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Briefing note November 2012

Corporate assets and divorcing couples: a modern day Wars of the Roses?

A big money divorce case has exposed a fissure between the Judges of the Family Division of the English High Court and those who sit in the Chancery Division. The battles lines are firmly drawn: on the one side, the Family courts wish to do justice between divorcing spouses; on the other, the Chancery Division Judges wish to uphold the basic tenets of English property law. The Court of Appeal's decision in *Petrodel Resources Ltd v Mrs Yasmin Prest* [2012] EWCA Civ 1395 is the latest instalment. For now, the house of Chancery has gained the upper hand, with the Court of Appeal reaffirming the distinction between a company and its shareholders.

The Wars of the Roses were a series of dynastic wars fought between supporters of two rival branches of the House of Plantagenet, the houses of Lancaster and York, for the throne of England. They were fought in several sporadic episodes between 1455 and 1485 before final victory went to Henry Tudor, formally a Lancastrian but who married a Yorkist and in reality started his own royal house. A similar battle has been raging for some years now in big money divorce cases between the Judges of the Family and Chancery Divisions.

Corporate assets

Mr and Mrs Prest were married for nearly 20 years and amassed significant wealth over that time, including a number of London properties, most held in the name of three companies owned and controlled by Mr Prest. On Mr and Mrs Prest's divorce, the key questions for the trial judge charged with splitting the assets between them were the extent of Mr Prest's wealth, including the nature and extent of his interest in the companies, and whether the Judge could make orders directly against properties held in the name of the companies. The case turned on the meaning of section 24(1)(a) of the Matrimonial Causes Act 1973 ("... the court may make... an order that a party to the marriage shall transfer to the other party... such property as may be so specified, being property to which the first-mentioned party is entitled, either in possession or reversion..."). Did the properties held in the name of the three companies fall within the scope of section 24(1)(a) and thus within the power of a judicial order?

The matrimonial home had been bought using the husband's money but held in the name of one of the companies, PRL. The judge said that if it were necessary, he would have held that this home was held by PRL on trust, or as a nominee, for Mr Prest and ordered its transfer to Mrs Prest. There was no appeal against that order and the Court of Appeal did not interfere with it.

Key issues

- The distinction between a company and its shareholders must be respected
- Divorce law does not allow the assets of a company to be treated as the assets of one of the spouses
- That can be done in the rare cases when the corporate veil can be pierced
- But matrimonial homes may be different

The appeal instead concerned the seven other London properties held by PRL and another company ultimately owned by Mr Prest, Vermont. The companies were not established under English law but the case proceeded on the basis that English law applied to them.

At trial, the Judge held that Mr Prest effectively ran the companies and drew from PRL whatever he and his

family required. In these circumstances, the Judge side-stepped well over a century of precedent distinguishing between the assets of a company and the assets of the owner of the company. The Judge held that the properties in the names of PRL and Vermont were caught by the MCA 1973 and ordered that they be transferred to Mrs Prest. The companies, not Mr Prest, appealed.

Fairness orders

The Court of Appeal was split. One Lord Justice, hailing from the Family bar and the Family Division, delivered a judgment strongly in favour of the trial judge's decision. Thorpe LJ said that the court's power to redistribute assets on divorce came into being in 1971 and that their development in subsequent case law had been a gradual process ultimately aimed at enabling divorce judges "to do justice".

The decision "present[s] an open road and a fast car to the money maker who disapproves of the principles developed by the House of Lords... in big money [divorce] cases" (Thorpe LJ)

In an attack on the decision of the majority, Thorpe LJ said that he believed he was following years of case law in the Family Division. If the Court of Appeal was now to conclude that all those cases were wrongly decided, it would "present an open road and a fast car to the money maker who disapproves of the principles developed by the House of Lords... in big money [divorce] cases." So for Thorpe LJ, the trial judge had sought to do justice and that was enough to justify the orders made.

Corporate law prevails

Disagreeing with Thorpe LJ, Rimer LJ (hailing from the Chancery bar and the Chancery Division) delivered a long and detailed judgment in favour of the appellant companies. He reminded the reader that *Salomon v Salomon* [1897] AC 22 provides the highest authority for the principle that a duly incorporated company is a legal entity wholly separate from those who incorporate it, with rights and liabilities of its own. He described as "heretical" the suggestion that a single individual's total control over the affairs of his one-man company means that the company's assets are the individual's assets. Rather, those who control a company's affairs act merely as the company's agents.

In strong language for a judge, Rimer LJ said that the trial judge's finding to the opposite effect was "astonishing and does not begin to pass muster". Put simply, Rimer LJ reasoned that even in a one-man company, the shareholder cannot lawfully to distribute to himself the entirety of his company's assets at any time - only distributable profits are capable of being distributed. That is plainly right.

Rimer LJ also considered the position of third party creditors. If the trial judge had been right, Mr Prest would have been entitled to assert upon liquidation of the companies that the remaining assets belonged to him and that there was nothing available for the creditors. Rimer LJ said that if that had been correct, third parties would be unlikely ever again to be willing to trade with one-man companies.

The trial judge had considered whether it was possible to pierce the corporate veil but concluded that he could not do so. Rimer LJ agreed that it was not possible to pierce the corporate veil as there was no evidence that the creation of the companies had been used to conceal impropriety, as would have been the case if the properties had originally been beneficially owned by Mr Prest but belatedly transferred into the names of the companies in order to defeat his wife's claims. Without a basis to pierce the corporate veil, the majority decided that the assets of the companies could not be treated as if they were assets of Mr Prest for the purposes of section 24(1)(a) of the MCA 1973.

Any other decision would be "astonishing and [would] not begin to pass muster" (Rimer LJ)

The focus of the case both at trial and on appeal was the Court's ability to order the transfer of real estate held in the names of companies. It is unclear why the Court did not spend more time considering an order to transfer the shares in those corporates.

Thorpe LJ briefly noted that, in the course of argument, the Court of Appeal had been referred to the process of "telescoping", which involves ordering an individual to transfer shares or to vote himself dividends or loans as a route to the property. Thorpe LJ described this as cumbersome, expensive and uncertain to achieve the desired end: "It is to import the discipline of company law into a situation where at all material times the individual has not respected or utilised that discipline." But, curiously, he then said that the point hardly arose as none of the parties had advocated it. The majority of the Court of Appeal did not mention the point at all, though they were certainly keen on the disciplines of company law.

A cheat's charter?

The Court of Appeal's decision has received press attention and commentary to the effect that it is a "cheat's charter", but this ignores the ability of the courts to pierce the corporate veil when faced with impropriety and to make orders with regard to the shares in a company. Indeed, Rimer LJ said in terms that the court will not be bamboozled by the use of shams and artificial devices to pretend that property is owned by entities other than the spouse in question.

Ultimately, Rimer LJ found that it is not open to a court to disregard the separate identity between a company and its members simply because a court regards it as just and convenient: "A one-man company does not metamorphose into the one-man simply because the person with a wish to abstract its assets is his wife."

Patten LJ (another former Chancery Division judge) agreed with Rimer LJ. His reasons were brief and pointed: "Married couples who choose to vest assets beneficially in a company for what the judge described as conventional reasons including wealth protection and the avoidance of tax cannot ignore the legal consequences of their actions in less happy times."

This comment does of course beg the question whether both the husband and the wife "chose" to vest assets beneficially in a company – in some cases, the structuring may be overseen by just one of the spouses with relatively little transparency for the other.

So where are we now?

Pending any appeal by Mrs Prest, divorcing spouses in her position will be confronted with a major obstacle - a legal principle that resort to fairness alone cannot overcome. They still have the means to attack corporate structures, perhaps through "telescoping" orders, but piercing the corporate veil is difficult. If spouses are forced to pursue claims that the corporates are concealing impropriety, this will up the stakes in big money divorces. Professional third parties may face significant reputational risk if they are dragged into that mire.

The matrimonial home may be in a slightly different category. The Court of Appeal did not interfere with the order made in *Prest* even though the distinction between how it and how the other London investment properties were held is not obvious.

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For wealth planners and trustees, *Prest* is judicial encouragement for genuine corporate structures. For those structures to pass the scrutiny of the divorce courts, it will be important to show how transactions were financed, for decisions to be taken by directors and documented in formal minutes, and for accounts to be properly prepared.

For lenders and other creditors, *Prest* is positive. But this area is plainly dynamic, and loans for matrimonial homes may be treated differently from properties held for investment purposes. Where possible, lenders will want to take security over the underlying assets but they may also want to carry out due diligence as to the company's source of funds and the extent to which proper governance procedures are followed.

Unsecured creditors may also want to consider how they can seek to guard against later claims by the spouse that the company is a sham to conceal impropriety. Unless the spouse is a director in the business, this may be difficult to achieve.

To conclude, the judicial Wars of the Roses are not yet over. We understand from press coverage that Mrs Prest is going to seek permission to appeal to the Supreme Court. Even if she is given permission, we would not anticipate judgment being issued for some months. In the meantime, the battle lines are clear as between the Houses of Chancery and Family. *Prest* is an important victory for the former but further skirmishes lie ahead. What any Tudor-style settlement between the hostile factions might look like is not clear.

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