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## Employee Fraud

### Julian Wilson

1. Last year, the KPMG Forensic Fraud Barometer, a respected survey which has been collating figures on reported fraud for over 25 years, found that insider fraud by employees and management accounted for 48.6% of all companies' fraud losses. That was more than the losses caused by the activities of professional criminals. Employee-perpetrated frauds in the £1m to £10m value range increased more than ten-fold and the perpetrator profile included not only senior executives but also more junior employees using the proceeds of fraud against their employers to fund extravagant lifestyles or gambling habits.
2. Whilst most employers take a firm stance on employee fraud from a disciplinary perspective, the financial consequences of employee fraud are too often regarded as just another cost of business. That attitude does nothing to deter recurrence. But it is to an extent understandable when the legal means of redress are so varied and far from straightforward and employers can feel stranded in the maze of non-complementary criminal and civil procedures. Parallel criminal and civil proceedings have always been a recipe for problems in the control and use of documentary evidence and the effects of the privilege against self-incrimination. The "restraint and confiscation orders" regime in the Proceeds of Crime Act 2002 has added interim relief to the problems menu because of the strictness of confiscation orders and the delays in criminal proceedings reaching confiscation and compensation order stage.
3. We, civil practitioners, have a responsibility to assist in getting employers through this maze and achieving early recovery on a commercial budget.
4. Today I want to explain to you how it can be done by reference to a recent case<sup>1</sup> in which we successfully obtained early summary judgment together with an order for transfer to my client of title in property derived from the fraud.

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<sup>1</sup> LS Systems Limited & Ors v David Scott & Anor, Arnold J. [2015] EWHC 1335 (Ch) (17 February 2015) in which I appeared together with Patrick Halliday also of 11KBW.

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5. The facts of that case are typical and commonplace. The fraudulent employee was our client's financial controller. The fraud consisted of him abusing his authority and control over his employer's on-line banking system to cause payments to be made to bank accounts he controlled and for the fact of his receipt to be disguised in the accounting system by showing the payments as having been made to legitimate suppliers so as to deceive the employer.
6. The armory of available civil claims against such fraudsters is broad. At common law, the obvious claim is in the tort of deceit; and there are claims for conversion; claims for unjust enrichment; or claims for breach of express and implied contractual terms; and where there is multi-party liability, claims in the economic torts. All are supportable by interim freezing injunctive relief.
7. But none of these claims provides a ready and effective means of redress against this typical fraudulent employee. By effective I mean: quick so as to offer the claimant the best chance of early recovery; relatively straightforward and cheap so offering the possibility of summary judgment rather than the substantial expense of Disclosure and trial; and effective in securing recoverable property.
8. Let's consider some of the reasons why.
9. Take the requirements of the natural claim in deceit -- *the deception of C by representation of D*. Despite its ready association with the concept of fraud, the traditional requirements of the tort of deceit do not fit many modern employee frauds. C must prove that D made a representation of fact to C, which C relied on, and which caused him loss. Identifying the representation and reliance can be difficult especially where the fraudster has abused automated payment and accounting systems; so too, the employer's conscious reliance. And the employee's silence (a failure to correct the employer's misunderstanding) may not be enough.
10. And C must prove dishonesty, namely that D knew his representation was false or had no belief in it or was reckless as to its truth. Although the ordinary civil standard of proof applies, courts expect dishonesty to be shown to a higher degree of cogency than honest conduct because their starting point is one of

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improbability that a person has acted dishonestly. Clear and convincing evidence is required which usually means prolonged analysis of oral evidence following full trial. There is still a judicial reluctance in deceit cases to make findings of dishonesty on a summary basis. This was recognised in Lewison J.'s exposition of the test for summary judgment in Nigeria v Santolina Investment Corp [2007] EWHC 437 (Ch):

“Summary judgment: the test...

*(vii) Although there is no longer an absolute bar on obtaining summary judgment when fraud is alleged, the fact that a claim is based on fraud is a relevant factor. The risk of a finding of dishonesty may itself provide a compelling reason for allowing a case to proceed to trial, even where the case looks strong on the papers: Wrexham Association Football Club Ltd v Crucialmove Ltd [2006] EWCA Civ 237 at [57].”*

11. Apart from the substantial costs of full trial, there is also a risk of enhanced liability for costs where a claim of dishonesty fails.
12. If the employer proves deceit at trial, the normal remedy of damages may prove fruitless unless assets have been preserved pending trial by freezing injunction. But freezing injunctions offer no security or priority<sup>2</sup> and the assets can be, and in my experience usually are, substantially diminished or exhausted before trial by living expenses, legal fees or transfers in the usual course of business. This is a problem of all common law claims because of their personal nature.
13. Even in conversion<sup>3</sup> the main remedy is not recovery of the stolen chattels but damages. Whilst a claim for breach of the implied contractual term of honesty and fidelity, implied into every contract of employment, may now offer the remedy of an account rather than damages, that is still a personal remedy. Whilst on its face unjust enrichment appears to offer a simple route to judgment, it is still sufficiently novel and uncertain to preclude summary judgment in many cases<sup>4</sup>.

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<sup>2</sup> A freezing injunction is directed at the defendant personally; it is not an *in rem* attachment of his assets: The Angel Bell [1981] QB 65 at 71-72; C&EC v Barclays [2007] 1 AC 181.

<sup>3</sup> **Conversion** – the requirements: interference by D with a possessory interest of C in tangible assets; D's deliberate dealing with a chattel in a manner inconsistent with C's right whereby C is deprived of use and possession. Conversion – the disadvantages: narrow scope (confined to tangibles, including cheques and coins or notes but not money in banking system or electronic documents or data); main remedy is not recovery of the stolen chattels but damages: s.3 Torts(IwG)Act 1977.

<sup>4</sup> **Unjust Enrichment** – the requirements: D enriched; at C's expense; enrichment unjust, e.g. arose from mistake of C induced by D or failure of consideration; no defence of change of position, or BFPFVWN, or ministerial receipt.

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Claims based on the economic torts are in practice difficult to make out and are incapable of giving rise to proprietary remedies.

14. What then is the answer?

15. Well, there is one claim that recent decisions have shown can overcome each of these difficulties: the equitable claim for breach of fiduciary duty.

16. That was the claim we pursued in the recent case to which I have referred following recent judgments on such claims in summary applications in Psycare v Mundy [2013] EWHC 4573 (Ch) following Ross River Limited v Waverley Commercial Limited [2013] EWCA Civ 910 and in Fern Advisers Limited v Adrian Burford [2014] EWHC 762 (QB).

17. Its advantages are that:

- a) it is a good conceptual fit with modern employee frauds compared to deceit;
- b) the burden of proof is reversed and it is not necessary to prove dishonesty;
- c) summary judgment is therefore more readily achievable;
- d) it enables proprietary interim and final remedies which can provide disclosure, security and priority and enable tracing even into mixed funds and substituted assets and summary vesting orders.

18. Let's examine each of those advantages in a bit more detail.

## The good conceptual fit

19. There is no universally accepted definition of a fiduciary but its origin is trust law.

A fiduciary is someone who has undertaken to act for another in a particular

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Unjust Enrichment – the disadvantages: its pleading (reluctance of courts to abandon old technical forms of action); its uncertainty (still an area of law that is not settled so summary judgment is not guaranteed, e.g. Esprit Telecom UK Limited v Fashion Gossip Limited CA (2000)); the contract exclusion zone (if D used a contract to induce payment and performance does not materialize as expected only a total failure of consideration will permit this claim: Taylor v Motability [2004] EWHC 2619 (Comm)).

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matter or transaction in circumstances which give rise to a relationship of trust and confidence. By reason of the trust and confidence with which the fiduciary is bestowed, the fiduciary has an obligation of undivided loyalty to the principal, requiring him to put the principal's interests first and before his own (sometimes called *self-denying loyalty*). Facets of the duty include obligations to act in good faith; the "no conflict rule" requiring him not to be swayed by considerations of personal interest; and the "no profit rule" which precludes the fiduciary from actually misusing his position for his personal advantage<sup>5</sup>.

20. My case, like most employee fraud, involves the abuse of the employee's position of trust to *feather his own nest* at the expense of his employer. He prefers his own selfish interests over his duty to act in the interests of the employer in effecting the transactions for which he has been trusted with authority -- just the form of conduct that fiduciary duties preclude.

21. But generally employees who are not directors do not owe fiduciary duties. The basis of their relationship is contractual and statutory, not derived from trust. As Elias J. said in University of Nottingham v Fishel [2008] ICR 1462:

*"The essence of the employment relationship is not typically fiduciary at all: its purpose is not to place the employees in a position which he is obliged to pursue his employer's interests at the expense of his own."*

22. But, as he continued, the employee may have undertaken specific contractual obligations, the functions of which have placed him in a situation where equity imposes these rigorous fiduciary duties in addition to the contractual obligations owed.

23. It is necessary to identify with care the particular duties undertaken by the employee and to ask whether, in all the circumstances, he has by undertaking these duties placed himself in a position of self-denying loyalty with regard to

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<sup>5</sup> See Bristol & West BS v Mothew [1998] Ch. 1; Chan v. Zacharia (1984) 154 CLR 178,198 cited with approval in Don King Productions Inc v. Warren [2000] Ch 291 and in Ultraframe (UK) Ltd v Fielding [2005] EWHC 1638

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their carrying out. Each activity, each transaction or group of transactions, must be looked at: Fishel (above).

24. When analysed with real care by reference to the contractual role and job description, the employment duties of most of those employees who engage in typical *nest feathering* fraud include functions and responsibilities which are a source of fiduciary obligation. In particular, they usually involve dealings with the employer's monies or property for which the employee is trusted to act honestly and loyally with regard to those monies. So in my recent case, the financial controller's functional responsibilities included authority for making on-line banking transactions with his employer's bank accounts. Carefully defining the functions of the employee giving rise to the fiduciary obligations and showing that the frauds were perpetrated in the discharge of those functions is the only difficult part of pleading this claim.

*The burden of proof is reversed and there is no need to show fraud or dishonesty*

25. The primary obligation of a fiduciary is to account to his principal for his dealings with the principal's money. The obligation is a strict one and does not depend on the principal showing fraud or loss:

*“The rule of equity ... insists on those, who by the use of a fiduciary position make a profit, being liable to account for that profit, in no way depends on fraud, or absence of bona fides; or upon such questions or considerations as whether the profit would or should otherwise have gone to the plaintiff, or whether the profiteer was under a duty to obtain the source of the profit for the plaintiff, or whether he took a risk or acted as he did for the benefit of the plaintiff, or whether the plaintiff has in fact been damaged or benefited by his action. The liability arises from the mere fact of a profit having, in the stated circumstances, been made. The profiteer, however honest and well intentioned, cannot escape the risk of being called upon to account”*

Regal (Hastings) Ltd v Gulliver [1967] 2 AC 134, per Lord Russell of Killowen at 144G-145A.

26. In a number of recent judgments, the courts have reiterated and emphasised that this obligation operates to reverse the ordinary burden of proof whenever the principal questions the fiduciary's dealings with the principal's monies. In such circumstances, the onus lies on the person owing the fiduciary obligations to establish the propriety of any particular payment and to account for it. So, in Ross

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River Limited v Waverley Commercial Limited [2013] EWCA Civ 910, the Court of Appeal made clear at [94] that:

*“Where a person is subject to a fiduciary obligation as regards his dealings with assets, then it is up to that person to establish the justification for his dealings, if there is any contest, rather than for it being for the beneficiary (i.e. the person to whom the obligation is owed) to prove that payment was not justified.”*

27. In Psycare v Mundy [2013] EWHC 4573 (Ch) Carr J at [30] - [31] applied that reverse burden finding that it was particularly appropriate where on the facts the recipient is the fiduciary himself and, in such circumstances, the burden is a heavy one:

*“The burden lies on the person owing the fiduciary obligations in case of any doubt to establish the propriety of any particular payment and to account for it. This in my judgment is particularly so where on the facts, as here, the admitted recipient is the fiduciary himself. There is a heavy burden to account and justify.”*

Summary judgment is more readily achievable

28. Because the fiduciary obligation to account does not depend on the employer proving the fiduciary’s dishonesty, the court’s investigation on a summary judgment application is directed to whether the defendant fiduciary has a real prospect of discharging the onus of establishing the propriety of the payments. The whole focus of the court’s analysis is on the defendant’s ability to satisfy the onus on him as a fiduciary.
29. The strictness of his obligation to account makes summary judgment achievable. So, in Psycare (above) where the allegations were misappropriation, summary judgment was granted against the defendant fiduciary where the court found that he would not be able to satisfy the burden because he had failed to provide explanations supported by any documentary evidence. And in Fern Advisers (above) where the allegations amounted to theft, summary judgment was granted against the defendant fiduciary where the court found there was no purpose in a trial because the fiduciary’s account defied commercial sense.



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30. And in our recent case, summary judgment was granted against the defendant fiduciary when the court accepted my submission that the justification advanced by him, that the monies represented a “commission” paid pursuant to an unparticularised oral agreement, was preposterous and showed that he would not be able to satisfy the onus.

31. Of course, summary judgment was not a “doddle” - time and care was needed to marshal the evidence and to make it understandable and persuasive and thorough. The claimant has to ensure that the evidence is sufficiently comprehensive if he is to avoid the defendant escaping judgment on the basis that disclosure is necessary. This is the problem highlighted by another recent case - Exsus Travel Ltd & Ors v James Turner [2014] EWCA Civ 1331 - which whilst again confirming that, on the taking of an account the accounting fiduciary carries the burden of proof, held further that where the principal was alleged to have failed to disclose material documents, the evidential burden would then shift to the principal to either deny the assertion, with cogent reasons, or to produce the records.

*It enables proprietary interim and final remedies which can provide disclosure, security and priority, and enable tracing even into mixed funds and substituted assets and summary vesting orders*

32. In addition to the fiduciary’s personal obligation to account for his dealings with his principal’s monies, where any fiduciary obtains a benefit from his principal in breach of his fiduciary duty, he holds the benefit, being not merely the property but also its proceeds, on constructive trust for his principal. The principal has a proprietary claim over the property and proceeds against the defendant and against anyone who derives title from him except a bona fide purchaser for value without notice of the breach: Foskett v McKeown [2001] 1 AC 102 at 127 (per Lord Millett) and 108 (per Lord Browne-Wilkinson).

33. So where a fraudulent employee owing a fiduciary duty has improperly received his employer’s monies or property, the employer has a proprietary claim to assert his beneficial ownership to the monies or property, their proceeds and any



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substituted assets (including uplifts in value of investments) or can enforce an equitable lien or charge on the proceeds in support of the personal claim to secure restoration: see Foskett (above) at 130A - 131H per Lord Millett and see Boscawen v Bajwa [1996] 1 WLR 328 where Millett LJ said:

*"If the plaintiff succeeds in tracing his property, whether in its original or in some changed form, into the hands of the defendant, and overcomes any defences which are put forward on the defendant's behalf, he is entitled to a remedy. The remedy will be fashioned to the circumstances. The plaintiff will generally be entitled to a personal remedy; if he seeks a proprietary remedy he must usually prove that the property to which he lays claim is still in the ownership of the defendant. If he succeeds in doing this the court will treat the defendant as holding the property on a constructive trust for the plaintiff and will order the defendant to transfer it in specie to the plaintiff. But this is only one of the proprietary remedies which are available to a court of equity. If the plaintiff's money has been applied by the defendant, for example, not in the acquisition of a landed property but in its improvement, then the court may treat the land as charged with the payment to the plaintiff of a sum representing the amount by which the value of the defendant's land has been enhanced by the use of the plaintiff's money. And if the plaintiff's money has been used to discharge a mortgage on the defendant's land, then the court may achieve a similar result by treating the land as subject to a charge by way of subrogation in favour of the plaintiff."*

34. The power of the proprietary claim includes the following aspects.

- a) It permits interim proprietary injunctions against the fiduciary and against third party recipients to restrain dealings with the employer's monies and property. Unlike freezing injunctions such orders do not aim to prevent dissipation of the respondent's general assets to defeat judgment at trial; they operate to vindicate the claimant's proprietary rights in specified assets. So unlike freezing injunctions they give security and priority over other creditors. The assets "frozen" cannot be used to fund the respondents' ordinary living or legal expenses nor to make payments in the ordinary course of business. Such injunctions are made on the American Cyanamid basis unlike freezing injunctions.
- b) It permits ancillary disclosure orders at an interim stage requiring the disclosure of the present whereabouts of the claimant's monies or their proceeds: CPR r.25.1(1)(g); A -v- C [1981] QB 956.

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- c) It permits the employer to obtain orders for disclosure against the fraudulent employee's banks of dealings in the accounts into which the employer's monies were received for the purposes of following or tracing the monies because equity will act energetically to preserve or restore a trust fund: Bankers Trust v Shapira [1980] 1 WLR 1274 CA.
- d) It permits tracing in equity into and through mixed funds, through banks' clearing and electronic payments systems and into substituted assets. In my experience, the most commonly substituted assets are houses or cars, particularly white Range Rovers which tend to be the vehicle of choice for fraudulent employees! Where the substituted assets are houses, the claimant takes any increase in value and therefore real property investments by the fraudster will normally represent the claimant's best prospect of substantial recovery
- e) It can be made against third party recipients from the fiduciary and restricts such recipients' defences to "bona fide purchaser for value without notice". Most fraudulent employees use others to hide or launder their gains in circumstances where invariably the transactions were not bona fide or value was not given or the recipients were on notice that the payer did not have good title. Compare the more demanding requirements in a personal claim against a recipient from the fiduciary of showing knowing (now unconscionable) receipt.
- f) It enables the claimant to vindicate his rights to property made subject to a criminal restraint order. Even those with personal claims who have secured a judgment for liquidated damages against the defendant cannot seek to enforce that judgment while a restraint order is in place. Only those with proprietary claims can obtain a variation to a restraint order, see SFO v Lexi Holdings PLC (In Admin) [2009] 2 WLR 905.
- g) It can be combined with personal claims.

35. In our recent case, we obtained early disclosure orders against the fraudster's bank on the Bankers Trust basis and by careful tracing could show that a

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substantial part of the misappropriated sums had been applied in the purchase and development of 3 houses. At the summary judgment hearing, we sought and successfully obtained judgment and an order that the fraudster convey title in those properties to our client. After the fraudster failed to convey title within the time permitted, we obtained an order vesting title in the employer. The increase in value of the principal property will have made up for other irreversible dissipations.

36. The moral of this tale is that employee fraud does not have to be treated as a cost of business. There are recovery mechanisms which skillfully employed can lead to recoupment.

**Julian Wilson**

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