Directors Beware: The Court's Stringent Stance on Breaching Fiduciary Duties

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Exploring the recent Court of Appeal decision in Recovery Partners GP Ltd v Rukhadze and others [2023] EWCA Civ 305

Introduction

1. Imagine you are a director who is found to have breached your fiduciary duties by taking preparatory steps to take advantage of a business opportunity at the cost of your principal business, before resigning from your directorship and pursuing the business opportunity in a new venture.

2. Naturally, your old company now seeks to recover all of the profits you have amassed which have derived from your breach.

3. But what are the arguments you could explore to justify reducing the scope of the account for profits?

4. The Court of Appeal considered how the account should be fashioned where the subject matter of the breach was an ongoing business, to which the errant fiduciary had contributed by applying his own skill and management. In that context it decided, first, that the account would not be limited by any prior agreement or understanding (between the fiduciary and his principle) as to how the profits of that venture would be split between them. Secondly, the fiduciary could, in exceptional cases, obtain an allowance for his skill and effort that produced the profit. Such an allowance will not routinely be granted, and only where it is consistent with the policy underlying the no-profit rule and would not encourage a breach. But a degree of culpability does not preclude such an allowance. Thirdly, the principal's entitlement to an account may be barred by unreasonable delay, if combined with factors that render it unconscionable to grant relief.

Background

5. SCPI was established in 2001 to provide investment management services to Badri and Boris Berezovsky. After Badri's passing, the Claimants were formed in 2008 to handle Recovery Services for SCPI.

6. The Recovery Services involved regaining control and the management of Badri's assets, which were spread out across the world. The individual Defendants played key roles in the Recovery Services. Disagreements arose between them and SCPI's owner, Mr Jaffe, which led to the Family terminating SCPI's services in 2011. The Individual Defendants subsequently continued providing Recovery Services through a new corporate structure, Hunnewell.

7. The Claimants objected to the Defendants' provision of the Recovery Services, and reserved their rights against the Defendants but didn't commence proceedings until 2016.

8. The High Court found the Individual Defendants had breached their fiduciary duties during their work for SCPI and the Claimants, by disloyally carrying out preparatory steps while working for SCPI and the Claimants, and then resigning with the intention of undertaking the Recovery Services themselves.

9. By way of a remedy, the Claimants sought an account for profits. The High Court was then faced with discerning which principles and calculations should apply to the account for profits.

The High Court's Decision

10. In its judgment dated 25 March 2022, the High Court made the following key findings in relation to how the account for profits should be determined:

    - There was no pre-existing profit-sharing agreement between the individual Defendants and the Claimants. They had discussed and reached a common understanding as to the rough percentages of a split, but it did not amount to a contract. Therefore, the account for profits would not take into account a 50/50 split which was alleged to have been discussed between those initially undertaking the Recovery Services.
    - The Defendants could not limit the temporal scope of the account due to the Claimant's alleged unconscionable delay in bringing the proceedings. The delay was not unconscionable, it was justified.

- Notwithstanding the above, the Defendants were entitled to a 25% equitable allowance of profits generated, reflecting the hard work and skill deployed in generating the profits.

The Grounds of Appeal

11. The Defendants' first ground of appeal challenged the Judge's decision in relation to the alleged pre-existing profit-share agreement. They also argued in the alternative that, even if such an agreement was not binding, there was an understanding as to a 50/50 split which should have dictated the percentage of the equitable allowance made.

12. The Defendants' second ground of appeal challenged the High Court's findings regarding unconscionable delay. They argued that it is a freestanding discretionary defence which could and should have resulted in the account being temporally limited, and that the Claimants' delay was unconscionable as they stood by and watched the Defendants take risks to generate the profits.

13. The Claimants cross-appealed against the award of the equitable allowance, submitting that the Defendants did not argue for the market value of their services and that there had been no disclosure or evidence as to such value. They also argued that the High Court had erred in finding that 25% was an appropriate measure of equitable allowance when this finding appeared to be based on the expectations of various of the Defendants and other persons, none of which should have been relevant.

Court of Appeal Analysis

Was the existence of a profit share agreement proven, or even relevant?

14. The starting point for this question was the "stringent" rule, as considered in cases such as *Gray v Global Energy Horizons Corporation, Boardman v Phipps* and others.[1]

15. The Court of Appeal described the stringent rule:

> *"a fiduciary must not make an unauthorised profit from his fiduciary position, requiring an errant fiduciary to account to his principal for all unauthorised profits falling within the scope of his fiduciary duty. The court emphasised that the rule is intended to have*

[1] Gray v Global Energy Horizons Corporation [2020] EWCA Civ 166; Boardman v Phipps [1967] 2 AC 46

> *a deterrent effect, and to ensure that no defaulting fiduciary can make a profit from his breach of duty, echoing the opinion of Lord Hodson in Boardman v Phipps…"* (para 34).

16. The same principle was described in other authorities as an *"inflexible rule"* which *"must be applied inexorably"*.[2]

17. The result was that, having considered the authorities and whether the existence of a pre-existing profit-share agreement could limit the extent of the account for profits, the Court of Appeal concluded that the authorities made the position quite clear:

> *"it is no defence to a fiduciary's liability to account (i) that the result is to confer a benefit on the principal which the principal would not otherwise have been able to reap (Gray [126]); (ii) that the fiduciary would have made the profit even if there had been no breach of fiduciary duty (Murad [67]); or (iii) that the fiduciary would have been able to secure the principal's agreement to the fiduciary keeping some of the profits (Murad [71])."* (para 36).

18. The only way in which the court would be able to justify limiting the scope of the account would be via an equitable allowance of the type laid out in *Boardman v Phipps*, where the court may make an allowance for the hard work and skill which contributed to the making of the relevant profits.

19. The Court of Appeal therefore concluded that even if there was a pre-existing profit-share agreement (an argument the High Court rejected on the evidence) this would not circumvent the stringent rule – a rule which serves as a deterrent and which the courts have consistently and robustly imposed in a variety of circumstances.

Can the Claimant's unconscionable delay in bringing the claim be used to justify limiting the temporal scope of the account?

20. In this case, the short answer was no. Irrespective of whether any such principle exists, no limitation would have been justified on the facts found by the Judge. While there had been a significant delay, it was not unconscionable.

21. The Defendants criticised the way in which the Claimants had seemingly stood by to see how much profit accrued and if the claim was worth pursuing, whilst conveniently not

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[2] Murad v Al-Saraj [2005] EWCA Civ 959; Parker v McKenna (1874) LR 10 Ch App 96.

assuming any risk in the creation of those profits. They also argued that the Claimants were fully aware of the grounds for such a claim and could have initiated proceedings in or around 2011. It was further contended that there ought to be a temporal limit on the account in recognition of these facts, and various dates were offered as being the appropriate 'cut off' dates for the purposes of the account.

22. Both courts went through a number of authorities both within and outside of the jurisdiction, finding analogous examples and distinguishing features.[3]

23. The authorities provided the following guiding principles:

- Limiting the scope of the account is not merely a question of assessing the reasons for the delay in question; it is a question of justice. The question is, are the Claimants, in justice, entitled to reap the benefit when they could not be made subject to the loss? (para 60)
- Examples such as *Dwyer* show that the court may be justified in limiting the temporal scope of the account where it is satisfied that the defined period would clearly cover the whole of the benefits acquired by the fiduciary as a result of the breach, without extending beyond that. (para 63)
- Unreasonable delay, or indeed other unreasonable behaviour on the part of a Claimant, may justify limiting rather than barring relief if justice so requires, whether temporally or otherwise. However, mere delay, even if lengthy, would be insufficient. As with the defence of laches, any restriction on relief by reference to delay would need to involve not only delay that was unreasonable in the circumstances, but factors that render it unjust to grant the relief. (para 77)
- The law does not, and should not, require a Claimant to take action as soon as they become aware of a breach of fiduciary duty, or else risk losing their ability to obtain an account of profits. That would be inconsistent with the long-established strictness of the rule that unauthorised profits made by persons subject to fiduciary obligations must be accounted for. (para 80)
- It may be reasonable for a Claimant to "wait and see" before deciding to bring a claim. Reasons for this might include whether the Defendant's activities prove profitable in order to see if a claim is economically viable, as well as other considerations, such as

[3] Clegg v Edmondson (1857) 8 De G M & G 787; Warman International v Dwyer (1995) 182 CLR 544; Grundt v Great Boulder Pty Gold Mines Ltd [1937] 59 CLR 641; Ford v Foster (1872) LR 7 Ch 611; Murdoch v Mudgee [2022] NSWCA 12.

the evolving relationships of those involved in the dispute, or even a lack of funds to commence and sustain the litigation. (para 81)

24. The Court of Appeal saw no reason to go behind the High Court's finding that, on the facts, the Claimant's delay was reasonable. Thus, there was no basis on which to limit the temporal scope of the account.

25. As regards the personal and commercial risk undertaken by the Defendants during the delay, the Court of Appeal again agreed with the High Court's conclusion that *"The element of real serious commercial risk shouldered by the Defendants and deliberately dodged by Mr Jaffe was lacking." Further, it was found that during this period of delay, "Mr Jaffe was not avoiding participation. He wanted to participate but, at least in part due to the Defendants' actions, he was unable to do so."* (para 84, 85). This further contributed to the finding that there was no injustice which justified limiting the temporal scope of the account.

The Defendants' 25% equitable allowance

26. Lastly, the Court of Appeal turned its attention to both sides' arguments regarding the 25% equitable allowance given to the Defendants on account of their hard work and skill, which contributed to the profits earned. This was based on the principle outlined in *Boardman v Phipps*.

27. The Claimants argued that such an allowance was not justified on the evidence and had not been part of the Defendant's case at the outset of the proceedings. The Defendants argued that if such an equitable allowance was given, it should be based on the pre-existing profit-share agreement – i.e., a 50/50 split.

28. The Court of Appeal was not convinced by either of these arguments. As discussed above, the High Court found that there was no valid or binding profit-share agreement. Instead, it looked to five indicators to ascertain the qualitative value of the Defendants' work (para 110), which were to be considered in the light of the stringent rule. Both courts agreed that an equitable allowance would be reserved for exceptional cases, and the stringent rule should be at the forefront of any such consideration (para 116).

29. The Court of Appeal further observed that the quantification of any equitable allowance is not a straightforward numerical formula:

"the quantification will often not be a matter of mathematical calculation. The determination of what is equitable involves an evaluative judgement akin to the exercise of a discretion, and this court will only interfere with a first instance decision in the well-known and restricted circumstances which apply to the exercise of such a discretion" (para 123)

30. The Court of Appeal also considered that the extent of the breach and any disloyalty by the fiduciaries were relevant factors in determining how much (if any) equitable allowance should be given. Here, the Defendants were not found to be dishonest – a factor which no doubt made the court more comfortable in granting an equitable allowance.

31. Overall, the Court of Appeal upheld the High Court's decision in relation to equitable discretion and agreed with its reasoning – namely, that the five indicators set out in paragraph 110 were a valid reference point from which to determine the significance of the Defendant's contribution to the profits, as opposed to relying on the alleged profit-share agreement.

32. The Court of Appeal further held that it was within the High Court's discretion to make such a 25% allowance. Even though this argument was not specifically relied upon in the Defendants' pleadings, the Defendants' pleadings were drafted in such a way as to give the court discretion to make an allowance of less than 50% (the Defendants' preferred amount) in a manner the court deemed fit.

Key Takeaways for Fiduciaries in Breach

33. Fiduciaries and those advising them regarding potential breaches should bear in mind that:

- Beware the stringent rule: it will be upheld and enforced robustly.
- Profit-sharing agreements will not always protect you: Even a binding profit-share agreement that existed before the alleged breach will not limit the court's ability to enforce the stringent rule and examine the circumstances of the breach and the accrual of the relevant profits in the round, with 'justice' being the paramount concern.
- Time is not always on your side: with the exception of specific limitation arguments, the fact that time may have elapsed between the Claimant's knowledge of the fiduciary breach and their decision to bring litigation will not justify a temporal limit on the account for profits. The delay must be truly unconscionable, and there is no rule against a Claimant sitting back and weighing up the viability of the claim whilst profits are being generated.

- The court may make an equitable allowance for the fiduciaries to account for their hard work and skill, but their efforts in accruing the profits will be scrutinised, and the court will look to discern unique or specialist contributions, rather than just the normal work that would have been expected of anyone in the fiduciary's position.

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