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DEFINING (OR REFINING) THE MEANING OF DISHONESTY AFTER *TWINSECTRA*

Barlow Clowes International Ltd. v. Eurotrust International[1]

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I. INTRODUCTION

The case arose from a large-scale investment fraud. Peter Clowes, through his company Barlow Clowes International Ltd., attracted about £140 million from U.K. investors, ostensibly for investment of funds in gilt-edged securities. The money was mostly dissipated by Clowes. When the scheme collapsed he was convicted and sent to prison. In prior proceedings,[2] the investors attempted to recover some of their funds from money still retained in bank accounts.

These proceedings were commenced by the company, now in liquidation, against Peter Henwood and Andrew Sebastian, the directors of International Trust Corporation (Isle of Man) Ltd. ('ITC'). It was sought to make the directors of ITC liable for dishonest assistance in the misappropriation of investors' funds. In the words of Lord Hoffman:

> ITC provided off-shore financial services. In particular, it formed and administered off-shore companies, provided off-shore directors who would act upon the instructions of beneficiaries, opened bank accounts and moved money, sometimes through its own client account. ITC was instructed to form and administer a number of off-shore companies for Mr. Cramer, an associate of Mr. Clowes.[3]

Initially, ITC's involvement was transaction-based, processing payments from Barlow Clowes to off-shore companies. Even at this stage, the transactions were not easy to reconcile with proper commercial behaviour. The trial judge was provided with information regarding ten transactions which involved transfers of money from Barlow Clowes to accounts under Cramer's control, in circumstances where there were no commercial reasons for the payments. The trial judge held that even at this stage Sebastian was suspicious of the transactions, although Henwood was not.

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1 [2006] 1 All E.R. 333 [*Barlow Clowes*].

2 *Barlow Clowes International Ltd. v. Vaughan* [1992] 4 All E.R. 22.

3 *Supra* note 1 at 335.

Later, Henwood became much more closely involved with ITC. He travelled and met both Clowes and Cramer. Discussions occurred in which it was suggested that Henwood's business might be absorbed into the Barlow Clowes businesses. As a consequence, Henwood obtained substantial information about Barlow Clowes' business and the source of its funds. Two crucial transactions occurred after this time.

One transaction (known as transaction 11) occurred with money that had been set aside for underwriting a proposed reverse takeover. When it became apparent that the money was not needed, Henwood authorised the payment of the money for Cramer's personal business.

A second crucial transaction (transaction 15) occurred in two parts. The first stage was when £6 million in a Barlow Clowes account (set aside to bid for a brewery company) was instead transferred by Henwood and Sebastian to Cramer's personal account. A further £205, 329 was later transferred on their instructions to a company controlled by Clowes.

The Acting Deemster, Hazel Williamson Q.C. held Henwood, Sebastian and ITC liable for the money transferred away pursuant to transactions 11 and 15. Sebastian and ITC were also held liable for another transaction worth more than £1 million. All defendants appealed to the Staff of Government Division of the High Court. Sebastian and ITC appealed unsuccessfully on a limitation point. Henwood's appeal was against liability and he was successful. The Court of Appeal overturned the decision, holding that although the trial judge had correctly stated the law, the evidence did not support the finding of dishonest assistance.

Barlow Clowes' appeal to the Privy Council was successful, and the Privy Council restored the decision of the trial judge. Sebastian and ITC did not take part in the Privy Council appeal. The Privy Council decision deals with two issues:

(1) What is the meaning of 'dishonesty' from *Twinsectra Ltd. v. Yardley*?[4]
(2) Was the law correctly applied to the facts in this case?

II. Dishonesty

The trial judge stated the law from *Royal Brunei Airlines v. Tan*[5] that liability requires a dishonest state of mind, but the standard by which dishonesty is judged is objective. She held that Henwood was dishonest because he had suspicions that the money was being misappropriated and deliberately decided not to make inquiries. The judge however, also held that Henwood may have had different standards, and may have "seen nothing wrong in what he was doing".

Henwood's counsel argued that although this would be dishonest following the test from *Royal Brunei*, it would not be dishonest following the later House of Lords decision of *Twinsectra*. This was the opportunity for the Privy Council to address the question of dishonesty as stated in *Royal Brunei*, and whether *Twinsectra* correctly interpreted Lord Nicholls' judgment on the meaning of dishonesty.

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[4] [2002] 2 A.C. 164 [*Twinsectra*].
[5] [1995] 2 A.C. 378 [*Royal Brunei*].

A. *The* Twinsectra *Meaning of Dishonesty*

In *Royal Brunei*, Lord Nicholls emphasised the objective component to dishonesty.[6] In *Twinsectra*, a majority of the House of Lords held that Lord Nicholls' use of "dishonesty" involves consideration of both objective and subjective elements. Importantly, the decision was perceived to require that the defendant must have consciously realised that to assist in the transaction would offend ordinary standards of honesty. For example, in *Ultraframe (U.K.) Ltd. v. Fielding*,[7] Lewison J. stated:

> What constitutes dishonesty in this context is laid down by the majority of the House of Lords in *Twinsectra*. Dishonesty in this context must be proved according to the so-called "combined test", that is to say:
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> (i) The conduct complained of must be conduct which is dishonest by the standards of ordinary and reasonable people; and
> (ii) The Defendant must have realised that he was contravening those standards; and that ordinary and reasonable people would have regarded his conduct as dishonest.[8]

This "combined test" is derived in particular from the judgments of Lords Hutton and Hoffman in *Twinsectra*. It is necessary to set out the relevant parts of their judgment verbatim. Lord Hutton stated that:

> It would be less than just for the law to permit a finding that a defendant had been "dishonest" in assisting a breach of trust where he knew of the facts which created the trust and its breach but had not been aware that what he was doing would be regarded by honest men as being dishonest… your Lordships should state that dishonesty requires knowledge by the defendant that what he was doing would be regarded as dishonest by honest people, although he should not escape a finding of dishonesty because he sets his own standards of honesty and does not regard as dishonest what he knows would offend the normally accepted standards of honest conduct.[9]

Similarly, Lord Hoffman was of the opinion that dishonesty requires "consciousness that one is transgressing ordinary standards of honest behaviour."[10] It seemed clear enough from these statements that consciousness of normal standards of honesty was required. Criticisms were levelled at the test, on the basis that it would permit defendants to inappropriately escape liability.[11]

B. *The* Barlow Clowes *Meaning of Dishonesty*

The judgment of the Privy Council rejects this interpretation given to the judgments from *Twinsectra*. According to the Council, those aspects of the judgments

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6 *Ibid.* at 389-390.
7 [2005] EWHC 1638 (Ch.).
8 *Ibid.* at para. 1480.
9 *Supra* note 4 at 174.
10 *Ibid.* at 170.
11 See *e.g.* C. Rickett, "Quistclose Trusts and Dishonest Assistance" (2002) 10 R.L.R. 112; Thornton, "Dishonest assistance: Guilty Conduct or a Guilty Mind" (2002) 61 Cambridge L.J. 524.

in *Twinsectra* have been misinterpreted, due to "ambiguity" in the judgments. In terms of the persuasive weight of the decision, in correcting the ambiguity from House of Lords judgments, it is significant that the Board's judgment is given by Lord Hoffman. About Lord Hutton's test, the Privy Council stated:

> 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 *Twinsectra* 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 acceptable 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.[12]

In relation to Lord Hoffman's test, the Board said it was "intended to require consciousness of those elements of the transaction which make participation transgress ordinary standards of honest behaviour. It did not also require him to have thought about what those standards were."[13] Accordingly, the Board held that *Twinsectra* did not change the law as stated in *Royal Brunei*.

C. *Comment*

The *Barlow Clowes* concept of dishonesty is a definite improvement on what was said in *Twinsectra*. It offers a middle ground, which avoids the problems with the test as it was interpreted. However, although it is defended as a clarification of ambiguity, there is a clear step backwards from what was said in *Twinsectra.* The references in *Twinsectra* judgments to "knowledge" and "consciousness" of "ordinary standards of behaviour" invited the interpretation given to them. This reinterpretation reconciles the need for some subjective awareness that the transaction is not honest, without permitting the defendant's own state of mind to govern the determination. The defendant who does not subjectively realise that conduct contravenes normal standards of honesty may nonetheless be liable if their participation with knowledge offends ordinary standards. As a consequence, judges will now be able to engage in a two-phase analysis:

(1) What did the defendant know of the transaction? This phase is subjective and considers the defendant's state of mind.
(2) Does participation in the transaction with this knowledge offend ordinary standards? This phase is purely objective.

III. Application of the Law to the Facts

The Staff of Government Division overturned the findings of the trial judge on the basis that the evidence did not support a conclusion of dishonesty. In overturning

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[12] *Supra* note 1 at 338.
[13] *Ibid.*

this finding and restoring the trial judge's verdict, the Board trenchantly criticises the Staff of Government Division. Criticisms were levelled at the Appeal Court on several bases: (1) its interpretation of the trial judge's findings on Henwood's state of mind; and (2) its treatment of the law regarding the facts a defendant must know. Some important statements of law are made when criticising the Appeal Court's approach.

A. *Did the Trial Judge Identify a Subjective State of Mind?*

In holding that Henwood had acted dishonestly, the trial judge had regard to:

(1) the facts known to him about the nature of ITC's transactions;
(2) his knowledge of Cramer's previous dishonesty; and
(3) his lies in evidence.

On the basis of this material, she held that he had suspicions that he consistently ignored. However, the appellate court stated that her findings of dishonesty were wholly based on her "legitimate disbelief" of Henwood's evidence, and the inference that as a matter of "objective assessment" Henwood must have realised funds were being misappropriated. The Board considered this conclusion to be "a travesty of the judge's findings."[14] Considering the various matters on which the trial judge based her finding the Board concluded that she made a finding of fact as to his *subjective* state of mind. The Board approved of the process used by the judge to ascertain Henwood's state of mind. It said:

> Since there is no window into another mind, the only way to form a view on these matters is to draw inferences from what Mr. Henwood knew, said and did, both then and later, including what he said in evidence. This is what the judge did and it is hard to see what other method could have been adopted.[15]

Hopefully this functions as a reminder of the difficulties faced by trial judges in assessing another's subjective state of mind. The process of drawing inferences is critical to that task, and cannot be removed.

B. *What Must Be Suspected?*

The Appeal Court concluded that Henwood may not have realised that the disposals were of misappropriated trust money because he did not know the specifics of Barlow Clowes' processes. The Board determined that this conclusion involved two errors of law. The first was the position that Henwood be required to conclude that a breach of trust was occurring. The Board reiterated that it is "sufficient that he should have a clear suspicion that this was the case".[16] This was supported by reference to judgments of Lords Hoffman and Millett in *Twinsectra*. The Board specifically disagreed with the judgment of Rimer J. in *Brinks Ltd. v. Abu Saleh (No. 3)*[17] where

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[14] *Supra* note 1 at 340.
[15] *Ibid.*
[16] *Supra* note 1 at 341.
[17] [1996] C.L.C. 133 [*Brinks*].

it was held that there could be no liability for dishonest assistance unless there was knowledge of the trust or the facts giving rise to it.

It was also stated that it was "quite unreal to suppose"[18] that it was necessary for Mr. Henwood to know the specifics of those processes. What was important was that he had enough information to suspect that Clowes and Cramer were engaged in misappropriating others' money. This misappropriation could have been a breach of trust or a breach of fiduciary duties owed by company directors; suspicion in relation to either was sufficient.

C. *Comment*

Two points are significant here. The first is the conclusion that the action can apply to fiduciary misappropriation. The second is that actual knowledge of the obligations owed in relation to the property is not required. The recognition that the defendant can be implicated in fiduciary misappropriation without the need to prove a breach of trust is long overdue. This decision may finally bring the English courts into line with what has long been the position in Australia. The Australian courts have never required that the action for assistance require knowledge of a breach of trust, as opposed to a breach of fiduciary duty. The leading High Court decision of *Consul Development Pty. Ltd. v. DPC Estates Pty. Ltd.*[19] concerned a breach of fiduciary duty, not a breach of trust. The second point flowing from this part of the analysis is that the defendant need only have "clear suspicions" of misappropriation rather than actual knowledge that a breach of trust or fiduciary duty was occurring.

This is important, and solves a question that has been unresolved since the *Brinks* decision. In combination with the first point it will ensure that the action of dishonest assistance continues to be relevant in combating commercial fraud. Participation can be dishonest without the requirement to have actual knowledge of the conditions attaching to the use of property. Requiring knowledge of the terms of a trust, or the precise obligations owed to third parties would reduce the dishonesty test back to one of knowledge.

Nonetheless it is important to stress that, in order to be liable, the defendant must have dishonestly assisted in the breach. The assistance cannot be dishonest unless the defendant has enough knowledge of the transactions to suspect that the other party is limited by trust or fiduciary obligations in relation to the money or property and that the conduct engaged in exceeds those limits.

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[18] *Supra* note 16.

[19] (1975) 132 C.L.R. 373.