CLAIMS AGAINST THIRD PARTIES

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A. Introduction

1. This paper supports and provides the references for the Wonderland Ltd case study[1] which will be considered during the seminar.

2. The aim of the case study is to explore claims which go beyond the usual fare of the office-holder's statutory remedies by way of transactions at an undervalue, preference, s. 212 misfeasance claims, wrongful or fraudulent trading or transactions defrauding creditors. Instead we explore claims against third parties, where there has been a breach of the Companies Act and/or breach of fiduciary duty by directors, unlawful dividends being used as an example.

B. Dividends

3. There are usually 3 potential grounds for challenging dividend payments:

    3.1. the conventional technical claim made under the Companies legislation that dividends have not been paid out of profits available for that purpose and that the dividends have been paid in breach of the Companies legislation;

    3.2. that the internal regulations of the company were breached and/or

    3.3. breach of the common law maintenance of capital rule.

    We consider these in turn.

B1 Part VIII CA 1985

4. In the case study the dividends were paid between 1 Sep 2007 and 1 March 2008. The relevant law is therefore Part VIII Companies Act 1985 (ss. 263 – 281 CA 1985)[2].

5. A distribution of a company's assets (which includes a dividend) can only be made out of profits available for the purpose (s. 263(1) CA 1985)[3] being its accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made (s. 263(3))[4].

6. Section 270 CA 1985[5] requires that the dividend be justified by reference to the company's accounts, being either the last annual accounts (s. 270(3) CA 1985)[6] or interim accounts under s.270(4)(a) CA 1985[7], if the dividend could not be justified by reference only to the last annual accounts.

7. Although the provisions in s. 272 CA 1985[8] stipulating the formal requirements for "interim accounts" for public limited companies strongly suggest that less formality is required for private companies, nevertheless the statute requires that, as a minimum requirement for private companies, "accounts" must exist which are such as "to enable a reasonable judgment to be made as to" (s.270(4) CA 1985[9]):

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[1] The Mediation Case Summary is immediately before this paper in the delegate pack.
[2] Part VIII CA 1985 continues to apply to distributions made before 6 April 2008. The new part 23 Companies Act 2006, ss. 829 – 853 apply to distributions made on or after 6 April 2008: see Sch 4, Pt 1, paras 33-35 Companies Act 2006 (Commencement No.5, Transitional Provisions and Savings) Order 2007, SI 2007/3495, as amended by the Companies Act 2006 (Commencement No.6, Saving and Commencement Nos 3 and 5 (Amendment)) Order 2008, SI 2008/674, art5, Sch 3, para 6(1) and (3).
[3] s.830(1) CA 2006 from 6 April 2008
[4] s. 830(2) CA 2006
[5] s. 836 CA 2006
[6] s. 836(2) CA 2006
[7] s. 836(2)(a) CA 2006
[8] s. 836(2)-(6) CA 2006.
[9] s.839(1) CA 2006

7.1. profits, losses, assets and liabilities;

7.2. provisions of any of the kinds mentioned in paragraph 88 and 89 of Schedule 4 to CA 1985 (e.g. depreciation, diminution in value of assets and (most importantly for present purposes) retentions to meet liabilities); and

7.3. share capital and reserves (s. 270(2) CA 1985)[10].

8. It is now settled that Part VIII is a rigid and inflexible code which must be observed strictly in order to ensure that a distribution is valid[11]. The position is summarised in Gore-Browne on Companies, 45th Ed, 25[4]:

"The courts have consistently emphasised the strict and mandatory character of these requirements and regarded any distribution in breach as ultra vires the company and incapable of being ratified by its members, for example where the accounts failed to present a true and fair view by substantially overstating the company's profit, where they failed to make proper provision against tax and other liabilities and where the auditors had qualified the company's accounts without making the appropriate written statement."

B2 Internal regulations

9. The dividends may be challenged if the procedure for the declaration and payment of dividends laid down in the company's articles of association has not been complied with.

10. Table A in the Schedule to the Companies (Tables A to F) Regulations 1985 as amended by the Companies (Tables A to F) (Amendments) Regulations 1985 ("Table A") deal with dividends in regulations 102 – 108. For present purposes regulations 102 and 103 are relevant and provide:

"102. Subject to the provisions of the Act, the company may by ordinary resolution declare dividends in accordance with the respective rights of the members, but no dividend shall exceed the amount recommended by the directors.

103. Subject to the provisions of the Act, the directors may pay interim dividends if it appears to them that they are justified by the profits of the company available for distribution. …"

11. A failure to comply with the company's internal regulations in respect of the recommendation by directors for the payment of a dividend, approval and declaration of a dividend by the shareholders in general meeting, or as regards interim dividends the decision by the directors to pay the same and that they are justified by reference to the profits of the company available for distribution may be overcome by an application of the principles set out in *In re Duomatic Ltd* [1969] 2 Ch 365 at p. 373 per Buckley J:

"[W]here it can be shown that all shareholders who have a right to attend and vote at a general meeting of the company assent to some matter which a general meeting of the company could carry into effect, that assent is as being as a resolution in general meeting would be."

EIC Services Ltd v Phipps [2004] 2 BCLC 589 at para [122] per Neuberger J:

"The essence of the *Duomatic* principle, as I see it, is that, where the articles of a company require a course to be approved by a group of shareholders at a general meeting, that requirement can be avoided if all members of the group, being aware of the relevant facts, either give their approval to that course, or so conduct themselves as to make it inequitable for them to deny that they have given their approval. Whether the approval is given in advance or after the event, whether it is characterised as agreement, ratification, waiver or estoppels, and whether members of the group give their consent in different ways at different times, does not matter."

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[10] s. 836(1) CA 2006

[11] *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1986] 1 Ch 447; *Bairstow v Queens Moat Houses plc* [2001] 2 BCLC 531; *Inn Spirit Ltd v Burns* [2002] 2 BCLC 780; *Commissioners of Inland Revenue v Richmond & Jones* [2003] EWCA 999 (Ch); *It's a Wrap (UK) Ltd v Gula* [2006] 2 BCLC 634; and *Holland v Revenue & Customs Commrs* [2010] 1 WLR 2793.

12. However the curative power of the *Duomatic* principle has substantial limitations as to when it can be deployed:

12.1. the consent must be of all the shareholders, not just a majority;

12.2. the shareholders must be aware of the relevant facts and have full knowledge as to what they are being asked to approve or ratify: see EIC Services v Phipps (supra) para [135]:

"Before the Duomatic principle can be satisfied, the shareholders who are said to have assented or waived must have the appropriate of "full" knowledge. If a shareholder is not even aware that his consent is at least a significant factor in relation to the matter, he cannot, in my view, have the necessary "full knowledge" to enable him to "assent", quite apart from the fact that I do not think he can be said to "assent" to the matter if he is merely told of it."

12.3. The shareholders must have actually known about the breach or proposed act and addressed their minds to the matter in question, i.e. whether a particular act should be authorised or ratified. It is not enough that they would have done so, if they had known about it or thought about it at the time: see *Re D'Jan of London Ltd* [1994] 1 BCLC 561 at p. 563 per Hoffmann LJ:

"It is not enough that they probably would have ratified if they had known or thought about it before the liquidation removed their power to do so."

Newey J *SofS v Doffmann* [2011] 2 BCLC 541 at para [40]:

"…the principle will not apply if the shareholders did not address their minds to the matter in question."

12.4. the Duomatic principle is also displaced on liquidation and at the earlier stage[12] where a company is "of doubtful solvency or on the verge of insolvency"13 or "is in financial difficulties to the extent that its creditors are at risk"14

12.5. certain statutory formalities of CA 1985 cannot be dispensed with by the Duomatic principle, where the formalities are for the protection of creditors, e.g. s. 164 CA 1985 as regards prior approval of proposed contract for off-market purchase of own shares15.

B3 Maintenance of capital rule

13. Directors are under an unqualified duty not to cause an unlawful and ultra vires distribution of capital to shareholders[16]:

14. This is a common law rule devised by the courts for the protection of a company's creditors, ensuring that any distribution of a company's assets to a shareholder is made in accordance with specific statutory procedures, such as by dividend, through a winding up or a formal return of capital. Other distributions, disguised or otherwise, are unlawful. The maintenance of capital rule was re-affirmed and explained recently by the Supreme Court in *Progress Property Company Limited v Moorgarth Group Limited* [2011] 1 WLR 1 as a "judge-made" rule:
"[15]…almost as old as company law itself, derived from the fundamental principles embodied in the statutes by which Parliament has permitted companies to be incorporated with limited liability.

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[12] The displacement occurs at an imprecise point intime prior to formal or technical insolvency, which Newey J in *SofS v Doffmann* [2011] 2 BCLC 541 at paras [44]45] equated to the test applied in the next two mentioned cases.
[13] *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd* [2003] 2 BCLC 153 at para [74] per Leslie Kosmin QC
[14] *Re MDA Investment Management Ltd* [2004] 1 BCLC 217 at para [70] per Park J
[15] *R W Peak (Kings Lynn) Ltd* [1998] 1 BCLC 193; *Wright v Atlas Wright* [1999] 2 BCLC 301.
[16] *In re Exchange Banking Company, Flitcroft's Case* (1882) 21 Ch. D. 591; *Re Lands Allotment Company* [1894] 1 Ch 616, at 638; *In re Sharpe, Masonic and General Life Assurance Company v. Sharpe* [1892] 1 Ch 154; *Selangor United Rubber Estates Ltd v. Cradock and Others* (No 3) [1968] 1 WLR 1555, at 1575; *Belmont Finance Corp v. Williams Furniture Ltd and others (No 2)* [1980] 1 All ER 393, at 404; *Bairstow v. Queens Moat Houses plc and others* [2000] 1 BCLC 549, at 555; and *Re Loquitur Ltd, Inland Revenue Commissioners v. Richmond and another* [2003] 2 BCLC 442, at 471, 472

Whether a transaction infringes the common law rule is a matter of substance, not form. The label attached to the transaction by the parties is not decisive."

15. The opening words of Lord Walker's judgment in *Progress Property* describe the rule by reference to two earlier High Court decisions as follows:

"[1] A limited company not in liquidation cannot lawfully return capital to its shareholders except by way of a reduction of capital approved by the court. Profits may be distributed to shareholders (normally by way of dividend) but only out of distributable profits computed in accordance with the complicated provisions of the Companies Act 2006 (replacing similar provisions in the Companies Act 1985). Whether a transaction amounts to an unlawful distribution of capital is not simply a matter of form. As Hoffmann J said in *Aveling Barford Ltd v Perion Ltd* [1989] BCLC 626 at 631:

"Whether or not the transaction is a distribution to shareholders does not depend exclusively on what the parties choose to call it. The court looks at the substance rather than the outward appearance."

Similarly Pennycuick J observed in *Ridge Securities Ltd v IRC* [1964] 1 All ER 275 at 288; [1964] 1 WLR 479 at 495:

"A company can only lawfully deal with its assets in furtherance of its objects. The corporators may take assets out of the company by way of dividend or, with leave of the court, by way of reduction of capital, or in a winding up. They may of course acquire them for full consideration. They cannot take assets out of the company by way of voluntary disposition, however described, and, if they attempt to do so, the disposition is ultra vires the company."

16. In paragraph 21 of the same judgment, Lord Walker cited with approval the following additional extract from the judgment of Hoffmann J in *Aveling Barford* to the effect that it is not a necessary pre-condition for the application of the Rule that the company should be insolvent:

'It is clear however that Slade LJ[17] excepted from his general principle cases which he described as involving a "fraud on creditors" ([see [1985] 3 All ER 52 at 86, [1986] Ch 246 at 296). As an example of such a case, he cited *Re Halt Garage*. Counsel for the defendants said that frauds on creditors meant transactions entered into when the company was insolvent. In this case Aveling Barford was not at the relevant time insolvent. But I do not think that the phrase was intended to have such a narrow meaning. The rule that capital may not be returned to shareholders is a rule for the protection of creditors and the evasion of that rule falls within what I think Slade LJ had in mind when he spoke of a fraud on creditors. There is certainly nothing in his judgment to suggest that he disapproved of the actual decisions in *Re Halt Garage* or *Ridge Securities*.'

17. In other words:

17.1. the rule represents an entrenched and fundamental principle and is not something which is engaged only when a company is in the vicinity of insolvency;

17.2. dispositions which offend the rule cannot be ratified by the shareholders – were it otherwise, the rule would have little or no effect; and

17.3. the rule directs the court to assess the substance of a transaction and, in doing so, to be astute to identify disguising labels or other attempts at mischaracterising the true legal nature of a given transaction.

C Breach of fiduciary duty by directors

[17] The reference by Hoffmann J to the judgment of Slade LJ is to *Rolled Steel Products (Holdings) Ltd v British Steel and Corp* [1986] Ch 246 at 276-8 in which the Court of Appeal re-stated the principle that all the persons entitled to attend and vote at a meeting of a company can ratify a misfeasance by its directors.

18. The liability of directors in respect of the unlawful dividends is relatively straightforward. Whilst the 1985 Act does not expressly deal with the consequences of the payment of an unlawful dividend as regards the directors, at common law directors who cause such an unlawful dividend to be paid are potentially personally liable for breach of their duty of care and diligence, their fiduciary duty to act bona fide in (what they consider to be) the best interests of the company and fiduciary duty as a quasi-trustee in the stewardship of the company's assets[18]. Directors would therefore be liable if they[19] :

    18.1. acted with knowledge that the payment came out of capital;

    18.2. did not conduct a proper investigation into the accounts or have such an investigation carried out on their behalf; or

    18.3. acted under a mistake as to the law or the proper construction of the memorandum or articles.

19. Nelson J in *Bairstow v Queens Moat Houses plc* [2000] 1 BCLC 549 at p. 559h summarised the circumstances in which a director who authorised payment of an unlawful dividend would be in breach of his duty as a quasi trustee and liable to repay such dividends:

    "(1) if he knows that the dividends were unlawful, whether or not that actual knowledge amounts to fraud; or

    (2) if he knows the facts that established the impropriety of the payments, even though he was unaware that such impropriety rendered the payment unlawful (*Re Kingston Cotton Mill Co (No.2)* [1896] 1 Ch 331 at 347 and *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1985] BCLC 385 at 390, [1986] Ch 447 at 457);

    (3) If he must be taken in all the circumstances to know all the facts which render the payments unlawful (*Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1985] BCLC 385 at 390, [1986] Ch 447 at 457);

    (4) if he ought to have known, as a reasonably competent and diligent director, that the payments were unlawful (*Norman v Theodore Goddard* [1991] BCLC 1028, *Re D'Jan of London Ltd* [1994] 1 BCLC 561 and s 214 of the Insolvency Act 1986)."

Claims against the Shareholders

D Statutory remedy - section 277 CA 1985

20. Section 277 CA 1985 provides a remedy for the recovery of dividends from shareholders:

    "(1) Where a distribution, or part of one, made by a company to one of its members is made in contravention of this Part and, at the time of the distribution, he knows or has reasonable grounds for believing that it is so made, he is liable to repay it (or that part of it, as the case may be) to the company or (in the case of a distribution made otherwise than in cash) to pay the company a sum equal to the value of the distribution (or part) at that time.

    (2) The above is without prejudice to any obligation imposed apart from this section on a member of a company to repay a distribution unlawfully made to him; but this section does not apply in relation to [not relevant]."

21. The statutory remedy given by s.277(1) only applies where there has been a contravention of Part VIII CA 1985. It does **not** apply where the distribution contravenes the common law maintenance of capital rule or the internal regulations of the company: *It's a Wrap (UK) Ltd v Gula* [2006] 2 BCLC 634 at para [12]. A breach of the maintenance of capital rule or internal regulations would have to be dealt with by the common law.

[18] *Bairstow v Queens Moat Houses* [2001] 2 BCLC 531 at p. 549 a-c
[19] Gore-Browne 25[14]

22. In order to invoke successfully the s. 277(1) statutory remedy in respect of the breaches of Part VIII CA 1985 it would be necessary to establish that the recipients of the dividends knew or had reasonable grounds for believing that the dividends were made in contravention of Part VIII CA 1985. It is not necessary to show that they knew (or had reasonable grounds for believing) that the dividends contravened the CA 1985 (or specific sections thereof); it is sufficient to show that they knew (or had reasonable grounds for believing) the facts which gave rise to the contravention, e.g. that the company had not made profits so as to allow a distribution[20].

23. Apart from actual knowledge of the facts giving rise to the contravention, s.277(1) also applies where the shareholder "has reasonable grounds for believing" those facts giving rise to the contravention. The interpretation of those words did not fall to be decided in *It's a Wrap (UK) Ltd*, although Arden LJ and Chadwick LJ appear to have had differing views on their width:

    23.1. Chadwick LJ stated:

    "[52] … But to my mind, it is by no means self-evident that they are to be equated with "constructive knowledge" if by that expression is meant knowledge which a person would have but for his negligence. I do not think that the composite phrase "knows or has reasonable grounds for believing" has the same meaning as "knows or ought to know".
    [53] In *Swain v Puri* [1996] PIQR 442 this Court rejected the contention that the words: "has reasonable grounds to believe" in section 1(3) of the Occupiers Liability Act 1984 were equivalent to "ought to have known". As Lord Justice Pill put it, (ibid, p.446)

    > "…the expression "has reasonable grounds to believe" does not include constructive knowledge. Actual knowledge or reasonable grounds to believe must be established. That does not permit an occupier to turn a blind eye. …"

    And, in the words of Lord Justice Evans (ibid, p.448):

    > "It is not sufficient for the plaintiff to prove that [the defendants] ought to have known those or other facts. That would imply that a negligent lack of knowledge was enough. They must be proved either to have had actual knowledge of the relevant fact or to have known facts which have reasonable grounds for the relevant belief."

    [54] The phrase used in article 16 of the Second Directive is "could not in view of the circumstances have been unaware of …". My present, and provisional, view is that the meaning given to the words "has reasonable grounds to believe" in *Swain v Puri* is a meaning which is more likely to be consistent with the meaning to be given to the phrase in the Community instrument than "ought to know". The knowledge which the legislature has sought to describe in section 277(1) of the 1985 Act is, I think, knowledge which the member has and knowledge which the member "must be taken to have" or, perhaps, "may reasonably be taken to have"."

    23.2. Arden LJ appears to have taken a wider interpretation [para 25]:

    "On this basis the concluding words of article 16 must be directed to a situation where the shareholders ought reasonably to have been aware of the factual situation that the distribution contravened the Act. It follows that article 16 has been correctly implemented by section 277(1) in this respect even though it uses different wording."

    Whilst she considered *Swain v Puri*, her view was that it had no bearing on the interpretation of s. 277(1) which had to be interpreted so as to conform with Article 16 of the Second Directive [30].

[20] *It's a Wrap (UK) Ltd* (supra)

E Knowing receipt

24. The express statutory remedy under s.277(1) CA 1985 is (by s. 277(2) CA 1985) without prejudice to any obligation imposed apart from the section on a member of a company to repay a distribution unlawfully made, i.e. at common law.

25. The traditional and conventional view has been that the only common law remedy against a shareholder to recover an unlawful dividend made in breach of Part VIII CA 1985, internal regulations or the maintenance of capital rule was by way of knowing receipt by the shareholder, i.e. the third parties (the shareholder recipient of the unlawful dividend) who receives the dividend with knowledge that the distribution was unlawful or in breach of duty by the directors may be liable as a constructive trustee.21 Arden LJ summarised the position in It's A Wrap (UK) Ltd:

"[11] … Liability under the general law attaches where the shareholder knew or ought to have known that the distribution was unlawful. Mr Robins submitted that it would apply where the shareholder had acted unconscionably[22], but the authorities under the general law on distributions impose the former test: see for example *Moxham v Grant* [1900] 1 QB 88.

[12] … In sum, the remedy under article 16 is more absolute and stringent than that available under the general law. That is no doubt because it has been tailor made to facilitate the recovery of unlawful distributions whereas the remedy under the general law is an adaptation of the law of constructive trusteeship. However, the need for some form of actual or constructive knowledge on the part of the shareholder is common to both forms of remedy."

26. The ingredients of the cause of action are usefully summarised in Arthur v Attorney General of the Turks & Caicos Islands [2012] UKPC 30, a recent decision of the Privy Council on an appeal from the Court of Appeal of the Turks and Caicos Islands, by Sir Terence Etherton as follows:

[31] A Defendant incurs an equitable liability for knowing receipt when he or she acts unconscionably by receiving and retaining trust property with the knowledge that it was transferred in breach of trust. Liability for knowing receipt can also be incurred when property is transferred in breach of a fiduciary duty other than a breach of trust. An obvious example would be the transfer of a company's property in breach of the directors' fiduciary duties, a director not being a trustee of the company's assets. That is also the basis of the claim in the present case since it is not alleged that the Property was held by or for the Crown on trust, but rather that the Minister acted in breach of fiduciary duty to the Crown in authorising the transfer to the Appellant.

[32] The essential requirements of knowing receipt were stated by Hoffmann LJ in *El Ajou v Dollar Land Holdings plc* [1994] 2 All ER 685, 700, [1994] 1 BCLC 464, [1994] BCC 143, as follows:

"For this purpose the Plaintiff must show, first, a disposal of his assets in breach of fiduciary duty; secondly, the beneficial receipt by the Defendant of assets which are traceable as representing the assets of the Plaintiff; and thirdly, knowledge on the part of the Defendant that the assets he received are traceable to a breach of fiduciary duty."

[33] There has been debate in England and Wales and elsewhere about the nature of the recipient's state of knowledge necessary to give rise to equitable liability for knowing receipt of trust property transferred in breach of trust. In the present case both parties accept that the correct test is that stated by Nourse LJ in *Bank of Credit and Commerce International (Overseas) Ltd v Akindele* [2001] Ch 437 at 455, [2000] 4 All ER 221, [2000] 3 WLR 1423, namely that the Defendant's state of knowledge must be such as to make it unconscionable for the Defendant to retain the benefit of the receipt. Mr Misick accepted that such unconscionable conduct can properly be described as equitable fraud.

[21] *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1985] BCLC 385; *Aveling Barford Ltd v Perion Ltd* [1989] BCLC 626; *Re Cleveland Trust plc* [1991] BCLC 424; Gore-Browne, 25[14]; Gower's Principles of Modern Company Law, 6th Ed., p.292, footnote 72; Hannigan, Annotated Guide to the Companies Act (2001) p.536.

[22] The reference to "unconscionably" is to the standard test for liability for knowing receipt: "such as to make it unconscionable for [the receipient] to retain the benefit of the receipt": per Nourse LJ *BCCI v Akindele* [2001] Ch 437; Goff & Jones, para 8-123.

[34] When considering relief for the consequences of knowing receipt it is necessary to distinguish between proprietary and personal remedies. The beneficiaries or innocent trustees will pursue a proprietary claim by following the trust property wrongly transferred or tracing its inherent value into something substituted for it: *Foskett v McKeown* [2001] 1 AC 102, 127 – 129, [2000] 3 All ER 97, [2000] 2 WLR 1299 (Lord Millett). The claim for personal liability is for the recipient to account as a constructive trustee and will usually only be necessary where following or tracing is not possible because, for example, the property has been acquired by a bona fide purchaser for value without notice or has been dissipated and is otherwise no longer identifiable. As Sir Robert Megarry V-C said in *Re Montagu's Settlement Trusts* [1987] Ch 264, 285, [1992] 4 All ER 308, [1987] 2 WLR 1192:

"The equitable doctrine of tracing and the imposition of a constructive trust by reason of the knowing receipt of trust property are governed by different rules and must be kept distinct. Tracing is primarily a means of determining the rights of property, whereas the imposition of a constructive trust creates personal obligations that go beyond mere property rights."

F Dishonest assistance or accessory liability

27. A claim against a shareholder or third party in respect of an unlawful dividend is most likely to be made by way of knowing receipt. However a party other than a director could also be liable in respect of an unlawful dividend as an accessory if he has dishonestly assisted the directors.

28. There is little doubt that an outsider who participates in the misapplication by directors of company property can be made liable as an accessory: *Selangor v United Rubber Estates Ltd v Cradock (No 3)* [1968] 1 WLR 1555, Belmont Finance Corp Ltd v Williams Furniture Ltd (No 2) [1980] 1 All ER 393 and Brown v Bennett [1999] 1 BCLC 649.

29. A useful and recent summary of the ingredients of the cause of action known as accessory liability or dishonest assistance can be found in the judgment of Hamblen J in *Brown and others v InnovatorOne plc and others* [2012] EWHC 1321 (Comm.)[23]. It is difficult to do better than cite the relevant passages from Hamblen J's judgment in full:

[1039] The legal principles for a claim in dishonest assistance are well established and are summarised in Lewin on Trusts at para 40-09, namely:

"(1) there is a trust;

(2) there is a breach of trust by the trustee of that trust;

(3) the Defendant induces or assists that breach of trust;

(4) the Defendant does so dishonestly."

[1040] In relation to the first requirement it is established that "fiduciary obligations in relation to the property of another person come within the reference to a trust" – see Morgan J in *Aerostar Maintenance International Ltd v Christopher Wilson* [2010] EWHC 2032 (Ch) at 178.

[1041] The Claimants contended that there is no requirement for there to be trust property and relied in particular upon the judgment of Peter Smith J in JD *Weatherspoon v Van de Berg* [2009] EWHC 639 (Ch) at 518, [2009] 16 EG 138 (CS). Lewin on Trusts describes this (at 40-16) as an "open question" and I shall assume (without deciding) in the Claimants' favour that there is no such requirement.

[1042] In relation to the third requirement, the assistance "must be an act which is part of the fraudulent and dishonest design and must not be of minimal importance" – see *Baden v Société Générale Pour Favoriser le, Developpement du Commerce et de L'industrie en France SA* [1993] 1 WLR 509 at 246.

[23] The claimant is understood to be appealing the decision of Hamblen J.

Dishonesty
[1043] In relation to the fourth requirement, the authorities support a combined test containing both a subjective and an objective element.

[1044] The test for dishonesty was considered in detail by the House of Lords in the *Twinsectra* case. The majority (Lord Slynn agreeing with Lord Hutton and Lord Steyn agreeing with Lords Hutton and Hoffmann. Lord Millett dissenting) adopted what is generally known as the combined test.

[1045] Lord Hutton rejected that dishonesty was purely subjective, ie was dishonest by the individual's own standards, even if the individual's own standard of honesty is contrary to that of reasonable and honest people. He also rejected the notion that dishonesty was purely objective, ie that an individual could be found to be dishonest by the standards of reasonable and honest people even if the individual did not himself realise that he was acting dishonestly. Lord Hutton stated at 27:

> ". . . there is a standard which combines an objective test and a subjective test, and which requires that before there can be a finding of dishonesty it must be established that the Defendant's conduct was dishonest by the ordinary standard of reasonable and honest people and that he himself realised that by those standards his conduct was dishonest. I will term this the 'combined test'."

Lord Hoffmann put the test as follows:

> "For the reasons given by my noble and learned friend, Lord Hutton, I consider that those principles require more than knowledge of the facts which make the conduct wrongful. They require a dishonest state of mind, that is to say, consciousness that one is transgressing ordinary standards of honest behaviour."

[1046] The test of dishonesty was reviewed again by the Privy Council in *Barlow Clowes International v Eurotrust International* [2005] UKPC 37, [2006] 1 All ER 333, [2006] 1 WLR 1476. Lord Hoffmann stated at 10 that:

> "The judge stated the law in terms largely derived from the advice of the Board given by Lord Nicholls in *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378. In summary, she said that liability for dishonest assistance requires a dishonest state of mind on the part of the person who assists in the breach of trust. Such a state of mind may consist in knowledge that the transaction is one in which he cannot honestly participate (for example, misappropriation of other people's money), or it may consist in suspicion combined with a conscious decision not to make inquiries which might result in knowledge: see *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd* [2003] 1 AC 469. Although a dishonest state of mind is a subjective mental state, the standard by which the law determines whether it is dishonest is objective. If by ordinary standards a Defendant's mental state would be characterised as dishonest, it is irrelevant that the Defendant judges by different standards. The Court of Appeal held this to be a correct state [sic] of the law and their Lordships agree." (Emphasis added)

[1047] Lord Hoffmann went on to state that this was consistent with the test of dishonesty set out in *Twinsectra*. As he stated at 15:

> "Their Lordships accept that there is an element of ambiguity in these remarks which may have encouraged a belief, expressed in some academic writing, that the Twinsectra case had departed from the law as previously understood and invited inquiry not merely into the Defendant's mental state about the nature of the transaction in which he was participating but also into his views about generally acceptable standards of honesty. But they do not consider that this is what Lord Hutton meant. The reference to 'what he knows would offend normally accepted standards of honest conduct' meant only that his knowledge of the transaction had to be such as to render his participation contrary to normally acceptable standards of honest conduct. It did

not require that he should have had reflections about what those normally acceptable standards were."

[1048] There are a number of recent decisions that have considered the test to be applied in the light of the leading authorities. In *Aerostar Maintenance International Ltd v Wilson* [2010] EWHC 2032. Morgan J stated at 183 and 184:

> "The legal test for dishonesty in this context has been much discussed. The principal authorities are the decisions of the Privy Council in *Royal Brunei Airlines v Tan* [1995] 2 AC 378, of the House of Lords in *Twinsectra Ltd v Yardley* [2002] 2 AC 164 and of the Privy Council in *Barlow Clowes International Ltd v Eurotrust International Ltd* [2006] 1 WLR 1476. The two decisions of the Privy Council represent the law to be applied in this jurisdiction: see *Abou-Rahmah v Abacha* [2007] 1 All ER (Comm) 827, at 66 – 70.
>
> The test as to dishonesty, distilled from the above authorities, is as follows. Dishonesty is synonymous with a lack of probity. It means not acting as an honest person would in the circumstances. The standard is an objective one. The application of the standard requires one to put oneself in the shoes of the Defendant to the extent that his conduct is to be assessed in the light of what he knew at the relevant time, as distinct from what a reasonable person would have known or appreciated. For the most part dishonesty is to be equated with conscious impropriety. But a person is not free to set his own standard of honesty. This is what is meant by saying that the standard is objective. If by ordinary objective standards, the Defendant's mental state would be judged to be dishonest, it is irrelevant that the Defendant has adopted a different standard or can see nothing wrong in his behaviour."

[1049] In *The Secretary of State for Justice v Topland Group plc* [2011] EWHC 983 (QB), King J stated:

> "First, on any current understanding of the law on accessory liability (see the analysis of recent authority by the Chancellor in *Starglade Properties Ltd v Nash* [2010] EWCA Civ 1314), although the test of dishonesty or put another way the standard of honesty, is an objective one, there being a single standard of honesty objectively determined by the court and the views of the Defendant on what is dishonest are irrelevant, (see *Barlow Clowes Ltd v Eurocrest Ltd* [2006]1 WLR 1476 where the Privy Council explained and interpreted the decision of the House of Lords in *Twinsectra v Ltd v Yardley* [2002] 2 AC 164)), the subjective state of mind of the Defendant, and what he knew or did not know about the circumstances of the impugned transaction, is still highly relevant since it is to the conduct of the Defendant in the light of that subjective state of mind that the court has to apply the objective test."

[1050] The test for dishonesty that the court needs to apply in the light of these authorities was not in dispute. As explained by Lord Hoffmann in *Barlow Clowes*, the combined test of dishonesty has two elements:

> "(1) The subjective element – The court must consider the Defendant's subjective state of mind and what the Defendant actually knew and understood; and
>
> (2) The objective element – The court must consider whether or not, with that state of mind, knowledge and understanding, the relevant conduct is dishonest, applying an objective standard of dishonesty."

[1051] It is not necessary for the court to establish whether or not the individual considered that he was acting dishonestly. This is not an element of the test of dishonesty as set out in *Twinsectra* and explained by *Barlow Clowes*.

G Defences to knowing receipt / dishonest assistance claims

30. Formal defences to these claims are limited to (i) limitation or laches and (ii) concurrence, acquiescence or release.[24] A change of position defence is not available in respect of a knowing receipt claim, as the traditional basis of the claim is unconscionability or fault, rather than unjust enrichment[25].

H Unjust enrichment

31. As indicated above, the traditional view as to causes of action against shareholder recipients of unlawful dividends is that claims are pursued either under the statutory remedy, by way of knowing receipt or (rarely) as an accessory for dishonest assistance.

32. However there is powerful and compelling academic argument[26] which suggests that the Court should now, with the continued case by case development of the principles of unjust enrichment, allow a claim for unjust enrichment against the recipient of an unlawful dividend, albeit there is at present no case law where such a claim has been tested.

33. Such an unjust enrichment claim would be restitutionary in response to the unjust enrichment of the recipient of the unlawful dividend and would therefore be one of strict liability. In other words, it has the advantage over a (fault–based) knowing receipt claim because it would not be necessary to show fault/knowledge of unlawful dividend by the recipient. Instead, it would be subject to the usual defences to a restitutionary claim, including a “change of position” defence.

34. In summary the argument runs as follows (quotation references are to the article by Payne[27] at (2003) 119 LQR 583):

    34.1. The essential elements of an unjust enrichment claim are (i) the defendant must have received an enrichment, (ii) the enrichment so received must have been at the claimant’s expense, (iii) the enrichment must fall within one of the recognised grounds for restitution, i.e. there must be an “unjust factor” making it appropriate to order restitution and (iv) the defendant must not be able to raise a defence, e.g. change of position.

    34.2. The traditional approach of the common law to recovery of unlawful dividends is a wrong-based liability derived by the courts by way of analogy with trust law. Thus, directors, in being held liable to recompense the company for causing unlawful dividends to be paid, are described as quasi-trustees and the liability of the recipient of an unlawful dividend was said to be on the basis that they received the monies as a constructive trustee, insofar as they dishonestly assisted in the breach or received the dividend with notice of a breach of trust by the director in causing the dividend to be paid.

    34.3. The analogy with trust law in the context of unlawful dividends is inappropriate as the trust law model involves 3 parties, a trustee, who holds the legal title to the assets, a beneficiary who holds the equitable title and the third party to whom the trust assets are transferred by the trustee in breach of trust.

    34.4. By way of contrast there are only 2 parties involved in an unlawful dividend situation: the company, which holds title to the assets and the recipient shareholder. There is no division of the legal and equitable title to the monies paid by way of dividend. Directors will be involved but they hold no title to the company assets and the directors are merely acting as agents for the company such that:

    “Their imposition between transferor (the company) and transferee (the shareholder) does not affect the fact that this is a two party situation, not a three party situation as in the trust model. The company owns its own property. It is the company that pays the

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[24] Lewin on Trusts para 40-45
[25] Lewin on Trusts para 42-73.
[26] Initially suggested by Jennifer Payne “Unjust Enrichment, Trusts and Recipient Liability for Unlawful Dividends” (2003) 119 LQR 583.
[27] “Unjust Enrichment, Trusts and Recipient Liability for Unlawful Dividends”

dividend to the shareholder, and then seeks recovery from that shareholder when the payment subsequently turns out to have been unlawful. When the payment of the unlawful dividend is made, legal title to the money passes to the shareholder, despite the fact that the company has no power to make such a payment.

The fit between trust law and company law in this instance is not a good one. The company holds full title to its assets, there is no division of legal and beneficial ownership. Although, in some circumstances, it may be appropriate to impose trust-like obligations on the directors or on those in receipt of company property as general rule these are not trust obligations in a real sense. The liability of the shareholder in receipt of an unlawful dividend should not be modelled on the liability of a third party in knowing receipt of trust property. The wrong-based trust law model does not fit the situation involved in an unlawful dividend situation" (p.592)

34.5. The trust model was developed in the late 19th Century when restitutionary principles were little developed, whereas the development of unjust enrichment provides a more compelling and appropriate remedy (p.592):

"The heart of the relationship between the transferor (company) and the transferee (shareholder) is the fact that the transferee is richer, out of the transferor's pocket, as a result of a defective transfer, the defect being that the transfer was believed to be a lawful dividend payment but was not. Lawyers today would recognize this as a situation in which the most obvious remedy to be applied is a restitutionary remedy, to require the shareholder to hand back the property, the dividend, which has been non-voluntarily paid to it by the company.

34.6. It is a feature of the historical development of company law that when many of the unlawful dividend cases were first decided, the late nineteenth century, the trust law model was in favour and the claim for money had and received, still based on the fictional implied contract, did not provide a viable alternative. It is now time for the law in this area to recognise the availability of a strict liability claim based on unjust enrichment."

34.7. The unjust enrichment model in contrast (p.593):

"seems to fit the situation involved in recovering unlawful dividends from recipients much better than the trust law model described in the previous section. The claim against the recipient has never been regarded as compensatory, unlike the claim against the directors. The claim is, at heart, that one party, the company, has handed over money to a second party, the shareholder, in circumstances which make the transfer defective. The company then seeks the return of the property from the shareholder. There is a direct transfer between the two, and therefore no need to resort to tracing to establish the necessary link between the transferor and the transferee."

34.8. As regards the "unjust factor" Payne suggests 4 possible factors (i) mistake, (ii) failure of consideration, (iii) powerlessness or (iv) policy, of which the policy factor appears to be the most compelling (p.605):

"The purpose of the statutory provisions governing dividend payments is the protection of shareholders and of creditors both pre- and post-insolvency. The protection of these groups would seem to require a policy of repayment of unlawfully paid dividends (whether pre- or post-insolvency) by the recipients. In the context of ultra vires rather than illegal payments, the House of Lords in Kleinwort Benson v Lincoln City Council were keen to look at the policy behind the concept of ultra vires. That policy is also, of course, maintenance of capital. In the context of ultra vires payments it has been said that the "concern of the law is that the monies or other property of the corporation shall not be transferred into other hands by an unauthorised act of the corporation, and that, if such an unauthorised transfer does take place, the corporation shall, so far as possible, be saved from incurring a loss thereby." The policy underlying the doctrine of *ultra vires* specifically, and maintenance of capital more generally, was acknowledged by the House of Lords in *Kleinwort Benson* to require the restitution of the money paid away *ultra vires*. Their Lordships were wary of allowing any potential defences which might subvert that policy. Although, as previously discussed, unlawfully paid dividends are more appropriately regarded as illegal rather than *ultra vires*, the underlying concept of maintenance of capital is the same in both cases and the approach of the House of Lords in *Kleinwort Benson* has obvious resonance in the unlawful dividend situation also. It is suggested that the courts would be keen to give effect to the maintenance of capital doctrine embodied in the dividend provisions set out in the Companies Act 1985 in a similar way, that is prima facie requiring repayment of the unlawful payment to the company."

35. Whilst Payne's argument is not universally accepted amongst academics, it is endorsed and supported by the leading textbook on restitution and unjust enrichment, Goff & Jones[28], para 24-37:

"As we discuss in Ch. 8 liability for knowing receipt of misdirected trust funds is not a restitutionary liability arising in response to the defendant's unjust enrichment, but a compensatory liability arising in response to the defendant's (equitable) wrongdoing. As we discuss there, it remains to be seen whether the English courts will impose a concurrent liability in unjust enrichment on recipients of misdirected trust funds that does not require proof of fault, as some legal writers have urged. A similar argument has been made in the present context by Jennifer Payne, that strict liability in unjust enrichment should be imposed on shareholders who receive unlawful dividends contrary to the capital maintenance rules. She envisages that this would run concurrently with their statutory liability under s.847 [CA 2006], but that it would supercede their liability for knowing receipt because this rests on an analogy between company directors and trustees that she considers to be imperfect and unconvincing. She correctly observes that "incapacity" would be a problematic label for the ground of recovery if such liability were to be imposed, since it would exacerbate the confusion between ultra vires and capital maintenance doctrines that has already been described, and she concludes that the ground of recovery should instead be located in the policy underpinning the common law rule invalidating unlawful returns of capital, namely the protection of creditors.

Consistently with the view that we take in Ch. 8, that the English courts should impose strict liability in unjust enrichment for the receipt of misdirected trust funds, we agree that they should also impose strict liability in unjust enrichment for the receipt of company funds paid away in breach of the capital maintenance rules, and that the ground of recovery should lie in the policy considerations underpinning the rule that invalidates such transactions. However we consider that this liability should not supercede, but should run concurrently with, the fault-based, wrong-based liability that already exists at common law, the measure of recovery being different in some cases for the two types of liability, as we also discuss in Ch. 8".

I Defences to unjust enrichment claim

36. A claim against a shareholder that he has been unjustly enriched by the dividend and that an order for restitution of the moneys received should be made may be met by a defence of "change of position" by the shareholder. Change of position is a recognised defence to such a claim following its acceptance by Lord Goff in *Lipkin Gorman v Karpnale Ltd* [1991] 2 AC 548 who provided a broad general description of the defence as follows (p.580):

"At present I do not wish to state the principle any less broadly then this: that the defence is available to a person whose position has so changed that it would be inequitable in all the circumstances to require him to make restitution, or alternatively to make restitution in full". The precise boundaries of the defence have been a matter explored and developed by the courts in subsequent cases but are not clear cut.

37. The rationale or justification for allowing such a defence has been variously expressed. Goff & Jones, The Law of Unjust Enrichment, 8th Ed. (2011) suggest (at para 27-03):

[28] The Law of Unjust Enrichment, 8th Ed. (2011)

"The point of the defence is essentially to strike a fair balance between the claimant's interest in restitution and the defendant's interest in making spending decisions freely, without fear that a claim in unjust enrichment might later invalidate the assumptions that he makes about the means at his disposal."

38. Burrows, The Law of Restitution, 3rd Ed. p.526 provides a more compelling analysis:

"It is submitted that the essential justification for the change of position defence is that the defendant has lost the enrichment, ie, disenrichment. Although the defendant was initially enriched (or appeared to be initially enriched) the change of position defence responds to the fact that that enrichment has subsequently (or even in anticipation of the initial enrichment) been countered by causally related loss or detriment so that overall the defendant has not been enriched. However, not all causal losses count. In particular, it would be unfair to a claimant if one included losses incurred by the defendant in bad faith: bad faith therefore disqualifies the defendant from the defence."

39. The mere fact that the recipient has spent the money, in whole or in part, does not of itself render it inequitable that he should be called upon to repay. The defendant must have incurred "extraordinary expenditure" and this must be proved[29]. The causal test is whether he entered into a transaction that he would not have entered "but for" the enrichment. However even if the recipient has spent the monies but has purchased assets which remain in his hands he would thereby still be enriched and, provided he has other cash or the asset purchased can be easily realised without serious personal inconvenience or transaction costs, then the change of position defence will not be allowed: see Goff & Jones, paras 27-15[30]:

"Most types of property can be sold with little personal inconvenience to their owners, but the same cannot generally be said of houses. What should the law do where the defendant buys and retains an asset, the value of which cannot be easily realised in cash? Forcing him to sell the asset might be unfair if this would mean forcing him to incur serious personal inconvenience and/or heavy transaction costs. This may not be a problem if the defendant can afford to pay a cash equivalent to the value locked up in the asset, but what if the defendant does not have the funds needed for this?"

Change of position must be in good faith - disqualifyng conduct

40. If there is disqualifying conduct on the part of the defendant then change of position will not be available as a defence. This has been described as a "lack of good faith". What is meant by "good faith" in this common law context and how far does it extend? In particular, it has been suggested that the concept of good faith does not mean acting without bad faith but can extend to a defendant who is acting in a commercially unacceptable way[31]. There is in effect a "fault spectrum"[32] which is easy to apply where there is dishonesty or actual knowledge (e.g. of a mistaken payment) at one end but where in the middle of the spectrum it is apparent from the cases and decisions on individual facts that good faith "is a fuzzy-edged concept"[33].

41. The cases in which "good faith" in the context of change of position has been considered have concerned mainly mistaken payments. By way of example:

41.1. Lord Goff in *Lipkin Gorman* identified the classic example of bad faith as being where a defendant receives money knowing it has been paid by mistake and yet pays it away without alerting the payor.

41.2. In *Niru Battery Manufacturing v Milestone Trading Ltd*[34] the claimant bank acting for its customer paid the defendant bank a sum of money under a documentary letter of credit in respect of which a false bill of lading had been presented. The defendant bank,

[29] *Dextra Bank & Trust Co Ltd v Bank of Jamaica* [2001] UKPC 50; [2002] 1 All ER (Comm) 193 (at 38)
[30] See Burrows p.536 for practical examples.
[31] *Niru Battery Manufacturing Co v Milestone Trading Ltd* [2003] EWCA Civ 1446; [2004] QB 985 at 1004 [164]; *Jones v Churcher* [2009] EWHC 722 (QB), [2009] 2 Lloyd's Rep 94.
[32] Goff & Jones, para 27-32
[33] Burrows, p.539

[34] (supra)

through its manager, just at least have suspected that a mistake had been made in making the payment but without making any further enquiries of the claimant bank, it paid the money way in accordance with its customer's instructions. Moore-Bick J at first instance held that change of position defence was not available as the defendant bank had not been acting in good faith as:

41.2.1. bad faith "is capable of embracing a failure to act in a commercially acceptable way and sharp practice of a kind that falls short of outright dishonesty itself" (para [135]);

41.2.2. "Greater difficulty may arise, however, in cases where the payee has grounds for believing that the payment may have been made by mistake, but cannot be sure. In such cases good faith may well dictate that an enquiry is made of the payer … I do not think that a person who has, or thinks he has, good reason to believe that the payment was made by mistake will often be found to have acted in good faith if he pays the money away without first making enquiries of the person from whom he received it."

41.3. In *Jones v Churcher*[35] the claimant bank by reason of a clerical error paid £40,000 to D through her bank. D paid the money on to Mr Sharkey, a fraudster. HHJ Havelock-Allan QC held that D had not been acting in good faith when paying Mr Sharkey because all of the circumstances were suspicious and her own knowledge of that was indicated by the fact that she had routed £20,000 to Mr Sharkey via a bank account in Inverness and paid £18,000 to him in cash in a pub.

41.4. However in contrast the change of position defence in good faith was allowed in *Abou-Rahmah v Abacha*[36]. The claimants had by deceit of fraudsters made 2 payments into a London bank for the account of the defendant, a Nigerian bank. The defendant bank acting on the instructions of its client paid the money into its client's account from which it was withdrawn by the fraudsters. The CofA allowed the change of position defence to the claim for restitution for mistaken payment as, whilst the defendant bank had had suspicions that its client was involved in money laundering, it had made all relevant checks as required by Nigerian law on money laundering and had had no residual suspicions about the 2 particular payments. In contrast with the Niru case, there were therefore no further investigatory steps that the defendant should have taken.

42. It should be noted that the test for not acting in good faith (and thereby being disqualified from relying upon a change of position defence) is not the same test as that applied to dishonest assistance or knowing receipt but is a lower test: see Burrows, p. 539:

"In both the *Abou-Rahman* case and *Jones v Churcher*, claims were also brought unsuccessfully against the banks for compensation for the equitable wrong of dishonestly assisting a breach of trust. There is no necessary reason why the test for dishonesty in relation to that wrong should be the same as the test for bad faith in relation to change of position. The policies involved are different. That ties in with why in *Jones v Churcher* the bank was held to be in bad faith for the purposes of the change of position defence but was held not to be dishonest for the purposes of the wrong of "dishonest assistance". Judge Havelock-Allan QC precisely said that a higher degree of knowledge was required to establish liability for the equitable wrong than was required to bar the change of position defence."[37]

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[35] (supra)

[36] [2006] EWCA Civ 1492; [2007] 1 All ER (Comm) 827

[37] See also *Haugesund Kommune v Depfa ACS Bank* [2010] EWCA Civ at para [22] per Aikens LJ who said that a defendant could not rely upon a change of position "if he has acted in bad faith or has failed to show good faith, which is not the same as having acted dishonestly." Cf. the conflicting view of Arlen Duke "The Knowing Receipt "Knowledge" Requirement and Restitution's "Good Faith" Change of Position Defence: Two Sides of the Same Coin" (2010) 35 UWA Law Review 49, who suggests by reference to Australian authorities that p. 50 "there may not be a significant difference between the standard of fault that the plaintiff is required to show in order to make out a claim in knowing receipt and the standard of fault that disqualifies a defendant from relying on the defence of change of position" and p. 73 "The above discussion leads to the conclusion that whether a claim is brought against a recipient by way of action of knowing receipt or the action of unjust enrichment, it is unlikely to succeed against a recipient who has changed her position unless the recipient had actual knowledge that the assets received were misapplied property."

J Personal or Proprietary Remedy

Proprietary Remedies

43. Whereas a personal claim entitles the claimant to an order for the payment of a sum of money by way of compensation for loss suffered from a defendant, a proprietary claim entitles the claimant to assert a beneficial interest in the trust property which has been applied in breach of trust[38] (or property representing the trust property) against both the person who has committed the breach of trust and third parties into whose hands that property has come. A proprietary claim has a number of advantages:

    43.1. if the defendant is insolvent, it will be preferable for the claimant to be able to assert a beneficial interest in the asset, thereby taking such asset out of the pool available for distribution by the insolvency office holder, than to have to rank in the insolvent estate *pari passu* as an unsecured creditor;

    43.2. if the defendant has parted with the trust property, the claimant may be able to pursue a proprietary claim against the recipient of the property from the defendant, unless the recipient is a third party purchaser for value without notice; and

    43.3. the more favourable treatment in obtaining interim injunctions to preserve property subject to a proprietary claim, as opposed to the more restricted circumstances in which a freezing injunction can be obtained against a defendant's assets (and terms thereof) where there is merely a personal claim.

44. In the context of unlawful dividends and the claims discussed above:

    44.1. the statutory remedy under s.277 CA 1985 is clearly a personal claim against the shareholder and not a proprietary claim;

    44.2. a claim for dishonest assistance or accessory liability is a personal, fault-based liability, resulting in a personal liability of the defendant to pay compensation to the company and has nothing to do with the receipt of trust property39. Although the person who dishonestly assists in a breach of trust is said to be subject to a "constructive trust"40, that does not mean that there is a trust over particular property or a proprietary claim. The position and use of the term "constructive trust" in respect of a dishonest assistance claim is explained in Lewin on Trusts, para. 40-09:

    "…the defendant is liable personally to account in equity in respect of the breach of trust as though he were a trustee. The remedy of dishonest assistance is a purely personal equitable remedy, a remedy which we have described earlier in this work as a compensatory remedial constructive trust. Although a constructive trust is imposed on the defendant, the constructive trust must not be understood in the sense of a trust imposed on any property which is or has been in the hands of the defendant, for there need be none. Rather, it must be understood in the sense of imposition of a personal liability to account on the basis applicable to a trustee. The term is simply used to describe the equitable obligation to account which is imposed on him. The defendant is made liable not because he is a trustee of any property, but because he is a dishonest accessory to the breach of trust committed by someone else."

45. The position of a defendant who is liable for knowing receipt is however different. There is a personal remedy but there may also in addition be a proprietary remedy if the defendant has retained the property received. Such a defendant is, in a similar manner to a defendant who is

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[38] In this context a "breach of trust" is not confined to trusts in the strict sense but also extends to property which is at the outset subject to a fiduciary relationship: Lewin on Trusts 41-11; *Agip (Africa) Ltd v Jackson* [1990] Ch 265 at 290.

[39] *Twinsectra Ltd v Yardley* [2002] 2 AC 164 at p. 194 per Lord Millett; *Royal Brunei Airlines v Tan* [1995] AC 378 at p. 387 per Lord Nicholls.

[40] See e.g. Lord Browne-Wilkinson in Westdeutsche Landesbank Girozentrale v Islington LBC [1996] AC 669 at p. 705E "In order to establish a trust there must be identifiable trust property. The only apparent exception to this rule is a constructive trust imposed on a person who dishonestly assists in a breach of trust who may come under fiduciary duties even if he does not receive identifiable trust property."

liable for dishonest assistance, said to be subject to a constructive trust, i.e. he is subject to a personal equitable remedy to account: see Lewin on Trusts, para 42-23:

"…the defendant is a constructive trustee of the trust property concerned. It follows that the property is recoverable from him by the equitable proprietary remedy that we consider in Chapter 41. But that is not the main significance of knowing receipt. Its main significance lies in the personal accountability as a trustee which flows from the constructive trusteeship of the property received, retained or dealt with, and hence in its use as a personal equitable remedy against the recipient of the trust property. …

If the defendant is insolvent, it is likely that the claimant will concentrate on the proprietary remedy, and the question of availability of a personal remedy will often be academic. The proprietary remedy may be adequate even if the defendant is solvent, for example where he has retained the trust property and the income. But if the defendant is solvent and has not retained, or wholly retained the trust property and its income, then the question of personal equitable liability becomes crucial."

46. It appears that a shareholder who knowingly receives an unlawful dividend (at least where there is a breach of the maintenance of capital rule or Part VIII CA 1985) is subject to a proprietary claim by the company to recover the unlawful dividend. See *Allied Carpets Group v Nethercott* [2001] BCC 81 per Colman J:

"The principle behind the remedy is clearly that where directors have caused a company to divest itself of company assets in circumstances which render that course ultra vires the powers of [the] company or ultra vires the provisions of the articles, and the transferee of the assets has knowledge of the facts rendering the disposition ultra vires, that party is under a duty to restore those assets to the company because he is deemed to hold them as constructive trustee. Title will have passed to him but, by reason of his state of knowledge at the time of the disposition of assets, or, subsequently if a volunteer, he holds subject to the beneficial interest of the company.

It is to be observed that the incidence of liability as constructive trustee depends on the inability of the recipient of the company's assets to make good a beneficial interest in the assets in view of his state of knowledge that the transference was ultra vires the company or the directors.

…

In the *Precision Drippings* situation, the constructive trust is imposed on the recipient of the company's property not because he has agreed to hold it as trustee under a bare trust for some special commercial purpose but because the property has been transferred to him to his knowledge ultra vires the powers of the company. The conjunction of want of power of disposal and knowledge of that deficiency produces the position where no beneficial interest has passed from the company to the transferee. It is in that sense that he is said to be a constructive trustee. When the company claims repayment of the unlawfully distributed dividends it is simply reclaiming its property from a transferee who, because he has acquired it with knowledge that the company has been wrongly divested of it, is under a duty to restore it."

47. In order to pursue a proprietary remedy, it will be necessary for the claimant to identify what has happened to the trust property, whether it has been retained by the defendant or can be traced into other property. This is likely to involve a process of either *following* or *tracing*.

48. Following is the process of following the same asset as it moves from hand to hand. For example, X Ltd owns the entire issued shares in its subsidiary, Y Ltd. In breach of fiduciary duty, the director of X Ltd (A) causes it to transfer 50% of the shares to his wife, B, for no consideration. B subsequently dies and the shares are left in her will to her son, C. In this case, X Ltd can follow the shares through the hands of B to C and claim a proprietary remedy against C.

49. However, the fact that an asset can be followed in this way does not necessarily mean that a proprietary remedy can be obtained against the ultimate recipient because the claimant's beneficial interest will be extinguished by a bona fide purchase for value of the legal estate, provided that the purchaser acted in good faith and without knowledge of the claimant's interest. For example, C sells the shares to D for £100. D is not aware that the shares had previously

been transferred to B in breach of trust. In this case, although X Ltd can follow the shares through the hands of both B and C to D, it is not entitled to a proprietary remedy against D, a bona fide purchaser.

50. In contrast to following, which is concerned with the specific asset transferred in breach of trust, tracing is concerned with the process of identifying a new asset as the substitute of the old through identifying the value inherent in the old asset with the value inherent in the new one.

51. Thus, in our previous example, the sale of the shares by C to D involves the conversion of X Ltd's beneficial interest in the shares into a comparative interest in their net sale proceeds. Accordingly, having followed the shares through the hands of B to C, X Ltd may then seek to trace into the sum of £100 paid by D to C for the shares (assuming that that sum has not yet been dissipated) and then to bring a proprietary claim against C asserting that those monies represent the traceable proceeds of its property.

52. It can therefore be seen that both following and tracing are essential processes in determining whether it is possible for the claimant to assert a proprietary claim. As Lord Millett summarised in *Foskett v McKeown* [2001] 1 AC 102:

"Tracing is thus neither a claim nor a remedy. It is merely the process by which a claimant demonstrates what has happened to his property, identifies its proceeds and the persons who have handled or received them, and justifies his claim that the proceeds can properly be regarded as representing his property. Tracing is also distinct from claiming. It identifies the traceable proceeds of the claimant's property. It enables the claimant to substitute the traceable proceeds for the original asset as the subject matter of his claim. But it does not affect or establish his claim."

53. It is therefore necessary to consider in greater detail the circumstances in which tracing can apply.

Tracing

54. Tracing operates both at common law and in equity. It is generally considered that equitable tracing is more flexible than common law tracing. Equitable tracing will always be available against a trustee who has wrongfully misappropriated trust property, because the beneficiary retains his equitable title to the trust property. As breach of fiduciary duty is broadly analogous to breach of trust, this paper will be confined to a consideration of equitable tracing.

55. The editors of *Lewin on Trusts (18th ed)* identify three distinct types of substitution into which the claimant may seek to trace:

55.1. Clean Substitution – The whole of the value inherent in the new asset is attributable to the value inherent in the old one (e.g. a director applies £200,000 of company money to purchase for himself a house at the price of £200,000);

55.2. Mixed Substitution – The value in the new asset is attributable in part to the value inherent in the old one and in part to another source (e.g. the director applies £100,000 of company money and £100,000 of his own money to purchase for himself a house at the price of £200,000);

55.3. Mixture – A number of assets become mixed up so that it is difficult or impossible to identify which asset came from which source (e.g. the director withdraws £100 in cash from the company and mixes the monies with his own money).

(i) Clean Substitution

56. In the case of a clean substitution, the matter is straightforward. As the new asset is effectively a wholesale replacement of the old one, the claimant can simply substitute the new asset for the old as the subject matter of his claim.

57. However, greater difficulty arises in the context of mixed substitutions, especially where the breach of trust involves payment of monies into a bank account which is already in credit.

(ii) *Mixed Substitution*

58. It will be appreciated that money which is paid into a bank account does not belong to the account holder but belongs absolutely to the bank. This is because a bank account is no more than a relationship of debt and credit between the bank and the account holder. Whenever money is paid to the bank, a corresponding amount will be credited to the account; whenever money is withdrawn a corresponding amount will be debited from the account.

59. Thus, a positive credit balance on the account reflects the level of the bank's indebtedness to the account holder and an overdrawn balance reflects the level of the account holder's indebtedness to the bank. Such indebtedness is a chose in action.

60. Accordingly, where money, in breach of trust, is paid into a defendant's bank account, the effect is to increase the credit balance and thus the bank's indebtedness to the account holder. Accordingly, the inherent value in the money is substituted for comparative value in the account holder's chose in action (i.e. the credit balance on the account).

61. Where that account was already in credit, following the payment, the value of the account holder's chose in action is attributable in part to the trust monies and in part to the sum already standing to the credit of the account. It is into this chose in action which the claimant must seek to trace. By way of example:

    61.1. A causes X Ltd to pay the sum of £10,000 into his bank account by way of dividend. Prior to the payment, the account had a credit balance of £5,000. At the time of the payment, X Ltd does not have sufficient available profits to enable any dividend to be lawfully paid.

    61.2. Assuming that no further withdrawals are made out of the account, this does not present any practical difficulties. After the payment of the unlawful dividend the account is in credit in the sum of £15,000 of which £5,000 is the property of A and £10,000 of X Ltd.

    61.3. However, assume that A subsequently withdraws the sum of £4,000 from the account to purchase a painting, leaving a credit balance of £11,000.

    What is the effect of such payment on X Ltd's potential proprietary claim?

62. The answer depends upon a number of evidential presumptions which have arisen under English law.

    62.1. Generally, the starting point is the rule in *Clayton's Case*[41]. Pursuant to this rule, payments out of a bank account are attributed to payments into the account in the order in which payments were made in (i.e. first in, first out).

    62.2. If that rule applied in our example, it would be assumed that the £5,000 standing to the credit of the account before the unlawful dividend payment was paid out first. That would mean that the painting was purchased entirely with A's own monies, with X Ltd being able to trace its £10,000 into the sum of £11,000 remaining to the credit of the account.

    62.3. However, what if A, having subsequently gambled away the remaining £11,000 at the Bath races, discovered that the painting was a previously undiscovered Vermeer worth £150,000? Clearly it would be inequitable for enable A to profit from his breach of fiduciary duty by virtue of the arbitrary application of an arcane rule.

63. Happily, it is clear from the cases of *Re Hallett's Estate* (1880) 13 Ch D 696 and *Re Oatway* [1903] 2 Ch 356 that as against a misfeasant trustee the court will apply the equitable maxim that 'everything is presumed against a wrongdoer'. It follows that it will be assumed that the trustee has dissipated his own monies before wrongfully divesting himself of trust property.

64. Thus, in our example the court will assume that A astutely invested £4,000 of X Ltd's monies in the recently revealed masterpiece, enabling X Ltd to claim beneficial entitlement to the entire net

[41] (1816) 1 Mer. 572.

65. sale proceeds. Conversely, had the painting proven to be worthless but A had had the fortitude to back Spray Tan in the Fillies' Handicap at an unlikely 20-1, the contrary will be presumed, with X Ltd entitled to trace into the winnings.

66. The position will naturally be different where the mixed substitution into which it is sought to trace involves property of another innocent contributor. Thus in our very first example, if rather than the transfer of shares, A caused X Ltd to pay £10,000 to B's bank account, which was already in credit, the rule in *Clayton's Case* will apply to further transactions on the account. In consequence, X Ltd will be at the mercy of the arbitrary application of the first in, first out rule.

(iii) Mixtures

67. Generally a mixture can take place in one of three ways:

   67.1. Goods of the same kind are mixed together and cease to be separately identifiable. For example, two bottles of water are poured into a single bowl.

   67.2. Goods of the same kind are mixed together and remain physically separate but cannot be identified separately. For example two boxes of matches are placed into a single box.

   67.3. Goods which are not of the same kind though they may be similar are mixed together. For example a couple's personal DVD collections are placed into the same cupboard.

68. As against the trustee, the prevailing view is that, in the first two cases the claimant would be entitled receive out of the mixture a quantity equal to that of his goods which went into the mixture, any doubt as to that quantity being resolved in his favour and in the latter case, he will be entitled to every portion of the blended property which the trustee cannot positively prove to be his own.

Limits to Tracing

69. Whilst the application of the equitable maxim that 'everything is presumed against a wrongdoer' will come to the assistance of the claimant whenever a trustee has subsequently divested himself of monies paid into a bank account in breach of trust, it cannot operate to preserve the trust monies in the account beyond the 'lowest intermediate balance'. This is the point at which sufficient sums have been withdrawn from the account that all of the trust monies must have been paid out.

70. Thus, returning to our example where A wrongfully causes X Ltd to pay the sum of £10,000 into his bank account, which had a credit balance of £5,000 but then pays out the entire sum of £15,000, it can be seen that the entire trust monies must have now been paid out. It follows that even if A subsequently paid a further £30,000 of his own monies into the account X Ltd cannot seek to trace into the account; the lowest intermediate balance has been reduced to nil.

71. Similarly, whilst it is entirely possible to trace into an account with a positive credit balance, it will be appreciated that it is not possible to trace into an overdrawn account. This is because the money is used to reduce the trustee's indebtedness to the bank and is therefore dissipated.

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