HOW EFFECTIVE IS YOUR SECURITY — THE IMPACT OF RECENT CASES

Linter Case

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INTRODUCTION

This is a comparative law comment on aspects of the Victorian case of **Linter Group Ltd v Goldberg** [1992] considered in the excellent paper of the main speaker.

The main issue examined is the competition between:

(a) a proprietor of money tracing the money into its ultimate product and;

(b) a secured creditor who has security over that product.

In the **Linter** case, Citibank credited a Goldberg company which indirectly financed another Goldberg company to make a bid for Tootal. The money was used to buy some Tootal shares which were then sold. The proceeds of sale were not used to repay Citibank as agreed, but instead for on-lending to another Goldberg company (Arnsberg) to bid for Brick & Pipe shares. Citibank sought to trace the Tootal proceeds into Brick and Pipe shares as a super-priority claim.

CIBC lent money to Arnsberg to help finance the bid for Brick & Pipe and took an equitable mortgage over the Brick & Pipe shares. Most of the other finance came from Linter which lent $205m (77% of its assets) to Arnsberg, a $2 company, without security or documentation. Arnsberg and Linter were ultimately controlled by Goldberg, but were in separate groups.

All the relevant Goldberg companies went into insolvent liquidation. The liquidator of Linter claimed that the directors of Linter breached their fiduciary duties in lending to Arnsberg (because the loan was excessively imprudent and was designed to further the interests not of Linter, but of the Goldberg family as the ultimate beneficiaries of Arnsberg), that therefore Linter could trace its money into the Brick & Pipe shares, and that this claim primed the CIBC share mortgage.

Held: (1) The Citibank claim failed because (inter alia) they could not trace. The Tootal proceeds had been used to retire FX swaps and that was held to break the chain.

(2) The Linter proprietary claim primed the CIBC mortgage because (inter alia) CIBC should have known of the misfeasance by the directors of Linter.

The facts were much more complicated, but the above skeleton indicates the point at issue for present purposes.

COMPARATIVE LAW BACKGROUND

Intense Roman law objection to false wealth - where a debtor has many possessions but little property - which induces creditors to grant false credit. This leads to non-recognition in many civil code states of the following on the bankruptcy of the possessor:

- the trust (including collapse of nominee custodianship of securities)
- goods held by agent for sale or safekeeping unless marked with owner's name
- leases of goods (in a few countries)
- non-possessory chattel mortgages
- non-notified assignments of debts (France, Japan, Korea, Scotland)
- tracing of money.

The 'false wealth' hostility leads to the result that, on the possessor's bankruptcy, property possessed by him but belonging to another go to the possessor's creditors, ie the real owner is expropriated to pay another man's debts. This was seen by the common law countries as so monstrous that they got rid of the doctrine. But the 'false wealth' doctrine clung on tenaciously in English-based states in 'reputed ownership' clauses in bankruptcy statutes for **individuals** (not companies) - finally abolished in England in 1986, although it had been substantially eroded by 1850.

Other civilian objections to possession without ownership are:

- priority contests with purchasers and mortgagees leading to commercial unpredictability (the **Linter** problem)
- fraudulent claims of ownership in collusion with the debtor (there was a strong Napoleonic suspicion of bankruptcy frauds defeating creditors)
- (probably) tax evasion.

EXTENSION OF ENGLISH DOCTRINE TO MONEY

The English policy in favour of protecting creditors against a bankrupt (as opposed to protecting the bankrupt and his unsecured creditors) was (and is) so strong that the trust was extended to fungible liquid invisible money in the following main cases:

- Proceeds of sale of goods or securities held by agents and proceeds of collection held by banks; on the agent's bankruptcy, the money belongs to the principal as a proprietary claim if traceable and if the agent was not permitted to deal with it as his own. Dozens of cases.
- Special purpose payments, eg to enable a debtor to pay his creditors, or loan proceeds for a special purpose, or cash cover for acceptances. On the payee's bankruptcy, often the money resulted back to the payer as a proprietary claim if traceable. Ditto for advance payments, eg subscription money for shares, or for consumer goods. Again, the payee must not have been permitted to deal with the money as his own. Numerous cases.
- Mistaken payments. On the holder's bankruptcy the mistaken payer may have a proprietary claim if the money if traceable. Ditto for accidentally commingled fungible assets (oil, grain). Some important, fairly recent, cases.

- Payments made under ultra vires transactions. On the payee's bankruptcy, his counterparty can sometimes recover his money as a proprietary claim. The most recent case is **West LB v Islington** (1933) - the upshot of the local authority swaps litigation.

- Wrongful takings, especially loss of corporate money by delinquent directors, secret profits and takings by delinquent fiduciaries. On the holder's bankruptcy, the real owner can often get his money back as a proprietary claim if traceable. A host of cases.

In these situations, **depending on the circumstances**, the real owner of the money gets it back in priority to the unsecured creditors of the bankrupt. He is outside the bankruptcy - like a fully secured creditor.

But all of these could theoretically cause a **Linter** problem.

This English-based view about tracing proceeds is rejected by the civil code countries, with very few exceptions. The money goes to the creditors of the bankrupt misfeasant.

WHAT IS REALLY GOING ON?

The main fights are:

- the policy against false wealth is in competition with the policy protecting the real owner of property from the creditors of the possessor of the property

- debtor protection against creditor protection.

The English position is that it is outrageous that, if a wrongdoer misappropriates funds, those funds or their ultimate product or proceeds should go to pay his creditors on his bankruptcy (wrongdoers generally end up bankrupt) and that the victim should be defeated by being left with a mere unsecured claim (which is normally worthless). This position was primarily developed by Lord Mansfield and the courts of equity. But it is completely rejected in, for example, France, the Netherlands, Germany and related countries. In other words, the 'false wealth' policy is overridden in common law states by a higher priority intended to defeat unjust enrichment or misappropriations. The false wealth agreement was seen as obsolete.

But, as soon as one lets in hidden or secret or unseen ownership, there is a collision with the interests of purchasers and mortgagees and potential prejudice to the predictability of commercial transactions. Predictability, security and safety in commercial dealings is a powerful English policy.

ATTEMPTED RECONCILIATION

The attempt to reconcile the competing policies of

- owner protection (eg protecting victims against misfeasants)

- purchaser/mortgagee protection (ie predictability of commercial transactions)

is mainly achieved by the bona fide purchaser doctrine. This has three limbs:

- The person who gets the best title is better off, eg possession of goods, registration as owner (the legal title - the only title recognised in many civil code countries). Hence the English purchaser/mortgagee has a self-help escape hatch - the legal title, such as a legal mortgage of shares.

- The winner must give value - he cannot expect a gift to win. Change of position is effectively value: **Lipkin Gorman** (1992) HL.
- The winner must not know about the prior claim. This is the problem area and the most productive of uncertainty and insecurity - exemplified in **Linter**.

Unhappily, the reconciliation can never be complete, unless one goes for the civilian black/white solution.

It is impracticable to design a formal security registration system to cope with these priority problems, because usually the skullduggery is secret.

The common law approach increases the complexity of legal relationships. This is one of the reasons that civil law seems simpler - it has nothing to do with the archaic view that a legal system is simpler if one writes it down in a code. The degree of 'codification' in legal systems is probably not that different nowadays in substance.

TRENDS IN ENGLISH CASE LAW

The recent English trends seem to be to support predictability but without dropping the fundamental policy of tracing money and protecting deprived owners. This is achieved by limiting the scope of the investigative due diligence duty - ie notice which the claimant would have had if he had made reasonable enquiries (constructive or imputed notice). This is a perceptible move away from a hiccup period in English law - illustrated by the high point 'big pocket' cases of **Selangor** (1969), **Karak** (1972) and **Belmont** (1979). These were all cases of banks as transferees of company money in situations where the company was helping to buy its own shares (a controversial and highly technical corporate rule concerned with the compulsory subordination of share capital to creditors). The current attitude seems more protective of banks and does not insist on elaborate due diligence or the monitoring of corporate behaviour by banks.

Examples:

Lipkin Gorman (1986-1992): The gambling solicitor case. Mere suspicion or unease not enough. Bank is not required to be an amateur detective.

Baden Delvaux (1985): Tail-end of IOS. The reasonably prudent banker does not have to defer all action until he is left with no scintilla of doubt.

Nihill v Nihill (1983): Mere possibility of breaches of trust not enough.

Re Montagu's Settlement Trusts (1987): Trust pictures. Forgotten knowledge is not notice. Genufluxion in the direction of human fallibility.

Barclays Bank plc v Quincecare Ltd [1922]: 'A Hercule Poirot would have made the connection: the law demands a lesser standard of bankers'.

Polly Peck International plc v Nadir (No 2) [1922]: 'The constructive trust test, the "honest and reasonable banker" being put on inquiry (if that is indeed the test), postulates inquiry as to whether or not impropriety is being committed. The test is not satisfied by the inference of no more than curiosity.'

See also **Eagle Trust plc v SBC Securities Ltd** [1991]: The entity was a securities house which had underwritten a share issue.

Cowan de Groot Properties Ltd v Eagle Trust plc [1922] 4 All ER 701: The entity was a property company which had bought three properties.

The first **Eagle Trust** case has a particularly good review of the authorities in this area.

Agip (Africa) Ltd v Jackson and others [1992]: The decision went the other way, but one can see why on the facts of the case.

Comment: In a case such as **Linter**, the courts ought to require actual notice of highly suspicious circumstances and a high degree of obvious corporate mischief to cause a mortgage to be overridden by a group's internal misappropriation claim. The result was to prefer the Linter creditors to the Arnsberg creditors. Otherwise the law requires everyone to be a PhD in constructive trusts and the separate entity theory, as well as a ferret.

TRACING

Recent English tendency **in special cases** to facilitate proprietary claims without insisting on strict rules of tracing by 'hunt the thimble' sequential tracking through substituted assets. Instead, the courts have imposed a super-priority charge:

- **Space Investments** (1986) (Privy Council) (Trustee of a will mixes funds. Tracing not necessary).
- **Chase Manhattan Bank v Israel-British Bank** (1979) (Mistaken payment. Financial machinery of clearing systems ignored).
- **West LB v Islington** (1993) (Ultra vires swap payments paid into overdrawn bank account - but this was not a bankruptcy case).

In other words, the courts ignored the technicalities of finding the asset in order simply to restore the cash as a super-priority claim.

Note also override of strict tracing in the remarkable case of **Re City of Melbourne Bank Ltd** (1895) 21 VLR 563. But if this case were taken up, it would cause serious problems for netting in clearing systems. This is an example of how difficult it is to balance policies in this area.

Comment: In **Linter**, the court broke tracing of the Tootal proceeds when these were used to close out FX contracts (if that is what happened). But FX contracts are executory contracts to deliver money, sharing the characteristics of sale or barter, and are not contracts to pay debts: see the **British American Continental Bank** cases in 1922 and **Bank of India v Patel** (1981). Hence, if in fact there are accelerated exchanges on the close-out of these contracts with the same counterparties (I cannot follow exactly what happened), it is arguable that tracing should have followed through to the A$ proceeds. Tracing flows through into the asset purchased. Note also the dropping of strict tracing, especially in **West LB v Islington**. But the point was academic in **Linter** because Citibank was held to be estopped on other grounds (the court found that it gave up its tracing claim and acquiesced in CIBC's priority on the Brick & Pipe shares).

OTHER LINTER ISSUES

(1) **Director's liability**

- Business judgment rule in England, US, Germany, Scandinavia, but patchy erosion in some jurisdictions. Tracing misfeasant proceeds in England and US.
- Negligence liability in France, Belgium, Luxembourg and (probably) Spain. No tracing in these countries.
- Wrongful trading liability in England, Ireland, but not US or Canada.

Note: Dorchester Finance Co v Stebbings (1989) (Non-executive directors liability for failure to monitor active director who misappropriated company funds).

Bishopsgate Investment Management v Maxwell (1993) (Director wrongfully signed transfer forms for pension shares held in trust).

(2) **Veil of incorporation and groups**

- Erosion of 'separate entity' theory in US (notably by half-way house of equitable subordination), but not in England (except in tax cases).
- Statutory override in Germany under elective regime.

(3) **Inducing breach of contract**

- Probable English caution in negative pledge cases. Reasonable degree of actual (not constructive) notice likely to be required.

(4) **Preferences**

- Low threshold of value in England: preferences to non-insiders are unpopular and the scope of preference law is sharply curtailed by the 'intent' doctrine. Only a few countries contemplate the possibility of security for existing debt escaping if the security is necessary for the debtor to survive: England (**Re M.C. Bacon**) and the Netherlands (sometimes). In most countries work-out security for pre-existing debt in the suspect period is automatically void.

SURVIVAL OF 'FALSE WEALTH' PRINCIPLE

The 'false wealth' doctrine has remarkable powers of survival. It lives on in the following main contexts in common law countries:

- Very elaborate registration systems for non-possessory security, including over fugitive intangibles and ephemeral tangibles. Compare the American UCC Art 9 (and the modified Canadian equivalents) with, say, the hostility to registration in the Netherlands and Germany (which incidentally limited their case law development of the floating charge to a 50% version). English-based registration of corporate charges is an intermediate system.
- Tendency in some states (notably in the US) to recharacterise vendor/lessor quasi-security, eg retention of title, financial leasing, repos, hire purchase, recourse factoring, sale and lease-back etc.

In this area, the civil code/common law classification breaks down completely (as in so many other areas) with numerous civil code countries rapidly developing 'secret' vendor/lessor quasi-security.

Southwell J shattered Justinian's iron wand in **Linter**. Will Australia re-forge it for security and quasi-security?

GENERAL

Which is better - Rome or Melbourne? Or something in between? The law is our servant, not our master.