Business Law Briefing

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Business **Governance**

Directors' Duties

Madoff Securities International Ltd v Raven & Ors

[2013] EWHC 3147 (Comm)

The judgment examines the scope of a Director's duty to act in what he honestly believes to be in the Company's best interests where he is one of a larger Board and when he may and may not defer to other Directors

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This was an unsuccessful claim by the Liquidators of Bernard Madoff's London business, MSIL, which was not part of the Ponzi scheme, to hold its Directors liable for breaches of their duties in making or approving certain substantial payments. At all material times Bernard Madoff was MSIL's executive CEO or chairman, and owned virtually all of the voting shares. Popplewell J had to consider the Directors' conduct in the context of well-established principles concerning the scope of the duty to act in what a director honestly believes to be in the best interests of the company and the large Board setting within MSIL. The court found:

(a) Whilst some division or delegation of responsibility for particular aspects of the management of a company is legitimate and necessary, every director nevertheless owes inescapable personal responsibilities actively to inform himself of the company's affairs and to join in supervising them with his fellow directors. He cannot be simply passive. It is a breach of duty for a director to allow himself to be dominated, 'bamboozled' or manipulated by a dominant fellow director where that involves a total abrogation of his responsibility.

(b) It is the duty of every director to form an independent judgment as to whether acceding to the request of a shareholder is in the best interests of the company.

(c) A director who takes no steps to prevent a fellow director's misapplication of company property, when he has knowledge of it, will himself be treated as a party to the breach of fiduciary duty as having authorized or permitted it and will also breach the duty of reasonable care and skill.

(d) When the Board is called upon to make decisions, in fulfilling his own personal responsibility a director is entitled to rely upon the judgment, information and advice of another director whose integrity, skill and competence he has no reason to suspect. Corporate management often requires the exercise of judgment on which opinions may legitimately differ and requires some give and take. A director is entitled legitimately to defer to and to take into account the views of his fellow directors, provided he is persuaded that his fellow directors' views have been put forward in what they perceive to be in the best interests of the company.

(e) Where a decision as to the commercial wisdom of a transaction is taken by a majority of the board, a minority director is not obliged to respond by resigning or by refusing to be party to the implementation of that decision. Part of his duty as a director acting in the interests of the company is to listen to the views of his fellow directors and to take account of them. A director is not in breach of his duty to act in what he considers to be in the best interests of the company simply because, if he had been left to himself, he would have done things differently.

Commentary

- The decision is a useful examination of individual Directors' duties in the context of a relatively sophisticated Board setting.

11KBW Business Law members regularly advise and act in cases involving allegations of breach of directors' duties.

Business **Governance**

Qualifications on subjective nature of Director's duty to act in Company's best interests

Hellard & Anor (Liquidators of HLC Environmental Projects Ltd) v Carvalho

[2013] EWHC 2876 (Ch):

A Director's duty to act in what he considers bona fide to be in the Company's best interests extends to the interests of creditors whenever action puts at real risk the prospects of creditors being paid.

The subjective nature of the duty is qualified and only applies where the Director has actually considered the best interests of the Company, If he has not, then the test is objective.

Findings

In 'misfeasance' proceedings under s.212 Insolvency Act 1986, the liquidators of HLC Environmental Projects Ltd sought financial relief against its principal director, in respect of a number of payments which he caused the Company to make in circumstances where it was alleged that the Company was at the time insolvent. John Randall QC, sitting as a Deputy, was called upon to examine and apply the duty owed by directors to act in what they consider bona fide to be in the best interests of the Company (now s.172 CA 2006) and determine when the duty extended to the interests of creditors, and how the subjective nature of the duty was qualified.

The court found that established, definite insolvency before the transaction or dealing in question, was not a pre-requisite for a duty to consider the interests of creditors to arise. The underlying principle was that directors are not free to take action, which puts at real (as opposed to remote) risk the creditors' prospects of being paid, without first having considered their interests rather than those of the company and its shareholders. The court found that the general principle of subjectivity applying to the duty was subject to three qualifications of relevance:

(a) Where the duty extends to consideration of the interests of creditors, their interests must be considered as "paramount".

(b) The subjective test only applied where there was evidence of actual consideration by the director of the best interests of the company. Where there was no such evidence, the proper test was objective, namely whether an intelligent and honest man in the position of a director of the company concerned could, in the circumstances, have reasonably believed that the transaction was for the benefit of the company.

(c) where a very material interest, such as that of a large creditor (in a company of doubtful solvency, where creditors' interests must be taken into account), is unreasonably (i.e. without objective justification) overlooked and not taken into account, the objective test must equally be applied. Failing to take into account a material factor is something which goes to the validity of the directors' decision making process. This is not the court substituting its own judgment on the relevant facts (with the inevitable element of hindsight) for that of the directors made at the time; rather it is the court making an (objective) judgment taking into account all the relevant facts known or which ought to have been known at the time, the directors not having made such a judgment in the first place.

The director's breaches of duty were held to be made out on the facts.

Commentary

- Whilst it has been recognised for some time that, even applying the subjective test, it is much harder for a director to persuade the court that he honestly believed his actions were in the interests of the company where those actions resulted in substantial detriment to the company, see Regentcrest v Cohen [2001] BCC 494, per Jonathan Parker J. and see e.g. Dryburgh v Scotts Media Tax Ltd [2011] CSOH 147, this case is significant in its further consideration of how the subjective nature of the s.172 duty cannot excuse unreasonable conduct
- 11KBW Business Law members regularly act and advise on directors' duties.

Business **Reward**

When Commission can be witheld

Stupples-v-Stupples & Co (High Wycombe) Ltd

[2012] EWHC 1226 (Ch)

[2013] 1 BCLC 729

A breach of fiduciary duty by an agent may disentitle the agent to his commission without the principal having to either show (i) any subjective dishonesty on the part of the agent or (ii) any loss suffered by the principal.

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Mr Stupples was the founder of the estate agency Stupples & Co, but the time had come for him to retire. As part of a package for Mr Stupples to sell his shares to another partner in the business, Mr Stupples entered into a consultancy arrangement in relation to certain projects that were outstanding on his retirement. It was accepted in the proceedings that Mr Stupples acted as the business' agent, and in a fiduciary capacity.

HHJ David Cooke found that Mr Stupples had acted in breach of his fiduciary duties to the business in two ways. First, he had sought to obtain a secret profit by arranging for a personal fee to be paid to him by the client, in addition to the commission from the business to which he was contractually entitled. Second, he encouraged a client to disinstruct the business, and to instead instruct Mr Stupples directly.

The main issue of law to be determined by the court was whether it is necessary for the principal to show that his fiduciary has been dishonest in order for a breach of fiduciary duty to disentitle the fiduciary to their contractual remuneration (an equitable remedy). If the fees have already been paid, the remedy of disentitlement is retrospective and so may be described as restitutionary.

The Judge held that there is no need to establish that an agent knew what they were doing was improper, or had any motive that could be considered dishonest in any other sense. The breach of fiduciary duty *per se* is sufficient for the agent to be disentitled to his commission, and insofar as previous cases referred to a requirement of dishonesty, they merely meant that an agent must not breach his fiduciary duties: "*in that sense, receipt of a secret profit is 'per se dishonest'*".

The Judge emphasised, however, that there is a difference between mere breach of a *contractual* duty owed to a principal (an "*honest breach of contract*"), and breach of the particular *fiduciary* duties owed by an agent to his principal. Further, there are circumstances where a breach of fiduciary duty will not disentitle the fiduciary to his commission, such as where the breach does not go to the core of the fiduciary's function (a "*harmless collaterality*").

The Judge also held that the remedy of disentitlement to commission does not require the principle to prove any loss caused by the breach. The Judge relied on the reasoning in *Andrews v Ramsey & Co* [1903] 2 KB 635, to the effect that it will often be impossible to say what the outcome would have been had the agent acted in accordance with his duties.

Commentary

- Stupples continues the tendency of the courts to strengthen the standards of conduct required of agents and other senior employees in fiduciary relationships.
- The fact that the court held that it is not necessary for a principal to show loss resulting from the breach of duty, or dishonesty on the part of the agent, will make it easier in future for principals to argue that defaulting agents are disentitled to their commission.

11KBW Business Law members regularly advise on and act in disputes involving commission.

Business **Protection**

Availability of Proprietary Remedy for breach of fiduciary duty

FHR European Ventures LLP v Mankarious

[2013] 3 WLR 466

A fiduciary who received a secret commission in connection with the sale of property held that commission on constructive trust for the beneficiary with the consequence that the beneficiary had a proprietary and not merely personal claim against the fiduciary.

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Findings

The Claimant wished to buy a hotel. It agreed to do so at a price negotiated on its behalf by the Defendant. However, the Defendant had also entered into an agreement with the vendor by which the Defendant was paid a fee of €10 million in return for procuring a purchaser. It was a term of the agreement providing for the fee that the Defendant would disclose the agreement (and thus the fee) to the Claimant. It did not do so. It was held that, in the absence of disclosure, the fee paid was a secret profit or commission.

It was not in dispute that the Defendant was under a *personal* obligation to pay the Claimant the fee on the basis that it had profited from its breach of fiduciary duty. What was in issue was whether the Claimant had a *proprietary* claim to the fee paid with the consequence that the Claimant could trace the secret commission. Applying *Sinclair Investments UK v Versailles Trade Finance Ltd* [2012] Ch 453, Simon J held that the claimant was entitled to a personal remedy only.

The Court of Appeal disagreed. It held that the fee paid to the Defendant was part of the overall arrangement for the acquisition of the hotel and that, by taking a fee, the Defendant had exploited an opportunity which was the Claimant's because the Defendant had deprived the Claimant of the opportunity to buy the hotel at a price up to €10 million lower than it did.

Therefore the fee which resulted from the Defendant's exploitation of this opportunity was held on constructive trust for the Claimant, giving the Claimant a proprietary claim to the secret commission.

Commentary

- *Sinclair* holds that a beneficiary may claim a proprietary interest only where (a) the money or asset acquired by the fiduciary is or was beneficially the property of the beneficiary or (b) the fiduciary acquired the money or asset by taking advantage of an opportunity or right which was properly that of the beneficiary. It held that a bribe received by a fiduciary did not fall into either of these categories and so did not entitle the beneficiary to a proprietary remedy in respect of a bribe.
- The Court of Appeal held that the fee paid in *FHR* fell into category (b) in *Sinclair*. However, *FHR* is not easy to reconcile with *Sinclair* on the basis that many secret commissions could be seen as part of a larger transaction. It is not easy to see, therefore, why a constructive trust was imposed in this case and not in the general bribe / secret commissions case. As the Court recognized, decisions in this area turn on 'very fine factual distinctions'.
- It is plain from the judgments in *FHR*, in particular that of Sir Terence Etherton, that the Court of Appeal had misgivings about the decision in the *Sinclair* case.

11KBW Business Law members regularly undertake cases involving breach of fiduciary duty and equitable remedies.

Business **Protection**

Database Right

Flogas Britain Limited v Calor Gas Limited

[2013] EWHC 3060 (Ch)

Vicarious liability for infringement of a database right. Overlap of damages for breach of confidence and for infringement of a database right

At a trial of quantum, where liability for breach of confidence had been previously admitted, Flogas sought damages from Calor Gas for misuse of a copy of part of Flogas's customer database and also claimed damages for infringement of a database right. Calor disputed that it should be liable for infringement of a database right on the basis that vicarious liability for the acts of its employees could not be established.

Mrs Justice Proudman found that damages for breach of confidence should be assessed on the loss of profits basis and not limited to the value of the confidential information itself. As to the claim for infringement, the Judge applied the following principles on vicarious liability in tort which she extracted from Weddall v Barchester Healthcare Ltd [2012] EWCA Civ 25:

(1) Vicarious liability as a principle of strict liability had to be kept within clear limits.
(2) There must be an analysis of what the employee was employed to do, and secondly of the connection between what the employee was employed to do and the tort committed.
(3) The question was whether the tort of the employee was so closely connected with the employment that it would be fair and just to hold the employers vicariously liable
(4) The sufficiency of the connection may be gauged by asking whether the wrongful acts can be seen as ways of carrying out the work which the employer had authorised.
(5) The fact that the employment gave the employee the opportunity to commit the wrong is not enough to make the employer liable. He is liable only if the risk is one which experience shows is inherent in the nature of the business.
(6) Another way of formulating the issue is to ask the question whether the wrongful conduct may fairly and properly be regarded as done in the ordinary course of the firm's business or the employee's employment. This is a value judgment by the court.

Applying those principles, the Judge found that the handling and/or copying of data from the Flogas Database had a close connection to the employment of the employees in that they related to business intelligence that was closely linked to the conduct of the business. That connection was so close that it would not be unjust to impose vicarious liability on Calor for it. The wrongful conduct might fairly and properly be regarded as effected by the employees while acting in the ordinary course of the employment, because the copying and handling of this data was in principle something that would come within the realm of the ordinary course of their employment. Nevertheless, as the infringement of Flogas's database right arose on exactly the same facts as the liability for breach of confidence, Flogas was already being compensated for the loss it has suffered and could not recover twice.

Commentary

- The assessment of damages followed the approach of Arnold J. in Force India.
- The issue of vicarious liability was approached strictly on the tort basis.

11KBW Business Law members regularly deal with quantum issued in breach of confidence cases.