

Third party liability – the sequel

IN LAST MONTH'S ARTICLE (*IHL150*, P59) WE SAW that the blanket of liability can cover employers, ISPs and companies with lax security systems. This article is intended to expand on this theme and explore additional parties who may be held liable, in particular those who become liable due to inaction despite knowledge of wrongdoing.

Increasingly, those who suffer financial loss are looking to third parties in order to recover their losses. A claim against a third party, particularly one that is insured, may be more successful than one against the ultimate wrongdoer who, particularly in the case of cyber criminals, may be difficult to locate or may lack sufficient funds.

RECENT DEVELOPMENTS

In January this year US retailer TJX announced that hackers had accessed its computer system, which handled credit and debit card transactions. As a result, up to 45 million people could be exposed to identity theft and fraud. It has now been reported by vnunet (an online computer and technology magazine) that TJX is facing two lawsuits in the US. The first relates to a claim being brought by a number of banks for the costs and damages amounting to tens of millions of dollars incurred in relation to the compromised cards. The second relates to a claim brought by a shareholder to access confidential company documents, which, it is reported, could lead to a claim for damages.

MISREPRESENTATION

Misrepresentation can expose a business to a claim for damages. PCB Litigation acted for a number of foreign nationals who had been deceived into investing in an advanced fee scam. They had received e-mails inviting them to participate in a prime bank lending arrangement that would generate very significant returns but required an initial investment to set up the arrangement. The parties offering the arrangement comprised a British Virgin Islands company, a shell company and a number of individuals based abroad. None had any identifiable assets.

In an effort to provide a legitimate façade to the fraud, the company that was arranging the relevant banking documents appointed a firm of solicitors to whom the victims' money was first to be transferred. The solicitor told the victims that their money would be safe in the firm's client account as it would not be transferred until all the lending arrangements that would enable the transaction to successfully proceed were in place. The victims relied upon this representation.

However, the money was released before the arrangements were in place. While there was no suggestion that the solicitor was in any way involved in the fraud, a successful settlement was reached on the basis of the misrepresentation.

TRUSTS

Claims for breach of trust or assistance in a breach of trust are another alternative means by which an injured party may be able to successfully recover their losses.

This is important for three reasons. First, businesses need to ensure that they do not act in a way that leaves them open to liability as constructive trustees. Secondly, businesses should be aware of their options in circumstances where they have suffered a loss through the actions of others. Satisfaction need not always be sought from the most obvious target. Thirdly, in circumstances where assets may be transferred and business carried out via e-mail or on the internet, vigilance is key.

It is becoming increasingly common for businesses to enter into transactions without those involved ever meeting face-to-face. The world wide web makes it far easier to conduct business with, and in, other countries. Neither of these factors is a defence if suspicions or knowledge of wrongdoing are ignored.

Businesses that receive and hold assets for the benefit of others may be subject to certain fiduciary obligations. Breach of these obligations may give rise to a constructive trust. From the point at which a constructive trust exists, the constructive trustee holds the assets for the benefit of others to whom they must be returned. This applies whether the constructive trustee still retains the assets or not.

A constructive trust may arise in one of two ways: there must be 'knowing receipt' of the assets or 'dishonest assistance' with the assets.

Knowing receipt

Knowing receipt involves the receipt of property that has been disposed of in breach of a fiduciary duty. >

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The receiver must have knowledge of the breach of fiduciary duty involved in the disposal and have retained the benefit or a benefit that is traceable to the breach. In the case involving the advance fee scam, the solicitors were not instructed by the victims and it therefore could not be said that there was a fiduciary relationship between them.

A party can be said to know of the breach of the fiduciary duty if they:

- 1) have actual knowledge;
- 2) wilfully shut their eyes to the obvious;
- 3) wilfully and recklessly fail to make such enquiries as an honest and reasonable person would make;
- 4) have knowledge of circumstances that would indicate the facts to an honest and reasonable person; or
- 5) have knowledge of circumstances that would put an honest and reasonable person on inquiry.

However, in relation to banks, it was said in *Macmillan Inc v Bishopsgate Investment Trust Plc and others* that:

'Account officers are not detectives. Unless and until they are alerted to the possibility of wrongdoing, they proceed, and are entitled to proceed, on the assumption that they are dealing with honest men.'

Knowing assistance does not require the third party to behave in a dishonest manner. It is the knowledge of the breach that is of concern. A third-party bank may break no laws whatsoever in carrying out certain transactions. If, however, it knew, or should have known, of a breach and it carried on with the transactions regardless, it may become liable for losses incurred by the victim party.

DISHONEST ASSISTANCE

For a claim of dishonest assistance, the claimant must show that they have suffered a loss as a result of the defendant dishonestly assisting a third party in the breach of a trust of fiduciary duty. A court will not find a constructive trust exists if the defendant shows that there were merely suspicions that their actions may be construed as dishonest. Dishonesty is judged objectively.

A recent case provided some clarity to the mental element involved in dishonest assistance. The case was *Barlow Clowes International Ltd and another v*

Eurotrust International Ltd and others (Isle of Man) and it involved an Isle of Man financial services provider (ITC) and its two principal directors, Mr Henwood and Mr Sebastian. The claim involved money that had been invested in a company called Barlow Clowes International Ltd during the 1980s. This company operated a fraudulent offshore investment scheme and most of the money invested went towards sustaining the lavish lifestyle of the owner, Mr Clowes.

Some of the money of investors in Barlow Clowes International had been transferred via several bank accounts which were maintained by companies administered by ITC. The Privy Council held that Mr Henwood strongly suspected that the funds were investors' funds and that he 'consciously decided not to make inquiries because he preferred in his own interest not to run the risk of discovering the truth'. This, it was decided, was sufficient for liability.

This case was important because the test for the state of mind involved in dishonesty was objective. It also clarified the point that liability may arise where an individual fails to ask questions about the business they are conducting.

WHISTLEBLOWING

Employees may find that they are liable if they do not expose wrongdoing when it becomes apparent to them that it exists. In 2002 a Mr Rastogi was arrested along with various senior members of his firm (RBG) (*RBG Resources Plc v Rastogi and others*). RBG had received funding totalling some \$400m. This money had been made available on the basis that the company was involved in a raft of what transpired to be fictitious transactions. The money was siphoned off by the directors of the company.

One of the defendants in the case had been employed at the firm as the financial controller. He was the subject of a freezing order in relation to the main fraud case and he made an application to have the freezing order discharged. The case against him rested on allegations that, although he had not been involved in the fraud, he had at the very least failed to monitor, prevent and report upon the wrongdoing of the directors, which resulted in a breach of duty.

The employee argued that he should not be subject to the freezing order because it was not arguable that a senior employee was under any such duty. Even if the duty did exist, it only extended to reporting internally to the directors. Reporting a wrongdoing to directors who were themselves involved would, he claimed, have been futile and the losses would still have occurred.

CYBER CRIME PCB Litigation LLP

The High Court did not agree. It held that in the circumstances of the case, not only did the duty exist for senior employees to whistleblow, there was no obligation of confidence owed which overrode this duty. The court also found that there was one director at RBG who had not been involved in the fraud and there may have been a different outcome had he been informed of the wrongdoing. The freezing order remained in place.

The Pensions Act 2004 extended responsibility for whistleblowing far wider than had previously been the case. The duty to report a breach relevant to the administration of a pension scheme now applies to all those involved in running occupational and personal pension schemes. For instance, the duty applies not only to trustees and managers of pension schemes but can also include insurance companies, independent financial advisers, consultants, scheme auditors, legal advisers and fund managers.

Not all breaches will require a report to be made. The following set of circumstances must exist. The individual must have reasonable cause to believe that:

- 1) a duty relevant to the administration of the scheme has not been or is not being complied with;
- 2) that duty is 'imposed by or by virtue of an enactment or rule of law'; and
- 3) the failure to comply is likely to be of material significance to the Pensions Regulator in the exercise of any of its functions.

Again, it must be stressed that carrying on business in this area electronically does not mean that the

degree of vigilance required is reduced. It is important to make all those involved aware of their duties and that ignorance of wrongdoing is no defence if the individual concerned ought reasonably to have known about it.

CONCLUSION

It is clear that those with responsibility for advising on legal matters must take great care to ensure that anyone who may have a duty as a third party is aware of that duty. The duties may involve actively seeking out a distasteful truth or involve the loss of a valued customer if wrongdoing is involved. However, the damage may be greater both financially and to the reputation of a business where breach of a duty results in liability for the loss of another.

Ignorance is no defence, neither is relying on the fact that the parties have never met in person. It is likely that a greater level of vigilance is required when using the services of a business electronically. This is particularly so if the transactions involve the assets of others.

Financial institutions are particularly vulnerable to being used by cyber criminals who may begin to move stolen or misused assets through the institution via the internet. It is imperative that all the necessary steps to establish the background of the assets are taken. If there are suspicions, these should be raised immediately. Once the criminals have taken what they want, the victim will be looking to apportion blame.

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Macmillan Inc v Bishopsgate Investment Trust Plc and others (No 3) [1995] 3 All ER 747

Barlow Clowes International Ltd and another v Eurotrust International Ltd and others (Isle of Man) [2006] 1 Lloyd's Rep 225

RBG Resources Plc v Rastogi and others [2002] EWHC 2782 (Ch)