those rules.

(3) In prescribed cases, a contravention of a rule which would be actionable at the suit of a private person is actionable at the suit of a person who is not a private person, subject to the defences and other incidents applying to actions for breach of statutory duty.

(4) In subsections (1) and (3) 'rule' does not include—

(a) Part 6 Rules; or

(b) a rule requiring an authorised person to have or maintain financial resources.

(5) 'Private person' has such meaning as may be prescribed.

80. Spreadex denied that it had broken any rule in COBR and contended that, even if it had, the breach wasn't causative of any loss to Dr Sekhon; his losses were attributable to his own decision to keep his positions open so that he was contributorily negligent in respect of the losses he sought to claim from Spreadex.

81. It was common ground that the spread betting transactions constituted a regulated activity and that the conduct of such activities was governed by COBR. Morgan J found that Spreadex had on a number of occasions expressed concerns about keeping Dr Sekhon's positions open but that he had persuaded them to give him more time before closing them out.

82. Notwithstanding provisions in the agreement between Spreadex and Dr Sekhon to the effect that he contracted as principal and the bets were placed on an execution only basis at Dr Sekhon's own risk (as to which a two page document entitled '*Risk Warning Notice*' was included in the agreement), the Judge agreed that Spreadex had committed an actionable breach of COB7.10.5R, one of the provisions dealing with margin requirements, by not closing out Dr Sekhon's positions earlier.

83. COB7.10.5R provided as follows:

'A firm must close out a private customer's open position if that customer fails to meet a margin call made for that position for five business days following the date on which the obligation to meet the call accrues, unless:

(1)(a) the firm has received confirmation from a relevant third party that the private customer has given instructions to pay in full; and

(b) the firm has taken reasonable care to establish that the delay in its receipt is owing to circumstances beyond the private customer's control; or

(2) the firm makes a loan or grants credit to the private customer to enable that customer to pay the full amount of the margin call in accordance with the requirements of COB7.9.3R (Restrictions on lending to private customers).'

84. The Judge found, consistently with Dr Sekhon's case, that he received one or more margin calls while a private customer, that he failed to meet them, that Spreadex had not extended credit to him consistently with the requirements of COB7.9.3R and that, accordingly, Spreadex should have, but did not, close all his open positions by 14 September 2006 in order to comply with the terms of the agreement and COBR.

85. However, reminding himself of the remarks of Lord Hoffmann in *Reeves v Metropolitan Police Commissioner* [2001] 1 AC 360 at 368c-d that: '*People of full age and sound understanding must look after themselves and take responsibility for their actions*', the Judge held that: '*As to relative blameworthiness and responsibility for the losses in this case, I regard Dr Sekhon as the principal source of his own misfortunes. He was much more the moving force than Spreadex was. He wanted to keep his positions open and it was he who persuaded Spreadex to permit him to do so*'.

86. The Judge held that Spreadex must bear some responsibility for the losses because one part of the purpose of COB7.10.5R was to require Spreadex to protect Dr Sekhon from himself, at any rate in relation to giving him credit. While Spreadex was liable to Dr Sekhon for the deterioration of his open positions between 14 September and 5 October 2006, the appropriate apportionment was that Dr Sekhon was himself 85% contributory negligent for that deterioration.

87. In many respects liability under s150 FSMA adds little to liability for negligence at common law since the standard of care to be expected of a financial services professional will involve compliance with the Rules in any event. In *Loosemore v Financial Concepts* [2001] 1 Lloyd's Rep 235 HHJ Raymond Jack QC considered the standard of care to be expected in advising an investor on the merits of certain investments. The Judge held that the test to be applied to a firm would '*ordinarily include compliance with the rules*'. Similarly, in *Seymour v Christine Ockwell & Co* [2005] PNLR 39 the court held that '*the regulations afford strong evidence as to what is expected of a competent adviser in most situations*'.

88. However, because s150 FSMA imposes a specific statutory duty, it has the major advantage that one only has to point to breach of a relevant Rule and loss to establish liability. This is because the wording of s150 FSMA makes contravention of a Rule '*actionable at the suit of a private person who suffers loss as a result of the contravention*'. Accordingly, many of the potential difficulties involved in establishing that a duty of care at common law is owed

by a particular professional to a particular claimant simply do not arise. One limitation of s150 FSMA, however, is that it is only applicable to breaches of the Rules and does not extend to breaches of FSMA itself: s417 FSMA defines '*rule*' as '*a rule made by the Authority under this Act*'.

89. It is anticipated that a substantial proportion of litigation under s150 FSMA is likely to involve reliance upon provisions from the COBS (conduct of business) and CASS (client assets) modules in the Handbook since these provisions in large part govern the day to day relationship between financial services professionals and their customers. COBS includes detailed provisions regulating communications with clients, including financial promotions; information about the firm, its services and remuneration; provisions regulating the content of agreements; rules dealing with the requirements for ascertaining the suitability of investments for clients; provisions about dealing in and managing investments; requirements concerning the preparation of product information; rules on providing product information to clients and reporting to clients.

90. As mentioned above, s150 FSMA is subject to the defences and other incidents applying to breach of statutory duty. For example, the normal rules of causation and remoteness will apply (for an illustration, see *Walker v Inter-Alliance Group* [2007] EWHC 1858 (Ch)). The claimant must establish that the loss and damage he complains of were caused by the breach of duty in question and were reasonably foreseeable. The negligence of a financial services professional is nothing to the point if the customer would not have acted any differently had he been competently and appropriately advised. In *Beary v Pall Mall Investments* [2005] EWCA Civ 415 the defendant financial adviser had advised negligently in respect of certain changes to Mr Beary's pension provision. The funds available to Mr Beary subsequently dwindled and he complained about the advice he had been given. Pall Mall Investments admitted breach of duty, in particular it admitted that there had been a failure to advise Mr Beary on the possibility of buying an immediate annuity, but the Judge found that, even if he had been properly advised in respect of the annuity, Mr Beary would not have purchased one. Accordingly, causation was not established.

91. In *Australia and New Zealand Banking Group Limited v Cattan* LTL 3/9/2001 the claimant sought to recover sums owed to it by Mr Cattan. In his counterclaim Mr Cattan contended that the claimant was liable to him for damages for breach of statutory duty since it had breached certain regulatory requirements in respect of client classification. It was held that the breaches had caused no loss since, even if Mr Cattan had not been able to make the trades in question before the formalities required to classify him as a non-private customer had been completed, he would have made the same trades afterwards at the same price. The breach had caused no loss and, accordingly, the claimant was not liable.

92. The basis for the calculation of quantum of damages for breach of the statutory duty under s 150 FSMA is the same as at common law: the appropriate amount is that which is necessary to put the claimant in the position that he would have been in if the financial services professional had discharged his duty properly.

93. One aspect of the calculation of damages is the evaluation of the loss of a chance of a better outcome if the defendant had done his duty. In an investment environment, where the value of trades or investments can go down as well as up, the loss of a chance doctrine takes on particular difficulties. In order to establish liability based on a lost chance, the claimant must show that he would have taken steps that would have given him a real or substantial chance of a particular outcome as opposed to a chance that was purely speculative. In *Bailey v Balholm Securities* [1973] 2 Lloyd's Rep 404 Kerr J stated:

> '*But those were all cases in which the plaintiff might or might not have obtained some pecuniary advantage or benefit and lost the chance of doing so as the result of the defendant's wrongful act. He therefore lost the chance of being better off than he was, but he was not exposed to the risk of being worse off. In cases like the present, on the other hand, a person who is prevented from speculating in cocoa or sugar futures may have lost the chance of making money or may have been saved from losing money...the loss of the general opportunity to trade – as opposed to the loss of the particular bargain – is in my view much too speculative to be capable of having any monetary value placed upon it*.'

94. In the recent case of *Parabola Investments Limited v Browallia Cal Limited* [2009] EWHC 901 (Comm) Flaux J held that there was nothing in *Bailey* preventing loss of profits from hypothetical transactions that a claimant contended he would have entered into had he been properly advised forming part of an award of damages if the claimant could demonstrate a real or substantial chance that, but for the breach of duty, alternative transactions in which he would have engaged would have been profitable. The Judge's decision was upheld by LJJ Mummer, Toulson and Rimer on appeal in *Parabola Investments Limited v Browallia Cal Limited* [2010] EWCA Civ 486.

95. And finally, the prize for being your own worst enemy goes to...In *JP Morgan Chase Group v Springwell Navigation Corporation* [2008] EWHC 1186 (Comm), Gloster J found that, even if Springwell established a breach of duty by JP Morgan Chase, a substantial reduction for contributory negligence would have to have been made on the basis its '*clear disregard*' for its own interests by:

    a. expecting a full advisory service throughout but never bothering to request it;
    b. treating contractual documents with contempt, whether they included terms of business or terms and risks relating to individual investments;
    c. not bothering to read Chase research or, apparently, the research of any other bank;
    d. ignoring any views that it did not want to hear;
    e. aggressively pursuing a strategy of high returns and opportunistic investments thereby assuming obvious risk; and

f. taking no steps to understand either the nature of the instruments which it was buying or the level of risks attached to those instruments.

In conclusion

96. Where a wealthy individual has involved himself in an investment opportunity that has gone wrong and his '*sure bets*' and '*cunning plans*' have gone awry, it is always worth considering the following preliminary questions: (1) Is the client's money held pursuant to the statutory trust in CASS7? (2) Are the arrangements the investor has entered into enforceable against him? (3) Has there been a breach of the Rules actionable under s150 FSMA? (4) Is the matter of sufficient seriousness that the FSA may consider exercising its power to apply for an injunction or for restitution orders or to wind up the investment counterparty? If so, perhaps FSMA can give your client a remedy or bolster his or her claim at common law.

FRANCIS TREGEAR QC
SARAH BAYLISS

10 September 2010

Breaking and entering: asset protection under fire

Stephen Moverley Smith QC

Edward Knight

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Barristers

London & Geneva

Breaking & Entering
-
Asset Protection Under Fire

Stephen Moverley Smith QC
Edward Knight

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Private trust companies: is this what you want, what you really, really want?

David Brownbill QC

Elizabeth Weaver

XXIV Old Buildings

Barristers

London & Geneva

PRIVATE TRUST COMPANIES

The litigation context

David Brownbill QC & Elizabeth Weaver

I. INTRODUCTION

1. Almost all offshore finance centres have in recent years amended their regulations to accommodate the "private" trust company, imposing a light touch licensing and regulatory regime on trust companies which will not be providing services to the public or on a commercial basis. These trust companies will usually be single purpose companies, acting in relation to the affairs of one family or corporate group, undertaking no other activity and having no material assets or income. If not completely circular, the various relationships within private trust company structures can be very close with settlors and beneficiaries of the trusts of which the private trust company is a trustee often also being involved in the management of trust company and, at the same time, controlling the private trust company shares or membership interests.

2. The advantages, or at least the promise, offered by private trust companies are substantial:

   (1) "acceptable" settlor/family control or involvement in the administration of the trusts handled by the private trust company;

   (2) greater managerial flexibility and responsiveness than that available from professional trust companies;

   (3) difficult, complex, or high risk assets can be accepted on trust, professional trustees being happier to provide directors of private trust companies in these cases than to take such assets into their names;

   (4) reduced administration costs.

II. PRIVATE TRUST COMPANY STRUCTURES

Structuring Options

3. In all private trust company structures someone must own or hold the shares or membership rights and control the board of the private trust company. The very same estate planning issues that most likely prompted the establishment of the main trust structure will need to be addressed in relation to the shares or membership interests in the private trust company. Typical offshore private trust company structures can therefore add several additional layers or elements to the usual trust structure: the private trust company board of directors, the holding vehicle for the shares/membership rights of the company and the enforcers/protectors connected with that vehicle.

4. There are four broad approaches to private trust company share ownership:

(1) a second family trust dedicated to the private trust company share ownership alone;

This may simply shift the problems of succession, management and control further up the tree leaving them still to be dealt with. However, the perception is that such "holding trusts", merely holding the shares of the private trust company, present less of a challenge, allowing both professional trustees and settlors to take a more relaxed approach to them.

(2) an "orphan" trust – a purpose trust or a charitable trust, again established solely for private trust company share ownership;

(3) ownership by a self owning/stand alone entity such as a Liechtenstein or common law foundation.

(4) direct settlor/family ownership.

- Direct ownership introduces, or replicates, a number of problems. The concentration of largely unfettered control in the hands of the settlor may raise questions in relation to the integrity of the structure and carries obvious problems of succession and subsequent fragmentation of ownership.

- Sole, direct ownership by the settlor is not the only possibility. If other family members can be brought into the structure then joint tenancies, split or varied voting arrangements, share options, and multi-membership guarantee company structures all become possible.

- Joint or divided ownership with the second generation may alleviate some of these problems but will often simply put off the fateful day when a succession problem will arise and the inevitable fragmentation of ownership that will follow will present further problems of its own.

- In most cases it is inevitable that some form of succession vehicle – whether a trust or a foundation – will be essential.

What could possibly go wrong?

5. The advantages and attractions of private trust companies come at a price. The use of a private trust company has far reaching consequences many of which are of considerable significance in the litigation context.

   (1) *the enforcement of beneficiaries' rights in the event of a breach of trust*:

   - the absence of any effective recovery of compensation for breach of trust against a penniless trustee;

   - the contortions needed to claim recovery against secondary parties such as the private trust company directors;

   - difficulties in regard to other remedies such as a change of trustee where this results in the destruction of what may be a complex family holding structure.

   (2) *the private trust company holding structure*: its validity and administration and its significance in a dispute;

   (3) *the risks to the integrity of trusts*: where settlor involvement or control is too great, or where settlors misuse their otherwise legitimate powers.

6. Two preliminary points

   (1) the first is the obvious one: private trust companies are companies and the parties will be faced with issues of company law not just trust law. The combination of the two can produce a complex result: see *Australian Securities Commission v As Nominees Limited and others* [1995] FCA 1663, per Finn J:

> "These are somewhat unusual proceedings. Their object is to secure the removal of trustees and managers of a number of superannuation and unit trusts. Yet in form they involve two applications under the Corporations Law, the one for the winding up of the three corporate respondents, the other (in the alternative) for the appointment of a receiver and manager of all of the property of the corporate respondents and of specified property of the individual respondent. There are good and proper reasons for the proceedings taking the form they have. But as will become apparent in these reasons, the need to view what are essentially trust law problems through the prism of corporations law is itself a complicating factor."

(2) The second is that the dispute dynamic does not change simply because the trustee is a private trust company. The underlying fact patterns will remain more or less the same:

(A) what has passed for acceptable conduct by past generations is called into question by the current generation;

(B) a loss has been suffered by the trust fund and beneficiaries seek redress;

(C) the frustrations of the beneficiary who is convinced he is getting the short end of the stick;

(D) dissatisfaction among a faction of the family who object to or want a different approach to investment management or distributions;

(E) power struggles: a family member or faction of the family do not want to be subject to the decisions of others and want full control.

Control and administration

7. Control of the private trust company shares gives control of everything: choice of directors, effective day to day trust administration, the acceptance or ratification of directors' actions, and enforcement of directors' duties and liabilities.

8. Where dissatisfied beneficiaries wish to bring about a change in the administration of the trust the traditional route of direct challenges to the trusteeship and its conduct remain open: seeking the trustee's replacement, orders directing a particular course of action by the trustee, the removal of protectors and other fiduciary power holders, the neutralisation or restriction of such powers.

9. But control of the private trust company – or control of the shares in the private trust company – could well be the bigger prize and may offer a simpler route to

effect the desired revolution. The forced removal of a trustee from office is far from simple especially if sought by a minority of beneficiaries. These more traditional battles pitched against the trustee may be less attractive than a challenge at the private trust company corporate or shareholder level.

10. It follows that close attention must be given to the holding of the private trust company shares not only from a succession point of view but also with a view, more generally, to ensuring that ownership and control of the shares and the votes attaching to them falls into the rights hands. It also means that the integrity of holding structure and its vulnerability to attack might be just as important as the integrity of the trust of which the private trust company is trustee.

11. Three aspects of the holding structure, therefore, will need to be considered:

    (1) the validity of the structure and the consequence if invalid;

    (2) the control elements over the structure (such as powers to appoint and remove trustees); and

    (3) the manner in which the holding structure should be administered.

12. Let us assume that there is a holding structure rather than direct ownership and that it is in the form of a trust, whether beneficiary or purpose trust. Largely, the same issues arise and need to be addressed if a foundation, civil or common law, is used instead.

13. We may start again with the obvious: a trustee of the holding trust will be needed and this, inevitably, will be a professional trust company.

    (1) A particular risk with holding structures is that scant attention may be given to them; their perceived lack of importance and limited function may seduce the parties into a relaxed approach so the traditional challenges to validity such as sham, failed constitution and the like, could have some scope.

    (2) How solid is the purpose trust when employed, specifically, as an orphan trust? Sham or impossible purposes and purposes limited to holding the trust assets, all seem inherently vulnerable. In some instances, the pure “holding” purposes are supplemented by additional purposes involving, one way or another, the promotion of the private trust company’s intended function. To

what extent do these additional purposes result in positive obligations to intervene in the affairs of the private trust company?

(3) Control of the holding trust gives control over the private trust company. Who has - or should have - the power to appoint and remove the holding trustee? If there is a protector or other third party power holder, who controls this office and the powers it carries?

(4) If the trust is not a purpose trust, who should be the beneficiaries of this trust and on what trusts should the shares be held?

(5) Where the holding trust is a purpose trust established under a regime which calls for an enforcer, similar questions arise as with a protector: who should take on the enforcer's role and who should control this office and what risks does the enforcer face?

14. Consider how the holding trustee should administer the holding trust where that trust is a beneficiary rather than a purpose trust.

(1) A disposition of the private trust company shares is unlikely ever to be on the agenda. How then should the trustee exercise the voting powers attaching to the private trust company shares? Even where the holding trust is a beneficiary trust, it may not help to say "in the interests of the beneficiaries".

(2) In exercising an administrative power what, in any particular instance, would be in the interests or for the benefit of the beneficiaries? Maintaining the value of the shares of the private trust company may not be very meaningful in the case of a lightly capitalised entity with no value to maintain or scope of value enhancement.

(3) Should the holding trustee take into account the function of the private trust company and react if it is aware that the private trust company is not administering the main trust properly? If things have gone wrong at that level already, should the holding trustee cause the private trust company to take action against its directors? If there are common beneficiaries under the holding trust and the main trust, can a beneficiary of the holding trust (who, as we have seen, may be in a very weak position vis a vis the main trust) seek a direction that the holding trustee exercise its powers accordingly?

15. In establishing private trust company holding structures some careful consideration of what is expected of the trustee of the holding trust and who can enforce its obligations (equally, prevent unwanted action) would seem essential.

16. Does a purpose trust offer the trustees of the holding trust a simpler life? A trouble free existence for trustees is the unstated promise offered by the use of a purpose trust. How accurate is this? Much will, of course, depend on the purpose of the trust and the means under the relevant proper law to enforce the purpose. But it is difficult to imagine a valid purpose which - if the trust were effectively enforced - would permit the trustee (having unfettered ownership and control of the private trust company shares and, accordingly, the votes attached to them) to stand unconcerned for the wellbeing of the private trust company.

17. Enforcement of the purpose trust will be an issue: who is entitled to bring the trustee to book? In Bermuda this includes a person with a “sufficient interest” in enforcement of the purpose trust: will this, necessarily, include a beneficiary of the main trust? If enforcement is limited to a designated “enforcer” what if he is the very object of those who seek a change in the operation of the private trust company?

18. Even if, in theory, everything is possible, the practicality of a person going through the multi-layered steps which would seem to be necessary to cause a recalcitrant trustee of a purpose trust to intervene in a private trust company is such that these holding structures offer very little hope for a beneficiary of the main trust. The position becomes all the more complex if the private trust company is a trustee of a number of trusts with different or possibly competing interests.

Conclusion

19. Ultimately, the question is: what does the settlor want? Does he want to expand the enforcement possibilities at the top level, creating a regime which provides beneficiary involvement or participation in decision making within the private trust company (inevitably through the holding trust). Or does he want to limit beneficiaries of the main trust to their rights (such as they are) against the private trust company?

III. BREACH OF TRUST: ENFORCING BENEFICIARIES’ RIGHTS

20. How does the use of a private trust company affect what a disgruntled beneficiary can do to enforce his rights?

21. As indicated above, in the typical structure the private trust company sits at the intersection of two sets of legal rules which provide the framework in which any claim by the beneficiaries has to be taken.

Trust Law

22. A beneficiary's basic remedy is to sue his trustee for breach of trust. Alternatively, the beneficiary may bring proceedings to remove or replace the trustee. The fact that the trustee is a company does not affect those rights but, in practice, a private trust company will probably not be worth suing. It is unlikely to have insurance or anything else to meet the claim except its minimal paid-up share capital.

23. Where loss has been caused to the trust assets by the actions of a third party, the cause of action against the third party will belong to the trustee. That is obvious where trust assets have misappropriated or depleted by the third party. Where the claim is against a third party such as an investment manager or accountant to the trust, the analysis is that the benefit of the contract between the trustee and the third party is an asset of the trust:

24. As Lord Nicholls said when considering the question of liability of third parties for negligence to beneficiaries of a commercial trust in Royal Brunei Airlines Sdn Bhd v Philip Tan Kok Ming [1995] 2 AC 378 at 391:

"*The majority of persons falling into this category will the hosts of people who act for trustees in various ways: as advisers, consultants bankers and agents of many kinds. This category also includes officers and employees of companies in respect of the application of company funds. All these people will be accountable to the trustees for their conduct. For the most part they will owe the trustees a duty to exercise reasonable skill and care. When that is so, the rights flowing from that duty form part of the trust property*."

25. The problem that the beneficiary may face is that if the board of the private trust company is affected by family divisions or there are conflicts of interest (eg the

third party advisor is a long-standing friend of the settlor), it will be unable or unwilling to take proceedings against the third party.

26. Where that happens, the beneficiary cannot sue the third party directly because (unless there are exceptional circumstances[19]) the third party will not owe a duty of care to the beneficiary[20]). The beneficiary has two possible courses of action. He could bring an administration claim against the trustee to compel it to sue the third party or he may be able to bring a claim in the name of and on behalf of the trustee directly against the third party. The ability of a beneficiary to bring such a derivative claim is well recognised and was recently considered and confirmed by the Supreme Court in Roberts v Gill [2010] 2 WLR 1227[21]. It is clear that a derivative claim is only permitted where there are "special circumstances". Because the Supreme Court decided the case on a procedural point (the inability of the claimant to amend to join the trustee as a party because of a limitation defence), it did not consider what constitutes "special circumstances". However Lord Collins endorsed the comments of Lord Templeman in Hayim v Citibank NA [1987] AC 730 at 747-8:

"…when a trustee commits a breach of trust or is involved in a conflict of interest and duty or in other exceptional circumstances a beneficiary may be allowed to sue a third party in the place of the trustee. But a beneficiary allowed to take proceedings cannot be in a better position than a trustee carrying out his duties in
a proper manner.
…
These authorities demonstrate that a beneficiary has no cause of action against a third party save in special circumstances which embrace a failure excusable or inexcusable by the trustees in the performance of the duty owed by the trustee to the beneficiary to protect the trust estate or to protect the interests of the beneficiary in the trust estate.".

27. If there is a serious question about the merits of suing the third party or, as may well happen in a situation of family conflict, disagreement between the beneficiaries as whether the claim against the third party should be pursued

[19] Eg if the third party has assumed responsibility to the third party within the principles developed from Hedley Byrne v Heller although even then the claim will limited to loss suffered by the beneficiary personally rather than loss to the trust fund
[20] See the continuation of the passage in Royal Brunei Airlines at 391
[21] although the case concerned the administration of an estate rather than a life-time trust

(because of costs risks or damaging publicity), an administration action will be needed to decide if the derivative claim should be brought.

Company law

28. The involvement of a corporate trustee superimposes company law considerations on the trust framework. Being a company, the trustee is a separate legal entity distinct from its shareholders. Its assets (including causes of action against third parties who have dealt with the company) belong to the company and not its shareholders.

29. The trust company acts by its directors who owe their duties to the company alone, not to the shareholders[22] or to the beneficiaries of the trust[23].

30. A director may become personally liable under a duty of care or a fiduciary duty[24] to a third party but only in where in circumstances where there has been an assumption of personal responsibility by the director which has created a special relationship between them justifying a direct duty. In Williams v Natural Life Health Foods [1998] 1 WLR 830, the House of Lords made it clear that the fact that the sole director was responsible for the running of the company and in doing made representations drawing on his personal knowledge and experience was not sufficient to "cross the line" into assuming personal responsibility.

31. As a matter of English law, the fundamental principle that a company – even a one-man company – has a separate existence from its directors and shareholders is not easily overcome. The ability of the courts to "pierce the corporate veil" is restricted to cases where the corporate structure has been used to perpetrate a legal wrong or evade existing obligations. In the absence of evidence that the company structure was adopted for some improper motive, the court will not ignore it so as to hold a director responsible for the actions of the company[25].

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[22] Companies Act 2006 section 170(1) reflecting the long established common law position
[23] Bath v Standard Land Co Ltd [1911] 1 Ch 618
[24] see eg Coleman v Myers (1977) 2 NZLR 225; Platt v Platt [1999] 2 BCLC 745
[25] see Adams v Cape Industries [1990] 2 WLR 657

32. It follows that the trust company is the only proper claimant in any proceedings to recover its property or to claim compensation for loss caused to the company by negligent or other breaches of duty by the directors.

33. Company law recognises that there may be situations in which the company will not take proceedings against its directors (usually because the wrongdoing directors have control at board and shareholder level) and allows a shareholder to bring proceedings in the name of the company against the directors[26].

34. Of course, a director who has improperly assisted in a breach of trust or fiduciary duty or dishonestly dealt with trust property will be open to a direct claim by a beneficiary for compensation for loss or to disgorge any profits made by him. The claim requires proof that the director acted dishonestly by the ordinary standards of reasonable and honest people (the objective element) and was himself aware that by those standards he was acting dishonestly (the subjective element)[27].

Consequences

35. None of these legal points may matter very much to a beneficiary whose corporate trustee is an independent, solvent entity. The company will be responsible for the directors' breaches. It can be sued by the beneficiary and can bring its own proceedings against the directors. If there are breaches of duty by the directors of the family companies owned by the trustee, the trustee can use its control to procure the company to take action against the directors. If necessary, the beneficiary could apply to the court to compel the trustee to act.

36. However where a PTC is the trustee, it is unlikely to be worth suing. The wrong-doing directors are not going to authorise proceedings against themselves. The dissastisfied beneficiary is not a shareholder. The close association between the settlor, the entity which owns the PTC and the directors (which is a common feature of PTC structures) means that there may be no independent shareholders willing to act. So there may be a real risk that loss to the trust will go unremedied.

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[26] In England, the derivative claim is now governed entirely by statute: the Companies Act 2006 sections 260-263

[27] Twinsectra v Yardley [2202] 2 AC 164

37. I therefore want to look at the question of whether there is any possibility of a derivative or dog-leg claim against the directors of a PTC, despite the decision in Gregson v HAE Trustees Ltd [2008] EWHC 1006 [2008] 2 BCLC 542 which is widely thought to have killed off such claims.

The dog-leg claim

38. The legal basis of the claim draws on elements of the legal framework set out above as follows:
    (1) A corporate trustee owes a duty to its beneficiaries to avoid causing loss to the trust funds
    (2) A corporate trustee can only act by its directors
    (3) A director of a corporate trustee owes duties to the company including a duty to exercise reasonable skill care and diligence and to act in the best interests of the company
    (4) In performing their duties to the company so far they affect the trust the directors are performing the company's duty to the trust
    (5) Where a director acts in relation to the trust, the benefit of what he does and his duties and obligations in so acting form part of the trust assets just as the benefit of a contract between the trustee and a third party agent acting for the trust becomes trust property.
    (6) A beneficiary can in appropriate cases bring a derivative action against a third party to enforce a claim which is trust property
    (7) A beneficiary should therefore be able to bring a derivative claim against a director if the corporate trustee is unable or unwilling to sue.

The Gregson case

The facts

39. The case concerned a discretionary family settlement established by Henry Cohen who, with his brothers, had created the Courts furniture business. The trustee, HAE Trustees Ltd, was a company which had been set up to act as trustee or administrator. Its original directors were Henry Cohen and his two brothers, Alfred and Edwin, after whom the company was named. The trust assets consisted almost entirely of shares in Courts plc. In 2004, Courts went into administration. It was hugely insolvent. Its shares, and therefore the assets of the settlement, were worthless. The Claimant, Mrs Gregson, was a beneficiary of the settlement, who alleged that the trustee was in breach of trust in failing to consider the need to diversify the settlement's investments. She claimed if the

trustee had done so, it would have diversified out of Court shares and so avoided the loss which had occurred. As the trustee company had no assets, she brought a claim against the current directors. The directors applied to strike that claim out on the ground that the dog-leg claim had no prospect of success and also that, under the terms of the settlement, there was no duty to consider diversification. The judge, Mr Robert Miles QC sitting as a deputy, rejected the argument that the duty to review diversification was excluded but upheld the challenge to the claim against the directors.

The decision

40. In rejecting the claim, the judge, made these points:

(1) The dog-leg claim would circumvent the clear principle that directors of trust companies owe no duty of care to the beneficiaries of the trust.

(2) There was no legal basis or mechanism whereby the director's duty to the company became trust property. The judge rejected the analogy with advisers to the trust company on the basis that advisers were engaged by the trustee in the course of administration of the trusts but directors were appointed by the organs of the company (either the board or the shareholders in general meeting) not appointed by the trustee.

(3) He rejected the argument that equity should treat the directors' duties as trust property on the basis that it was not necessary to do so either to avoid injustice or to give effect to the intentions of the parties.

(4) The judge was very concerned about the scope of a dog-leg claim, pointing out it could not apply to all duties owed by directors, many of which would either have nothing to do with the administration of the trust (eg preparing accounts, dealing with take-over bids) or (in the case where the trustee was trustee of various trusts) have nothing to do with the trust in question.

(5) The judge did not accept the argument that the claim could apply to the limited duty to take reasonable care to avoid loss to the particular trust fund. He took the view that the directors' duties were as set out in the Companies Act 2006 (ie to exercise reasonable skill and care in performing his functions for the company) and could not defined as a duty to avoid loss to the trust funds.

(6) The judge said that the dog-claim would cut across established principles of law. If the corporate trustee was insolvent, its property (including claims against directors and others) should be available for its creditors generally; claims should not be "carved out" to benefit particular trusts. If the claims

against directors were trust property, the shareholders could not ratify or sanction the breach (as they could do on normal company law principles).

(7) Finally, the judge was clearly influenced by the lack of support for the dog-leg claim in case law and legal writing. Attempts to advance the claim in Australia and Jersey have been unsuccessful: see Young v Murphy [1996] VR 279 and Alhamrani v Alhamrani [2007] JLR 44.

The dog-leg claim in the future

41. The prospects for bringing a dog-leg claim seem pretty bleak. However it is worth noting that none of the cases where the claim has been rejected involved a PTC structure of the type we have been considering. The corporate trustee in Young v Murphy, was trustee of various investment trusts. It seems to have been a professional trustee with auditors and indemnity insurance. In Alhamrani, the trust companies were large companies with many client trusts. Although the trustee in Gregson was a trust company established by a family, it is clear from the facts of the case that it had not been established for the purpose of acting as trustee of the settlement in dispute, it was the trustee of various other family trusts established at different times and, importantly, it had outside creditors.

42. In those cases, the judge's view that company law principles are paramount and exclude a claim by a beneficiary against a director is understandable. But where there is a much closer identity of interest between the settlor, the trust company, its directors and the trust with no outside interests, a strict company law analysis can seem artificial. For example, if the PTC structure is established with the intention that the appointment and removal of directors is controlled by the settlor, the directors are family advisers or associates and the holding vehicle of the PTC is a purpose trust, the distinction drawn in Gregson between an outsider adviser and a director on the basis that one is engaged by the trustee but the other is appointed by the organs of the company is harder to justify.

43. Similarly, the distinction between the director's duties (owed to the company) and the performance of those duties (dealing with the trust) becomes more difficult to draw. In passing it is worth noting section 172 of the Companies Act 2006. Subsection (1) states that a director must act in the way he considers would be most likely to promote the success of the company for the benefit of its members. Subsection (3) says that where or to the extent the purposes of the company

consist of or include purposes other than the benefit of its members, subsection (1) has effect as if it referred to achieving those purposes.

44. The suggestion that the nature of the corporate trustee and the scope of its activities are relevant to whether a dog-leg claim can be brought has some, albeit limited, judicial support. In HR v JAPT [1997] OPLR 123, the corporate trustee only had conduct of one trust, it had no other business or assets and no general body of creditors. Lindsay J refused to strike out a dog-leg claim, saying that in those circumstances it was not unarguable that the directors' duties were trust property since the directors' involvement in the trusts was deeper and more extensive than that of a third party adviser who, following Lord Nicholls' dicta in Royal Brunei Airways (mentioned above) would be open to a claim by the trustee. Significantly, Lindsay J said that the question of whether a particular cause of action against a third party was trust property had to be decided on the particular facts of a particular case.

45. The Royal Court of Justice in Alhamrani also acknowledged that the courts might recognise a dog-leg claim in certain circumstances. Commissioner Page said[28]:

"This is what the dog-leg claim is all about: trying to pigeon-hole the trustee's rights against its directors as chose in action belonging to the trust …and one in respect of which a beneficiary may therefore sue if the trustee is unable or unwilling to do so. Given the fact that…whether or not something is a trust asset is very much a matter of fact rather than high principle, this clearly leaves the court with considerable scope for either granting or withholding a remedy according to its view of where the justice of the matter lies so long as it can be accomplished without doing too much violence to accepted notions of property and ordinary language. That the court should take the view that a dog-leg type claim …ought not to be struck out in a case as strong as HR v JAPT where the beneficiaries might otherwise have been without an effective remedy is therefore not altogether surprising."

46. This passage highlights what I think is a very important consideration to which insufficient attention was perhaps paid in Gregson. Derivative claims in both the trust and company law context are procedural devices designed to avoid injustice

[28] at pages 60-61

which would occur if a wrong if suffered for which no redress can be claimed. That is shown clearly by the comments of Lord Justice Browne-Wilkinson (as he then was) in Nurcombe v Nurcombe[29] [1985] 1 WLR 370 at 378:

"Since the wrong complained of is a wrong to the company, not the shareholder, in the ordinary way the only competent plaintiff in an action to redress the wrong would be the company itself. But where such a technicality would lead to manifest injustice, the courts of equity permitted a person interested to bring an action to enforce the company's claim. The case is analogous to that in which equity permits a beneficiary under a trust to sue as plaintiff to enforce a legal right vested in trustees (which right the trustees will not themselves enforce)." [emphasis added]

47. Looking at the problem from this perspective may provide some answers to the points raised in Gregson. The judge was very concerned that the rule in Bath v Standard Land was being circumvented. But the fact that a director does not owe a duty directly to the company's shareholders does not prevent a minority shareholder bringing a derivative claim in appropriate circumstances.

48. If it is not possible or practicable for the beneficiary to procure the appointment of a liquidator to pursue the claims against the directors, why should the courts of equity not impose a trust to prevent the injustice of allowing the claim to fail. Or, more radically, the beneficiary could be allowed to bring the claim, on behalf of the company, on the basis that he or she is a person with a legitimate interest in doing so.

49. That approach has been adopted in the context of a company derivative claim in a case in Hong Kong called Waddington Ltd v Chan Chun Hoo Thomas [FACV No 15 of 2007]. The Claimant, Waddington, was a minority shareholder in a Bermudan company called Playmates Holdings Limited ("Playmates"). Playmates had various wholly owned subsidiaries and sub-subsidiaries. Mr Chan was a director of these companies and had caused them to enter into various transactions which were detrimental to them pursuant to an arrangement under which Mr Chan benefited personally. Waddington applied to bring a derivative claim on behalf of the subsidiaries against Mr Chan who resisted the application on grounds analogous to the reasoning in Gregson.

[29] a minority shareholder claim in the context of a husband and wife company

50. The principal plank of his argument was that the claim contravened fundamental principles of company law because:
    (1) as director he only owed his duties to the companies and not the shareholders of the parent company;
    (2) any cause of action against him was vested in the companies, not in Waddington
    (3) Waddington, as shareholder in the parent company, had no title to or interest in the shares of the subsidiaries and no rights in relation to the conduct of the subsidiaries' affairs.
    (4) He also made the point that this was not a case where a wrong would be without redress because Waddington could bring unfair prejudice proceedings.

51. The Court of Final Appeal rejected these arguments and held that Waddington could sue on behalf of the subsidiaries. Lord Millett, who gave the main judgment, said the decisive issue was whether Waddington had a legitimate interest in the relief claimed sufficient to justify him in bringing proceedings to obtain it. He held that Waddington clearly did: if the case was proved, the subsidiaries had suffered depletion of their assets which had caused indirect loss to Waddington. Waddington therefore had a legitimate and sufficient interest to taking steps to redress the situation through a derivative action.

52. Lord Millett emphasised the public policy behind the decision saying "*If wrongdoers must not be allowed to defraud a parent company with impunity, they must not be allowed to defraud its subsidiary with impunity".*

53. In an one-trust company with no outside interests, why does the beneficiary not have a legitimate and sufficient interest in bringing proceedings to redress the wrong done indirectly to the trust? If not there may be situations where no redress can be obtained.

54. The interposition of a company as trustee would have the result that wrong-doing directors are immune. Such a result flies in the face of the long standing approach of equity that fraud should not be protected by legal niceties.

Conclusion

55. There is no doubt that directors of professional trust companies can sleep easier at night as a result of the Gregson decision. However directors of closely controlled family PTCs who breach their duties may find that there is some equitable life left in the dog-leg claim.

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Re the Jabberwock Trust

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Re the Jabberwock Trust

Alice has recently been appointed trustee of the Jabberwock Trust by the Trust's protector, the Mad Hatter, in place of Tweedledum, the previous trustee. The Trust's proper law is that of Wonderland, whose courts are its forum for administration.

Upon settlement of the Trust, the trust fund comprised 200 million jam tarts (the currency of Wonderland). However, in 2007, Tweedledum as trustee invested 150 million jam tarts in the Looking Glass Fund, on the strength of various representations made to him by the Cheshire Cat, who managed the fund. Tweedledum says that he was induced to invest solely on the basis of the marvellous – but entirely whimsical – presentation given by the Cheshire Cat. However, it should also be noted that, shortly following the Trust's investment, the Cheshire Cat (who had amassed a considerable personal fortune from operating other legitimate investment schemes) made a gift to Tweedledum of 15 million jam tarts – though he says this was purely in recognition of the great friendship the two men had struck up when Tweedledum and his family spent a week holidaying on the Cheshire Cat's yacht off the coast of Corfu.

Tweedledum immediately gifted the 15 million jam tarts he received from the Cheshire Cat to his twin brother, Tweedledee. Tweedledum has no assets of his own, although he is a beneficiary of two sizeable revocable offshore discretionary trusts, which hold the wealth he acquired as a trader in the 1980s.

As protector, the Mad Hatter's written consent was required to the Trust's investment into the Looking Glass Fund. The Mad Hatter gave his consent, and says he did so because the Looking Glass seemed such a marvellous investment opportunity. However, Alice has now discovered from the Mad Hatter's talkative best friend – the March Hare – that the Mad Hatter was himself heavily invested in the Looking Glass Fund. The Mad Hatter was delighted to consent since, by reason of the Trust's investment into the Fund, a redemption gate would be lifted, giving him a perfect opportunity to redeem his own personal investment in the Fund.

Much to everyone's astonishment, the Cheshire Cat was in fact a frumious fraudster, and the Looking Glass Fund little more than a Ponzi scheme. The Fund's assets were dissipated by the Cheshire Cat in funding his exuberant lifestyle. Needless to say, the Cheshire Cat has now disappeared except for his grin, and none of his assets can be traced.

The Mad Hatter, who *had* been hoping to spend his profits from the Fund on a lavish tea party for his friends, was furious at having been duped by the Cheshire Cat. However, he has indicated that he will use his considerable powers under the Trust to prevent Alice taking any action against anyone in relation to the failed investment – indeed, he is rather miffed about Alice's apparent desire to interfere, and would never have appointed her trustee had he known she was going to be so much trouble.

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