

# legal update

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## The Money Laundering Regulations 2007

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### ■ Introduction

The Money Laundering Regulations 2007 (SI 2007/2157) ('the 2007 Regulations') came into force on 15 December 2007. Modelled on the E.U. Third Money Laundering Directive, they form the latest addition to the body of legislation designed to tackle money laundering. The Proceeds of Crime Act 2002 makes it an offence to conceal, possess or deal with the proceeds of crime; the Terrorism Act 2000 prohibits the use of funds to promote terrorism; and the 2007 Regulations oblige professionals – not least lawyers – to check up on those they deal with.

### ■ (A) Customer due diligence

At the heart of the 2007 Regulations is an obligation to "apply" what are called customer due diligence measures ("CDD"). CDD is defined by regulation 5, as follows:

- Identifying the customer and verifying his identity;
- Identifying the beneficial owner, where there is one who is not the customer, and taking adequate measures to verify his identity, including measures to understand the ownership and control structure of any legal person (such as a company) or trust or similar arrangement; and
- Obtaining information on the purpose and intended nature of the business relationship.

Unfortunately, these definitions are anything but clear. What exactly, for example, does "identifying" mean and who is to say whether the measures taken are adequate? There is no definition. Get it wrong, however, and you let yourself in for up to two years in prison (see reg. 45(1)).

The remainder of this article will explain

when and how CDD needs to be undertaken. We will start by assessing CDD in general terms, and then move on to consider the particular issues that arise when the customer is a company or a person involved in matters concerning trusts or estates.

#### (i) Who does the CDD?

Those who have to do CDD are called relevant persons (reg. 3(1)). The list of relevant persons includes independent legal professionals, trust or company service providers, insolvency practitioners and tax advisers. Lawyers may be any of those.

A lawyer will count as an "independent legal professional", and so a relevant person, when (but only when) participating in "financial or real property transactions" for others (reg. 3(9)). The transaction must concern:

- "the buying and selling of real property or business entities", so ordinary commercial and domestic conveyancing is covered, as are business sales;
- "the managing of client money, securities or other assets";
- "the opening or management of bank, savings or securities accounts", so it apparently extends to solicitors acting in estates (if not themselves the personal representatives);
- organising "contributions" for companies; and
- "the creation, operation or management of trusts, companies or similar structures", so trust and company lawyers will often be caught.

Merely advising seems to be enough: "participating" in a transaction means "assisting in the planning or execution of the transaction or otherwise acting for or on behalf of a client in the transaction" (reg. 3(9)).

How far litigation is covered is unclear. When it comes to reporting suspicious transactions under the Proceeds of Crime Act 2002, *Bowman v Fels* [2005] 1 W.L.R. 3083 (C.A.) provides an exclusion for litigation; it is likely, though not certain, that the same reasoning applies to the 2007 Regulations. If so, the Regulations will not apply where advice is sought for the purposes of litigation which is on foot or in prospect, or of settling disputes in that context. So it should not be necessary to apply CDD in litigation-related matters.

Lawyers and others may also count as trust or company service providers, and so relevant persons in that way (reg. 3(10)). A provider is covered when he provides services to others consisting of:

- forming companies;
- acting, or arranging for someone else to act as a director or secretary of a company;
- providing office facilities for a company (e.g. a correspondence address); and
- acting, or arranging for someone else to act as trustee or nominee shareholder.

As mentioned, lawyers who act as tax advisers or insolvency practitioners are also caught.

### *(ii) When does the CDD have to be done?*

Regulation 7(1) provides that CDD has to be done when a relevant person:

- establishes a business relationship;
- carries out an occasional transaction;
- suspects money laundering or terrorist financing; or
- doubts the veracity or accuracy of documents, data or information previously obtained.

The relevant person must also apply the measures at other appropriate times to existing customers on a “risk-sensitive basis” (reg. 7(2)).

The first two occasions (establishment of business relationship and occasional transaction) will be the most important. The part of the CDD consisting of verifying the customer’s identity (and that of any beneficial owner) must generally be done before the relationship is formed or the transaction carried out, not left until

later (reg. 9(2)). A business relationship means a business, professional or commercial relationship between the relevant person and the customer, which the relevant person expects, when contact is established, to “have an element of duration” (reg. 2(1)). Presumably the necessary element of duration is present if the relationship is expected to continue beyond an occasional transaction. An occasional transaction is a transaction (carried out other than as part of a business relationship) amounting to 15,000 euro or more, whether in a single operation or in several apparently linked operations (reg. 2(1)).

So what about matters requiring urgent advice or drafting? The 2007 Regulations allow verification to be completed during the establishment of a business relationship, if this is “necessary not to interrupt the normal conduct of business ... provided that the verification is completed as soon as practicable after contact is first established” (reg. 9(2)). Quite how anyone knows when the establishment of a business relationship starts and stops is obscure but it seems permissible to accept the instructions and to carry out the CDD later once things have calmed down.

### *(iii) Reliance on others*

Regulation 17 permits relevant persons to rely on third parties to apply CDD measures, as long as the third party consents; clients would otherwise be repeatedly asked for the same information. The relevant third parties are credit or financial institutions, auditors, insolvency practitioners, external accountants, and independent legal professionals based in the UK, EEA or a country which imposes requirements equivalent to those of the Third Money Laundering Directive. Solicitors will often have to do their own CDD but may be able to rely on a professional referrer. Barristers will usually rely on a certificate from solicitors that they have already done the CDD on the client.

### *(iv) Ongoing monitoring*

There is a requirement to conduct ongoing monitoring of a business relationship (reg. 8(1)). Unlike CDD, ongoing monitoring has to be done personally. Ongoing monitoring is defined by regulation 8(2) as:

- “scrutiny of transactions undertaken through the course of the relationship (including, where necessary, the source of funds) to ensure that the transactions are consistent with the relevant person’s knowledge of the customer, his business and risk profile”; and
- “keeping the documents, data or information obtained for the purpose of applying customer due diligence measures up to date”.

Solicitors acting for a small property developer, for example, might sit up and ask questions if he suddenly appeared to be awash with unexplained funds.

### *(v) On whom does the CDD need to be done?*

As explained above, there are broadly two categories of people on whom CDD has to be done, namely ‘customers’ and ‘beneficial owners’. The former is not defined by the Regulations, although it seems obvious that a customer will be a person seeking the provision of business services of the sort provided by relevant persons.

‘Beneficial owner’ is a term used in the 2007 Regulations in connection with companies, trusts, partnerships and other arrangements. Regulation 6 contains an elaborate definition of the people who count as beneficial owners of a company, a trust, etc. – including many who by the ordinary use of language would not be regarded as the beneficial owner of anything.

But what the Regulations lack is any indication of the occasions when the relevant person has to be on the lookout for a beneficial owner: they simply require CDD when “there is” a beneficial owner who is not the customer (reg. 5(b)), without any further indication of the link between him and the customer. It looks as if what is meant is that either the beneficial owner is someone who owns or controls the customer or else the transaction is being in some sense conducted on behalf of the beneficial owner (cf. reg. 6(9)).

In what follows, we assess the scope of the obligation to carry out CDD in the context of companies and trusts and estates.

### ■ (B) Companies

When a company retains the relevant person, the company itself is the customer. The relevant person is therefore required, before a business relationship is established or occasional transaction carried out, to identify the company and verify its identity. Furthermore 'where there is a beneficial owner who is not the customer', he must also identify the company's beneficial owner (reg. 5(b)). These requirements are discussed below. Given that a company conducts its business through representatives, it would also seem prudent as a first step for the relevant person to verify the authority of the person standing in front of him to enter into the transaction on behalf of the company, and indeed enhanced procedures should be applied on a risk-sensitive basis "where the customer has not been physically present for identification purposes" (reg. 14(2)).

#### *(i) The Company's Identity*

The level of due diligence to be undertaken in any given business situation is determined by the relevant person's initial assessment of the degree of risk involved in the transaction (regs. 7(2) and 7(3)(a)). So in higher risk situations solicitors will be required to take enhanced CDD measures. However, the Regulations also provide for specific circumstances where simplified CDD measures can be used, for example identifying clients that are themselves credit or financial institutions subject to the regulations (reg. 13(2)(a)) or where the client is a listed company (reg. 13(3)).

Where a company is either listed and its securities are admitted to trading on a regulated market, or it is a majority-owned and consolidated subsidiary of such a company, only simplified CDD applies, and all that is needed may be confirmation of the company's listing on the regulated market. For a subsidiary of a listed company evidence would be required of the parent/subsidiary relationship, for example a note in the parent or subsidiary's last audited accounts, information from an online registry, or the subsidiary's last filed annual return. Where further CDD is required for a listed company (i.e. when it is not on a regulated market) the relevant person is required to obtain relevant particulars of the company's identity. Verification sources may include a

Companies House search or a copy of the company's certificate of incorporation.

Private companies are generally subject to a lower level of public disclosure than public companies and may represent an increased risk of laundering, or terrorist financing. It may therefore be appropriate to enquire further into, for example, the identity of the directors, the certificate of incorporation, details from Companies House, or the filed audited accounts.

#### *(ii) The Beneficial Owner*

Solicitors will be required to identify a beneficial owner where that owner 'is not the customer'. In the case of companies, this wording is odd, because the beneficial owner will never be the customer and so will always need to be identified.

The definition of a beneficial owner of a "body corporate" is in two parts (see reg. 6(1)(a) and (b)). As respects unlisted companies, it is "any individual who ... ultimately owns or controls ... more than 25% of the shares or voting rights in the body" (reg. 6(1)(a)). CDD therefore requires the relevant person to understand the ownership and control structure of the company. The level of investigation that he undertakes to find this out will differ according to the level of risk that he attributes to the transaction. It may include getting assurances from the client on the existence and identity of relevant beneficial owners, or conducting searches on the relevant online registry, for example Companies House. Where the holder of the requisite level of shareholding of a company is another company, the risk-based approach will again need to be applied when deciding whether further enquiries should be undertaken.

The second limb of the definition of beneficial owner requires solicitors dealing with "any body corporate", to identify "any individual who otherwise exercises control over the management of the body" (reg. 6(1)(b)). Such control may rest with those who have power to manage funds or transactions without requiring specific authority to do so, and who would be in a position to override internal procedures and control mechanisms. It is not clear to what extent the relevant person would be required to make inquiries into the internal management of a company

where this information could not be obtained from a general understanding of its ownership and control structure. Such measures would seem to be excessively draconian unless it became obvious during the ongoing monitoring of the company that control structures were being continually bypassed by a certain individual or entity.

#### *(iii) In what capacity is the company entering the transaction?*

It should be noted that a company may have several 'hats', and the capacity in which it enters into the business relationship will dictate who the relevant beneficial owners are for CDD purposes. If, for example, a bank retains a law firm in order to purchase new premises, the beneficial owners will be the bank's shareholders or controlling minds as discussed above. However, if the bank retains the firm in its (the bank's) capacity as trustee of a trust corporation in order to sell trust property, then the beneficial owners will be those with specified interests in, or control of, the trust, as set out below.

### ■ (C) Trusts and estates

#### *(i) Creation of trust or will*

When a settlor approaches a solicitor with a view to creating a settlement, the solicitor will have to do CDD on the settlor: the solicitor will be participating in the creation of a trust and so qualify as an independent legal professional. But at that stage there is no trust and hence no beneficial owner, so no CDD is needed on the intended beneficiaries even if the settlor already has a clear idea who they are to be. Once the trust is actually created, CDD on them will be advisable, though it is hard to see that the 2007 Regulations actually compel it, for they require CDD on the client and any beneficial owner before the business relationship is established, not later, and that stage is past once the trust is in being. A professional trustee who is not a lawyer is probably in a similar position, though he has a technical case for saying that he is not a trust or company service provider when first approached, because he is not then acting as trustee so as to qualify as a trust or company service provider.

A will is a difficult case but it does not look as if a solicitor drafting it has to do CDD on the testator unless (i) he is going to be the executor and (ii) the will creates a trust. When the testator

dies, if the solicitor takes office as executor there is no CDD to do because he has no customer; if the executor is someone else, who instructs the solicitor, the solicitor must do CDD on the executor but not the beneficiaries (reg. 3(8)).

### (ii) Trust administration: third parties

Trustees administering the trust need to deal with third parties, e.g. when opening a bank account or instructing estate agents to sell a house. They have no need to do CDD on the third party, because they are the customer; but the third party, if a relevant person, will have to do CDD on the trustees. Here there is plainly a beneficial owner in the form of the beneficiaries and the third party has to do CDD on them too.

Who counts as a beneficial owner where there is a trust? The definition is in regulation 6, in three parts:

- (1) First is any individual who is entitled to a "specified interest" in at least 25% of the capital of the trust property (regs. 6(3)(a) and (4)). Only a vested interest can be a specified interest, so contingent interests are excluded; but it may be in possession or in remainder and it may be defeasible or indefeasible. It is not clear whether an income interest is excluded.
- (2) Where the trust is not set up or run entirely for the benefit of beneficiaries with specified interests, the class of persons

in whose main interest the trust is run or operates is a beneficial owner (regs. 6(3)(b) and (4)). The obligation is then to identify them collectively (reg. 7(4)), not individually as with specified interests; and it will often be enough just to identify them by reference to the trust instrument, e.g. a discretionary class consisting of X's grandchildren.

- (3) Lastly, anyone having control over the trust is a beneficial owner (reg. 6(3)(c) and (4)), provisions with a very wide reach. Anyone with a power to dispose of trust property or to advance, lend, invest, pay or apply it is covered; and so is anyone with a power of veto over such powers. So the donee of a power of appointment is a beneficial owner; a protector will nearly always be one; and anyone with a power to appoint new trustees is also included. There are a few qualifications – for example, the *Saunders v. Vautier* power to terminate the trust does not count – but they do not go very far.

Third parties will have to identify all of the foregoing. Unless banks and estate agents are going to start maintaining armies of trust lawyers, they will be looking to the trust solicitors to do their CDD for them under regulation 17.

### (iii) Trust administration: beneficiaries

It does not seem that trustees of a trust in existence when the 2007 Regulations came into effect need do CDD on their beneficiaries: the beneficiaries are not customers of the trustees and though some or all of them will be beneficial owners there is need to do CDD on anyone if there is no customer. For the same reason, making a distribution to a beneficiary (whenever the trust was created) does not require CDD.

### (iv) Legal advisers

Legal advisers dealing with the creation of the trust will not need to do CDD on the beneficial owners, though (see above) they will have to do it on the settlor.

If the trustees later ask for advice on the effect of the trust instrument, and what is contemplated is a financial or real property transaction, the lawyers will have to do CDD on both the trustees and the beneficial owners. (But there will be many occasions when no such transaction is contemplated.) If a settlor or protector asks for similar advice, e.g. on the appointment of new trustees, the lawyers will have to do CDD on their client and, it seems, on the beneficial owners, since the transaction is in some sense being conducted on their behalf. But if a beneficiary wants advice on his rights or a trustee wants advice on a possible liability for breach of trust, CDD is needed on the client alone: the advice is not being sought on behalf of the trust.

## Pye Revisited: Human Rights and Adverse Possession

*JA Pye (Oxford) Limited v UK*

James Thom Q.C. and Shelley White

James  
Thom Q.C.



Shelley  
White



### Introduction

On 30 August 2007 the Grand Chamber of the European Court of Human Rights, held by a 10-7 majority that there had been no violation of the ECHR when the applicants lost property through the application of the law of England and Wales prior to the commencement of the *Land Registration Act 2002* ('the 2002 Act'). This, in effect, reversed the earlier decision of the Chamber.

### Background

In *J A Pye (Oxford) Ltd v Graham* [2003] 1 AC 419 the Claimant property developer ('Pye') lost its claim for possession of 25 hectares of registered land, against the Defendants ('the Grahams'). The Grahams had continued to use and occupy the land for over 12 years after Pye refused to extend a previous agreement allowing them to do so. Pye's title to the land was therefore extinguished (*Limitation Act 1980, section 17*) and the land was held on

trust for the Grahams, who were entitled to be registered as proprietors (*Land Registration Act 1925, section 75*). The Court of Appeal ([2001] Ch 804) decided that the Grahams were not in adverse possession, because they hoped to obtain Pye's agreement to their occupation. The House of Lords, while making plain that they were driven to reach a result which they felt was unjust, overturned the Court of Appeal ruling and made clear that the requisite intention was not an intention to own or acquire ownership, but to possess and exclude the world at large, including

the paper title owner, so far as possible.

Pye applied to the European Court of Human Rights, alleging that the rules of law by which they had lost their land operated in violation of Article 1 of Protocol 1 to the Convention (the right not to be deprived of one's possessions except in the public interest and subject to conditions provided for by law)

### ■ The Chamber Judgment

On 15 November 2005 the Court, by a 4-3 majority, held that there had been a violation: see *JA Pye (Oxford) Limited v. United Kingdom* (Application no. 44202/02). Pye claimed over £10 million in compensation. The Court decided that the legislation was not proportionate to the legitimate aims of limitation periods because Pye suffered the total loss of its property without compensation, and there was no procedure for the landowner to be warned that he was at risk.

### ■ The Grand Chamber Decision

The majority of the court noted, citing *Anheuser-Busch Inc v Portugal* [GC], no 73-49/01, that Article 1 contains 3 "distinct" but connected rules: (1) the general principle of peaceful enjoyment of property (2) the rule covering deprivation of possessions and the conditions which must apply, and (3) the recognition that contracting states are entitled to regulate the use of land in the general interest.

#### Article 6

Contrary to the UK government's argument that the case should be decided under Article 6 because it concerned limitation and, therefore, simply a bar to a remedy, the majority held that even if Article 6 was engaged, that did not prevent Article 1 from being engaged also, and that the Chamber's conclusion that Article 1 applied was "inescapable".

#### Deprivation or Regulation?

The majority then considered a key issue: was the loss of Pye's land properly to be characterised as a "deprivation" of property (within rule 2 of Article 1), or was it the exercise by the state of its right to control the use of the land (within rule 3 of Article 1)?

This was critical because where the second rule applies, the absence of compensation is by itself normally enough to establish a violation. The majority held that this was a "control of use" case.

#### Justification for the Regulation

In considering whether the interference with Pye's rights of ownership was justified the majority concluded that the relevant statutory provisions pursued a legitimate aim in the general interest. They noted that similar provisions existed in many member states (although the approach was far from uniform).

#### Fair Balance

Having decided that the case was one of control of use and that the time limit pursued a legitimate aim, the only remaining argument for Pye was that the legislation did not strike a fair balance between the public interest and respect for Pye's property rights. The majority concluded that the fair balance "was not upset in this case".

The judgment of the majority of the Grand Chamber illustrates the importance of the "margin of appreciation" allowed to member states. This is the principle that the court recognises that different member states might have a variety of different responses to a particular problem, and might strike the public/private balance at different points in the range of possible outcomes. Provided the state's law falls within the wide margin of appreciation, it will not be overturned by the court.

The majority found that the (pre 2002 Act) law of England and Wales was not so unfair as to be outside the margin of appreciation.

#### Subsequent Reform

It is clear from paragraph 81 of the majority judgment that the majority was not impressed by the argument that a violation could be established because subsequent changes in the law must show that the existing law was unsatisfactory.

#### The Minority Decisions

Five judges accepted most of the reasoning of the majority, and in

particular agreed that the case was a "control of use" case. However they concluded that a fair balance was not struck by the relevant provisions.

The final two judges took a stronger view. They held that the interference with Pye's property rights did not have any reasonable foundation, and that if it had (and they would have been inclined to treat the case as one of deprivation) the means were "completely disproportionate" to the aim pursued.

### ■ Conclusions

Because the statutory provisions which were under consideration in the *Pye* case have now been replaced, the decision is not one with long term implications for the law of adverse possession of registered land.

The case has wider importance for three main reasons.

First, it reinforces the fact that one's property can be lost without it being a case of "deprivation". There is here a somewhat elusive (and the property owner might say illusory) distinction but it is an important one. The state did not take away Pye's land as with expropriation or compulsory purchase. It made laws which provided that the free actions and omissions of Pye and others could result in a situation in which Pye lost its land.

The second is the recognition that a wide margin of appreciation is appropriate, and perhaps especially appropriate, in the context of property law. Property law is connected to family law and the law of inheritance and different member states have very different approaches to the social problems which the disposition of family property creates. A generous degree of *laissez faire* from the ECHR is to be welcomed.

Finally, this article arises out of one written after the Chamber judgment (Issue 2, June 2006), one comment in which remains true: if there are still any practitioners who believe that it is possible to ignore the possibility of a human rights dimension to a property case, the *Pye* case is a clear warning that this is not so.

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