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# Armstrong v Winnington – taking allowance(s) with the law?

On 17 October 2011 the first trial concerning cyber theft of EU Allowances from a Member State registry took place in the English High Court. Although the value of the claim was small, the resulting judgment decides legal issues having wider implications for the carbon markets.

**Introduction**

The claimant in this case was Armstrong DLW GmbH ("**Armstrong**"), a German subsidiary of an international flooring manufacturer. Armstrong owned and held 22,000 EU Allowances ("**EUAs**") in its account in the German national registry. On 28 January 2010 Armstrong was the victim of a 'phishing scam'. An Armstrong employee received an email purporting to be from the German national registry and responded by offering up his account details by replying to the email. These details were then used by the sender of the phishing email within a matter of hours to transfer 1,000 of Armstrong's EUAs to an account in the Danish registry and the other 21,000 EUAs to the defendant's account in the UK registry (as described below).

The defendant was Winnington Networks Limited ("**Winnington**"), a UK-based commodities trading company that trades in, amongst other things, EUAs. Winnington was approached by a company called Zen Holdings Limited ("**Zen**") who posed as the legitimate owner of the 21,000 stolen EUAs. Zen sold the EUAs to Winnington for €267,645 who then, almost immediately, onward sold them via a broker to a third party making a profit of €4855 in the process.

Armstrong made a claim against Winnington in respect of the stolen EUAs even though Armstrong no longer held them and had itself purchased them at a price which was not said to raise suspicions. The case was tried by Deputy High Court Judge Stephen Morris QC (hereafter "**Morris J.**") over a 5 day trial in October 2011.

**The Background**

On 28 January 2010, Winnington was contacted by a Mr Singh who claimed that Zen had 21,000 EUAs to sell. A few days earlier Mr Singh had contacted Winnington to express Zen's interest in doing business and Winnington had responded by asking Zen to provide the information necessary for Winnington to conduct its "Know Your Client" checks ("**KYC**"). During the trial, Winnington had claimed that the KYC information was not sought to check that the seller was the owner of the EUAs, or that it

## Key issues

- **EUAs were held to be intangible property, although the Judge failed to classify which *type* of intangible property they were.**
- **The Judge considered that having control "ministerial control" and deemed possession was sufficient to give a thief de facto legal title. There was no consideration of how this view fits with the *nemo dat* principle.**
- **According to this Judgment, a *bona fide* purchaser for value without notice can not only be used to defeat an equitable claim, it can also be used to defeat a legal claim.**
- **The Judge rationalised that 'knowledge = notice = bad faith', ensuring that a *bona fides* defence could not be successfully relied upon by Winnington.**

had authority to sell them but rather to prevent money laundering and VAT carousel fraud.

Zen had, however, failed to provide all of the information requested by Winnington. Irrespective of this, Winnington went ahead with the purchase in the comfort that they did not have to settle payment for the spot EUAs until after delivery.

Zen then transferred the EUAs from Armstrong's account directly into Winnington's UK account. Winnington asked Zen to provide the remaining KYC documentation and, significantly, asked them to confirm that the account number from which the 21,000 EUAs were transferred belonged to Zen. Despite an absence of response, Winnington made payment to Zen and continued to request the missing KYC the following day, albeit to no avail. Before paying Zen, Winnington had transferred the EUAs to its broker that had already quoted an indicative price. This quote had informed Winnington's decision as to the price it was going to offer Zen for the EUAs.

**The Claims**

Armstrong's claims were advanced on three alternative basis: (1) a proprietary restitutionary claim, (2) a claim for unjust enrichment, and (3) a claim for unconscionable receipt of trust property. The claim for unjust enrichment failed because Winnington had paid full value for the EUAs, and not had merely received the EUAs from Zen and that legal title had passed from Armstrong. The judges reasoning in relation to the other two heads of claim merits more detailed analysis.

1. *Proprietary restitutionary claim*

Armstrong sought to enforce its rights at common law by way of "a claim to vindicate its proprietary rights in the EUAs". According to Morris J.:"if and where legal title remains with the claimant, a proprietary restitutionary claim at common law is available in respect of receipt … of a chose in action or other intangible property". In order for this claim to therefore, exist it was fundamental that, notwithstanding the theft, Armstrong retained legal title to the EUAs. The importance of this premise is seen when contrasted with the alternative basis for Armstrong's claim.

Morris J. acknowledged that Winnington's argument that it was a bona fide purchaser for value without notice (i.e. it had bought the EUAs in good faith with no notice as to the theft) could be a defence (the "***bona fides* defence**") to a proprietary restitutionary claim.

2. *Claim for unconscionable receipt of trust property*

The alternative basis for Armstrong's case was a personal claim in equity based on Winnington's knowing or unconscionable receipt of the EUAs or their traceable proceeds. Such a claim implicitly recognises that legal title in the EUAs had passed to Winnington and looks at whether that legal title is subject to an equitable or trust interest in favour of the victim of the theft.

In his judgment Morris J. recognised that a vital element for such a claim was that the property, which the defendant receives must, at the time of receipt, be "trust property". As per Morris J.:"legal and equitable title must have become separated by the time of receipt of the property by the defendant". In short, Armstrong must be able to demonstrate that the stolen EUAs were subject to a trust before they were received by Winnington and not that a trust was created upon Winnington's receipt.

In order to find a basis for this claim, Morris J. concluded that the thief became the trustee of the EUAs at the time of the theft, and that it held them on constructive trust for Armstrong. Thus, legal and equitable title must have been separated at the point at which the allowances were deemed to have been stolen.

Another element that Armstrong would have to demonstrate in this claim, is that Winnington had knowledge of matters that would make it unconscionable for it to retain the stolen EUAs. Therefore, it was Winnington's defence that it had no such knowledge.

**The Judgment**

In reaching his decision in favour of Armstrong, Morris J. reached a number of conclusions, the main ones of which are as follows:

1. *EUAs as property*

One of the main issues of law relevant to the case identified by Morris J. was "what is the nature of an EUA as property, and in

particular is it chose in action or a form of other intangible property?". Sadly, whilst finding that an EUA is indeed 'intangible' property, Morris J. does not reach a conclusion on what type of intangible property it is.

He does however, express a view that EUAs are not strictly a chose in action "in the narrow sense" because "they cannot be claimed or enforced by action. However to the extent that the concept encompasses wider matters of property, then it could be so described". He also finds that EUAs are not choses in possession.

Ultimately, he states that the legal classification is not relevant for the purposes of his decision.

2. *Transferring title in EUAs*

The proprietary restitutionary claim brought by Armstrong rested on the idea that legal *and* equitable title to the stolen EUAs remained with Armstrong. In contrast, the claim for unconscionable receipt of trust property, brought in the alternative, is based on the idea that the thief gets legal title to the EUAs whilst equitable title remains with Armstrong. Logically, therefore, the accuracy of one of these positions is fatal for the other. Either title did pass to the thief or it did not.

Morris J. held that "some form of *de facto* legal title "was obtained by the fraudster". On this basis, he was compelled to decide the dispute by reference to Armstrong's claim for unconscionable receipt of trust property. But he went on to say that, should he be wrong about the separation of legal and beneficial title in the EUAs, then Armstrong should succeed in its proprietary claim because Winnington's *bona fides* defence could be defeated by Winnington's notice or absence of good faith.

Arguably, by not classifying what type of legal intangible property right an EUA was (see above), Morris J. avoided any detailed analysis of how legal title in such property passes.

In fact, in order to justify his finding that legal title had passed to the thief, he concluded that "the fraudster had obtained ministerial control" of the EUAs in Armstrong's account in the German registry by obtaining access to Armstrong's account. The fraudster was therefore, to be "as in possession of the EUAs".

3. *Knowledge is Notice*

Winnington's defence to the claim of unconscionable or knowing receipt of trust property, was that they did not have the requisite knowledge. Winnington's defence to the proprietary restitutionary claim was the *bona fides* defence. Morris J. concluded that the defences in either claim were unsuccessful for, principally, the same reason. Since he found 'knowledge' and 'notice' (as applied to each of the defences) to be the same thing[1], his finding on the facts that Winnington had the requisite knowledge for the purposes of unconscionable receipt, meant that Winnington had notice, therefore preventing it from availing the *bona fides* defence.

Morris J. relied on the classification of types of knowledge in the case of *Baden v Societe Generale pour Favoriser le Develoment du Commerce et de l'Industrie en France SA*[2] (**"Baden"**) to indentify the knowledge necessary to make Winnington's receipt of the stolen EUAs unconscionable. The five different types of knowledge indentified in Baden were:

1. Actual knowledge;
2. Wilfully shutting one's eyes to the obvious;
3. Wilfully and recklessly failing to make such enquiries as an honest and reasonable man would make;
4. Knowledge of circumstances which would indicate the facts to an honest and reasonable man; and
5. Knowledge of circumstances which would put an honest and reasonable man on inquiry.

In the context of the equitable claim, Morris J. concluded that knowledge of types 1 to 3 would automatically render receipt of trust property "unconscionable", whilst knowledge of types 4 and 5 would only render receipt unconscionable subject to the reasonable man test.

[1] "the tests for knowledge and for notice overlap considerably", per Morris J at para.131

[2] [1993] 1 WLR 509

Pursuant to this test if, knowing what the defendant knew, a reasonable person would have either appreciated that the transfer was probably in breach of trust or would have made inquiries or sought advice which would have revealed the likelihood of a breach of trust, then such knowledge would render receipt of the trust property unconscionable.

On the facts of the case, he determined that Winnington either deliberately closed their eyes to the risk or possibility that the allowances were stolen (type 2 knowledge) by failing to acknowledge the alarm bells which began ringing when Zen failed to supply the requisite KYC information, or that they wilfully and recklessly failed to make the enquiries which an honest and reasonable man would make (type 3 knowledge); in particular, because Winnington failed to follow through with the inquiries that it itself made.

In the context of the defence to the proprietary restitutionary claim, Morris J. concluded that knowledge of types 1 to 3 constitute notice without having to show that the defendant realised that the transaction was "obviously" or "probably" improper or fraudulent. However, knowledge of types 4 and 5 only constituted notice if they passed the 'reasonable man' test.

Morris J. found that, on the facts, that Winnington had "notice" within the Baden types (for knowledge) 2 and 3.

But even if his findings of fact were wrong on the above, he also found that Winnington had notice under Baden types (for knowledge) 4 and 5. According to Morris J., if Winnington had made further enquiries or had sought advice in relation to the transaction, the probability of the breach of trust, or the probability that the EUAs did not belong to the thief, would have been revealed.

Therefore, Morris J. found for Armstrong primarily on the claim of unconscionable receipt of trust property. However, if he was wrong in his conclusion that legal title had passed to Winnington, he would equally find in favour of Armstrong on the basis of the proprietary restitutionary claim.

## Comment and analysis

### *Legal classification of EUAs*

This case raises a number of interesting points. This was the first case with an opportunity to provide a legal classification for an EUA under English law. Although the Judge finds that they are intangible property (in contrast to a personal licence or some other right), by not determining what type of intangible property right it is, he avoids making a finding that might have had a fundamental impact on whether Armstrong had a claim in the first place.

If the theft occurred in the German registry account of Armstrong, the question of whether title passed to the thief by reason of the thief's access to the account would more likely be determined by principles of German than English law. The judgment however, doesn't even acknowledge that possibility, probably because neither party argues that German law applied. If German law had applied, the conflicts of law position under English law would have been an additional consideration for the Judge.

Without knowing how title in EUAs pass, how does Morris J. determine whether Armstrong retained or lost its legal title in the stolen EUAs?

This is something that, of course, cannot be done unless you first know whether an EUA is a chose in action, a chose in possession or something else. After all, the requirements for the transfer of a chose in action (typically assignment) are different from those of a transfer of a chose in possession. Admittedly, an EUA doesn't fit into any traditional category perfectly, but Morris J. avoids trying to find the best fit for it amongst those that do exist.

More worrying is that the Judge does not consider the common law rule of *nemo dat quod non habet*[3]. Under this rule, only the legal owner of the property (or someone who has been authorised or held out as being entitled to dispose of it) can make a disposition which will be effective to divest the owner of his title. Applying *nemo dat* would make it clear that no legal title could have passed to the thief. If so, Armstrong would not have needed to resolve

[3] Traditionally, no person could give better title than he himself had

to the equitable claim because it could assert a proprietary claim.

***Taking allowance with the law***

In order to justify his conclusion, Morris J. takes a number of leaps of faith in relation to established principles of English law.

When causes of actions are framed (as it was in this case) the difference between a claim for unjust enrichment and a proprietary claim are not often clear. However, in practice the impact is significant as one is an equitable remedy and the other is a common law remedy, each with distinct defences. The leading cases dealing with unjust enrichment and proprietary restitution however, relate to tracing the proceeds of the original asset and not to following the asset itself (which requires the claimant to have a pre-existing property right).

In this case, tracing was not relevant. Therefore, Morris J. interprets the leading authorities[4] on unjust enrichment (an equitable remedy) as authorities on proprietary restitution (a legal remedy). By doing so, he made available to Armstrong a proprietary restitutionary claim that it might not otherwise have had.

The knock-on effect of this, of course, was that the *bona fides* defence (otherwise known as equities' darling) had also to be made available as a possible defence to a legal claim (as opposed to just the equitable claim for which it became everyone's darling).

After all, having relied on the trio of equitable remedy cases as authority to for a legal claim, Morris J. couldn't just ignore Lord Millet's dicta in Fosket: "An Action like the present is subject to the bona fide purchase for value defence, which operates to clear the defendant's title"[5]. Therefore, he had to find that the *bona fides* defence is available not just to defeat equitable claims, but also to defeat legal claims. This was a consequential leap resulting from his previous one.

Thirdly, despite the fact that he recognised that "there is often overlap between, and sometimes a mixing up of, the concept of "notice" for this [*bona fides*] defence and the concept of "knowledge" in the context of knowing or unconscionable receipt of trust property", he goes on to argue that there should be not any relevant distinction between the two concepts. In short, he is happy to mix these concepts up and clearly does so in equating knowledge with notice.

Morris J. goes so far as to suggest that "commercially unacceptable conduct", where the defendant had knowledge of certain facts, is sufficient to constitute constructive notice under Baden knowledge types 4 & 5. He, however, fails to determine those "certain facts" of which a defendant must have "knowledge" and, in the absence of any kind of standard, essentially equates "notice" to "bad faith" or, to use the Judge's terminology, "commercially unacceptable conduct".

Even though he recognises that "notice" and "good faith" have distinct ingredients, he cannot see a situation where someone found to be acting without good faith could not have had notice. Therefore, if someone didn't have good faith, they *must* have had notice.

Even outside of the suitability of applying the "knowledge" test to "notice", Morris J.'s leap that no person with notice could ever be acting in good faith leaves one wondering why the *bona fides* defence required "good faith" and "notice" as separate elements of the defence in the first place?

The *bona fides* defence has, until now, always worked to ensure legal title trumps equitable title claims. It is very much an exception to circumstances where the equitable jurisdiction of a court might otherwise come to the aid of a claimant at the cost of the defendant's proprietary rights. The application of the constructive knowledge test to "notice" and then, the conflation of "notice" with the existence of "bad faith", is at odds with the idea that there should be circumstances where the court's equitable powers should not trump common law proprietary rights.

Morris J. takes a (knowledge) test applied in unjust enrichment cases (an equitable remedy), applies it to

[4] Lipkin Gorman v Karpnale Ltd. [1991] 2 AC 548; Foskett v McKeown [1998] Ch. 265; and Trustee of FC Jones & Sons v Jones [1997] Ch. 159

[5] As per Lord Millet at 129 D-H.

one for unconscionable receipt (another equitable remedy) but then applies it to defeat a defence to a claim for proprietary restitution (a legal claim).

***The wider impact – looking towards the future***

In developing a formula which equates to:

"knowledge = notice = bad faith",

Morris J. also fails to recognise the wider impact such formulation may have outside the narrow facts of this case.

As far as we are aware, the Judge's attention in this case was not drawn to Article 37 of Commission Regulation 1193/2011 (*Nature of allowances and finality of transactions*)[6]. This Regulation provides that a "purchaser and holder of an allowance ... acting in good faith shall acquire title to an allowance ... free of any defects in the title of the transferor." [7]

The ingredients of the English law *bona fides* defence have, by this EU Regulation, been converted to a positive right (the "**Article 37 right**") that may be exercised by a holder satisfying these requirements. Notably, there is no requirement that the transferee has any notice of such defects.

The Article 37 right shall become available to holders of allowances once the Union Registry becomes available to account holders[8] . However, the interpretation of the meaning of the Article 37 right will be left to the national courts. In such circumstances, does an English judgment such as this one actually help create the market certainty that the Regulation seeks to establish?

Put another way, the interpretation of "bad faith" as being equivalent to a purchaser who has "notice" in the Baden sense may have been the right approach for the Judge to take to find for the greater of the two innocents in Armstrong v Winnington, but does this end justify his means?

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[6]Or its equivalent at Article 32(b) of EC Regulation 920/2010 of 7 October 2010
[7]At Article 37(4)
[8]Scheduled for the Summer of 2012

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