

**The usual suspects: recoveries for financial fraud victims in a financial  
meltdown**

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*I view derivatives as time bombs, both for the parties that deal in them and the economic system..... the parties to derivatives also have enormous incentives to cheat in accounting for them. Those who trade derivatives are usually paid, in whole or part, on “earnings” calculated by mark-to-market accounting. But often there is no real market, and “mark-to-model” is utilized. This substitution can bring on large-scale mischief. As a general rule, contracts involving multiple reference items and distant settlement dates increase the opportunities for counter-parties to use fanciful assumptions. ...In extreme cases, mark-to-model degenerates into what I would call mark-to-myth.*

Warren Buffett, Berkshire Hathaway Annual Report, 2002

*Berkshire’s net worth tumbled \$10.9 billion in the final quarter of 2008 ... due mostly to losses on derivatives contracts ....*

NY Times, 13 March 2009

*You only find out who is swimming naked when the tide goes out.*

Warren Buffett

*If life gives you limes, make margaritas.*

Jimmy Buffett

**A. Introduction**

1. The widespread use of complex financial products over the last 10 years has involved investors and investment managers being exposed to assets whose riskiness and value was often not fully understood or, it now seems in many cases, not understood at all.
2. This, together with conflicts of interest that often arose and the unbridled optimism of the era, meant that conditions were ripe both for fraud and gross mismanagement of risk.
3. The resulting losses have been huge – as is the area of law applicable to trying to recover some of those losses. This paper accordingly is

directed towards three issues:

- (1) A brief overview of some of the relevant distinguishing features of the present litigation environment;
  - (2) A review of key concepts of fraud and dishonesty, with particular reference to wilful blindness; and
  - (3) A (brief) reference to a recent case on the fiduciary obligations of investment banks, which provides a useful reminder that fiduciary obligations may well intrude in this area and that the potential application of the “no conflicts” rule should be considered whenever issues such as valuations and side letters arise.
4. The concept of wilful blindness seems to be of particular importance in the current claims climate:
- (1) It seems to be something of a recurrent theme, both in particular cases and as a general background to mindset that seemed to be operative in some parts of the financial sector. So, for example, in the Madoff case, investors, feeder funds and the SEC itself apparently failed to understand that it was simply impossible to produce the returns claimed through the “*split strike conversion strategy*” Madoff said he was using. There does, however, seem to have been no shortage of others who spotted that there was a problem<sup>1</sup>.
  - (2) Moreover wilful blindness, or something coming very close to it, also appears to have occurred on a much wider scale. In particular it seems likely that the ratings agencies will attract allegations that they were recklessly blind not only to criticism of their ratings but to large-scale bets sophisticated investors were making that they were wrong.<sup>2</sup>
  - (3) Concepts of wilful blindness are implicated in many applicable causes of action – deceit, conspiracy, procuring breaches of contract and dishonest assistance in breach of a fiduciary duty.

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<sup>1</sup> Not only the now famous whistleblower Harry Markopolos, who reported the matter as an obvious fraud to the SEC and was ignored, but also, it seems, many others - Societe Generale and Goldman Sachs were amongst the many financial institutions who would have no dealings with Mr Madoff and advised their private clients to do likewise.

<sup>2</sup> See Michael Lewis, “The End” at <http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets-Boom>. This essay is, incidentally, a must read for anybody who enjoyed “Liar’s Poker”.

The presence or absence of dishonesty may be relevant to the basis on which relief may be granted<sup>3</sup>. It will also require consideration when looking at the application of exclusion clauses in indemnities and D&O policies.

5. Though I do not have the space to go into the matter, a closely related issue is the way the law responds to circumstances where the prevailing wisdom is subsequently shown to have been wrong.
6. Where professionals are involved the law's response is mainly concerned with what is involved in giving a proper degree of skill and care. This will always be determined by reference to members of the profession concerned. But what is uncertain is whether the requisite standard is the one which members of the particular profession in fact ordinarily achieved or that which, in the opinion of the Court, members of the profession ought to achieve.<sup>4</sup>
7. The better view is that the latter approach is the more correct one.<sup>5</sup> This certainly seems to be in sympathy with the prevailing public mood. (As a further aside, it will be interesting to see whether the resistance to finding professionals liable in negligence where large financial losses are involved that has been a feature of commercial litigation over the last 20 years will continue.)

**B. The tide going out: the Box Clever litigation in England as a paradigm case**

8. In England a good recent example of the “*tide going out*” – albeit rather earlier than the current crisis - was the “*Box Clever*” litigation. That litigation arose out of a 2002 securitisation. It involved allegations of deceit against the modeller of structured consumer debt – the well known private equity firm Terra Firma Capital Partners Limited – in circumstances where not only was the model wrong (which by the time of trial was common ground) but where it was said

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<sup>3</sup> So, for example, where there has been dishonesty on the part of the fiduciary, that dishonesty will bear upon the question whether the fiduciary is entitled to any allowance for his own contribution: see *Murad v Al-Saraj* [2005] EWCA Civ 959 at [68], per Arden LJ; see also *Crown Dilmun v Sutton* [2004] EWHC 52 (Ch), [2004] 1 BCLC 468 at para 213; *Guinness plc v Saunders* [1990] 2 AC 663.

<sup>4</sup> The relevant authorities for each proposition are set out in Jackson & Powell on Professional Liability (2007, 6<sup>th</sup> Ed) at 2-119

<sup>5</sup> *Ibid* at 2-120.

to be known to be wrong by Terra Firma.

9. The case involved an issue in June 2002 of consumer debt (television rental payments and the like) by a special purpose company in the Box Clever group. In October 2002 the claimant, IXIS, purchased notes for about £200 million from CIBC. IXIS had relied on an offering circular, published for the purpose of inducing investors like IXIS to purchase notes, which had stated that the cashflows had a net present value of £943 million. This NPV was derived from a flawed model which, had it been correct, would have yielded at least a 20% lower figure.
10. Just 6 months after the purchase of the Notes and less than 10 months after the closing of the securitisation Box Clever had to restructure to avoid insolvency. The end result was that IXIS sold its notes for much less than their face value and lost some £91 million (excluding interest).
11. Terra Firma, the modeller, West LB, the arranger and CIBC the seller were each sued.
12. All three Defendants however also had wider interests in the transaction. Terra Firma and WestLB had enormous financial interests in the securitisation as respectively, the 50% owner of Box Clever and the primary lending bank who was effectively going to be repaid from by the securitisation. CIBC had been involved in the securitisation from an early stage.
13. Importantly, all three defendants also had a hand in the development of the model. Terra Firma admitted that it introduced the error into the model but otherwise all three defendants said that the other defendants were at fault, denying their own liability.
14. The matter went to trial but was compromised prior to judgment<sup>6</sup>. It however provides a good illustration of some of the hallmarks of this species of litigation:
  - (1) An error in a financial model upon which massive investments are based not easily detectable until financial collapse;
  - (2) The interconnectedness of major participants in the transaction both commercially and in terms of liability to the claimant and between each other;

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<sup>6</sup> Andrew Twigger and Oliver Hilton of 3 Stone Buildings and Joe Smouha QC of Essex Court represented the Claimant.

- (3) The need for clear financial expert evidence to explain the model; and
- (4) The necessity to devote substantial resources to disclosure – where the hard interlocutory slog of reading (and moreover, comprehending) emails and disclosure applications for back up tapes and other electronic documents may well yield results.

**C. The current legal landscape: certain distinguishing features**

15. I thought it useful to mention some of the distinguishing features of the current environment, which may have been absent from fraud recoveries, conducted during previous downturns:

- (1) *Litigation funding*: Claims in this area are self evidently expensive. The last decade has seen a growing acceptance by the courts of litigation funders<sup>7</sup> and a slow development of the rules relating to funding, in particular limiting the funder’s exposure to cost orders.<sup>8</sup> At least up until 2008 the market for legal funding of commercial litigation appeared to be growing at a rapid pace with a number of new entrants - including hedge fund managers who claimed that their expertise in managing risk made them unusually qualified for managing litigation risk! Although some funders will now doubt now have disappeared, established funders appear to be still active.
- (2) *Jurisdiction*: So far insolvency proceedings have thrown up important jurisdictional questions.<sup>9</sup> However many fund disputes will involve parties domiciled in EU states. The

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<sup>7</sup> In England see in particular *Factortame & Ors, R (on the application of) v Secretary of State for Transport* [2002] EWCA Civ 932 [2003] QB 381. In Australia see *Campbells Cash and Carry Pty Ltd v Fostif Pty Limited* [2006] HCA 41.

<sup>8</sup> See *Arkin v Borchard Lines Ltd & Ors* [2005] EWCA Civ 655 [2005] 1 WLR 305

<sup>9</sup> *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 374 B.R. 122 (Bankr. S.D.N.Y. 2007), and *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37 (Bankr. S.D.N.Y. 2008), which considered applications for recognition submitted by ‘foreign representatives’ (i.e. non-US administrators of insolvent companies) who sought to establish primary jurisdiction for the restructuring outside of the US based upon a statutory presumption in the Model Law favouring the recognition of proceedings pending in the country in which a debtor maintains its registered office. In both of these cases, the US courts failed to apply the statutory presumption, even though the applications were unopposed!

decision of *Owusu v. Jackson*<sup>10</sup> means that there is ample scope for forum shopping (particularly through the use of negative declarations) because if proceedings are commenced against a party in its home European state then neither the doctrines of *forum non conveniens* nor (it seems) *lis alibi pendens* can be used to shift it. The decision is controversial<sup>11</sup> - and in January 2009 was made the subject of a further reference to the European Court of Justice.<sup>12</sup>

- (3) *Arbitration clauses*: Arbitration clauses raise particular problems in cases of fraud. They will typically impede the efficient resolution of fraud litigation because not all of the parties to the fraud will be parties to the arbitration clause. Moreover, since the decision in *Fiona Trust & Holding Corporation v Privalov*<sup>13</sup>, it is almost inevitable that, fraud notwithstanding, the particular arbitration clause will be binding. However the implications of the recent case of *Allianz SpA v West Tankers*<sup>14</sup> remain to be worked out. In that case the Grand Chamber found that an anti-suit injunction based on an

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<sup>10</sup> [2005] QB 801. The case dealt with Article 2 of the Brussels Convention (which is in the same terms as in the Judgments Regulation). In substance, Article 2 directs that persons domiciled in a Member State shall, whatever their nationality, be sued in the courts of that Member State. The European Court of Justice held that as Article 2 was mandatory in nature there could be no derogation from the principle it laid down, except in the cases expressly provided for by the Convention. No exception on the basis of *forum non conveniens* was provided for by the authors of the Convention, though the question had been discussed by them.

<sup>11</sup> See the discussion of *Owusu v Jackson* in Civil Jurisdiction and Judgments, Briggs & Rees, 4<sup>th</sup> edition, at paras. 2.219 to 2.229 where the reasoning in the decision is criticised and the circumstances in which the decision may potentially not apply are discussed.

<sup>12</sup> *Goshawk Dedicated Ltd & ors -v- Life Receivables Irl. Ltd* [2009] IESC 7 (30 January 2009)

<sup>13</sup> [2008] 1 Lloyd's LR 254. In *Fiona Trust* the question was whether the arbitration clause was wide enough to embrace a dispute over the owners' claim to rescind a charterparty on the ground of bribery by the charterers of the owners' agent. In this context their Lordships took the opportunity to review the jurisprudence emanating from the Court of Appeal which had drawn narrow distinctions between forms of words used in arbitration clauses, which were said to apt or inapt to cover, for example, disputes as to whether the contract in question had been validly concluded at all, as opposed to disputes as to the rights and obligations assumed under a contract which had been validly concluded. Their Lordships swept aside these distinctions.

<sup>14</sup> Case C-185/07; see also *DHL (UK) Ltd v Fallimento Finmatica Spa* [2009] EWHC 291 Comm.

arbitration clause would be contrary to the principle that every court seised of a dispute should itself determine the issue of jurisdiction, under the rules applicable to it and was therefore incompatible with the Regulation for a court of a Member State to make an order.

- (4) *Intelligibility of documentation:* Difficulties arising from length, complexity and lack of consistency in documentation appear to be a not infrequent factor in litigation involving collateralised debt obligations and insolvent structured investment vehicles.<sup>15</sup> This may, conceivably, one day give rise to a negligence claim against the solicitors concerned in drafting such documents.
- (5) *Problems specific to pensions trustees:* I will not go into these in any detail but two matters might be worthwhile noting.

The first is that a time lag between the powers in a trust deed and the development of a particular financial product might mean that there was an absence of power to enter into a particular transaction. So, for example, local authority pension funds are still unable to enter into over the counter derivative contracts.<sup>16</sup>

The second is that any trustee might have a difficult time justifying a hedge fund investment which goes bust. Such investments (had they existed) historically would have been prohibited by rules preventing trustees from making hazardous investments. Moreover there is arguably an absence of empirical evidence that hedge funds after the deduction of fees do achieve higher returns over the entire market cycle.<sup>17</sup> Where

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<sup>15</sup> See, for example, *Cheyne Finance Plc (In Receivership), Re* [2007] EWHC 2402 (Ch); [2008] Bus. L.R. 1562 (Ch D (Companies Ct)) *Whistlejacket Capital Ltd (In Receivership), Re* [2008] EWCA Civ 575; [2008] B.C.C. 826 (CA (Civ Div)) and Evans, "Inscrutable, ambiguous and inconsistent" I.F.L. Rev. 2008, 27(8), 28-32.

<sup>16</sup> See *R v Hammersmith and Fulham London Borough Council* [1991] 2 WLR 372 (HL) and see generally on this topic Sims, "Legal issues in liability driven investment and derivative programmes." Tru. L.I. 2007, 21(4), 165-176.

<sup>17</sup> See Hurst, "Hedge funds in the 21st century: do the benefits outweigh potential dangers to the financial markets?" *Company Lawyer* (2007) 228 at 229-30:

"....although hedge funds are widely touted as being "market neutral" and able to achieve above average returns over the entire market cycle, empirical evidence does not support such claims. A recent study by Presidio Wealth Management of San Francisco compared the performance of a diversified portfolio to the Hedge Fund Research Fund of Funds Composite Index, which is the industry benchmark for

the trustee of a pensions fund has invested in a failed hedge fund there will be a high hurdle to be jumped to show that the investment decision was both understood and properly made.

**D. Dishonesty and Wilful Blindness: Deceit**

16. It is convenient to set out the basic rules for the tort of deceit, which may be found in the following three statements<sup>18</sup>:

(1) Lord Herschell in *Derry v. Peek*<sup>19</sup>:

*"First, in order to sustain an action in deceit, there must be proof of fraud and nothing short of that will suffice. Secondly, fraud is proved when it is shown that a false representation has been made (1) knowingly, (2) without belief in its truth, or (3) recklessly, careless whether it be true or false."*

(2) Bowen LJ in *Angus v. Clifford*<sup>20</sup>:

*"Not caring, in that context, did not mean not taking care, it meant indifference to the truth, the moral obliquity of which consists in a wilful disregard of the importance of truth, and unless you keep it clear that that is the true meaning of the term, you are constantly in danger of confusing the evidence from which the inference of dishonesty in the mind is to be drawn –*

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*hedge fund of funds. For a six-year period from 2000-2006 the diversified portfolio generated an average annualised return of 6.2 per cent while the hedge fund index gained only 5.2 per cent.<sup>2</sup> Furthermore, over an even longer period from 1990 when the Hedge Fund Index was started, the diversified portfolio's average annual return was 10.6 per cent as opposed to 10.1 per cent annually for the hedge fund index (ID). Even over shorter periods of time, comparisons do not strongly favour hedge funds. In 2004, an index of hedge funds compiled by Hedge Fund Research gained 8.91 per cent after fees and 9.35 per cent in 2005. In comparison, the Standard & Poors 500 Index was up 8.99 per cent for 2004 and 10 per cent in 2005.<sup>3</sup> Thus, the potential downside risk posed by highly geared hedge funds may not be justified by the insignificant rewards which, as a group, they have achieved."*

<sup>18</sup> Each of which was recently reendorsed by the Court of Appeal in *AIC Ltd v ITS Testing Services (UK) Ltd "The Kriti Palm"* [2006] EWCA Civ 1601 (28 November 2006), [2007] 1 Lloyd's Rep 555 [256]-[259].

<sup>19</sup> (1889) 14 App Cas 337 at 374.

<sup>20</sup> [1891] 2 Ch 449 at 471.

*evidence which consists in a great many cases of gross want of caution – with the inference of fraud, or of dishonesty itself, which has to be drawn after you have weighed all the evidence."*

- (a) Further to this, a statement is also made fraudulently if the defendant had 'blind eye knowledge' of its falsity. Blind eye knowledge is established where the defendant has a firmly grounded suspicion that specific and relevant facts do exist and, because he does not want to know the facts, he deliberately decides to avoid obtaining confirmation of facts in whose existence the defendant has good reason to believe<sup>21</sup>.

- (3) Devlin J in *Armstrong v. Strain*<sup>22</sup>:

*"A man may be said to know a fact when once he has been told it and pigeon-holed it somewhere in his brain where it is more or less accessible in case of need. In another sense of the word a man knows a fact only when he is fully conscious of it. For an action of deceit there must be knowledge in the narrower sense; and conscious knowledge of falsity must always amount to wickedness and dishonesty. When Judges say, therefore, that wickedness and dishonesty must be present, they are not requiring a new ingredient for the tort of deceit so much as describing the sort of knowledge which is necessary."*

- (a) Further to this, if fraud is proved, the motive of the person guilty of it is immaterial. Nevertheless, in trying to decide whether a person made a statement fraudulently it must be relevant to consider the reason for doing it. Although the test is subjective and is not concerned with negligence, in determining whether or not the defendant did in fact know or believe the statement was false, and in determining what inference can be made from the facts as to the defendant's knowledge and belief, the defendant's means of knowledge and the grounds for the belief are weighty

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<sup>21</sup> *Manifest Shipping v Uni-Polaris Insurance* [2003] 1 AC 469 at paras 24-26 and 112-116).

<sup>22</sup> [1951] 1 TLR 856 at 871

factors for consideration<sup>23</sup>.

17. Finally, it is necessary to say something about inequality of access to information. Bowen LJ said in *Smith v Land and House Property Corporation* that “if the facts are not equally known to both sides, then a statement of opinion by one who knows the facts best involves very often a statement of a material fact, for he impliedly states that he knows facts which justifies his opinion”<sup>24</sup>. Lord Evershed MR said in *Brown v Raphael* that “it suffices for the application of the principle if it appears that, between the two parties, one is better equipped with information or the means of information than the other”<sup>25</sup>.

**E. Accessory liability: Subjective standards in the common law – “vindicating honesty at expense of intelligence”**

18. In *OBG Limited and others v. Douglas* [2007] UKHL 21 Lord Hoffman at [39] – [41] said as follows:

*“To be liable for inducing breach of contract, you must know that you are inducing a breach of contract. It is not enough that you know that you are procuring an act which, as a matter of law or construction of the contract, is a breach. You must actually realize that it will have this effect. Nor does it matter that you ought reasonably to have done so. This proposition is most strikingly illustrated by the decision of this House in *British Industrial Plastics Ltd v Ferguson* [1940] 1 All ER 479, in which the plaintiff’s former employee offered the defendant information about one of the plaintiff’s secret processes which he, as an employee, had invented. The defendant knew that the employee had a contractual obligation not to reveal trade secrets but held the eccentric opinion that if the process was patentable, it would be the exclusive property of the employee. He took the information in the honest belief that the employee would not be in breach of contract. In the Court of Appeal McKinnon LJ observed tartly ([1938] 4 All ER 504, 513) that in accepting this evidence the judge had “vindicated [his] honesty...at the expense of his intelligence” but he and the House of Lords agreed that he could not be held liable for*

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<sup>23</sup> *Barings Plc v Coopers & Lybrand* [2002] 2 BCLC 410

<sup>24</sup> (1884) 28 Ch D 7 at 15.

<sup>25</sup> [1958] Ch 636

*inducing a breach of contract.”*

**F. Accessory liability: Objective Standards in Equity?**

19. In *Barlow Clowes International Ltd & Anor v Eurotrust International Ltd & Ors*<sup>26</sup> the Privy Council, in an advice given by Lord Hoffman, resolved an “element of ambiguity” in the law concerning liability for dishonest assistance in breach of fiduciary duty. The decision is also an important example of liability being established against a professional who deliberately ignored the suspicious aspects of the transactions in which he was assisting.
20. *Barlow Clowes* concerned an appeal by an employee of a company which provided offshore financial services in the Isle of Man. The company and its employees had facilitated certain suspect banking transactions on behalf of a client. The appeal principally involved one of the employees, Mr Henwood, who had “strongly suspected” that the funds being banked on behalf of his client arose from fiduciary breaches. Mr Henwood consciously decided not to make inquiries about the transactions because he preferred in his own interest not to run the risk of discovering the truth. Additionally it was found that Mr Henwood had an

*“exaggerated notion of dutiful service to clients, which produced a warped moral approach that it was not improper to treat carrying out clients' instructions as being all important. Mr Henwood may well have thought this to be an honest attitude, but, if so, he was wrong.”*

21. Mr Henwood was found liable at first instance. But he was successful on appeal because it was thought the necessary facts to ground an inference of dishonesty were absent. In essence it was thought that before an inference of dishonesty could be drawn Mr Henwood needed to know essentially all the details of the scheme in which he was assisting before he could have had grounds to suspect it was dishonest.
22. On this point, the Privy Council described the intermediate appellate court’s reasoning as a “travesty of the judge’s findings”.
23. This led Mr Henwood to rely the following passage in Lord Hutton’s

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<sup>26</sup> (Isle of Man) [2005] UKPC 37, [2006] 1 WLR 1476

reasons in *Twinsectra Ltd v Yardley*<sup>27</sup>:

*"35. There is, in my opinion, a further consideration which supports the view that for liability as an accessory to arise the defendant must himself appreciate that what he was doing was dishonest by the standards of honest and reasonable men. A finding by a judge that a defendant has been dishonest is a grave finding, and it is particularly grave against a professional man, such as a solicitor. Notwithstanding that the issue arises in equity law and not in a criminal context, I think that it would be less than just for the law to permit a finding that a defendant had been 'dishonest' in assisting in 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.*

*"36. ... I consider that the courts should continue to apply that test and that 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." (underlining mine)*

24. There is an obvious conflict between what is said at paragraph [35] and what is said at paragraph [36]. This conflict had led some commentators to claim that *Twinsectra* had departed from the law as previously understood. In short, it had been claimed that what is said in paragraph [35] gave rise to a “moral idiot” defence, in that it invites inquiry not merely into the participant’s mental state about the nature of the transaction in which he or she was participating but also into his or her views about generally acceptable standards of honesty.
25. Lord Hoffman succinctly buried this argument. He conceded that Lord Hutton’s reasoning in *Twinsectra* was ambiguous. However he explained that the reference to “what he knows would offend normally accepted standards of honest conduct” in the passage quoted above meant only that the 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 the participant should have had reflections about what those normally acceptable standards were.
26. Lord Hoffman also took the opportunity to clarify a passage of his own

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<sup>27</sup> [\[2002\] 2 AC 164](#), 174

in *Twinsectra*. He had there said that a dishonest state of mind meant "consciousness that one is transgressing ordinary standards of honest behavior". He further explained this as being "intended to require consciousness of those elements of the transaction which make participation transgress ordinary standards of honest behavior" (emphasis added). It did not, he said, also require the participant to have thought about what those standards were.

27. This decision is to be welcomed on three fronts. *First*, it resolves ambiguity in *Twinsectra* which added an unwelcome element of uncertainty in the pursuit of participants in fiduciary breaches. *Secondly* it provides a cautionary example of a civil court (on this occasion the intermediate appellate court) being overly wary of drawing inferences of dishonesty. Lord Hoffman helpfully pointed out that since there is no window into another's mind, the only way to form a view on these matters is to draw inferences from what the participant knew, said and did, both then and later, including what was said in evidence. *Thirdly*, it is a useful example of liability being founded upon the willful blindness of a professional to investigate clearly suspicious transactions.
28. The precise status of *Twinsectra* remains uncertain in England given that its "clarification" occurred in the Privy Council.<sup>28</sup> However the current law appears to be helpfully summarised by Sir Anthony Clarke MR in an article entitled *Claims against Professionals: Negligence, Dishonesty and Fraud* [2006] 22 Professional Negligence 70-85, adopted by Peter Smith J in the last mentioned case at para.357.

*"The test is an objective one, but an objective one which takes account of the individual in question's characteristics, experience, knowledge etc. ....It is a test which requires a court to assess an individual's conduct according to an objective standard of dishonesty. In doing so, a court has to take account of what the individual knew, his experience, intelligence and reasons for acting as he did. Whether the individual was aware that his conduct fell below the objective standard is not part of the test. "*

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<sup>28</sup> See *Abouh-Rahmah v Abacha* [2006] EWCA Cav 1492, where the Court of Appeal favoured an acceptance of the "clarification". See also Evans-Lombe J's review of the authorities in *Statek Corp v Alford* [2008] EWHC 32 (Ch).

## **G. Conflicts of interest**

29. This is a massive topic<sup>29</sup> and limitations of space in this paper mean that very little can be said about it. So I will limit myself to simply stating the conflicts rule itself and drawing attention to a recent Australian Federal Court case which found that, in the context of a takeover, a fiduciary relationship did not arise between an investment bank and its client such as to give rise to the “no conflict” fiduciary duty – but only because a fiduciary relationship was inconsistent with the express terms of the mandate letter which regulated the relationship between the two.
30. The “no conflict” duty is the duty of a fiduciary not to put him or herself in a position in which he or she had, or could have, a personal interest that conflicted, or which may have conflicted, with the interests of the person to whom the duty is owed (see *Aberdeen Railway Co v Blaikie Brothers*<sup>30</sup> and *Phipps v Boardman*<sup>31</sup>).
31. In *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Limited* (No. 4)<sup>32</sup> Jacobsen J found that the contents of a mandate letter between a client and an investment bank in relation to a takeover prevented a fiduciary relationship which brought the “no conflict” duty into operation from arising.
32. The facts of the case were as follows:
- (1) Citigroup’s investment banking division had been engaged by a company, Toll, to provide financial advisory and investment banking services to it in relation to a proposed takeover of another listed company, Patrick for about AU\$4.5 billion on

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<sup>29</sup> See in particular Finn, PD, “Fiduciary Obligations” (1978) Chapter 21, Finn PD, “The Fiduciary Principle” in Youdan TG (ed), *Equity, Fiduciaries and Trusts* (1989) □ Tuch A, “Investments Banks as Fiduciaries: Implications for Conflicts of Interest” (2005) 29 MULR 478 □, Tuch A, “Obligations of Financial Advisers in Change-of-Control Transactions: Fiduciary and Other Questions” (2006) 24 C&SLJ 488 □ Law Commission, United Kingdom, *Fiduciary Duties and Regulatory Rules*, Consultation Paper No 124 (1992) □ Law Commission, United Kingdom, *Fiduciary Duties and Regulatory Rules*, Report No 236, (1995), McCormack, “Conflicts of interest and the investment management function” (1999) *Company Lawyer* 2 and Bandi, Conflict of interest in financial advisory services in Australia after *ASIC v Citigroup: what next?* (2008) *JIBLR* 538.

<sup>30</sup> (1854) 1 Macq 461, 471 per Lord Carnworth LC

<sup>31</sup> [1967] 2 AC 46, 123 per Lord Upjohn

<sup>32</sup> [2007] FCA 963 (28 June 2007) at <http://www.austlii.edu.au/au/cases/cth/FCA/2007/963.html> .

completion. Toll had appointed another investment bank to advise it in relation to the bid itself.

- (2) Importantly, the mandate letter engaged Citigroup as “an independent contractor and not in any other capacity”.
  - (3) Citigroup had within it a Chinese wall separating its investment banking and equities division. Notwithstanding this on the Friday before the Monday on which the takeover was due to be announced a Citigroup trader in possession of inside information had started buying Patrick shares and its share price had risen. After speaking with his superior he stopped buying shares and sold down some of his position.
  - (4) The corporate regulator, ASIC, alleged amongst other things that Citigroup had breached certain statutory provisions regulating financial services providers in that it had breached a fiduciary duty owed by it to Toll to avoid conflicts of interest and duty (referred to as conflicts claims by Jacobson J.).
33. Jacobsen J found that the “independent contractor” terms strongly pointed to an intention that a fiduciary relationship be excluded.
34. However he also found (at [325]) that but for these express terms the pre-contractual dealings between Citigroup and Toll would have pointed strongly towards a fiduciary relationship.
35. It should (perhaps) come as no surprise – but it is still of some interest – to see that Jacobsen J did not accept an argument that investment bankers were to be subject to the same implied terms as real estate agents that was found in *Kelly v Cooper* to preclude a relevant fiduciary obligation from arising. His Honour said<sup>33</sup>:

*“I do not consider that the circumstances of the present case are identical with those of Kelly v Cooper where the Privy Council held that there was to be implied in a contract with a real estate agent, a term that the agent was free to act for other principals selling similar properties. Such a term was implied because the practice is notorious and it would otherwise be impossible for the estate agents to perform their ordinary business functions: see Kelly v Cooper at 214 per Lord Browne-Wilkinson.*

*In my opinion, there is nothing in the relationship of investment*

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<sup>33</sup> at [359]-[360]

*banker/financial advisor and client which requires a conclusion that it is an inherent part of the business of investment banking for the banker to engage in trading in its client's target's shares."*

36. The decision is an important reminder that, unless excluded by contract, fiduciary relationships may well arise both in relation to and within hedge funds and other alternative investment structures. This has both obvious and interesting implications both to the issue of side letters and their disclosure and, in some circumstances, to valuation claims.

#### **H. Conclusion**

37. This paper has barely scratched the surface of the issues that may arise in seeking compensation in relation to a failed investment where dishonest conduct is involved. Many issues – such as questions of attribution of knowledge, bases for proprietary and personal relief and liability under s. 150 of the Financial Services and Markets Act 2000 have not been mentioned at all.
38. A strong grasp of the fundamental concepts of fraud and dishonesty however will be necessary in plotting any litigation strategy in relation to the recovery of losses arising from a fund collapse – not only for the purpose of establishing or contesting causes of action but also for considering the likely operation of indemnities and insurance policies.
39. Equally an appreciation of the potential for fiduciary relationships to arise (and the mechanisms by which that relationship may be excluded) is essential in plotting any path to reclaiming assets.