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LEGAL UPDATE

Contents

- Fiduciary Duties:
Murad v Al-Saraj [2005]
EWCA Civ 959 (CA).
Charles Purle Q.C.
Page 1
- Fixed and Floating
Charges: *In re Spectrum
Plus* [2005] 2 A.C. 680
(HL)
Tim Akkouch
Pages 2-3
- Dishonest Assistance:
*Barlow Clowes v
Eurotrust* [2005] UKPC
37
Shelley White
Page 3
- Similar Fact Evidence:
*O'Brien v Chief
Constable of South
Wales Police* [2005] 2
W.L.R. 1038 (HL)
Michael Roberts
Page 4

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Next edition:
April 2006

Adverse Possession:
James Thom Q.C. and Robert
Levy on the European Court
of Human Rights' decision in
*J.A. Pye (Oxford) Ltd v The
United Kingdom*.

Corporate Insolvency:
David Eaton Turner on the
Court of Appeal's decision in
BCCI v Bank of India [2005]
2 BCLC 328

Should fiduciaries disgorge all profits made in
breach of fiduciary duty? 'Not always', say the
Court of Appeal in *Murad v Al-Saraj* [2005]
EWCA Civ 959

Charles Purle Q.C.

Head of Chambers, Chairman of the Chancery Bar Association



Facts: In 1997, Mr Al-Saraj convinced Aysha and Layla Murad to enter into a joint venture under which a hotel would be bought and run. He represented to them that he would contribute £500,000 towards the hotel's purchase price. This was a lie: the £500,000 which he purported to contribute was largely made up of a secret commission that the hotel's vendor had agreed to pay to him. Despite this dubious beginning to the venture, the hotel was run profitably for several years by Mr Al-Saraj and the Murads and sold at a profit. The parties then disagreed as to how the proceeds should be distributed, with the Murads finally deciding to sue Mr Al-Saraj for breach of fiduciary duty.

High Court: Etherton J held at trial that Mr Al-Saraj did indeed owe the Murads fiduciary duties, that he had breached these duties, and that he had made a profit as a result. He was, found Etherton J, liable to disgorge the entirety of his profit except for £500,000 which he could retain as recompense for the work, effort and skill he contributed to the venture. Etherton J also made the somewhat curious finding of fact that the Murads would still have entered into the venture had Mr Al-Saraj disclosed the profit that he was making on the hotel's purchase, albeit on terms that were more advantageous to them. Mr Al-Saraj appealed on the basis of this last finding, arguing that he should be entitled to some share of the profits made. The Murads cross-appealed on the basis that the £500,000 allowance was too generous.

Court of Appeal: Unsurprisingly, the majority of the Court of Appeal (Arden and Jonathan Parker LJJ) held that Mr Al-Saraj was not entitled to a share of the venture's profits and that the allowance granted to him was too generous. But the majority also made some rather interesting comments as to the extent of a fiduciary's duty to disgorge profits made after breaching his fiduciary duty. They both held that although they were bound by authority that dictated that a fiduciary that makes a profit as a result of a breach of his fiduciary duties must disgorge the entirety of that profit (save

for a modest allowance in respect of their expenses, effort and skill), a 'less inflexible' rule might sometimes be appropriate (see [82] *per* Arden LJ and [121] to [122] *per* Jonathan Parker LJ). No further guidance was, however, given.

Clarke LJ dissented on the profit-sharing issue. He held that it should be open to an errant fiduciary to "*persuade the court ... in the circumstances of a particular case, [that] he should not be ordered to account for the whole of the profits [that he has made]*" (at [141]). Nor, noted Clarke LJ, had any English decision "*focused on the correct approach to the assessment of the profit in respect of which an account should be ordered*" in any great depth (see [149]). He therefore looked to the High Court of Australia's decision in *Warman International v Dwyer* (1994-5) 182 CLR 544 to support his conclusion that an errant fiduciary could sometimes be allowed to split profits made in breach of fiduciary duty with his principal to "*meet the justice of the case*" (at [156]). A high burden of proof could be imposed, and the case management powers of the CPR used, to ensure that no injustice resulted to those to whom fiduciary duties were owed.

Clarke LJ concluded that he would have remitted the case back to the trial judge "*in order to give Mr Al-Saraj the opportunity to seek to persuade him that it would be inequitable to order him to account for all the profits of the joint venture, subject only to his expenses and [an allowance for his] skill*" (at [162]).

Comment: Clarke LJ's preferred approach certainly goes beyond accepted principle. One obvious problem arises from it. The no-profit rule provides a deterrent to those fiduciaries who contemplate breaching their fiduciary duty; if the no-profit rule is relaxed, this deterrent will be diluted. It will be interesting to observe how the Courts grapple with this tension in future cases.

Charles Purle Q.C.

The last word on the difference between fixed and floating charges? *In re Spectrum Plus* [2005] 2 A.C. 680 (HL)

Tim Akkouh



Spectrum Plus Ltd carried on the business of a manufacturer of dyes, paints and pigments for the paint industry. In 1997 it changed banks, opening a new account with National Westminster with an overdraft facility of £250,000. The overdraft was secured by a debenture, which included a 'specific charge [of] all book debts and other debts ... now and from time to time due or owing to [Spectrum].' Furthermore, Spectrum was required to pay into its account with the bank "all moneys which it may receive in respect of such debts and shall not without the prior consent in writing of the bank sell factor discount or otherwise charge or assign the same in favour of any other person ... and shall ... if called ... to do so ... execute legal assignments of such book debts and other debts to the bank." Spectrum duly paid the proceeds of its book debts into its account, which remained overdrawn. The overdraft was never called in, nor was any demand made by the bank for Spectrum to assign the book debts.

When Spectrum entered into voluntary liquidation in October 2001 its account was overdrawn to the tune of £165,407 odd. The bank sought to leapfrog Spectrum's preferential creditors in the insolvency hierarchy by asserting that their debenture over Spectrum's book debts was fixed and not floating; if successful, this argument would have yielded the bank an additional £16,136. Despite the comparatively small amount at stake, the appeal to the House of Lords raised a point of considerable importance; several hundred liquidations had been put 'on hold' pending their Lordships' decision.

The seven member House of Lords unanimously reversed a unanimous Court of Appeal and held that the charge created by Spectrum over its book debts was floating and not fixed. In the process, the House overruled the decisions of both Slade J in *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd's Rep 142 and the Court of Appeal in *re New Bullas Trading Ltd* [1994] 1 BCLC 485.

(i) *The importance of fixed and floating charges*

Lord Scott gave a useful historical introduction to the importance of the distinction between fixed and floating charges at the beginning of his speech. At paragraph 95, his Lordship stated: "By the middle of the 19th century industrial and commercial expansion in this country had led to an increasing need by companies for more capital. Subscription for share capital could not meet this need and loan capital had to be raised. But the lenders required security for their loans. Traditional security, in the form of legal or equitable charges on the borrowers' fixed assets, whether land or goods, could not meet the need. The greater part of most entrepreneurial companies' assets would consist of raw materials, work in progress, stock-in-trade and trade debts. These were circulating assets, replaced in the normal course of business and constantly changing. Assets of this character were not amenable to being the subject of traditional forms of security. Equity, however, intervened [by permitting the creation of floating charges over such circulating assets]."

As can be seen from the above description of a company's circulating assets, a floating charge has the potential of 'stepping in and sweeping off' virtually all of a company's moveable and intangible assets, leaving little or nothing for other creditors. In reaction to this state of affairs, Parliament has intervened

by introducing both the category of preferential creditors that rank in priority to the holders of floating charges and unsecured creditors (eg company employees are preferential creditors in respect of certain claims to unpaid wages: see s. 175 of the Insolvency Act 1986), and, more recently, a requirement that a proportion of the sums realised by some floating charge holders be made available to a company's unsecured creditors (see s. 176A of the Insolvency Act 1986). Hence, a chargee has a considerable incentive to argue that his charge is fixed and not floating. This is exactly what the bank sought to do in *Spectrum*.

(ii) *The distinction between fixed and floating charges*

Their Lordships held that if a company could deal with assets covered by a charge in the usual course of business, then that charge was floating and not fixed. Lord Scott made this point manifest in paragraph 111: "...the essential characteristic of the floating charge, the characteristic that distinguishes it from a fixed charge, is that the asset subject to the charge is not finally appropriated as a security for the payment of the debt until the occurrence of some future [crystallising] event. In the meantime the chargor is left free to use the charged asset and to remove it from the security."

On the facts of the case, the chargor could deal with book debts in the course of business as, although it was precluded from selling, factoring, discounting, assigning or charging them, it was *not* precluded from calling them in and paying them into its trading bank account.

The House agreed with Lord Millett's reasoning in *Agnew v Comr of Inland Revenue* [2001] UKPC 28, [2001] 2 AC 710 that parties could not create a fixed charge over book debts and only a floating charge over their proceeds because "the essential value of a book debt as a security lies in the money that can be obtained from the debtor in payment..." (per Lord Scott at 110).

Thus, one could not draw an artificial distinction between the book debts pre- and post- realisation. Such a dichotomy would, according to Lord Scott, have been wholly artificial, as "the expression 'floating charge' has never been a term of art but is an expression invented by equity lawyers and judges to describe the nature of a particular type of security arrangement between lenders and borrowers. The categorisation depends upon the commercial nature and substance of the arrangement, not upon a formalistic analysis of how the bank clearing system works. If part of the arrangement is that the chargor is free to collect the book debts but must pay the collected money into a specified account, the categorisation must depend, in my opinion, on what, if any, restrictions there are on the use the chargor can make of the credit to the account that reflects each payment in" (at para 116).

The *Spectrum* charge was, therefore, merely of the floating variety, as the chargor was free both to collect the charged asset and then to remove it from the security by making withdrawals from its bank account. In Lord Walker's words, the charge "did not in any way restrict [the chargor] from taking the most natural course for a trader in the ordinary way of business, that is

collecting the debts and paying them into its current account” (at para 145). Nor did it matter that the bank *could* have exercised its contractual rights to terminate Spectrum’s overdraft facility and demand that payment of proceeds from the book debts be made to a blocked account—while these acts could have had the effect of turning the floating charge into a fixed charge, they had simply not been carried out. Needless to say, characterisation of a charge as fixed or floating is a matter of substance and not form; as a result, little weight is attached to how the parties describe the charge in their debenture.

The House’s analysis will make grim reading for banks wishing to maximise their security. Lord Hope, however, provided the banks with some solace by considering instances in which a charge over book debts would be fixed. At paragraph 54 he gave three such scenarios, namely: (i) where a chargor is under an obligation not to deal with book debts at all, (ii) where a chargor is under

an obligation to pay the proceeds of those book debts to the chargee, or (iii) where a chargor is under an obligation to pay the proceeds of the book debts into a specific blocked bank account. However, their Lordships made it clear that it was not enough for the debenture to provide that payment was to be made to a blocked account, if in fact it was not operated as such an account (see, for example, Lord Walker’s speech at para 140).

(iii) Conclusion

The House’s unanimous overruling of the Court of Appeal’s decision in *Spectrum Plus* is to be welcomed. Expanding the situations in which fixed charges can be created is not only intellectually dubious, resting on a formalistic analysis, but is contrary to the intention of Parliament in implementing concessions for both preferential creditors and, more recently, unsecured creditors.

Tim Akkouh

**The Privy Council simplify the test for dishonest assistance:
Barlow Clowes & Ors v Eurotrust International Ltd
[2006] 1 All ER 333**

Shelley White



Barlow Clowes v Eurotrust arose from a fraudulent off-shore investment scheme which, rather than providing the high returns on investments that it promised, was in fact a means to fund the extravagant lifestyles of C and his associates. Payments that were made by investors were circuitously routed through offshore companies in order to make their origin harder to establish. This movement of funds, said *Barlow Clowes*’ liquidator, was aided by International Trust Corporation (Isle of Man) Ltd (‘ITC’) and its directors H and S. *Barlow Clowes*’ liquidator therefore claimed that ITC, H and S had dishonestly assisted in C’s breaches of fiduciary duty by failing to make inquiries about payments that ITC was instructed to make.

The liquidators were successful at first instance in the Isle of Man High Court. S and ITC brought an unsuccessful appeal on the ground that the actions brought against them were barred by the effluxion of time. H, however, successfully appealed on the basis that the trial judge’s decision was not supported by the evidence before her. The liquidator appealed against this finding to the Privy Council. Lord Hoffmann delivered the Privy Council’s decision.

In allowing the appeal, the Privy Council clarified the two-stage test for a dishonest assistance claim, namely:

1) *Identify the defendant’s state of mind.* This is a question of fact to be determined by drawing inferences from both the defendant’s knowledge and all the relevant circumstances both at the time of, and after, the transaction.

2) *Assess whether the defendant’s state of mind would be viewed as dishonest by ordinary people.* Lord Hoffmann said, “If by ordinary standards a defendant’s mental state would be characterised as dishonest, it is irrelevant that the defendant judges by a different standard [A defendant’s knowledge of a transaction only has to be such] as to render his participation contrary to normally acceptable standards of honest conduct. It [does] not require reflections about what those normally acceptable standards were”.

The trial judge had found that H consciously decided not to make inquiries as to the origin of the funds because he preferred “*in his own interest not to run the risk of discovering the truth*”. As this state of mind was dishonest by ordinary standards, it did not matter that H’s own moral standards led him to view that “*it was not improper to treat carrying out clients’ instructions as being all important*”.

Quite contrary to the Privy Council’s *Eurotrust* decision are some aspects of the House of Lords’ decision in *Twinsectra v. Yardley* [2002] UKHL 12; [2002] 2 A.C.164. For example, Lord Hutton said in *Twinsectra* that: “... *dishonesty requires knowledge by the defendant that what he was doing would be regarded as dishonest by honest people ...*”. In *Eurotrust*, Lord Hoffmann recognised the tension between the tests in *Twinsectra* and *Eurotrust*. He addressed it by saying there is “*an element of ambiguity in [Lord Hutton’s] remarks which may have encouraged a belief ... that Twinsectra had ... invited inquiry ... into [the defendant’s] views about generally acceptable standards of honesty*”.

With respect, it is hard to see any ambiguity in Lord Hutton’s judgment in *Twinsectra*. On the contrary, it seems he clearly intended to impose a requirement that the defendant realise that his actions would be regarded as dishonest by normal moral standards. In fact, it was for this very reason that Lord Millett dissented from the majority in *Twinsectra* (see, in particular, paras 121 and 127).

Despite this, the Privy Council’s decision in *Eurotrust* is eminently sensible. The *Twinsectra* test was overly restrictive in that it was always open to a defendant to successfully defend an allegation of dishonest assistance on the basis that he believed that his behaviour was honest by ordinary standards, no matter how dishonest ordinary people would have actually considered it to be.

Shelley White

An overturned murder conviction leads to important changes to the rules of civil evidence: *O'Brien v Chief Constable of South Wales Police* [2005] 2 W.L.R. 1038 (HL)

Michael Roberts



Mr O'Brien launched a claim alleging misfeasance in public office and malicious prosecution against the Chief Constable of South Wales Police after having his conviction for murder quashed by the Court of Appeal. Mr O'Brien's claim principally called into question the actions of two detective police officers who had been responsible for investigating his actions. To bolster his claim, Mr O'Brien sought permission to use similar-fact evidence that these two officers had improperly investigated other crimes. He succeeded in obtaining permission to use this evidence in front of the trial judge, the Court of Appeal and the House of Lords. In considering the case, the House laid down a two-stage test to determine the admissibility of similar fact evidence in civil cases.

(i) Stage 1: Is the evidence relevant?

Lord Phillips' analysis began by considering the criminal law similar-fact evidence test, which requires such evidence to have an "enhanced relevance or substantial probative value because, if the evidence is not cogent, the prejudice that it will cause to the defendant may render the proceedings unfair...".

His Lordship proceeded to disavow the relevance of such a strict test to civil cases, arguing that "I can see no warrant for the automatic application of either of these [criminal law] tests as a rule of law in a civil suit. To do so would build into our civil procedure an inflexibility which is inappropriate and undesirable. I would simply apply the test of relevance as the test of admissibility of similar fact evidence in a civil suit. Such evidence is admissible if it is potentially probative of an issue in the action" (at paras 52-53).

The other members of the House agreed. Thus the first hurdle that a party wishing to adduce similar fact evidence must surmount is in proving that the evidence that he wishes to call is logically probative or disprobative of some matter that requires proof: see further *R v Kilbourne* [1973] AC 729, at 756 per Lord Simon.

(ii) Stage 2: Limiting or controlling factors.

Lord Phillips referred to two specific exceptions to the general rule of admissibility. The first arises where the risk of prejudice outweighs the probative value of the similar fact evidence sought to be adduced.

Lord Bingham concurred, arguing that "it will be necessary to weigh the potential probative value of the evidence against its potential for causing unfair prejudice; unless the former is judged to outweigh the latter by some considerable margin, the evidence is likely to be excluded" (at para 6). This risk is especially acute where the trial is by jury, not an unknown phenomenon in certain civil suits (for example, claimants can opt for a trial by jury in cases involving deceit, libel, slander, malicious prosecution and false imprisonment: see s. 69 of the Supreme Court Act 1981).

The second exception noted by Lord Phillips applies where the admission of similar fact evidence would be contrary to the overriding objective, and, in particular, the objectives of proportionality and expedition (see CPR rule 1.1(2)).

In determining whether similar fact evidence is proportionate, the trial judge should, *inter alia*, "consider whether the evidence is likely to be relatively uncontroversial, or whether its admission is likely to create side issues which will make it harder to see the wood for the trees" (per Lord Phillips at para 56).

Applying these principles, their Lordships held that the trial judge had been correct to conclude that evidence of improper conduct of the two investigating officers on previous occasions should be admitted.

Although the evidence was hotly contested and would substantially lengthen proceedings, the House held that the trial judge had not erred in concluding that the evidence was critical to Mr O'Brien's action against the police, and that Mr O'Brien's action was important both to him as an individual and to the public at large.

(iii) Discussion

The House of Lords' decision in *O'Brien* certainly clarifies the different rules of admissibility of similar fact evidence that apply to civil and criminal cases. Their decision confirms the more relaxed approach of the courts to civil evidence generally, a trend also seen in the civil courts' everyday admission of hearsay evidence under the Civil Evidence Act 1995.

One can see that similar fact evidence may be helpful in a number of different situations. For example, posit a tort case defended on the basis that the risk of injury to a claimant was very low (and so the defendant was not negligent in failing to take precautions to guard against it); here, evidence that others have been injured in a similar way to the claimant may prove extremely useful in helping to establish the claimant's cause of action.

Take also a case in which a claimant seeks to prove impropriety against a professional man. Such allegations are notoriously difficult to prove, not least because of the higher burden of proof required to be overcome where serious allegations are made: see *Hornal v Neuberger* [1957] 1 Q.B. 247 (CA). Here too, then, it may also be especially helpful to point to other instances of impropriety to bolster an otherwise difficult claim.

Michael Roberts

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