KEY POINTS

- In the gloves-off world of modern fraud litigation, the defendant's solicitors are now fair game.
- Where there are proprietary claims, the provenance of fees must be carefully scrutinised to avoid the solicitor later becoming accountable for them.

Feature

Author Shantanu Majumdar

An impossible position: fraud claims, solicitors and their fees

This article considers a solicitor's liability to account in respect of fees received from its defendant client where a claimant makes a proprietary claim to the proceeds of fraud.

It is now fashionable in major fraud litigation for the claimant to adopt a policy of interlocutory attrition as a supplement to or even substitute for the ultimate determination of the claim at trial (eg, *JSC BTA Bank v Ablyazov* litigation). Most common is the making of contempt applications in respect of allegedly defective asset disclosure although there have been recent signs of judicial impatience with this phenomenon: see *PJSC Vseukrainskyi Aktsionernyi Bank v Maksimov* [2014] EWHC 4370 (Comm) where only one of five allegations of contempt was upheld and, since even this was "technical", most of the costs of the application were awarded to the defendant (on this point see also *Sectorguard plc v Dienne plc* [2009] EWHC 2693 (Ch)).

Another growingly common line of attack is in relation to the fees of the defendant's solicitors.

The typical form of freezing injunction provides that a respondent is entitled to spend "a reasonable sum on legal advice and representation. But before spending any money the Respondent must tell the Applicant's legal representatives where the money is to come from." In complex cases more detailed provisions are often necessary.

Where the claimant makes proprietary claims to trace the proceeds of fraud (or of some breach of trust) it is a salutary fact (see *United Mizrahi Bank Ltd v Doherty* [1998] 1 WLR 435) that compliance with the terms of such a provision does not in itself prevent a solicitor becoming liable:

- as constructive trustee for proprietary funds which are still held by the solicitor; and/or
- in unconscionable (knowing) receipt in respect of proprietary funds which have passed through the hands of the solicitor.

Here we are not primarily concerned with injunctions in proprietary form where the question is whether some particular fund which is claimed by the claimant can be used for legal expenses. There is a distinct line of authority on the approach to be taken in such cases, see eg *Ostrich Farming Corp Ltd v Ketchell (unreported)* CA 10 December 1997. Rather, the typical scenario in which proprietary/unconscionable receipt claims are made against a solicitor is where it receives sums in respect of fees (at least notionally) from third parties.

Both claims are obviously contingent upon the claimant vindicating a proprietary claim to the funds in question. Neither requires proof of dishonesty but neither the "mental" element nor the burden of proof is identical:

- in the case of the proprietary claim, mere possession is sufficient subject to the defence of *bona fide* purchase for value without notice;
- in the case of unconscionable (knowing) receipt, it is for the claimant to prove the requisite actual and/or constructive knowledge on the part of the solicitor.

In most cases, these differences are unlikely to make much practical difference.

A more significant difference is the time when such knowledge exists.

- Generally speaking, if, subsequent to receipt, the recipient acquires knowledge which makes it unconscionable for it to retain the money, then liability arises in respect of however much of the money the recipient still has at that point – "unconscionable receipt" is therefore a somewhat misleading name as even knowledge acquired only after receipt can give rise to at least *pro tanto* liability to account.
- By contrast, where the recipient can show that it is a *bona fide* purchaser for value without notice, no degree of later knowledge can render it liable to return any retained sum. The question is rather when it can first be regarded as a "purchaser for value". This would seem to be the time at which the service for which the money was paid was provided and which in the legal services context would include not only work done personally by the solicitor but also procuring the services of counsel.

But what knowledge on the part of the solicitor does liability require and what, if any, investigations is it required to make?

The high-water mark of the protective attitude to solicitors in this sort of situation was reached in the decision of the Court of Appeal in *Carl Zeiss Stiftung v Herbert Smith & Co* [1969] 2 Ch 276. There it was claimed that all the assets of the defendant belonged to or were held on trust for the plaintiff and, therefore, that the defendant's solicitors – necessarily on notice of that claim – were accountable to the plaintiff for sums received by way of payment of their fees from those assets. This was given short shrift, as Danckwerts LJ put it:

> "In my view, knowledge of a claim being made against the solicitor's client by the other party is not sufficient to amount to notice of a trust or notice of misapplication of the moneys."

He went on to say that "… claims are not the same thing as facts." and that the key question was:

> "the state of the defendant solicitors'

Feature

Biog box
Shantanu Majumdar is a barrister at Radcliffe Chambers, Lincoln's Inn.
Email: smajumdar@radcliffechambers.com

knowledge (actual or imputed) at the date when they received payments of their costs and disbursements. At that date they cannot have had more than knowledge of the claims above mentioned. It was not possible for them to know whether they were well-founded or not. The claims depended upon most complicated facts still to be proved or disproved, and very difficult questions of German and English law. It is not a case where the West German foundation were holding property upon any express trust. They were denying the existence of any trust or any right of property in the assets claimed by the plaintiffs. Why should the solicitors of the West German foundation assume anything against their clients?"

The court applied *dicta* in *Barnes v Addy* (1874) 9 Ch App 244 in which Lord Selborne had said (at 291-2) that:

"… strangers are not to be made constructive trustees merely because they act as the agents of trustees in transactions within their legal powers, transactions, perhaps of which a Court of Equity may disapprove, unless those agents receive and become chargeable with some part of the trust property, or unless they assist with knowledge in a dishonest and fraudulent design on the part of the trustees.

…

If those principles were disregarded, I know not how anyone could, in transactions admitting of doubt as to the view which a Court of Equity might take of them, safely discharge the office of solicitor, of banker, or of agent of any sort to trustees.

Sachs LJ characterised the solicitors' position as "impossible" and described the knowledge/conduct required for liability as follows:

"It does not, however, seem to me that a stranger is necessarily shown to be both a constructive trustee and liable for a breach of the relevant trusts even if it is established that he has such notice. As at present advised, I am inclined to the view that a further element has to be proved, at any rate in a case such as the present one. That element is one of dishonesty or of consciously acting improperly, as opposed to an innocent failure to make what a court may later decide to have been proper inquiry. That would entail both actual knowledge of the trust's existence and actual knowledge that what is being done is improperly in breach of that trust – though, of course, in both cases a person wilfully shutting his eyes to the obvious is in no different position than if he had kept them open."

Statements in two later cases were consistent with this approach. In *El Ajou v Dollar Land*[1993] BCC 698, Millett J said:

"A recipient is not expected to be unduly suspicious and is not to be held [to have notice] unless he went ahead without further inquiry in circumstances in which an honest and reasonable man would have realised that the money was probably trust money and was being misapplied."

In *Eagle Trust v SBC Securities* [1993] 1 WLR 484, Vinelott LJ said that:

"[actual knowledge or wilful and reckless failure to make reasonable inquiries] may be inferred if the circumstances are such that an honest and reasonable man would have inferred that the moneys were probably trust moneys and were being misapplied, and would either not have accepted them or would have kept them separate until he had satisfied himself that the payer was entitled to use them in discharge of the liability."

These *dicta* suggested that a recipient might be liable where it should reasonably have realised that the funds were probably trust moneys but subsequently, in *BCCI v Akindele* [2001] Ch 437, the Court of Appeal said that unconscionability is such state of knowledge as would make it unconscionable to retain the benefit of the receipt. On that basis the better (or at least appropriately cautious) view is that it is not necessary for the recipient to realise that the funds were *probably* the proceeds of breach of trust/fraud but rather that there was a serious possibility or real risk that this was so. The more recent first instance decision in *Armstrong v Winnington* [2013] Ch 156 is also consistent with this, lower, possibility/risk threshold.

In the author's view, *Carl Zeiss Stiftung* (see also *La Roche v Armstrong* [1922] 1 KB 485) remains good law in so far as it holds that a solicitor cannot ordinarily be expected to resolve the contradictory cases of the parties as to the existence of fraud or a trust. However, in the light of the positive obligations of inquiry imposed by the Money Laundering Regulations 2007 in particular, no solicitor can safely (or lawfully) fail to investigate the source of any funds remitted to it. Compliance with the 2007 Regulations does not, of itself, absolve a solicitor of liability as a constructive trustee in respect of proprietary funds but Regulation 7 requires those to whom it applies to:

"determine the extent of customer due diligence measures on a risk-sensitive basis depending on the type of customer, business relationship, product or transaction"

and in a case of fraud where proprietary claims are advanced, due diligence (including any "enhanced due diligence" under Regulation 14) will be informed by the nature and detail of the allegations made in the case and the facts which emerge from asset disclosure and other sources. This should be enough, but the inevitable lack of certainty puts solicitors in a rather unfair position. ■

Further Reading:

- Developments in freezing foreign assets [2015] 2 JIBFL 111.
- Freezing orders and third parties: casting the net just wide enough [2014] 8 JIBFL 518.
- LexisNexis Dispute Resolution blog: Quick guide on emergency interim remedies.