FHR v Mankarious: Secret Profits by Fiduciaries

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Introduction

Following the controversial case of *Sinclair v Versailles*[1] (which followed the similarly controversial case of *Lister v Stubbs*[2]), English law on proprietary remedies over secret profits made by fiduciaries is incoherent and unnecessarily complex. It is also submitted that it is wrong in principle. The interests of creditors of a fiduciary have been allowed to prevail over the interests of the principal. As discussed further below, it is difficult to justify such a policy.

In the recent case of *FHR European Ventures v Mankarious*,[3] the Court of Appeal did decide, on the facts of that particular case, that the secret profit received by the fiduciary was the property of the fiduciary's principal and therefore not available to the fiduciary's creditors. However, the rationale for the decision exposes the incoherence of English law on the issue. In particular it involves a fiction, namely that opportunities exploited by fiduciaries are effectively owned by their principals in order to paper over the hole that *Sinclair Investments* otherwise leaves. It is submitted that the law of property and the law of equity have as a result become incoherently fused.

Mankarious

In July 2004 the first defendant, Mr Mankarious, established Cedar Capital Partners ("Cedar") in order to provide consultancy services to the hotel industry. Cedar's client list included the Bank of Scotland ("BOS") and Fairmont Hotels and Resorts ("Fairmont"), the fourth and sixth claimants respectively, who instructed Cedar to investigate and recommend to them investment opportunities in the hotels market. The second claimant ("Kingdom"), which represented the commercial interests of Prince Alwaleed bin Talal bin AbdulAziz al Saud, became involved at a later stage, after Mr Mankarious had brought together the group of investors (which included Cedar) in or around August 2004.

The dispute centred on the sale of the Monte Carlo Grand Hotel ("the hotel"), which took place in December 2004. The hotel was owned by a Monegasque company called Monte Carlo Grand Hotel SAM ("the Monegasque company"). The Monegasque company's share capital was in turn owned by a BVI company, Monte Carlo Grand Hotel Ltd ("the BVI company"). The BVI company was controlled by a Lebanese businessman, Mr Toufic Aboukhater. The first claimant ("FHR") was established as a vehicle for the investors to purchase the share capital of the Monegasque company from the BVI company.

Mr Mankarious had learned of Mr Aboukhater's intention to sell the hotel some time prior to establishing Cedar, and so in early October 2004 he negotiated a memorandum of understanding with the vendors to assist with the sale of the hotel on an "off-market" basis. The memorandum set out indicative terms by which Cedar would introduce a joint venture company that would obtain exclusive rights to purchase the vendors' interest in the hotel for a sum in excess of €200 million. On December 21, 2004 the second, fourth and sixth claimants agreed terms by which their subsidiaries, the seventh, fifth and third claimants became shareholders in FHR. As agent, Cedar invoiced FHR in respect of its work to facilitate the sale.

Following the successful acquisition of the hotel, Cedar continued to work on behalf of FHR on other projects. However, in April 2005 the second claimant discovered that Cedar had been paid an additional commission of €10 million by the vendors in relation to the sale of the hotel. In September 2005 FHR wrote to Cedar complaining about the fee, ending the business relationship between FHR and Cedar and making clear that Cedar's invoices would not be paid pending the outcome of proceedings to recover the €10 million payment in a claim for breach of fiduciary duty.

It emerged that the vendors had granted Cedar the right to act as sole selling agent of the hotel on its behalf under an "Exclusive Brokerage Agreement" dated September 24, 2004. This agreement contained the following terms:

"2. **Responsibilities**

Cedar's sole responsibility during the term of the Agreement is to identify and introduce prospective purchasers. Cedar shall not participate in any negotiations with the Purchaser on behalf of the Owner …

3. **Fee**

In consideration of the services of Cedar hereunder in securing the Purchaser … Owner agrees to pay Cedar a fee … equal to … €10 million.…

[1] *Sinclair Investments v Versailles* [2011] EWCA Civ 347; [2012] Ch. 453.
[2] *Lister v Stubbs* (1890) 45 Ch. D. 1 CA.
[3] *FHR European Ventures v Mankarious* [2013] EWCA Civ 17; [2013] 3 W.L.R. 466.

4. **Investor Group**

Cedar intends to introduce Owner to a purchaser which is a group consisting of a number of investors, which shall include, but not be limited to the following companies/individuals: [BOS], [Fairmont], [Kingdom] ... (or any one or more entities related or affiliated with such parties ('Investor Group').

...

6. **Terms of Agreement of Sale and Purchase**

... Owner acknowledges that Cedar intends to advise and be a member of the Investment Group purchasing the Property and pursuant to Paragraph 7 of this Agreement, Owner waives any conflict that may arise due to Cedar acting as a facilitator under this Agreement and as participating as part of the Investor Group ...

7. **Conflict of Interest**

The parties all understand that Cedar is only acting as a facilitator to introduce the Owner to the Purchaser. It is contemplated that Cedar will advise and be part of the Investor Group purchasing the Property ... The parties all understand and waive any conflict of interest that may arise ... Cedar shall disclose its appointment hereunder to the investor group."

The trial judge, Simon J., had no difficulty in concluding that Cedar owed fiduciary duties to BOS and Fairmont (and their subsidiaries) in negotiating the purchase of the hotel and that it then owed certain duties to Kingdom from the time it agreed to join the joint venture in October 2004.

The main question that arose at trial was whether Cedar and Mr Mankarious had disclosed to FHR and the other investors the full nature and extent of the remuneration that was to be paid to them by the vendors if the sale of the hotel went ahead, as unless Cedar had obtained the informed consent of BOS, Fairmont and Kingdom, it could not keep the €10 million commission.

It was held that Cedar had not discharged its duty of full disclosure; it was incumbent on Cedar to inform its principals not only that it was receiving a commission but also, given that it was such a large sum in proportion to the €400,000 Cedar had invoiced, that it was to the value of €10 million. As such, it was not entitled to retain the commission. The judge went on to say that "if it did, it would hold the sum subject to a Constructive Trust".[4]

In a subsequent hearing to decide on the form of Order that the trial judge was to hand down, he acknowledged that his use of the phrase "Constructive Trust" had been unfortunate.[5] Arguments ensued around the Court of Appeal's decision in *Sinclair Investments*,[6] ultimately leading the judge to decide that the claimants were not entitled to a proprietary remedy against Cedar as they would have been if a constructive trust had been established; rather, they were only entitled to the personal remedy of an account in equity. The claimants appealed this decision.

On appeal, it was accepted by the defendants that they were liable to account (personally) in equity for their breach of fiduciary duty, but the key issue in dispute was whether the claimants were entitled to claim a proprietary interest over the defendant's secret commission. This was considered important so as to permit and facilitate the following and tracing of the funds.

The categorisation in Sinclair Investments

In *Mankarious*, the Chancellor referred to Lord Neuberger's analysis in [88] and [89] of *Sinclair Investments*, which he explained

> "divides into three broad categories the situations in which a fiduciary obtains a benefit in breach of fiduciary duty. The first category (Category 1) is where the benefit is or was an asset belonging beneficially to the principal (most obviously where the fiduciary has gained the benefit by misappropriating or misapplying the principal's property). The second category (Category 2) is where the benefit has been obtained by the fiduciary by taking an advantage of an opportunity which was properly that of the principal. The third category (Category 3) is all other cases. According to the analysis and conclusion of Lord Neuberger, the situations in Categories 1 and 2 give rise to a constructive trust [which gives the principal a proprietary claim over the assets in question], but those in Category 3 do not."[7]

The issue in *Mankarious* was ascertaining the borderline between Category 2 and Category 3.

The Chancellor went on to say that the case

> "throws into clear relief, however, the very considerable difficulties inherent in the analysis in Sinclair Investments and the decision in Lister in marking the borderline between cases in Category 2 and those in Category 3. This has made the law more complex and uncertain and dependant on very fine factual distinctions. If the law is to be made simpler and more coherent, but Sinclair Investments and Lister correctly represent the law, then that

[4] *Mankarious* [2011] EWHC 2308 (Ch); [2012] 2 B.C.L.C. 39 at [103].
[5] *Mankarious* [2011] EWHC 2999 (Ch) at [19].
[6] *Sinclair Investments* [2011] EWCA Civ 347; [2012] Ch. 453.
[7] *Mankarious* [2013] EWCA Civ 17; [2013] 3 W.L.R. 466 at [83].

suggests a need to revisit the very many longstanding decisions in Category 2 cases and to provide an overhaul of this entire area of the law of constructive trusts in order to provide a coherent and logical legal framework. If that can be done at all by the courts, rather than Parliament, it can only be accomplished by the Supreme Court. That indicates a need for informed debate and ultimately determination by the Supreme Court: (1) whether Sinclair Investments was right to decide that Lister is to be preferred to Reid; (2) in terms of constructive trusts and proprietary relief for breach of fiduciary duty, what are the principles to distinguish opportunity cases within Category 2 and those within Category 3; (3) what is the true jurisprudential nature of the constructive trust in this (and by necessity other) areas of the law, including whether it is—or should be—an institutional trust at all or something else. In considering those matters, there are important issues of policy, and the relative importance of different policies, to assess, including deterring fraud and corruption; the ability to strip the fiduciary of all benefits, including increases in the value of benefits, acquired by breach of duty, and vehicles or third parties through which those benefits have been channelled; the importance attached to the protection of those to whom fiduciary duties are owed; and the position of other creditors on the fiduciary's insolvency who may be prejudiced by a constructive trust or proprietary relief in favour of the fiduciary's principal but who, in the absence of such a trust and relief, would benefit from increases in value of assets acquired by the fiduciary's fraud, corruption or wrongdoing. It will also be necessary to bear in mind the international perspective applying to this area of trust law and equity, to which I have referred earlier in this judgment."[8]

It is submitted that the difficulties that the Chancellor had in ascertaining the borderline between Category 2 and Category 3 cases is because Category 2 appears to be little more than a fiction to try to reconcile *Lister* with *Keech v Sandford*[9] and similar cases.

In *Sandford*, the court ordered a trustee who had acquired a new lease for his own benefit to transfer that lease to the beneficiary, even though the landlord was not prepared to renew the original lease to the beneficiary. As the Chancellor explained in *Mankarious*, the only basis for the result in *Sandford* was that the new lease was held on constructive trust from the moment it was acquired by the trustee. There was no question that the new lease was an asset that already belonged to the beneficiary so as to fall within Category 1. It therefore required (on the basis of the analysis in *Lister* as approved in *Sinclair Investments*) the creation of a Category 2.

In *Boardman v Phipps*,[10] which was given only cursory attention in *Sinclair Investments* but was considered in more detail in *Mankarious*, the fiduciary acquired shares in a private company with knowledge gained from his fiduciary position and those shares increased in value. Again, there was no question that the shares were, before their acquisition by the fiduciary, the property of the claimant so as to fall within Category 1. However, the fiduciary was found to hold the shares on trust for the claimant. The Chancellor concluded that *Phipps* was therefore a Category 2 case, the fiduciary having used an opportunity that came to him while acting in his fiduciary capacity.

The supposed existence of Category 2 is, however, based upon the use of loose language in *Sinclair Investments* such as an opportunity (in particular the opportunity in *Sandford* to renew the lease) being "effectively" owned by a trust or being "really" owned by the beneficiary. As a matter of property law an opportunity is not property; it cannot be owned, charged or held on trust.

Further, in *Sinclair Investments* Lord Neuberger referred to a

> "fundamental distinction between (i) a fiduciary enriching himself by depriving a claimant of an asset and (ii) a fiduciary enriching himself by doing a wrong to the claimant".[11]

But the existence of such a distinction is not the explanation for the result in either *Sandford* or *Phipps*. In both cases, a proprietary remedy was granted, but in neither case was there an asset to which the claimants could assert title. In the first of those cases the landlord would not grant a new lease to the beneficiary and in the second case the evidence suggested the principal would not in any event have acquired the shares that the fiduciary did. So it is not clear in either case that the claimant was being deprived of an asset. What the claimant was being deprived of was the single-minded loyalty which he was entitled to expect from his fiduciary, free from the corrupting influence of an interest of his own. It is submitted that that is the reason why equity says the fiduciary does not obtain for himself the beneficial interest in the property acquired: he is liable to account for the property the moment he receives it and is not entitled to keep for himself or his creditors any benefit that accrues from his receipt. The proprietary interest which accrues to the principal under a constructive trust arises as a result of the application of the strict rules of equity governing breach of fiduciary duty; it does not depend upon establishment of a prior property interest on the part of the claimant.

In *Mankarious* the Court of Appeal then sought to grapple with whether that particular case fell within Category 2 or Category 3, seeking to shoehorn into

[8] *Mankarious* [2013] EWCA Civ 17; [2013] 3 W.L.R. 466 at [116].
[9] *Keech v Sandford* (1726) Sel. Cas. Ch. 61.
[10] *Boardman v Phipps* [1967] 2 A.C. 46 HL.
[11] *Sinclair Investments* [2011] EWCA Civ 347; [2012] Ch. 453 at [80].

Category 2 cases where the fiduciary had been found to hold property on constructive trust and consider the limits of Category 2 by reference to those cases.

This area of the law is, as the Chancellor indicated, badly in need of an overhaul to make it more coherent and to take into account the policy considerations referred to by the Chancellor. In following *Lister* and trying to reconcile it with cases such as *Sandford* and *Phipps*, the Court of Appeal has set English law on a path that is divergent from that taken by other jurisdictions, incoherent and, it is submitted, unsound in principle.

The divergence of English law from the law of other common law countries

In *Lister*, the defendant was employed to buy materials for his employers, but received commissions from the suppliers, some of which he invested profitably in shares. Lindley L.J. considered:

> "[T]he question, as between Lister & Co. and Stubbs, whether Stubbs can keep the money he has received without accounting for it? Obviously not. I apprehend that he is liable to account for it the moment that he gets it. It is an obligation to pay and account to Messrs. Lister & Co., with or without interest, as the case may be. I say nothing at all about that. But the relation between them is that of debtor and creditor; it is not that of trustee and cestui que trust. We are asked to hold that it is—which would involve consequences which, I confess, startle me. One consequence, of course, would be that, if Stubbs were to become bankrupt, this property acquired by him with the money paid to him by Messrs. Varley would be withdrawn from the mass of his creditors and be handed over bodily to Lister & Co. Can that be right? Another consequence would be that, if the Appellants are right, Lister & Co. could compel Stubbs to account to them, not only for the money with interest, but for all the profits which he might have made by embarking in trade with it. Can that be right? It appears to me that those consequences shew that there is some flaw in the argument. If by logical reasoning from the premises conclusions are arrived at which are opposed to good sense, it is necessary to go back and look again at the premises and see if they are sound. I am satisfied that they are not sound—the unsoundness consisting in confounding ownership with obligation."[12]

There is nothing remarkable in the consequences identified by Lindley L.J. were the secret commissions to be treated as property of the principal. There is no logical reason why creditors should expect to benefit from the fraud or wrongdoing of the fiduciary. There is also no logical reason why the fraudulent fiduciary should not have to account for all profits made using the bribe fraudulently obtained. Indeed, to allow him to do so would be inconsistent with the strict approach taken in secret commission cases: as Lord Templeman in *Attorney-General for Hong Kong v Reid* said, "Bribery is an evil practice which threatens the foundations of any civilised society."[13]

Even in *Sinclair Investments*, when Lord Neuberger followed *Lister* he expressed the view, inconsistent with that of Lindley L.J., that equitable compensation might be extended to enable the compensation to include the amount of profit obtained by the fiduciary. This was in recognition of the public policy reasons for stripping the defaulting fiduciary of all profits made.

Further, the issue of whether there is a proprietary claim is not just about the need to strip the fiduciary of any unauthorised profit. It is also about the need to trace the proceeds of the fiduciary's fraud into the hands of third parties, who may have had no involvement in the fiduciary's wrongdoing so as to be primarily liable. If the proceeds cannot be traced, then defaulting fiduciaries may seek to retain the benefit of their wrongdoing by setting up structures where a judgment against the fiduciary for an account will not enable enforcement to take place against any bribe received or the proceeds of such bribe. For example, if the bribe is paid to unsuspecting trustees of a discretionary trust of which the fiduciary and his family are the objects, the absence of a proprietary claim may deny any effective remedy to the principal, or at any rate make enforcement that much more difficult.

In *Sinclair Investments* the breach of fiduciary duty involved the defaulting company director pumping up the value of shares that he owned in order to make an unauthorised profit. What if the shares had first been settled into a discretionary trust in circumstances which did not enable such settlement to be set aside under any relevant insolvency provisions? If there is no arguable proprietary claim to the unauthorised profit, it is not at all clear that any judgment would treat the "profits" of the discretionary trust as those of the defaulting fiduciary so as to strip him of that unauthorised profit. The law on accessory liability, and in particular the requirements of knowledge, does not guarantee that a claim would lie against the trustee. This is not merely a theoretical risk: the author has had just such a case in practice.

In addition to the above policy considerations, Lord Millett, in his article "Bribes and secret commissions again",[14] sets out in detail why:

(1) *Lister* was wrong in principle;
(2) a proprietary claim to the secret commission is consistent with the authorities before *Lister* (and *Metropolitan*

[12] *Lister* (1890) 45 Ch. D. 1 at 15.
[13] *Attorney-General for Hong Kong v Reid* [1994] 1 A.C. 324 PC (New Zealand) at 330.
[14] Peter Millett, "Bribes and secret commissions again" (2012) 71(3) C.L.J. 583.

Bank v Heiron,[15] the one case relied on by the court in *Lister* in support of its conclusion); and

(3) a proprietary claim is the result of the proper application of equitable principles where a fiduciary receives a secret commission.

It is not proposed to repeat those arguments further in this article.

The courts of other countries, such as Australia, New Zealand, Singapore and Canada, have chosen not to follow *Lister*. As regards New Zealand, the decision not to follow *Lister* was taken by the Privy Council in *Reid*:

> "The decision in *Lister & Co. v. Stubbs* is not consistent with the principles that a fiduciary must not be allowed to benefit from his own breach of duty, that the fiduciary should account for the bribe as soon as he receives it and that equity regards as done that which ought to be done. From these principles it would appear to follow that the bribe and the property from time to time representing the bribe are held on a constructive trust for the person injured. A fiduciary remains personally liable for the amount of the bribe if, in the event, the value of the property then recovered by the injured person proved to be less than that amount.
>
> The decisions of the Court of Appeal in *Metropolitan Bank v. Heiron* , 5 Ex.D. 319, and *Lister & Co. v. Stubbs* , 45 Ch.D. 1, are inconsistent with earlier authorities which were not cited. Although over 100 years has passed since *Lister & Co. v. Stubbs*, no one can be allowed to say that he has ordered his affairs in reliance on the two decisions of the Court of Appeal now in question. Thus no harm can result if those decisions are not followed."[16]

The Court of Appeal in *Sinclair Investments* nevertheless decided that it was bound by *Lister* and doubted the reasoning in *Reid*. Lord Millett explains in "Bribes and secret commissions again" why the Court of Appeal was wrong to doubt *Reid*. In his article "Constructive trusts: an analysis of *Sinclair v Versailles*",[17] Paul McGrath QC explains why reliance in *Sinclair Investments* on authorities relating to categorisation of constructive trusts for purposes of limitation was misplaced. It is not proposed to repeat those arguments in this article.

Subsequent to *Sinclair Investments* the Jersey court in *Republic of Brazil v Durant*[18] stated:

> "Were it necessary for us to decide the point we would have been inclined to agree with Mr. Baker and would have applied *Reid*, this court not being constrained in the way that Lord Neuberger M.R. and the other members of the court in *Sinclair* evidently felt bound by a long line of authority including five Court of Appeal decisions. Moreover, the composition of the court in *Reid* (Lords Templeman, Goff, Lowry and Lloyd, and Sir Thomas Eichelbaum) reflected a notable breadth of jurisprudential experience. As Lawrence Collins J., later a Justice of the Supreme Court, put it in *Daraydan Holdings & Ors. v. Solland International Ltd.* [2005] Ch. 119 (a pre-Sinclair decision), in declaring that he would have followed *Reid* had he not been able to distinguish *Lister v. Stubbs*, 'There are powerful policy reasons for ensuring that a fiduciary does not retain gains acquired in violation of fiduciary duty … .'."

Thus there is presently a divergence between English law and the law of various other common law jurisdictions on the issue of whether or not a proprietary claim will exist when a fiduciary makes a secret profit. It remains to be seen how that will play out in cases involving multiple jurisdictions, where there may be a tension between the governing law of the fiduciary relationship and the law of the forum It is hoped that before then, English law is brought into line with that in *Reid*, given the policy reasons and the arguments of principle that have been set out by Lord Millett writing extra-judicially.

[15] *Metropolitan Bank v Heiron* (1880) 5 Ex. D. 319 CA.
[16] *Reid* [1994] 1 A.C. 324 at 336.
[17] Paul McGrath, "Constructive trusts: an analysis of Sinclair v Versailles" (2012) 4 L.M.C.L.Q. 517.
[18] *Republic of Brazil v Durant* [2012] JRC 211 at [184].