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INTRODUCTION

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A. Civil Law

1.01 Introduction

Fraud is not a new phenomenon. It has always been part of society. Even in Roman times, the basic provisions of law had to be supplemented and amended to cater for problems posed by dishonest activities, such as where a deceitful statement has induced an innocent party to enter into a disadvantageous contract. As society has evolved, fraudulent activity has taken new forms. In 1720, for example, false statements made to inflate the price of company shares (share ramping) presented acute problems and led to the collapse of the South Sea Company ('the South Sea Bubble') in the wake of a history of bribery and corruption. But, in the last 50 years, fraud has become more complex, more

international in character, and more ambitious in monetary terms. As society has become more advanced, fraudsters have become more imaginative and opportunistic. Consequently, as banks have tried to provide better services by harnessing new technology, fresh opportunities have become available for fraudsters to obtain money by electronic fund transfers.[1] The challenge for rogues has always been to stay one step ahead of detection.

In 2004, reported fraud had risen to £640 million (more than double what it was in 2003); the increase was largely attributed to a jump in VAT and tax fraud.[2] Many forms of dishonest activity will go unreported; it is therefore difficult to know precisely how much money is lost due to dishonest activities each year. Nevertheless, it is beyond doubt that fraud has evolved into a multi-million international industry.[3] Terrorism and international drug smuggling, prostitution, boot-legging and other forms of serious crime are frequently linked to each other. This text will not include any discussion of legislation which focuses upon terrorist activity; its purpose is to concentrate upon theft and fraud in general. But various measures designed to counter international criminal activities, such as measures to detect money laundering, will also hamper the activities of terrorist organizations.

1.02 The enquiry

A primary purpose of this text is to examine how the civil law deals with fraud. This involves an examination which gauges: (i) the extent to which fraudulent activity has historically been covered by principles of law which also cover carelessness and indecisiveness; and (ii) the extent to which special rules have emerged which are an exception to the general law. Where fraud is a clearly recognized exception to a general principle of law, there is the further question of the extent to which an allegation of fraud will unravel all transactions which are interlinked. The definition of fraud is vital in answering the second strand of

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[1] D Kirk 'Serious Fraud—A Banker's Perspective' in JJ Norton (ed) *Banks: Fraud and Crime* (1994, LLP) 15.

[2] J Ashworth, 'Fraud in UK soars to £640m' The Times, 5 January 2005.

[3] Estimates of fraud vary between £5 million and £16 million annually: Cabinet Office's Performance and Innovation Unit Report (2000), para 3.1; <http://www.number-10.gov.uk/su/criminal/recovering/03.htm>; see further, The Investigation, Prosecution and Trial of Serious Fraud (Royal Commission on Criminal Justice, Paper 14, 1993). In 1992, loss caused by reported fraud amounted to £8,500 million; in comparison, loss caused by reported burglaries totalled just under £500 million, retail crime £560 million and vehicle crime £700 million: Taking Fraud Seriously, Audit Faculty of the Institute of Chartered Accountants of England and Wales, January 1998, 7. See further Legislating the Criminal Code: Fraud and Deception, Law Commission Consultation Paper No 155 (1999) para 1.9, in which the Law Commission referred, inter alia, to the loss of £122 million due to plastic card fraud and fraudulent claims which cost the insurance industry £30 million a year.

the enquiry but is almost irrelevant in relation to the first, unless the remedies are different even when the general law is the same.

It would be unrealistic to examine the civil law without dealing with the Proceeds of Crime Act 2002, which creates offences relating to money laundering and which is intended to strip wrongdoers of all the fruits of their crime. Regulatory provisions have became increasingly important. International conventions are also influencing, both directly and indirectly, the direction of national law. Civil law cannot be conveniently studied in isolation. Furthermore, a more rounded picture of the law is needed to deal with what could be described as a 'drift into dishonesty'. As Kirk has observed,

> An enterprise, which may be intensely ambitious or of marginally dubious ethical standards, can, with a fair wind, become successful, popularly acclaimed and the recipient of a Queen's Award. With ill-fortune, most obviously, a collapse in the economy, but also for a variety of other reasons, the fragility of the original structure may be exposed and either lead to the commission of criminal offences, or to the perception that the whole basis of the business was fraudulently conceived. In other cases, perfectly properly constituted businesses, which run into difficulty because of forces beyond their control, may resort to deception in order to overcome their problems.[4]

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It should also be borne in mind that it is difficult to prove that a defendant is dishonest. Few individuals will happily admit that they have been dishonest; they will prefer to rely upon yet further subterfuge to explain their behaviour. This text concentrates on the civil law, where proof is the ordinary civil standard of balance of probabilities. However, as Lord Nicholls observed in *Re H (Minors) (Sexual Abuse: Standard of Proof)*:

> When assessing the probabilities the court will have in mind as a factor, to whatever extent is appropriate in the particular case, that the more serious the allegation the less likely it is that the event occurred and hence the stronger should be the evidence before the court concludes that the allegation is established on the balance of probability. Fraud is usually less likely than negligence . . . The more improbable the event, the stronger must be the evidence that it did occur before, on the balance of probability, its occurrence will be established.[5]

Domestic laws may be introduced or modified partly as a response to crime but also due to other factors, such as economic or social pressures. Policy issues may involve weighing the demand for certainty in the law against the need to deter fraud (such as in relation to the use of documentary credits to fund an international sale); balancing the protection of the rights of the original owner

[4] D Kirk, 'Serious Fraud—A Banker's Perspective' in JJ Norton (ed) *Banks: Fraud and Crime* (LLP, 1994) 13–14.

[5] [1996] AC 563, HL, 586–587.

with the interests of an innocent third party (such as where there are conflicting claims to property), assessing public policy and confidentiality (particularly in the field of human rights, search and seizure orders and surveillance) and power relationships and vulnerability.

The deterrence of criminal conduct was a major impetus behind the Proceeds of Crime Act but it may well be the case that anxiety to deter fraud is merely one factor amongst a host of others which prompt a particular legal response: this is true in relation to legislation dealing with insolvency and financial services. Conversely, where a rule has been developed to create an exception to the general law with the express intention of directly responding to fraud, the scope of the exception may be defined in such a narrow way that certain cases involving fraud will fall outside the scope of the exception created. An easy example of this phenomenon is provided in Chapter 8 in the context of bankers' documentary credits where it is seriously doubted whether 'fraud unravels all'. An argument which is therefore pursued through this text is that, where one can detect legal responses which are intended to raise standards in commercial dealings, this can be seen at least in part as a response to the risk of fraud.

1.03 The concepts of 'fraud', 'commercial probity', and 'commercial morality'

There has never been a common definition of fraud in the civil law. However, a useful definition of fraud which would cover the subject matter of this text is 'the dishonest non-violent obtaining of some financial advantage or causing of some financial loss'.[6] The concept of 'fraud' is often referred to in judgments in the context of dishonest misrepresentations but it is not confined to this context and it has been interpreted very widely at times.[7] Fraud is often treated as separate and distinct from theft in the civil law: this is particularly true in the context of title conflicts.[8]

In this text, references to the concept of 'fraud' will connote dishonesty. At various times, there are references to the notion of 'commercial probity.' In *Secretary of State for Trade and Industry v Goldberg*[9] Lewison J, in the context of directors' disqualification proceedings, considered that the phrase was synonymous with dishonesty. He suggested that, by way of contrast, 'a lack of commercial morality' involved a lower standard, which included

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[6] D Kirk, 'Serious Fraud—A Banker's Perspective' in JJ Norton (ed) *Banks: Fraud and Crime* (1994, LLP) 11. For general guidance, see Fraud Trials Committee Report (Roskill Report) para 3.14.

[7] See ss 1.05–1.07.

[8] See Chapter 11; see further *National Employers' Mutual General Insurance Association Ltd v Jones* [1990] 1 AC 24, HL.

[9] [2004] 1 BCLC 597. See further *Re Lo-Line Electric Motors Ltd* [1988] Ch 477.

untrustworthiness.[10] Commercial probity must therefore be distinguished from negligence; it encompasses not only deliberate dishonesty[11] but also recklessness as well.[12]

The basis for legal liability varies according to the context. The major offences in criminal law require proof of dishonesty as an ingredient and it must be shown that the defendant was not only objectively dishonest but also that subjectively he was aware that he was acting dishonestly.[13] This is also the test which has been adopted in relation to liability for dishonest assistance in equity.[14] In contrast, the basis for liability in the civil law for fraudulent trading rests more heavily upon subjective dishonesty. There are other civil law actions where dishonesty is irrelevant: liability is strict for the torts of conversion and money had and received. The same is true for various insolvency provisions dealing with transactions at an undervalue and preferences. This text will concentrate on the laws which apply where a defendant is suspected of dishonesty in a commercial context which causes economic rather than physical loss; it will attempt to assess the effectiveness of the different causes of action which may be available in these circumstances.

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1.04 Repercussions of fraud

Serious economic and social consequences follow from fraudulent activities. One notable example is the Enron fraud scandal in the USA, where the company's assets were wildly overvalued. This had an effect on the stock market in the United States, where share prices fell dramatically once it became clear that other companies' shares had also been overvalued. However, the scandal had a dramatic impact on overseas markets and, in particular, the London stock market; billions of pounds were wiped off the face of shares.

The collapse of the Bank of Credit and Commerce International (BCCI) had a similar global impact on the banking system. The bank had operations in over 70 countries; it was used as a vehicle to launder money derived from drug

[10] [2004] 1 BCLC 597, para 39, citing *Re Dawson Print Group Ltd* [1987] BCLC 601; *Secretary of State for Trade and Industry v Ettinger* [1993] BCLC 896. See further *Gill v Quinn* [2005] BP1R 129, paras 14–15; *Perry v Day* [2004] EWHC 1398, para 67; *Re Drivertime Recruitment Ltd; Re DST Ltd* [2004] EWHC 1637, para 168.

[11] *Secretary of State for Trade and Industry v Swan* [2003] EWHC 1780, para 91 (cheque 'kiting' which exploits the time lag which is needed to clear cheques); *Secretary of State for Trade and Industry v Reynard* [2002] BCLC 625, CA, para 6.

[12] *Bell Davies Trading Ltd v Secretary of State for Trade and Industry* [2004] EWCA Civ 1066, CA, paras 69–70; *Re Uno plc v Secretary of State for Trade and Industry v Gill* [2004] EWHC 933, para 153; *Re Alpahclub (UK) Ltd* [2002] EWCA Civ 135, CA, para 5; *Stocznia Gdanska SA v Latreefers Inc (No 2)* [2001] 2 BCLC 116, CA.

[13] *R v Ghosh* [1982] QB 1053, CA.

[14] *Twinsectra v Yardley* [2002] AC 164, HL.

trafficking and tax evasion and its employees engaged in criminal activities, such as lying to regulators and creating false bank records. In December 1991, the bank pleaded guilty to offences under the US Racketeering Influenced and Corrupt Organisation (RICO) and its assets were then subject to confiscation by the US government.[15] The collapse of BCCI caused significant loss to individual investors and it also eroded confidence in the banking system.

More broadly, particular types of misconduct may have a negative effect on commerce. Thus, counterfeit goods may push the prices up of the genuine article because the producers will suffer a loss of trade. There may also be an adverse affect on consumers in terms of the quality of the goods and safety.[16] A business caught up, however innocently, in some scam may suffer a loss of reputation. If its capital has been plundered by dishonest employees, it may become insolvent as a result. Any measures taken by businesses to counter the threat of fraud will be expensive. Any counter measures must take account of the fact that fraud is often dependent upon the support of third parties, from unquestioning purchasers to professionals who are prepared to shut their eyes to the risk of fraud in order to further their own careers. So, for example, the Proceeds of Crime Act 2002 and the Money Laundering Regulations 2003 dealing with money laundering and acquisitive crime reflect these concerns.

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The health of domestic economies depends upon traders being able to carry out transactions with laws which are certain and which respond to business needs. Therefore any exceptions created by law to deal with problems posed by dishonest activities must themselves be sufficiently clear in scope and effect. In 1982, the Cork Committee, in reviewing insolvency law, commented:

> A sound banking and financial system is essential for the prosperity of the nation. It facilitates the exchange of goods and services and enables the most efficient use to be made of human and material resources. The provision of credit for trade and industry stimulates production and encourages enterprise as well as helping individuals and businesses over difficult economic times. These factors must in turn be matched by an acceptance by all involved that the sanctity of contract is fundamental to the existence of business relations and that unless businessmen maintain a sense of financial responsibility and integrity, trading will be drastically curtailed and the economy suffer accordingly.[17]

[15] <http://www.fas.org/irp/congress_rpt/bcci/index.html>. The BCCI Affair: A Report to the Committee on Foreign Relations United States Senate; Cabinet Office's Performance and Innovation Unit Report (2000), para 3.10; <http://www.strategy.gov.uk/downloads/su/criminal/recovering/03.htm>.

[16] *R v Johnstone* [2003] 1 WLR 1736, HL, paras 52–53, per Lord Nicholls of Birkenhead. Lord Walker of Gestingthorpe observed that, 'A recent Green Paper from the Commission of the European Communities (Combating Counterfeiting and Piracy in the Single Market (COM(98) 569 final)) estimated that counterfeiting and piracy accounted for between 5% and 7% of world trade, with the estimated figure being as high as 25% in the audio-visual industry:' ibid, para 59.

[17] Report of the Review Committee, Insolvency Law and Practice (Cmnd 8558, 1982) para 20.

1.05 Commercial dealings

In *Carter v Boehm*, Lord Mansfield held that an assured owed his insurer a duty of good faith. Consequently, he should disclose all material facts in arranging an insurance policy. Lord Mansfield equated non-disclosure and mistake with the notion of fraud. He stated:

> Insurance is a contract upon speculation. The special facts, upon which the contingent chance is to be computed, lie most commonly in the knowledge of the insured only: the underwriter trusts to his representation, and proceeds upon confidence that he does not keep back any circumstance in his knowledge, to mislead the underwriter into a belief that the circumstance does not exist, and to induce him to estimate the risk, as if it did not exist. The keeping back such circumstance is a fraud, and therefore the policy is void. Although the suppression should happen through mistake, without any fraudulent intention; yet still the underwriter is deceived, and the policy is void; because the risk run is really different from the risk understood and intended to be run, at the time of the agreement. . . . The reason of the rule which obliges parties to disclose, is to prevent fraud, and to encourage good faith.[18]

Lord Mansfield was therefore concerned to encourage traders to be honest in their dealings with each other prior to the conclusion of a contract.[19] This doctrine of good faith survived in the law of insurance and in contexts where there is a fiduciary relationship. Indeed, where an individual owes another fiduciary duties, the law goes further and equity imposes a high standard of conduct upon all fiduciaries: a duty of loyalty is owed which prevents a fiduciary from making secret profits or from putting his own personal interests above those of his principal. These fiduciary duties are owed by all agents, including company directors, by operation of law. But there are many commercial relationships, such as the relationship of seller and purchaser, where the parties deal at arm's length and no fiduciary relationship can be found.[20]

In *Carter v Boehm*, Lord Mansfield had advocated that the doctrine of good faith should be one of general application to all contracts.[21] This proposition was strongly resisted. As Lord Hobhouse of Woodborough observed in *Manifest Shipping Co Ltd v Uni-Polaris Shipping Co Ltd*:[22]

> The commercial and mercantile law of England developed in a different direction

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[18] (1766) 3 Burr 1905, 1909 1911. See further Lord Mustill's judgment in *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1995] 1 AC 501, HL.

[19] (1766) 3 Burr 1905, 1909 1911. See further *Pawson v Watson* (1778) 2 Cowp 785, 788.

[20] See s 5.33.

[21] *Bell v Lever Bros Ltd* [1932] AC 161, HL, 227, per Lord Atkin; *Banque Financière de la Cité SA v Westgate Insurance Co Ltd* [1990] 1 QB 665, 773, affirmed by the HL [1991] 2 AC 249, 280.

[22] [2003] 1 AC 469, HL, para 45.

> preferring the benefits of simplicity and certainty which flow from requiring those engaging in commerce to look after their own interests.
>
> Consequently, the principle of *caveat emptor*—let the buyer beware—is applied at common law to contracts of sale. Admittedly, the principle of *caveat emptor* has gradually been eroded by statute over the last century in response to policy concerns, such as protection of consumers, and now exists only in an attenuated form. Nevertheless, it still exists and the notion that non-disclosure can be equated with fraud exists only in rare situations such as insurance and fiduciary relationships.

1.06 Insolvency

Insolvency raises difficult issues in relation to fraud. Risks are inherent in running any business. All traders hope to make handsome profits from their deals. However, if they or their companies become insolvent, others will inevitably suffer loss. For hundreds of years, bankruptcy was equated with misconduct and individuals who were unable to pay their debts were cast into prison.[23] Indeed, a statute of 1705 provided that fraudulent traders who had become bankrupt could be put to death.[24] The law was penal in nature and was designed to act as a deterrent, encouraging traders to be honest and responsible in their dealings.[25] From the seventeenth century onwards, the severity of the law was steadily softened. The Relief of Insolvent Debtors Act 1813 offered protection to debtors who had not been fraudulent: it provided that a debtor should not be sent into prison if the court was satisfied that the debtor had not been fraudulent or in breach of trust and had not taken property without 'reasonable assurance of being able to pay the debts'.[26] Eventually, the courts' powers to imprison debtors was restricted and then abolished altogether. It is only in recent times, however, that the social stigma of bankruptcy has diminished as it is recognized that commerce generates wealth and that commercial risk taking can produce benefits to the economy as a whole.

Unfortunately, there are individuals who have dishonest intentions from the commencement of business. As early as the sixteenth century, traders called for legislation to deal with the problem of fraudsters who, having tricked others into parting with possession of their property, then disappeared to use the property for their personal benefit.[27] Legislation passed in 1570 ensured that there would be equal distribution of the debtor's property amongst all of his general creditors and provided for the setting aside of fraudulent conveyances designed to benefit one party at the expense of another.[28] Prior to 1570, there had been a race for the assets as there was no machinery for any collective form of action against a debtor.[29] Major reform of insolvency law began with the

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[23] Cork Committee (Cmnd 8558, 1982), para 31.
[24] ibid, para 37.
[25] ibid, para 38.
[26] ibid, para 41.
[27] ibid, paras 35, 36.
[28] ibid, para 36.
[29] ibid, para 31.

Bankruptcy Act 1883 which was intended to ensure a fair and quick distribution of the insolvent's property. The aim of the statute was also to support commercial morality and encourage honest trading and consequently there were provisions which punished misconduct.[30]

During and after World War I, there were a number of company bankruptcies which attracted public attention. As a consequence, the Green Committee[31] was established in 1925 to consider law reform. One point identified in the report is the problem posed by fraud: yet any attempt to eliminate fraud runs the risk of creating difficulties in ordinary commercial life.

> Many of the suggestions made to us show that the idea that fraud and lesser malpractices can be stopped by the simple expedient of a prohibition in an Act of Parliament, dies hard. Other witnesses with a view to making such malpractices impossible have advocated the imposition of statutory regulations and prohibitions calculated, not merely to put a stop to the activities of the wrongdoer, but to place quite intolerable fetters upon honest business. It is often forgotten that in dealing with a matter such as company law, which affects so closely the whole business life of the nation, a certain amount of elasticity is essential if the system is to work in practice.

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The Green Committee was concerned to prevent misconduct and fraud. So, for example, it was recommended that undischarged bankrupts should not set up in business again without the leave of the Bankruptcy Court.[32] Recommendations were also made in relation to fraudulent trading.[33] A series of statutes followed during the twentieth century with the twin aims of strengthening the position of the ordinary creditor, which included provisions to set aside fraudulent preferences, and of facilitating the prosecution of dishonest directors.[34]

1.07 Statutory formalities

There are various statutory provisions which require agreements to be made in writing if they are to be enforceable. Their purpose is often manifold: to prevent purchasers rushing into transactions, to draw each party's attention to the gravity of their conduct and to prevent fraud by clarifying what has been agreed. In the commercial field, an important example is the Consumer Credit Act 1974 which is designed to protect consumers from aggressive selling of consumer

[30] ibid, paras 49, 191.

[31] Report of the Company Law Amendment Committee appointed by the Board of Trade on 19 February 1925 (Cmd 2657) (Greene Committee).

[32] Cork Committee (Cmnd 8558, 1982) para 91. [33] ibid, para 92.

[34] See Chapters 5 and 6. See further the Companies Act 1929 (following the Report of the Greene Committee (Cmd 2657)), the Companies Act 1948 (following the Report of the Cohen Committee (Cmd 6659)), the Insolvency Act 1976 (following the Report of the Jenkins Committee (Cmnd 1749)) and the Insolvency Act 1986 (following the Report of the Cork Committee (Cmnd 8558)).

goods on credit. One drawback of such statutes is that they can lead to injustice.[35]

In general, any requirements relating to formalities can be burdensome.[36] The Statute of Frauds Act 1677 was intended to prevent fraud and to create certainty in the law by requiring contracts to be reduced to writing. However, this requirement no longer applies to contracts for the sale of goods, which can be created informally.[37] If they are reduced to writing, it will be presumed that the written contract represents what has been agreed. This is known as the parol evidence rule but it is subject to numerous exceptions.[38]

As regards land, the formality requirements in the Statute of Frauds relating to leasehold interests were replaced by a series of provisions in the Law of Property Act 1925.[39] It is notable, however, that the courts have intervened at times to modify the severity of the formality requirements.[40] One of the maxims of equity is that 'equity will not allow a statute to be used as an instrument for fraud'. The maxim was once primarily used as a rule of statutory interpretation but its role shifted and it was used to justify creating certain exceptions to statutory formalities.[41] Thus, secret trusts are enforced despite the fact that they do not comply with the formality requirements of the Wills Act 1937. The basis for their enforcement is contentious but it is at least in part in order to prevent fraud in a wider sense of the word: the focus is not so much upon prevention of wrongdoing by a trustee (who would deny the existence of a secret trust in order to benefit personally) but to prevent the beneficiaries from being deprived of their property, thereby frustrating the intentions of the testator.[42]

In short, the problem with formalities requirements as an instrument for preventing fraud is that they may generate difficulties of their own and irresponsible individuals can take advantage of them in an unfair manner. They

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[35] See *Wilson v Secretary of State for Trade and Industry* [2004] 1 AC 816, HL; J Ulph and T Allen, 'Transactions at an Undervalue, Purchasers and the Human Rights Act 1998' [2004] *JBL* 1. See further *Actionstrength Ltd v International Glass Engineering IN.GL.EN SpA* [2003] 2 WLR 1060, HL (a contract of guarantee was rendered unenforceable for want of writing by s 4 of the Statute of Frauds 1677); see s 11.18.

[36] See, for example, the complex provisions contained in the Bills of Sale Acts 1878–1882 relating to security over chattels.

[37] Law Reform (Enforcement of Contracts) Act 1954.

[38] See *Chitty on Contracts* (28th ed, 1999) paras 12-94–12-104.

[39] See P Critchley, 'Taking Formalities Seriously' in S. Bright and JK Dewar (ed) *Land Law: Themes and Perspectives* (OUP, 1998) 507.

[40] For example, equitable mortgages by way of deposit before 27 September 1989 prior to the entering into force of the Law of Property (Miscellaneous Provisions) Act 1989. See K Gray and SF Gray, *Elements of Land Law* (Butterworths, 2001) 603.

[41] P Critchley, 'Instruments of Fraud, Testamentary Dispositions and the Doctrine of Secret Trusts' [1999] 115 LQR 631.

[42] *Blackwell v Blackwell* [1929] AC 318, HL.

can be justified in the context of the creation of wills and trusts and the transfer of equitable interests, leaseholds, and freeholds because, in all of these dealings, the parties have the time to sort their affairs out carefully. In relation to commerce, which may involve the sale of goods worth millions of pounds, the parties in a fluctuating market will usually need to act quickly and will not have the time for formalities. If fraud is to be prevented, it is not by reducing everything to writing.

1.08 Conclusions

Earlier laws tended to have a number of different objectives, only one of which was the deterrence of fraud. The statutory insolvency provisions, for example, were more preoccupied with other matters such as the prevention of asset stripping in the lead up to insolvency. Furthermore, certain aspects of the law facilitated fraud. An obvious example is the ease with which a fraudster can create a company, and use it as a screen for fraud. The Association of Chief Police Officers expressed concern, in a memorandum to the Home Office Affairs Committee, at 'the ease with which it is possible to form a limited liability company in the United Kingdom with minimum outlay and with the use of nominees to conceal beneficial ownership is exploited by the criminal'.[43]

The civil law has developed in a fragmentary way. It has often been the case that one particular type of fraud has become prevalent and Parliament has passed legislation in response. For example, in the early part of the twentieth century, share pushing and share hawking were particular problems; the first major effort to regulate the market and to protect investors in response was the Prevention of Frauds (Investments) Act 1939. A series of statutes followed. Pyramid selling was popular in the 1970s and was prohibited by the Fair Trading Act 1973. In many respects, this piecemeal approach can be seen as sensible and pragmatic but it has the tendency to stifle development of general principles as a consequence.

B. Criminal Law

1.09 The current law

Apart from money laundering offences and proceeds of crime, the provisions of the criminal law are beyond the scope of this text. However, it is noteworthy that currently there is no general offence of fraud—although the position may change in the future. Instead, in the past, there has been a fragmentary approach taken in dealing with the myriad types of misconduct which are seen as deserving punishment in the criminal law. There are various offences which are linked in

[43] See B Rider, 'Shutting the Stable Door!' (2002) 22 *The Company Lawyer* 239.

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the sense that some form of non-violent dishonest conduct provides the basis for prosecution. There are offences contained within the Theft Act 1968: theft (s 1), obtaining by deception (ss 15 and 16), false accounting (s 17), false statements by directors with intent to deceive members or creditors (s 19) and dealing with valuable securities, such as an irrevocable letter of credit (s 20). However, there are other important offences which are relevant in the commercial context which are governed by other statutes, such as fraudulent trading (s 458 of the Companies Act 1985), tax evasion, and common law conspiracy to defraud. Insider dealing in shares can be prosecuted under the Criminal Justice Act 1993. There are also various offences relating to financial services. For example, there are cartel offences in relation to horizontal agreements under ss 188 and 190 of the Enterprise Act 2002 and, by s 47 of the Financial Services Act 1986, it is an offence to knowingly or recklessly engage in making misleading statements, promises and forecasts to induce others to participate in an investment agreement. Forgery is dealt with not only in s 20 of the Theft Act but also in the Forgery and Counterfeiting Act 1981. In some respects, a series of statutes can be useful because of the wide variety of circumstances in which fraudulent activity may take place. Unfortunately, despite the plethora of legislation, there are various types of activity which have fallen through gaps in the law; there have also been changes in banking and investment services due to the revolution in new technology and these factors have led to pressure to reform the law.

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1.10 The concept of dishonesty and the Theft Act 1968

The Theft Act marked a watershed in relation to the law of theft. Before its enactment, there were a variety of common law and statutory offences which dealt with different types of theft of property. The most significant offence was larceny, which was preoccupied with the idea of deprivation of possession.[44] At common law, the defendant was guilty of larceny if he took and carried away goods with the intention of permanently depriving the owner of them and this was done without his consent: these requirements were restated in the Larceny Act 1916. Over a period of time, various other statutory offences were created to deal with obtaining by false pretences, embezzlement, and fraudulent conversion. The Theft Act 1968 was enacted as a result of recommendations made by the Criminal Law Revision Committee with the intention of simplifying the law.[45]

Section 1(1) of the Theft Act 1968 provides the key definition of theft:

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[44] Law Commission, Legislating the Criminal Code, Fraud and Deception (Law Com Consultation Paper No 155, 1999) para 3.2.

[45] Criminal Law Revision Committee (CLRC), Eighth Report: Theft and Related Offences Cmnd 2977, 1966).

> A person is guilty of theft if he dishonestly appropriates property belonging to another with the intention of permanently depriving the other of it; and 'thief' and 'steal' shall be construed accordingly.

The definition is similar in many ways to the earlier law regarding larceny; yet there are some crucial differences. In particular, s 1(1) requires the appropriation to be *dishonest*, whereas the Larceny Act 1916 referred to 'fraudulently and without a claim of right'. It was thought that juries found the concept of 'dishonesty' easier to understand.[46]

As regards the concept of dishonesty, it involves objective and subjective elements: in *R v Ghosh*,[47] the Court of Appeal stated that the prosecution had the burden of showing, firstly, that the defendant's conduct would appear dishonest if judged by the standards of reasonable and honest people and then, secondly, that the defendant must have realized that, judged by those standards, what he was doing was dishonest. The subjective element of the test has been criticized as promoting uncertainty and inconsistency as juries may end up struggling over an accused's system of values.[48] The test may be particularly difficult to apply in the context of commercial fraud, where the accused is operating in a world which may be completely alien to jury members.

Another major change in the Theft Act was the introduction of the concept of appropriation. The offence of larceny was narrower, requiring evidence that property had been carried away. Appropriation covers an assumption of any of the rights of ownership; it covers situations where property is acquired by dishonestly switching price tags[49] or making false representations.[50] The defendant may be convicted of theft even where he has received the property under a valid transfer with the owner's consent if he acted dishonestly in receiving it.[51] A leading authority on this point is *R v Hinks*.[52] In this case, the accused had befriended a man called John Dolphin and had persuaded him to give her a total of £60,000, which represented most of his savings. The money had been held in an account under the terms of which the maximum sum which could be withdrawn at any one time was £300 and so, on almost every day over a

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[46] CLRC Eighth Report, para 39. [47] [1982] QB 1053, 1064.

[48] G Williams, *Textbook on Criminal Law* (2nd edn Stevens, 1983) 727–728; T Palfrey, 'Is Fraud Dishonest?' (2000) *Journal of Criminal Law* 518; A Halpin, 'The Test of Dishonesty' [1996] *Crim LR* 286, 289–291.

[49] *R v Morris, Anderton v Burnside* [1984] AC 320, HL.

[50] *R v Gomez* [1993] AC 442 HL.

[51] *R v Gomez* [1993] AC 442, HL; *R v Hinks* [2000] 4 All ER 833, HL.

[52] [2000] 4 All ER 833. See JC Smith, 'The Sad Fate of the Theft Act 1968' in W Swadling and G Jones, *The Search for Principle: Essays in Honour of Lord Goff of Chievely* (OUP, 1999) 97, 112; ATH Smith, 'Gifts and the Law of Theft' [1999] *CLJ* 10; J Beatson, and AP Simester 'Stealing One's Own Property' (1999) 115 *LQR* 372.

seven-month period, the accused had accompanied Mr Dolphin as he made a withdrawal of £300 which she then deposited in her account. There was evidence that, although Mr Dolphin had managed to hold down an unskilled job, he had a lower than average IQ. The House of Lords upheld her conviction; the majority considered that an accused could be guilty of theft even where, as here, the victim had consented and had relinquished all rights in the property.

The decision in *Hinks* shifted the focus of any trial to an examination of the honesty of the accused and the question of identification of property. In the process, the distinction between theft and fraud has faded. The question of whether a transaction is valid or voidable, which can be a vital distinction to be made in the civil law, has become irrelevant.[53] Indeed, *Hinks* went further and, even if a transaction was valid in the eyes of the civil law, it may amount to theft. Yet the House of Lords in *Hinks* seemed reluctant to accept the full consequences of their decision. It had been put to them by counsel for the appellant that, logically, all manner of deceitful activities would now amount to theft, such as where a vendor sells goods or other property and keeps silent about some matter which will greatly diminish its value. Lord Steyn took the robust line that a jury would be unlikely to convict in these circumstances.[54] His Lordship considered that a conviction for theft was right on the facts of *Hinks*, where the accused had exploited the vulnerability of the victim. He expressed concern that, if some of the niceties of the civil law were imported into the criminal law, juries would struggle with the concept of appropriation. Rather than alter the trend of cases in the law of theft, Lord Steyn appeared reconciled to a serious rift opening up between the civil and criminal law.

One clear bright line in the civil law is the distinction between theft and fraud: a purchaser cannot acquire a good title to stolen property.[55] In contrast, where the seller is fraudulent, a good title can still be acquired under one of the exceptions provided the sale satisfies the legislative criteria.[56] The same distinction between theft and fraud is made in certain international treaties.[57] In some respects, it is

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[53] *R v Gomez* [1993] AC 442, HL. [54] [2000] 4 All ER 833, 843.

[55] See *Debs v Sibec* [1990] RTR 91; *White v Green* (1851) 10 CB 919, 927 per Talfourd J. See Chapter 11.

[56] One historical distinction made by statute (21 Hen. 8, c. 11) was that, even where the goods had been sold in market overt, if a thief was convicted then title reverted to the true owner; but this was not the case where a rogue was convicted of fraud rather than theft: see *Parker v Patrick* (1793) 5 TR 175. The distinction between theft and fraud is also significant in France and Germany: Law Reform Committee, Transfer of Title to Chattels (Twelfth Report, Cmnd 2958, 1966) para 5.

[57] See the UNIDROIT Convention 1995: Article 3(1) imposes an obligation to return a stolen cultural object upon its possessor. However, by Art 4(1), if the possessor has used due diligence when acquiring a cultural object, and neither knew nor ought reasonably to have known that the object was stolen, then the possessor is entitled to compensation; see further, LV Prott, Commentary on the UNIDROIT Convention (Institute of Art and Law, 1997).

unfortunate, as the distinction can be pivotal in the civil law, that the criminal law courts in this country have taken a different approach. On the other hand, it must be acknowledged that there are immense difficulties confronting prosecutors in terms of the wide variety of criminal activity in the commercial context. Where a company is the victim, it is convenient to have a rule that the consent of the victim is irrelevant if the property has been obtained dishonestly. Thus, even if the defendant is the *alter ego* of the company and can arrange for company property to be transferred to him, he may still be convicted of theft and it is no defence that the company consented to the arrangement.[58]

1.11 Law reform

The Law Commission has been encouraged to review the current law and there have been a series of working papers and reports relating to law reform.[59] In 1998, the Law Commission was invited to consider whether a general offence of fraud based upon the concept of dishonesty would be more easily understood by juries, would be fairer on defendants and would also be satisfactory for effective prosecution. The Law Commission initially had reservations regarding such a reform, arguing that it would be wrong to rely on the *Ghosh* test[60] of dishonesty as the paramount element.[61] However, in 2002, it was concluded that a general offence of this nature would improve the position and would also provide an opportunity to modernize the law to enable it to keep abreast of advances in modern technology.

The Government has stated that it plans to introduce a Fraud Bill which would replace the deception offences in the Theft Acts 1968–96 with a general offence. The emphasis will be upon the defendant's dishonest intention. Fraud will be defined as an offence in one of three ways: by false representation; by wrongfully failing to disclose information (where there is a legal duty to disclose); and by abuse of position. An innovation is the creation of a new offence of possessing equipment to commit fraud; equipment would include private financial information concerning another individual. In general, the offences in the Theft Act will be swept away. The Government is minded to retain the offence

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[58] *Attorney-General's Reference (No 2 of 1982)* [1984] QB 624, CA.

[59] See, for example, Law Commission Criminal Law: Conspiracy to Defraud (Law Com No 228, 1994); Offences of Dishonesty: Money Transfers (Law Com No 243, 1996); Legislating the Criminal Code: Misuse of Trade Secrets (Law Com Consultation Paper No 150, 1997); Legislating the Criminal Code: Corruption (Law Com No 248, 1998); Legislating the Criminal Code: Fraud and Deception (Law Com Consultation Paper No 155, 1999); Fraud (Law Com No 276, Cm 5560, 2002).

[60] See s 1.10.

[61] See Law Commission, Legislating the Criminal Code: Fraud and Deception (Law Com Consultation Paper No 155, 1999) para 9.1l and Part V, The Case Against a General Dishonesty Offence.

of conspiracy to defraud; although the Law Commission recommended its abolition, many of those who have commented upon law reform have suggested that it is flexible and a variety of frauds fall within its scope. The Fraud Bill is seen as being a useful weapon in the fight against organized crime: it is hoped that it will be better able to tackle fraudulent activities and to keep pace with modern needs, such as electronic transfers. Yet its provisions will need to be clear in order to avoid a challenge under the human rights legislation. Furthermore, the reform does not involve a comprehensive overhaul of the law. There will still be special legislation relating to particular branches of fraud, such as forgery and counterfeiting, tax evasion, insider dealing, and misleading market practices.

C. Financial Regulation

1.12 Introduction

At one time, the regulation of the investment industry could be described as complex and lacking in a rational structure.[62] Until the 1980s, there were three quite distinct sectors within financial services with their own traditions. Firstly, there was the Bank of England and the banking sector; secondly, there was the Stock Market and Lloyd's; thirdly, there was a sector consisting of a mix of building societies, insurance companies, and licensed securities dealers. There were various differences between the regulation of the different sectors. The first two of these sectors in particular have suffered dramatically over the last 30 years due to a combination of world events, the globalization of financial services, incompetence and fraud. A brief sketch of each sector will be given in turn.

1.13 The Bank of England and the banking sector

In certain respects, banks are different from any other type of company. If a bank becomes insolvent investor confidence is damaged. If the insolvent bank is in debt to smaller banks; they may struggle if they have substantial illiquid assets, such as loan portfolios, which may be worth relatively little if a quick sale is necessary to obtain funds for their customers. Any government is faced with conflicting policy concerns when problems arise. On the one hand, open competition between banks is a positive factor because it encourages efficiency; a rescue culture can lead to apathy and can be seen as a misuse of public funds. On the other hand, given the significant role played by banks in a country's economy, it can be argued that it is in the public interest to protect banks from failure.[63]

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[62] Gower, Review of Investor Protection (Cmnd 9125, 1984).
[63] See M Havranek, 'The Bank of England and bank failures' [2000] *Insolvency Lawyer* 73–74.

Traditionally, the Bank of England has exercised an informal supervisory role over the banking system, which consisted principally of the clearing banks, discount houses and accepting houses. The Bank relied upon informal persuasion based upon the notion of a gentleman's code of ethics.[64] However, a crisis occurred in the 1970s when it emerged that a number of secondary banks were struggling with serious liquidity problems. Although the Bank of England launched a rescue package to bail out the secondary banks where necessary, it became clear that more regulation was required to prevent further risks of insolvency. It was given formal supervisory powers by the Banking Act 1979, enabling it to issue and revoke banks' licences to operate. These powers were not enough and the Johnson Matthey crisis in 1984 (caused by a series of imprudent loans) prompted the Bank of England to intervene and to purchase the company for one pound sterling. In order to ward off further similar disasters, Parliament gave the Bank increased powers, including extensive information gathering powers, by the Banking Act 1987. These statutes were limited in scope to regulated deposit-taking institutions only and were intended to protect depositors; they did not deal with the UK financial services industry in general.

Unfortunately, the Bank of Credit and Commerce International (BCCI) collapsed in 1991 amidst allegations of fraud and money laundering. In 1995, Barings was brought to the edge of ruin by the appointment of one rogue trader (Nick Leeson) who ran up debts of nearly £600 million.[65] The Bank of England refused to bail out Barings: it would no longer rescue banks which had solvency problems as opposed to liquidity problems.[66] These dramatic events had two obvious effects. Firstly, it brought home to banks that fraud can ruin a company and that it was important to have a proper internal system of monitoring in place.[67] Secondly, the Bank of England's reputation suffered because it was suggested that it had not fully utilized the extensive powers which it had been granted by the Banking Act 1987. It was thought that it was not the right body to conduct banking supervision. Hence the Financial Services Authority (FSA) was put in charge by the Bank of England Act 1998. The FSA will not rescue a bank in difficulties unless there is a threat to the stability of the financial system.[68]

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[64] M Andenas and D Fairgrieve, 'Misfeasance in Public Office, Governmental Liability and European Influences' (2002) 51 *ICLQ* 757, 759. See further G Penn, *Banking Supervision* (Butterworths, 1989).

[65] See Report of the Board of Banking Supervision Inquiry into Circumstances of the Collapse of Barings (1995). For an explanation of the Barings collapse, see s 7.

[66] ibid, 77.

[67] M Havranek, 'The Bank of England and bank failures' [2000] *Insolvency Lawyer* 73–74.

[68] W Blair, 'Reform of the Financial Regulation in the UK' [1998] 2 *JIBL* 43, 46.

1.14 Lloyd's insurance market

Lloyd's of London consisted of a series of private individuals who provided capital to underwrite insurance and who traded with unlimited liability.[69] They joined syndicates under the management of a professional underwriter. Lloyd's had operated a self-regulatory system, in which the Committee of Lloyd's played a supervisory role over Lloyd's underwriters. The stock market and other organized markets were all based upon self-regulation. However, this system depended upon a network of relationships underpinned by shared norms of behaviour. This system was put under strain due to a number of different factors. Membership of Lloyd's grew four-fold between 1976 and 1987.[70] The dismantling of exchange controls in 1979 enabled foreign institutions to operate in the markets. There were a series of financial scandals in the 1980s. For example, Sir Peter Green, a former Chairman of Lloyd's, was fined £50,000 for discreditable conduct.[71] There were a number of cases where there was a clear conflict of interest involving Lloyd's underwriters. The Lloyd's Act 1982 had provided that the Committee of Lloyd's should be replaced by a Council which would include a number of external Names; in the wake of these scandals, the Neill Report in 1987 recommended that the number of independent members should be increased to form a majority on the Council.[72] There is no doubt that the traditional secrecy of Lloyd's was used as a cloak for bad practice. Between 1987 and 1992, huge losses were sustained by private individuals who were 'Names' at Lloyd's: the losses were caused by millions of pounds worth of claims prompted by a series of natural disasters and 'long-tail' liability in the US market, such as in relation to asbestos-related claims. As a consequence, because Names had unlimited liability, certain individuals lost everything. This led to private litigation on behalf of the Names, which is discussed in subsequent chapters.[73] It is sufficient to note for the moment that there were allegations of secrecy and conflicts of interest made against members of Lloyd's at that time and it was clear that further regulation would be desirable.

1.15 The remaining sector

This sector was subject for many years to statutory regulation rather than self regulation; it consists primarily of building societies, savings banks, insurance companies, and friendly societies. Hence, the Building Societies Act 1836 was

[69] As a private body, Lloyd's was not susceptible to scrutiny by way of judicial review: *R (on the application of West) v Lloyd's of London* [2004] EWCA Civ 506.
[70] See J Fisher, *The Law of Investor Protection* (Sweet & Maxwell, 2003) 188.
[71] ibid, 189.
[72] ibid. See Regulatory Arrangements at Lloyds, Sir Patrick Neill QC, 1987.
[73] See ss 5.30 and 7.16.

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enacted to offer protection to investors by regulating the industry. The Life Assurance Companies Act 1870 was designed to regulate the insurance industry following failures in the industry, most notably the Albert Life Assurance Company in 1869.

The Prevention of Fraud (Investments) Act 1939 was the first statute to attempt to fully regulate dealings in securities. The statute was enacted partly in response to fraudulent share pushing in the 1930s and partly in response to the growth of the unit trust investment. It was subsequently amended by the Companies Act 1947 and consolidated in the Prevention of Fraud (Investments) Act 1958. It became an offence to carry on a financial services business without obtaining a licence, renewable annually, from the Board of Trade. However, a large group were exempted from the licence requirement, including members of the London Stock Exchange, members of an association of dealers in securities, managers and trustees of an authorized unit trust, statutory corporations, industrial and provident societies, building societies, and persons granted exempted dealer status by the Board of Trade.[74] This legislation offered inadequate protection to investors as evidenced by a series of financial scandals in the late 1970s and 1980s. It was replaced by the Financial Services Act 1986, which created a Securities and Investments Board to oversee the work of self-regulated organizations.

1.16 The need for reform: the Financial Services Act 1986

There has been increasing internationalisation of the British market after the 'big bang' in the mid-1980s led to inward investment as foreign companies acquired shares in British companies.[75] There was a gradual recognition that the traditional system of self-regulation would have to be overhauled. There was also an emerging concern to protect investors, as members of the public were encourage to invest in denationalised industries. The Financial Services Act 1986 revolutionised the regulation of financial services. It provides a two-tier regulatory system which came into effect in 1988. The second tier consisted of self-regulating organizations (SROs), which were responsible for dealing with different parts of the financial services industry. The Securities and Investments Board (SIB) was placed above them as the principal authority; it was given wide powers to regulate the financial services industry in order to protect investors. Only those individuals who were authorized to carry on investment business could lawfully do so. It became a criminal offence for a person to carry on

[74] P Graham, 'The Statutory Regulation of the Financial Services in the United Kingdom and the Development of Chinese Walls in Managing Conflicts of Interest' ch 2 in E McKendrick (ed) *Commercial Aspects of Trusts and Fiduciary Obligations* (Clarendon Press, 1992) 43.

[75] R Dale, *Risk and Regulation in Global Markets* (Wiley, 1996).

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business without registration and it became a disciplinary offence for a registered person to conduct such business in breach of the rules. The manifest purpose of the regulatory regime was to protect the investing public by ensuring that individuals operating within the industry were fit and proper persons to carry on investment business. The SIB could obtain injunctions against rogue traders, including those based overseas,[76] and could penalize the professionals who acted upon their behalf.[77]

The scope of the 1986 Act was wide but not comprehensive. Controversially, it did not extend to Lloyd's of London. Furthermore, London money markets (sterling, foreign exchange, and bullion) were exempt and continued to be regulated by the Bank of England which issued a London Code of Conduct.[78] There were certain recognized professional bodies, such as The Law Society and the Institutes of Chartered Accountants, which could regulate business carried on by their members.

1.17 The Financial Services Authority

The Financial Services Authority (FSA)[79] was launched in October 1997, replacing the Securities and Investments Board. It was seen as necessary to have one single regulatory body to respond to the challenges posed by economic changes in the last part of the twentieth century. A revolution was taking place: financial services had become truly international due to improved methods of communication prompted by changes in information technology and the traditional demarcations in banking and the securities business were breaking down. The Government's aim was to create a regime which would help to maintain confidence in the integrity of financial markets. Certain policy concerns had to be balanced against each other: although there was a need to maintain international competitiveness, it was necessary to establish controls and to protect consumer confidence in the market.

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The principle of self-regulation by specialist bodies was abandoned in favour of a unitary authority to regulate and monitor most aspects of the financial markets. Consequently, the Bank of England Act 1998 was passed and it provided that, although the Bank of England would remain in overall charge of the financial system, it would lose its day-to-day responsibility for supervision. Its supervisory function was transferred to the FSA which would regulate not only banking but also financial services and insurance.

[76] See *SIB v Pantell SA* [1990] 1 Ch 426, CA (asset freezing order obtained); *SIB v Vandersteen Associates NV* [1991] BCLC 206 (injunction restraining defendant from destroying evidence).
[77] *SIB v Pantell SA (No 2)* [1993] Ch 256, CA.
[78] W Blair, 'The Reform of Financial Regulation in the UK' [1998] 2 *JIBL* 43, 44.
[79] <http://www.fsa.gov.uk>.

This move to consolidate power within one or a few bodies was not a British innovation. In September 1997, the Australian government announced changes to its regulatory system with three new authorities: a single Prudential Regulation Authority was created, which inherited powers which had previously been exercised by the Reserve Bank of Australia; a new Payments System Board was established to ensure efficiency in the payments system; and the new Corporation and Financial Services Commission will oversee market integrity and consumer protection issues.[80] There have been similar developments in the United States and Japan.

D. Further Analysis

1.18 The Financial Services and Markets Act 2000

This Act gave enhanced powers to the Financial Services Authority (FSA), which brought Lloyd's of London within its scope. The FSA therefore has the task of regulating all of the banking, securities, and insurance business. The wide-ranging role of the FSA is unusual but it is possible to defend it on the basis that some uniformity is needed in dealing with providers of financial services. From the 1980s, the boundaries between the various sectors had become indistinct. For example, building societies have been deregulated to an extent by the Building Societies Act 1986 and now compete openly with the major banks in retail financial products, including current accounts. European directives have also dealt with both banks and building societies as credit providers and a single regulatory authority ensures that these directives are properly implemented.

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The FSA publish rules and guidance expanding on standards and substantive obligations and can issue Warning Notices and Decision Notices in respect of proposed disciplinary and enforcement actions. If any recipient objects, the matter can be referred to the Financial Services and Markets Tribunal, which was created by s 132 and Sch 13 of the 2000 Act. There is a further right of appeal from the Tribunal on a point of law to the Court of Appeal. In essence, the 2000 Act is primarily concerned with procedural rights. It provides a statement of objectives and establishes a framework which can be fleshed out by statutory instruments. This emphasis upon procedural matters is essential to minimize the risk of any violation of the right to a fair trial guaranteed by Art 6 of the Human Rights Act 1998.[81]

[80] W Blair, 'The Reform of Financial Regulation in the UK' [1998] 2 *JIBL* 43.
[81] See s 2.24.

1.19 A hybrid body

In the past, the lines of demarcation between civil law offences, regulatory offences, and criminal offences were reasonably clear. Until recently, one could describe regulators as bodies which applied civil sanctions and the Serious Fraud Office as one which applied criminal sanctions. However, the new FSA is a hybrid.[82] It has been given enhanced enforcement powers by the 2000 Act so that it can take criminal action, in addition to regulatory or civil action, against offenders. The FSA has a discretion as to which powers are used and must have regard to the need to use its resources in an efficient and effective way in discharging its functions. The wide variety of circumstances in which providers operate and the need to protect investors has provided a catalyst for this change.

Although the FSA has been given a wide range of powers, its officers will be concerned to ensure that any response complies with the Human Rights Act. Although the FSA has the power to revoke the authority of a person to act as a reporting officer of money laundering activities, this would only occur in extreme circumstances; normally, a public reprimand or a fine would suffice. There is a right of appeal to the Financial Services and Markets tribunal.[83] In terms of a right to a fair trial, it can be argued that criminal proceedings are involved because the FSA's powers are draconian. For example, a failure to supply information is punishable with a fine or imprisonment; its powers extend to third parties who are connected with an authorized person or with a recognized investment exchange or clearing house. Furthermore, an offender can be fined for negligent conduct. There is no need for the FSA to show dishonesty or recklessness: negligence suffices because the aim of the legislation is to maintain consumer confidence in the financial markets. In arriving at a decision, the FSA will take account of whether the offender complied the provisions of the Codes of Conduct which are discussed below. The FSA also deals with 'financial crime' involving fraud or dishonesty, misuse of information relating to a financial market, or handling the proceeds of crime. The regulatory role of the FSA has therefore been expanded to cover activity which once would simply have fallen within the jurisdiction of the criminal courts. There is considerable overlap as a result.

Nevertheless, it could be argued that the proceedings are civil because, in most cases, the FSA will simply issue warnings or fines.[84] Professional disciplinary

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[82] J Beatson, 'The Relationship Between Regulations Governing the Financial Services Industry and Fiduciary Duties under the General Law' ch 3 in E McKendrick (ed) *Commercial Aspects of Trusts and Fiduciary Obligations* (Clarendon Press, 1992).

[83] See, 'Legal & General challenges FSA's enforcement formula' *The Lawyer* (2005) January 24, concerning a successful appeal by Legal & General against a fine of £1.1 million for allegedly mis-selling insurance; the FSA was criticized for not investigating the allegations fully.

[84] See ss 2.31–2.32; see further P Johnstone and J Haines, 'Human Rights and the Restructuring of Financial Services Regulation in the UK' (2001) 9 *Journal of Financial Crime* 179, 185.

proceedings are treated as civil in nature despite the fact that the penalties can be severe. In *R v Securities And Futures Authority Ltd And Another Ex Parte Fleurose*,[85] the Court of Appeal held that the Securities and Futures Authority, which regulates the securities industry, was civil in nature; one influential factor was that the proceedings concerned a specific group (securities traders) rather than the public as a whole. However, as discussed in Chapter 2,[86] the position may be more subtle and, even if the proceedings are civil in nature, the question of whether the complainant has been unfairly targeted or otherwise treated unjustly will be studied carefully because of the severe penalties available.

1.20 Codes of practice

A recent trend in the law is the development of codes of practice. The 1986 Act was amended by ss 191–206 of the Companies Act 1989, enabling the Securities and Investments Board to issue a 'Statement of Principles.' They were published in 1990, followed by the Core Conduct of Business Rules on 30 January 1991. The Principles were designed to ensure that high standards were set in the financial services industry, not only in terms of skill, care and diligence (Principles 2–5 and 7–10) but also high standards of integrity and fair dealing (Principle 1) and to avoid conflicts of interest (Principle 6). The Financial Services Authority replaced the SIB in 1997 and, in its Statement of Principles, it includes a requirement that firms must operate robust arrangements to deter involvement in market abuse or financial crime (especially money laundering).

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The Statement of Principles can be described as 'soft law' in the sense that they provide guidance but do not by themselves provide a basis for a damages claim by an investor. The FSA expects the Principles to be incorporated into an internal code of conduct operated by companies, with suitable staff training and an internal monitoring process. This is all part of a larger picture of paperwork and bureaucracy, which include further codes of practice for specialised industries,[87] although it has the praiseworthy intention of preventing rather than reacting to fraud. The FSA requires the board of directors of all regulated businesses to consider an annual report on money laundering compliance. This would also be good practice for all firms undertaking work in the regulated sector. The report will include details of staff training to demonstrate that the company has implemented proper systems of internal control as required by reg 3 of the Money Laundering Regulations 2003 (SI 2003/3075). There should be other information in the report as well, such as a summary of reports to the National Criminal Intelligence Service, any active involvement of the firm's

[85] [2002] IRLR 297. See s 2.33. [86] See s 2.33.

[87] For example, a new code of practice to strengthen the intergrity of the credit derivatives market was launched in 2005 and more than 600 banks are prepared to adopt it: R Irving, 'Banks get derivatives code of practice' The Times, 18 April 2005.

professional indemnity insurers (which would be necessary, for example, if any rumours alleging misconduct by company employees were in circulation in the press), performance statistics, changes in internal practice that alter the risk and changes in external risk factors, such as new UK or European legislation.[88]

E. International Corruption

1.21 The Convention Against Bribery of Public Officials in International Business Transactions

At one time, bribery of public officials in third world countries was common and countries allowed companies to deduct bribes to foreign officials from taxable income as legitimate business expenses. The US led the way in the fight against corruption with its Foreign Corrupt Practices Act in 1977. European countries lagged behind, possibly due to a concern that their national companies might not be able to compete effectively in some countries if they were not prepared to pay certain fees. It was eventually recognized by the international community, however, that bribery should be banned because of the damage that corruption may inflict upon local economies. The Organisation for Economic Co-operation and Development's Convention Against Bribery of Public Officials in International Business Transactions entered into force in February 1999. It makes it a crime to offer, promise, or give a bribe to a foreign public official in order to obtain or retain an international business deal. It provides for mutual legal assistance. All 29 OECD countries (which includes the EU Member States) and five non-OECD members signed the Convention and have enacted the necessary domestic legislation. The Convention is part of a larger effort to stamp out corruption: for example, the United Nations General Assembly adopted a Declaration against Corruption and Bribery in International Commercial Transactions in 1996 and the Council of Europe opened the Criminal Convention on Corruption for signature in 1999.[89]

The UK Government signed the Convention in December 1999 but was slow to enact legislation to implement the Convention in full. Criminal legislation already existed to deal with bribery of public officials in the UK itself.[90]

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[88] F Maher, 'Happy birthday, money laundering' *New Law Journal* (2005) 25 February.

[89] See Banking on Corruption, The Legal Responsibilities of Those who Handle the Proceeds of Corruption, The Society for Advanced Legal Studies, February 2002, ch 1.

[90] The Public Bodies Corrupt Practices Act 1889, the Prevention of Corruption Act 1906 and the Prevention of Corruption Act 1916. This legislation has been criticized as 'obscure, complex, inconsistent and insufficiently comprehensive' by the Law Commission, Legislating the Criminal Code: Corruption (1998) No 248. A draft Corruption Bill was issued by the Government in March 2003.

Eventually, the Anti-Terrorism Crime and Security Act 2001 was enacted. This legislation was introduced in the wake of the 11 September attacks and one aim was to combat international terrorism. Part 12 of the Act implements the Convention by conferring extraterritorial jurisdiction on the UK courts. UK citizens and companies can be prosecuted in relation to offences of bribery or corruption of a foreign public official committed in the UK or overseas and can be sentenced to up to seven years' imprisonment.

The 2001 Act went further than US Foreign Corrupt Practices Act 1977 and similar legislation elsewhere in that 'facilitation payments' made to encourage officials to perform their ordinary functions would be caught, which might include purposes such as the connection of a telephone line. The result has been that companies have established internal procedures and codes of conduct not only to deal with money laundering legislation but also to ensure that their employees are aware of the wide scope of the 2001 Act.[91] These actions should include a system for reporting suspected corrupt practices and thorough due diligence procedures.

The US authorities involved with prosecutions are the Securities and Exchange Commission, in relation to accountancy matters, and the Department of Justice, in relation to bribery itself. Individuals (such as directors of a company) can be sentenced to prison for up to five years and may be fined of up to $250,000 or twice the amount of the gross gain from the bribe. Companies are also subject to severe penalties: corporate fines of up to $2 million per violation can be imposed and the US government can also bar companies from bidding for US government contracts for a given period.[92] These are significant deterrents which encourage individuals and companies to behave in a socially responsible manner.

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One side effect of the Anti-Terrorism Crime and Security Act 2001 is that companies operating overseas are expected to establish internal monitoring systems, to minimise the risk of corruption. Records should be kept of payments made in the course of business and training procedures for those staff involved in transacting abroad. In addition, the company's anti-corruption policies and procedures should be publicized throughout the workplace together with its whistle-blowing procedures. In short, the company must ensure that there are thorough due diligence procedures in place to prevent bribes being made.

[91] See J Carver, 'Why lawyers must fight bribery' *Law Society Gazette* (2001) 31 August; D Allen, 'White Collar Crime: Straight Britain' *The Lawyer* (2005) February 21.

[92] C Brown and D Zarin, 'Pay day' *The Lawyer* (2003) 14 July.

F. Victims, the State, and the Public Interest

1.22 Internal monitoring system

A significant problem for companies and their shareholders is the risk of employee fraud. Senior management often carry out these frauds and they are in a position to cause significant economic damage. They may also condone fraudulent practice by junior employees if they receive some benefit from doing so. There is therefore a good reason for companies to establish a system to reduce the risks of fraud; equally, it is in the public interest to suppress this type of activity because it leads to a loss in investor confidence and it may have adverse effects upon the domestic economy.

Companies are now expected to establish an internal system to comply with money laundering legislation and the Money Laundering Regulations 2003.[93] Equally, any company involved in overseas business transactions is encouraged to establish a monitoring scheme to ensure that no payments are made to bribe foreign officials.[94] There should also be a proper system of corporate governance.[95] As a consequence, there has been a significant growth in codes of conduct which should assist in encouraging good behaviour particularly amongst senior officers. An internal structure might include the allocation of responsibility for the management of the risk of fraud to a senior officer, who might well already be the Money Laundering Reporting Officer. He would be responsible for collecting data on any fraud loss suffered and identifying key fraud risks. An important function would be ensuring that there are suitable 'whistle blowing' arrangements in place and evaluating their effectiveness.

If an employee is dishonest and misappropriated company property, the company can bring a personal or proprietary action. However, the codes of conduct can be seen as mechanisms to prevent misappropriation taking place. An interesting aspect of these codes is the notion of a 'trickle down' effect where even employees with a low status receive some form of training in spotting indicators of criminal activity. At the same time, companies will disseminate information in relation to 'whistle blowing' so that junior employees are aware that they should report anything suspicious rather than keeping silent. This relatively new legislation involves a culture change within the organization. Senior officers, as line managers, will be responsible for the supervision of junior employees and should make further enquiries if they become concerned about a subordinate's behaviour. However, the 'whistle blowing' legislation turns junior employees into detectives. There is some risk that the whistleblower will be sacked if he is

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[93] See Chapter 3. [94] See s 1.21. [95] See s 5.27.

reporting the conduct of his boss. Employees receive protection from dismissal by s 103A of the Employment Rights Act 1996, as amended by s 5 of the Public Interest Disclosure Act 1998. However, this statutory protection is only available to those who have acted in good faith (ss 43C(1) and 43G(1)(a)) in the sense of being sincere and honest. In *Street v Derbyshire Unemployed Workers' Centre*,[96] the Court of Appeal noted that s 43G(1) required not only evidence of good faith but also evidence of a reasonable belief that the information was substantially true. Consequently, the legislation is intended to assist in maintaining commercial morality: it is not a gossip's charter.

It has become increasingly clear to small and large companies that a system of checks and balances is desirable. If there are rumours of misconduct, this will damage a company's reputation. Furthermore, such rumours need to be disclosed and discussed with the company's insurers even if they are without foundation.[97] Although the increasing use of codes of conduct within an organization is beneficial in certain respects, the requirements may be bureaucratic, expensive, and onerous for smaller companies.

It may also be easier for banks and professionals to set up systems to detect odd movements of large sums of money (as required by the Money Laundering Regulations) than for small companies to set up schemes to ensure employee fraud is eliminated. If one considers staff morale, it may be easier to set up a system to detect fraud by third-party outsiders (as the banks are obliged to do) rather than a system clearly designed to detect fraud by one's own colleagues.

1.23 The position of the victim: the alternatives

Criminal prosecutions are funded by the State and in cases such as criminal assault, there may be an advantage in waiting for the prosecution and conviction of the defendant. However, in cases of commercial fraud, a victim may wish to pursue a civil action for a variety of reasons. Chapter 4 provides an analysis of the State's power to make confiscation orders which require the defendant to pay a certain sum of money to the State to reflect the benefit derived from the crime: in these circumstances, the victim may wish to bring a proprietary claim to recover property which may otherwise be swallowed up in satisfying the confiscation order.

Criminal trials tend to be lengthy and they are difficult to cut down to a manageable size. Kirk argues that,

> The problem is that it is rarely easy to keep a fraud case simple. Choosing to prove one sample transaction, however stark the facts, is often unsatisfactory for a

[96] The Times, 5 September, 2004.

[97] See s 8.78.

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> number of reasons: an isolated example does not show the true level of criminality; on its own it might not even appear dishonest; ignoring other facts might allow the defendant to turn them to his advantage, exploiting gaps in the prosecution's evidence or swamping the case with so much of his own evidence that he turns the case on its head.[98]

If the accused is tried alone, he can place the blame upon others; in any event, dividing the case into a number of separate trials can appear artificial.

It has been suggested that, where the facts are not clear cut, the police may be unenthusiastic about prosecuting corporate fraud, which tends to be complex and therefore expensive in terms of case preparation. The Serious Fraud Office focuses upon large scale frauds involving more than £5 million. If the police do make a decision to investigate, they are likely to obtain a search warrant and to seize any relevant documentation and to take possession of the company's files and computers for forensic analysis. This is a serious problem if a company is reporting a fraud by one of its staff: it will find that, having already suffered loss due to the fraud, it must suffer further as it may be weeks before these items are returned. However, professional advisers may be obliged to contact NCIS if the fraud involves money laundering in order to satisfy the duties imposed by the Proceeds of Crime Act 2002.[99]

If the victim is a private individual, he may have no choice but to wait and see if criminal or regulatory proceedings go ahead. Civil search and seizure orders (to prevent the destruction of computers, records, etc) and assets freezing orders (to prevent money being transferred out of the country) require cross-undertakings in damages.[100] General litigation is expensive and, because fraud cases are time-consuming, the cost is likely to be beyond most people's pockets.

The position may be different if the victim is a company. A company may be able to bear the costs and risks of litigation and a civil action may be attractive for a number of different reasons. Where the fraud is 'in house' and has been carried out by dishonest employee, it may be tempting to initiate enquiries secretly in order to preserve the company's reputation. If lawyers are called in at this early stage to co-ordinate the management of the investigation, they can invoke legal privilege in relation to documents created for the purpose of contemplated litigation to prevent their disclosure to public

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[98] D Kirk, 'Serious Fraud—A Banker's Perspective' in JJ Norton (ed) *Banks: Fraud and Crime* (LLP, 1994) 20.

[99] See s 3.22.

[100] As regards injunctions in general, the court is obliged to weigh up the injustice caused to the appellant in continuing the injunction with the injustice which would be caused to the respondent if it was discharged: *American Cyanamid Co v Ethicon Ltd* [1975] AC 396. An injunction may be discharged if it would be difficult to quantify the damages which the other party would suffer: *Douglas v Hello! Ltd* [2001] 2 WLR 992. See Chapter 9.

authorities.[101] Secondly, it is in the company's interests to act quickly; if it does not, crucial evidence may be destroyed or valuable information, such as client databases, may be passed across to trade competitors. The wealthy private claimant can call upon tertiary industries for assistance. These industries include accounting and computing forensics and private investigators. Although some employers also resort to telephone tapping, great care must be taken to act within the law.[102] An investigation could reveal the extent of the loss, whether there is any risk of insolvency as a consequence of the fraud and the location of the missing assets. Once the claimant's money has been traced through a series of bank accounts and located,[103] the claimant can seek an injunction freezing these assets. It is in these situations that civil search and seizure orders and asset freezing orders come into their own. These orders are sought *ex parte*, so that the claimant has the element of surprise. There are safeguards: the order must be proportionate to a legitimate aim[104] and service of the order must be done by a wholly independent solicitor appointed by the High Court; this solicitor must be present at all times during the search.[105] English courts can give world wide asset freezing orders which are effective as long as the defendant, or institution holding the assets, is subject to English jurisdiction. However, the claimant must demonstrate a good arguable case. In *Grupo Torras SA v Al-Sabah*,[106] Rix J defined it as 'a case which is more than barely capable of serious argument, and yet not necessarily one which the judge believes to have a better than 50% chance of success.'[107] Civil law cases have a lower standard of proof than the criminal law. The fraudster will also have to pay the costs if found guilty. The evidence can (with the judge's permission) subsequently be passed to the police for a follow-up criminal case. Consequently, civil actions still have a significant role to play in the fight against economic crime.

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1.24 Parallel proceedings

Criminal, regulatory and civil actions may result from the same set of circumstances. One example would be a dishonest director who uses his company as a vehicle to defraud creditors and who misappropriates company money: there

[101] Privilege is not available in relation to documents produced, for example, by accountants as part of a general investigation into the fraud: *Price Waterhouse v BCCI Holdings (Luxembourg) SA* [1992] BCLC 583. See further, *Three Rivers District Council v Governor of the Bank of England* [2004] 3 WLR 1274, HL.

[102] There is a right to privacy under Art 8 of the Human Rights Act 1998 and protection offered by the Data Protection Act 1998 and the Regulation of Investigatory Powers Act 2000. See Chapter 2.

[103] See Chapter 3.

[104] *Chappell v UK* (1990) 12 EHRR 1.

[105] 'White Collar Crime: Playing catch-up' *The Lawyer*, November 15, 2004. See Chapter 9.

[106] QBD 14 February 1996; reproduced in (2000) 14 *Trust Law International* 40.

[107] Citing *The Niedersachsen* [1983] 1 WLR 1412, [1983] 2 Lloyd's Rep 600, 605, per Mustill J.

may be a criminal prosecution of the director for fraudulent trading, a civil action by the liquidator for fraudulent trading, director's disqualification proceedings initiated by the Secretary of State and private actions by the creditors themselves. If the director is a member of a professional body, there may be professional disciplinary proceedings by, for example, the Accountants' Joint Disciplinary Scheme. In its Report on Parallel Proceedings, the Financial Regulation Working Group observed:

> Each of these proceedings serves a different set of purposes. In very broad terms, criminal proceedings are concerned with the attribution of blame to a particular individual. Civil proceedings are concerned with the redress of private wrongs principally, but not exclusively, remedying loss suffered. Regulatory proceedings are directed to upholding the statutory or self-regulatory scheme in the public interest. Proceedings before ombudsmen are intended to provide a quicker and cheaper means of remedying loss than civil proceedings. DTI investigations are for the purpose of finding out how the fraud occurred, to assess the impact of the fraud in the wider context and to consider the merits of criminal proceedings and possible law reform.
>
> The functional differentiation of proceedings has its disadvantages. Principally it allows the many different facets of what is often a complex situation to be addressed by processes specifically designed for a range of purposes.[108]

There are difficulties posed by the number of possible different actions available. The Working Group noted that there was a risk of inconsistent decisions on similar facts, duplication of resources, and multiple use of evidence initially obtained for one purpose. The most significant problem was in relation to the disclosure of information as there was a risk that proceedings in one process would prejudice the proceedings in another. The defendant may be obliged to reveal more information in relation to a civil action or regulatory investigation as opposed to a criminal prosecution, where he has the right to remain silent. The position is particularly acute because the defendant's human rights must not be violated by, for example, unreasonable delay or a violation of his privacy.

The Working Group were invited to consider whether there should be a unified system for dealing with complex fraud involving a judge and two lay assessors. The criminal proceedings would be dealt with first followed by regulatory issues; private civil actions would only be heard afterwards. The Group concluded that it was disadvantageous because of the problems of delay.[109] There was also doubt expressed over whether the regulatory investigation should

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[108] Financial Regulation Working Group, The Society for Advanced Legal Studies, Chairman: George Staple QC, December 1999, paras 2.2.–2.3.

[109] ibid, para 6.2.1.

take second place to the criminal prosecution as a fact-finding investigation may be a useful first step.[110]

The law has evolved since the Working Group's Report was published. There have been moves to reduce delays in order to comply with Art 6 of the Convention, although problems still occur.[111] As regards the problems of self-incrimination, the position is that information gathered from a defendant cannot be used in prosecuting him, although it may be used to prosecute others. Information obtained from the defendant may be used against him in civil proceedings but only at the trial judge's discretion where such evidence will not interfere with his right to a fair trial.[112]

Legislation and case law must therefore attempt to achieve a balance between the defendant's human rights and the State's interests to protect the general public by deterring wrongdoers and maintaining confidence in financial institutions and investments. The victim's role should also be added to the equation. The right of the victim to take action is usually seen as a private matter which is often overlooked. This is unfortunate. Victims may have a constructive role to play in combatting fraud. Information which the victim possesses may assist the State. For example, when a company is insolvent, office holders and the receiver have investigatory powers under the Insolvency Act 1986 which are used in dealing with the company's assets. In *Re Patmaenog Timber Co Ltd*,[113] the House of Lords held that information could be gathered under these powers for the purpose of disqualification proceedings. It will a relatively rare case where these powers are exercised solely for the purpose of disqualification proceedings because the company (the victim) will have to bear the costs of the investigation even though disqualification proceedings are brought by the State in the interests of the public. However, it is a useful illustration of how the victim may have a valuable role to play.[114] More broadly, the civil proceedings may be heard before the criminal trial; any evidence which the police acquire from attending civil proceedings may be admitted in the criminal proceedings at the trial judge's discretion.[115]

The following chapters will analyse the law relating to human rights and money

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[110] ibid, para 6.2.2. [111] See s 2.27. [112] See s 2.36.

[113] *Re Patmaenog Timber Co Ltd, Official Receiver v Meade-King, Official Receiver v Wadge Rapps & Hunt* [2004] 1 AC 158, HL; noted R Parry, Disqualification Newsletter (2003) November.

[114] However, information obtained under the statutory powers cannot necessarily be used to benefit others: *Sutton v GE Capital Commercial Finance Ltd; Anglo Petroleum Ltd v GE Capital Commercial Finance Ltd* [2004] 2 BCLC 662, CA (information provided to a debenture holder to enable it to sue a third party).

[115] *Attorney-General's Reference No 3 of 1999* [2001] 2 WLR 56, HL.

laundering and the civil actions available to the private litigant. A complex pattern of rules emerge, only some of which respond to fraud; it will be demonstrated that, in private law, victims of fraud may be assisted by laws which are triggered by a particular fact situation and where the state of mind of the defendant is quite irrelevant.

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