Comment on Recent Developments in the Law

Fiduciary Liability and Constructive Trust

Marr v *Arabco Traders Ltd*[1]

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The circumstances in which a fiduciary relationship, with its associated obligations, liabilities and remedies will be found to exist within a commercial context and, more specifically, within negotiations leading up to the formation of a joint venture or partnership, have of late been the subject of much litigation and legal commentary.[2] The same is true of the circumstances in which a third person who becomes involved in a breach of fiduciary duty will be held liable in constructive trust.[3] Both issues were recently canvased by the High Court of New Zealand in *Marr* v *Arabco Traders Ltd,* a decision which confirms and develops some emerging trends in equity, clarifies New Zealand law and signals future developments in the law of fiduciary duties.

The Facts

The factual narrative in Tompkins J's judgment is lengthy and detailed,[4] tracing the movements, meetings and correspondence of the parties to the proceedings over a period of several years against a background of political and economic upheaval in the Middle East. The facts in very condensed form were as follows: In the early 1970s, two American businessmen, Black and Marr, and one New Zealander, Bromiley, formed, through a series of meetings and communications, what might be termed a loose association for the exploitation of commercial opportunities which they perceived were arising from potential fisheries development in and around the

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[Accepted for publication August 1988.]

1 (1987) 1 NZBLC 102, 732.

2 See *Hospital Products Ltd* v *United States Surgical Corporation* (1984) 55 ALR 417; *United Dominions Corporation Ltd* v *Brian Pty Ltd* (1985) 60 ALR 741; *Elders Trustee and Executor Co Ltd* v *E G Reeves Pty Ltd* (Fed Ct of Australia, unreported, 29 September 1987, Gummow J) Lehane, "Fiduciaries in a Commercial Context" in Finn (ed), *Essays in Equity* (1985) 95; Austin, "Commerce and Equity – Fiduciary Duty and Constructive Trust" (1986) 6 Ox J Leg Stud 444; The Hon Mr Justice B H McPherson, "Joint Ventures" in Finn (ed) *Equity and Commercial Relationships* (1987) 19.

3 See *Baden Delvaux and Lecuit* v *Societe General etc* [1983] BCLC 325; *United States Surgical Corporation* v *Hospital Products Ltd* [1983] 2 NSWLR 157, reviewed on other grounds (1984), 55 ALR 417; *Consul Development Pty Ltd* v *DPC Estates Ltd* (1975) 132 CLR 373; *Westpac Banking Corporation* v *Savin* [1985] 2 NZLR 41; *Lipkin Gorman* v *Karpnale Ltd* [1987] 1 WLR 987; Austin, "Constructive Trusts" in Finn, P D (ed); *Essays in Equity* (1985) 196; Harpum, "The Stranger as Constructive Trustee" (1986) 102 LQR 114 and 292; Heydon, "Recent Developments in Constructive Trusts" (1977) 51 ALJ 635.

4 The CCH editors "for convenience" summarised the facts in the headnote of the NZBLC version of the case.

Arabian Gulf and, in particular, Oman. By 1974, their co-operative relationship had become clear enough for Tompkins J to be able to refer to their "joint interest"[5] in developing those opportunities. But it was not until February of 1975 that the three agreed to incorporate an umbrella company which would function as a vehicle for their activities and carry out contracts which they obtained for it.

In the meantime, Bromiley had persuaded a contact of his, a New Zealand businessman named Hazard, to participate in the venture. Hazard was the chairman of directors of Allied Farmers Co-operative Ltd ("Allied"), a company which subsequently became one of the parties to the legal proceedings. With some reluctance, Marr and Black accepted Hazard's presence among them.

After the February 1975 meeting, Marr and Black left the incorporation in New Zealand of the umbrella company to Bromiley on the understanding that the shares in the company were to be held equally among the four parties. And Bromiley did cause Arabco Trading Ltd to be incorporated, but he and Hazard took all the shares in their own names in a 50/50 split.

Within a few months of the incorporation, a substantial contract with the Omanese government was obtained for Arabco Trading, but that government required certain financial and performance guarantees. Hazard and Bromiley agreed that Hazard would sell his Arabco Trading shares to Allied and Allied would provide the necessary financial backing for the Oman contract. The sale was completed in July of 1975 without the knowledge or consent of Marr and Black. At the same time, Bromiley transferred to Allied one of his shares in Arabco Trading so that Allied thereupon had a majority shareholding in Arabco Trading. Developments over the next two years included an appreciation in the value of the shares in Arabco Trading and increasing pressure by Marr and Black on Bromiley to complete a transfer to them of what they believed to be their shares in Arabco Trading. Bromiley did not complete the share transfer and in June of 1977, sold his remaining Arabco Trading shares to Allied.

In September of 1977, Marr and Black commenced proceedings in New Zealand against, inter alia, Bromiley, Hazard and Allied. They alleged that the 1975 and 1977 sales of Arabco Trading shares to Allied constituted a breach of the fiduciary duties which Bromiley and Hazard owed to them. They further alleged that Allied had received those shares with such knowledge of the breach of fiduciary duty involved in the transfer as to make Allied a constructive trustee for them. They further alleged that Hazard had knowingly participated in Bromiley's dishonest and fraudulent breach of duty and was therefore also liable in constructive trust.

The Decision

Tompkins J found as follows:

1 By the time of the 1975 sale of Hazard's shares to Allied, a fiduciary relationship among Marr, Black and Bromiley had come into existence.[6]

5 *Marr* at 746.
6 Ibid at 746-747.

No fiduciary relationship, however, existed at that or any other time between Marr and Black, on the one hand, and Hazard, on the other.[7]

2 Bromiley breached his fiduciary duty to the plaintiffs by failing to ensure that the shareholding in Arabco Trading reflected the arrangement they had made, by failing to inform Hazard of that arrangement, by participating in the sale of the Hazard shares to Allied,[8] and by the sale of the shares in his own name to Allied.[9]

3 Allied was liable in constructive trust to the plaintiffs in respect of the Arabco Trading shares which it had received from Bromiley.[10]

4 Hazard was not liable in constructive trust for his participation in Bromiley's breach of fiduciary duty.[11]

The Fiduciary Issue

It has been clear since the decision of the High Court of Australia in *United Dominions Corporation Ltd* v *Brian Pty Ltd,*[12] that negotiations leading up to the formation of a partnership or joint venture agreement are capable of generating fiduciary duties among the negotiating parties. And Tompkins J appears to extend that decision by his statement in *Marr* that fiduciary duties may also arise where the negotiations lead not to a partnership or joint venture but to "some relationship bearing a similarity to one or the other".[13]

But Tompkins J is not in fact intent upon revealing yet another form of commercial association from which fiduciary obligations will flow. He expressly repudiates rigid thinking about "fiduciary categories"; that is, any approach whereby a finding that a party is, for example, a partner or joint venturer itself determines the question of whether fiduciary duties exist or what the scope of a fiduciary duty might be.[14] In his view, the court should look to the factual nature of the dealings between the parties and not simply to the legal form of their relationship when deciding whether or not a fiduciary relationship has arisen.

That much is clear and relatively uncontentious. But what exactly are the courts to look *for* when they look to the factual nature of the dealings between the parties? The answer, in *Marr,* seems to be "mutual confidence":[15]

7 Ibid at 749.
8 Ibid at 751.
9 Ibid at 762-763.
10 Ibid at 760.
11 Ibid at 762.
12 (1985) 60 ALR 741.
13 *Marr* at 747. Given the potential breadth of the "joint venture" concept in the current state of the law, one wonders what sort of relationship might be similar to a joint venture and yet not be one. Since the parties in *Marr* were found by Tompkins J, at 746, to have agreed to be "jointly associated" for a "common purpose", namely, the exploitation of business opportunities in fisheries development in the Middle East and also to have agreed to share the profits equally among themselves, it might simply be possible to call them "joint venturers" or "negotiators for a joint venture" and thereby analytically restrict the ambit of Tompkin J's judgment.
14 *Marr* and *Black* at 743.
15 Ibid at 745.

> The essential issue will be whether the relationship, however it may be described or categorised, imports between the participants a duty to act in perfect fairness, in good faith and honestly to each other. That will depend on the nature of their dealings and the extent to which those dealings, by their very nature, require the participants so to act. If the course of dealing indicates an intention to carry out a common purpose by a joint association in a way that involves mutual confidence in each other, fiduciary duties may well result.

And Tompkins J is able to point to an impressive array of authorities to support his view that the presence of such confidence is an important indication of the existence of a fiduciary relationship.[16]

The concept of mutual confidence, however, is an elusive one in the context of fiduciary relations. Gibbs C J pointed out in the *Hospital Products* case[17] that the existence of subjective trust and confidence cannot be either a necessary or a sufficient condition for the finding of a fiduciary duty. Parties to an ordinary commercial contract, dealing at arm's length, might well repose full subjective trust and confidence in each other without, presumably, thereby generating fiduciary obligations. And it is, surely, not the law that proof of one party's private and personal lack of trust or confidence in his business associate could preclude a finding of a fiduciary relation between the two. The "mutual confidence" must therefore be objectively determined and determinable; that is, the dealings must be such that the parties would be warranted or justified in reposing confidence in each other, whether they subjectively do so or not.

The issue is not directly addressed by Tompkins J. Although the reasoning in the passage quoted above is consistent with an objective test for the required confidence, a subjective note emerges when his Honour analyses the factual situation before him. In finding a fiduciary relationship among Marr, Black and Bromiley, he states that there had, "at least by that time, developed a mutual confidence that each would act in good faith . . .";[18] in finding that Hazard did not owe a fiduciary duty to the plaintiffs, he states:[19]

> I do not consider that the relationship that existed between Mr Hazard, the plaintiffs and Mr Bromiley, had reached such a degree of mutual confidence as to give rise to fiduciary relations.

It may be that his Honour is simply failing to make explicit one particular step in his analysis, that he intends to convey, for example, a finding that the actual dealings between Hazard and the plaintiffs were not such as to entitle either party to expect that the other would act in a 'fiduciary' manner towards him. But the same difficulty arises in *Brian,* since Dawson J's statements in that case also are at least consistent with the proposition

16 *Birtchnell* v *Equity Trustees Executors & Agency Co Ltd* (1929) 35 ALR 273; *New Zealand Netherlands Society "Oranje" Inc* v *Kuys & The Windmill Post Ltd* [1973] 2 NZLR 163; *Coleman* v *Myers* [1977] 2 NZLR 225; *United Dominions,* supra n 2.

17 *Hospital Products,* supra n 2 at 433.

18 *Marr* at 747.

19 Ibid at 749.

that the parties must in fact have confidence in each other before a fiduciary relation will be found to exist.[20]

The emergence of mutual confidence as a significant indicator of fiduciary duties makes an authoritative clarification of the concept urgently desirable.[21] Certainly the prospect of a judicial inquiry into the hearts and minds of business associates for the purpose of ascertaining the degree to which they trust each other is alarming, as is the prospect of the courts explicitly recognising an objective test and in fact applying a subjective one.

Once a fiduciary duty has been found to exist, the scope and content of the duty must be defined. What is one party to a consensual fiduciary relationship entitled to expect of the other? Tompkins J finds that the duty is "to act in perfect fairness, in good faith and honestly to each other";[22] one looks in vain in his Honour's judgment for a representative element in the duty, for any requirement that a fiduciary is to act "for or on behalf" of another in some particular matter or matters".[23] The replacement of a requirement that a fiduciary act "on behalf of" or "in the interests of" the beneficiary of the fiduciary duty with a requirement merely of good faith, fairness and honesty constitutes a significant restriction of the scope of a fiduciary duty and a corresponding increase in the vulnerability of the beneficiary. And "good faith" is, at least in the present state of equity, a nebulous concept. Professor Finn has recently described the good faith standard of conduct as one which permits a party to act in his own interests while requiring him to have "regard to the legitimate interests of the other"[24] and has warned against a confusion of that standard with the fiduciary standard.[25] It may be that the traditional "on behalf of" formulation of a fiduciary duty is inappropriate to consensual fiduciary relationships and should be modified to a formulation requiring such a fiduciary to act in the joint interests of himself and the beneficiary.[26] But diluting the fiduciary standard further than that is to risk undermining the established body of equitable principles and precepts which have hitherto been understood to

20 See, for example, the statements at 750 that, "even in a partnership, it is really the mutual confidence between partners which imposes fiduciary duties upon them . . ." and "the relationship may nevertheless be a fiduciary one if the necessary confidence is reposed by the participants in one another . . ."

21 Although both Gibbs C J and Dawson J in *Hospital Products* at 433 and 492, respectively, make their views plain, the *Brian* case makes a further consideration of the issues associated with the concept of mutual confidence desirable.

22 *Marr* at 745. See also at 747 where Tompkins J states that a fiduciary duty requires, "each to act towards the other with complete fairness, honesty and candour".

23 This formulation is found in Finn, *Fiduciary Obligations* (1977) at 201 and was given qualified acceptance by Gibbs C J in the *Hospital Products* case at 435. In *Elders Trustee* at 100, the test was whether the person alleged to be a fiduciary had undertaken to act on behalf of or in the interests of the plaintiffs.

24 Paper presented by P D Finn to *The International Symposium on Trusts, Equity and Fiduciary Relationships,* Faculty of Law, University of Victoria, British Columbia, Canada, February 14-17 1988 at 5.

25 Ibid at 33.

26 Professor Austin in "Commerce and Equity – Fiduciary Duty and Constructive Trust", at 446-447, suggests this extension of principle and draws support for it from the dissenting judgment of Mason J in *Hospital Products* at 456. Professor Austin notes that none of the other members of the court in that case disagreed with Mason J on the point.

regulate the conduct of fiduciaries. The stringent rules governing conflicts and potential conflicts of interest in fiduciary law, for example, could be transformed by a standard which merely requires a fiduciary to "have regard to" the interests of the beneficiary.

Third Person Liability

(i) Liability for Knowing Receipt

Strangers to a fiduciary relationship who knowingly receive property transferred by a fiduciary in breach of his duty hold that property on a constructive trust for the beneficiary of the fiduciary duty[27] and Tompkins J accordingly found that Allied was a constructive trustee of the shares in Arabco Trading which Bromiley had sold to it in breach of his fiduciary duty to the plaintiffs.[28] Allied did not, however, at the time of its share purchase, have actual knowledge that Bromiley was acting in breach of his fiduciary duty; nor did it have "Nelsonian" knowledge. Allied had only such knowledge of the circumstances as would indicate to an honest and reasonable man that a breach of duty was being committed or such knowledge as would have put an honest and reasonable man on enquiry as to whether a breach of duty was being committed.[29] In short, Allied had constructive knowledge and that, in the view of Tompkins J, was sufficient.

The requisite state of knowledge on the part of the third person recipient has been a subject of controversy in recent years and a sharp difference of opinion between the courts of the United Kingdom and New Zealand courts is beginning to emerge. *Marr* is in full accord with the earlier New Zealand Court of Appeal decision in *Westpac Banking Corporation* v *Savin* and both cases stand for the proposition that a third person who knows *or ought to know* that he is receiving property transferred to him in breach of fiduciary duty will be liable in constructive trust. That proposition, however, has been rejected in the two most recent English cases on the subject, *Lipkin Gorman* v *Karpnale Ltd*[30] and *Re Montagu's Settlement.*[31]

In the view of the present writer, a requirement of actual knowledge on the part of the third person recipient not only imposes too heavy a burden of proof and too great a risk of loss on the beneficiary of a fiduciary duty it provides no incentive to third persons to exercise care in their dealings with fiduciaries. Since the existence of a fiduciary relationship increases a beneficiary's vulnerability and risk of loss, it is not unreasonable to require of third persons that they minimise those risks by complying with an objectively-formulated standard of conduct. And this can be achieved by

27 *Barnes* v *Addy* (1874) L R 9 Ch App 244; *Westpac Banking,* supra n 3.

28 *Marr* at 760.

29 Ibid at 759. These two types of knowledge are increasingly being referred to as "types (iv) and (v) of the *Baden* categories". The reference is to a catalogue of the types of knowledge relevant to the law of third person liability made by Peter Gibson J in *Baden Pelvaux,* supra n 3, at 407, a catalogue which ranges from type (i), which is actual knowledge, through to type (v), which is such knowledge of circumstances as would put the reasonable man on enquiry as to whether a breach of fiduciary duty was being committed by the fiduciary with whom he was dealing.

30 Supra n 3.

31 [1987] 2 WLR 1192.

the application to third persons of the equitable doctrine of constructive knowledge, where constructive knowledge is defined in such a way that the concepts of "reasonableness" and the "reasonable man" inform the decision of what the third person ought to have known.

(ii) Liability for Knowing Assistance

Third persons who knowingly assist in a fiduciary's dishonest and fraudulent breach of duty are liable in constructive trust to the beneficiaries of that duty.[32] In *Marr,* Hazard was able to avoid such liability because he did not have the required *actual* knowledge of Bromiley's fraudulent and dishonest breach of duty and because he was not, in Tompkin J's phrase, "an assister of the kind envisaged in Lord Selborne's second category".[33]

Tompkin J's shift from accepting constructive knowledge as sufficient for liability in the category of knowing receipt to requiring actual knowledge for liability as a knowing assistant is, with respect, misguided. Recourse to authority in an area of law as confused and conflicting as this one[34] is not an adequate response to the problem and his Honour unfortunately provides little or no reasoning to support his position. In the view of the present writer, the considerations noted above with respect to the sufficiency of constructive knowledge in the category of knowing receipt apply with equal force to this category of liability. The law governing third person liability should strive for a balance between protecting vulnerable beneficiaries and avoiding an unduly onerous imposition of liability on third persons who, unlike fiduciaries, have never had confidence reposed in them and have never undertaken to act in anyone's interests except their own. The doctrine of constructive knowledge helps to create such a balance; the requirement of actual knowledge distorts it.

Hazard was found not to be an "assister" in Bromiley's breach of duty on the further ground that he had been involved in the sale transaction only by virtue of his position as chairman of Allied.[35] Although he had conducted the negotiations and played a mediating role between Bromiley and Allied's managing director, he had done so only in his capacity as chairman and in the view of Tompkin J a third person will not be made

32 *Barnes* v *Addy,* supra n 27.

33 *Marr* at 762. The reference is to Lord Selbourne's judgment in *Barnes* v *Addy,* ibid.

34 Tompkins J points at 761-762, to an *obiter* opinion of Sir Clifford Richmond in the *Westpac Banking* case, to *Belmont Finance Corp* v *Williams Furniture Ltd* (No 2) [1980] 1 All E R 393 and to the judgment of Stephen J in *Consul Development,* supra n 3, as authorities for the requirement of actual knowledge in this category of liability. But constructive knowledge has been accepted as sufficient for such liability in *Selangor United Rubber Estates Ltd* v *Cradock (No 3)* [1968] 1 WLR 1555; *Karak Rubber Co Ltd* v *Burden (No 2)* [1972] 1 WLR 602; *Rowlandson* v *National Westminster Bank* [1978] 1 WLR 798; *Baden Delvaux,* supra n 3. Furthermore, Tompkins J does not distinguish between "type (iv)" knowledge, that is, knowledge of circumstances which would indicate to a reasonable man that a breach of fiduciary duty was being committed, and "type (v)" knowledge, that is, knowledge of circumstances which would put the reasonable man on enquiry as to whether a breach of duty was being committed. Yet Stephen J in the *Consul Development* case rejects outright only the latter.

35 *Marr* at 762.

liable for knowing assistance unless he is "acting otherwise than on behalf of the person receiving the trust property".[36]

Marr, however, does not stand for any general proposition according protection to third persons acting *ex officio* in transactions involving fiduciaries. This is demonstrated by the *Westpac Banking* case, where the managing director of a limited company which had acted as a fiduciary agent for the plaintiffs and breached its duty was held liable at trial for having knowingly participated in the company's fraudulent design to breach its fiduciary duty.[37] In that case, however, the director had taken an active and indeed dominant role in the transactions and it was not clear that the simple fact of his position as director of a breaching fiduciary would have been a sufficient act of "assistance" to fulfil the requirements of that element of liability. The director did not appeal from the trial decision, so the Court of Appeal did not have the opportunity to review the law on the topic.

The areas of equity with which *Marr* is concerned are changing rapidly and the case itself is a valuable contribution to that process of change.

36 Id.
37 *Westpac Banking,* supra n 3, at 54.