Forfeiture of partner profit share

Hosking v Marathon Asset Management LLP

ten old square
Chancery and Commercial Barristers

THE SPECIFIC QUESTION CONSIDERED

- "Whether the share of profits of a partner of a partnership or a member of an LLP, paid out pursuant to and in accordance with a partnership or LLP deed, can be subject to the principle of forfeiture on the basis of the partner's/member's breach of fiduciary duties".
- Answer: Yes! (in principle).
- Appeal on a point of law from a decision of an arbitrator to forfeit £10.389 million!

THE GENERAL PRINCIPLES OF FOREITURE

Snell's Equity (33rd ed) states, at para 7.62, that (emphasis added):

> "If a fiduciary acts **dishonestly** he will **forfeit** his right to fees paid or payable by the principal (as distinct from sums paid by a third party, such as a briber). He will also forfeit his right to such fees **if he takes a secret profit from a third party which is directly related to performance of the duties in respect of which the fees were payable by the principal**, even if the principal has benefited from the fiduciary's performance of those duties. However, a fiduciary's fees **may not** be forfeit if the betrayal of trust has **not been in respect of the entire subject matter of the fiduciary relationship** and where forfeiture would be **disproportionate and inequitable**.
>
> A fiduciary **will also lose** his or her right to fees payable by the principal if the fiduciary's breach of duty is **so grave** that there has **effectively been no performance at all, on the basis of total failure of consideration**."

FACTS OF HOSKING

- a member of an LLP was found to have been planning a team move.
- The LLP began arbitration proceedings and the arbitrator found that the member had committed serious breaches of fiduciary duty.
- He therefore determined that he should:
  - pay the LLP a substantial sum by way of equitable compensation for the lost chance of keeping the team (an amount fixed at £1.38m); and
  - forfeit his right to 50% of his profit share (£10.389m).

WHY IN HOSKING WAS 50% FORFEIT?

- The arbitrator decided that 50% was the appropriate percentage because (given the terms of the LLP agreement), 50% of his profit share could be viewed as remuneration – this was the part he forfeited.
- The LLP agreement distinguished between what was called "half rations" and "full rations". Full rations (paid to executive members) being twice half rations (paid to non-executive members).
- Executive members had duties (including fiduciary duties). Non-executive members were being paid for their ownership interest. In effect the extra 50% was for running the business.
- Hence the arbitrator concluded 50% of the payments were "in substance, remuneration for the performance of executive duties".

NOW BACK TO THE PRINCIPLES…..

- This is in addition to damages! Can end up better off!
- *Premium Real Estate Ltd v Stevens* [2009] 5 LRC 56, per Blanchard J at 89F-G:

> "It is, however, quite clear that if the agents had not acted in good faith they would have been denied their commission, or been required to disgorge it if already received, notwithstanding that the plaintiff was being 'made whole' by the award of damages. **That would have left the plaintiff better off than if the transaction had proceeded without any breach of fiduciary duty**, but the **double sanction** of damages and forfeiture of monies received or receivable by way of remuneration is equity's method of deterring disloyal behaviour by fiduciaries".

POLICY REASON?

in *Imageview Management Ltd v Jack* [2009] Bus LR 1034 at paragraph 50:

> "The policy reason runs as follows. We are here concerned not with merely damages such as those for a tort or breach of contract but with what the remedy should be when the agent has betrayed the trust reposed in him – notions of equity and conscience are brought into play. Necessarily such a betrayal may not come to light. If all the agent has to pay if and when he is found out are damages the temptation to betray the trust reposed in him is all the greater. **So the strict rule is there as a real deterrent to betrayal.** As Scrutton LJ said in *Rhodes's* case 29 Com Cas 19, 28, 'The more that principle is enforced, the better for the honesty of commercial transactions'".

FACTS OF IMAGEVIEW (1)

- D was a national of Trinidad and Tobago who wanted to play professional football in the United Kingdom. He entered into an agreement with C, a football agent, by which he would pay C a commission representing 10% of his monthly salary if C arranged for him to sign with a UK club.
- C negotiated a contract for D to play for a Scottish football club (and thus C was prima facie entitled to its fee)
- At the same time C agreed that the club would pay it £3,000 in return for obtaining a work permit, which D required as a non EU-citizen. The actual value of the work done in getting the permit was £750 (the Judge found)
- The side deal to obtain the work permit was not disclosed to D. When he learned of it a year or so later he stopped paying the 10 % commission due under the agency agreement.

FACTS OF IMAGEVIEW (2)

- C commenced proceedings to recover unpaid commission. D denied liability and counterclaimed for the return of the commission he had already paid and the £3,000 C had received pursuant to the side deal made with the club in respect of D's work permit. The judge held that, in negotiating the side deal for itself, C had had a clear conflict of interest and had acted in breach of fiduciary duty.
- Accordingly, D was not liable to pay the unpaid part of the 10% commission, was entitled to recover the commission already paid and was also entitled to the whole of the £3,000 fee received by C under the side deal.
- Appeal dismissed. C's 10% commission was forfeit and C had to pay over the £3,000 fee without any allowance for work done on getting the permit or on placing D with a UK football club.

NOT IF IT IS AN HONEST BREACH

- *Keppel v Wheeler* [1927] 1 KB 577 at 592 (Court of Appeal): “Now I am quite clear that if an agent in the course of his employment has been proved to be guilty of some breach of fiduciary duty, in practically every case he would forfeit any right to remuneration at all. That seems to me to be well established. On the other hand, there may well be breaches of duty which do not go to the whole contract, and which would not prevent the agent from recovering his remuneration; and as in this case it is found that the agents **acted in good faith**, and as the transaction was completed and the appellant has had the benefit of it, he must pay the commission”

- In *Kelly v Cooper* [1993] AC 205, a decision of the Privy Council, at page 216H: “As to the defendants' claim for commission, even if a breach of fiduciary duty by the defendants had been proved, they would not thereby have lost their right to commission **unless they had acted dishonestly**. In *Keppel v Wheeler* [1927] 1 KB 577 the agents admitted an honest breach of fiduciary duty by mistake and yet were entitled to their commission."

MORE LESSONS FROM KEPPEL v WHEELER

- A homeowner employed estate agents to sell his house. An offer was received from a prospective purchaser and accepted, subject to contract. Subsequently the tenant in the house made a better offer.
- In the bona fide belief that they had performed their duty as agents to the owner when he had accepted the offer from the first prospective purchaser, subject to contract, the estate agents failed to inform the owner of the higher offer from the tenant. The sale completed on the basis of the original (lower) offer.
- The court found the agents to be in breach of duty in having failed to communicate the second (higher) offer.
- The homeowner was entitled to damages, being the difference between the price named in the contract and the higher price offered by the tenant. However the agents remained entitled to their commission on the actual sale price (being the lower of the two offers).
- This case also well illustrates the distinction between damages and forfeiture.

WHAT ABOUT NOT FORFEITING WHEN IT WOULD BE DISPROPORTIONATE AND INEQUITABLE?

- Snell suggests, no forfeiture "where forfeiture would be **disproportionate and inequitable**."
- Conceptually odd, given that by definition forfeiture is not proportionate to damage suffered?
- On one view the potential for double recovery makes the whole forfeiture process inherently inequitable?
- What then does this mean?

CASE WHERE FORFEITURE WAS NOT ALLOWED

- The case cited by way of footnote in Snell is the decision of Vos J in *The Governor of the Bank of Ireland v Jaffery* [2012] EWHC 1377 (Ch)
- There was a finding that Mr Jaffrey, a senior employee of the Bank, had betrayed the Bank's trust, albeit in respect only of a transaction involving a certain group of the Bank's customers.
- Vos J concluded at paragraph 373:

> "It would be unfair in my judgment, even taking into account the nature of Mr Jaffery's breaches, to require him to repay his salary and bonuses, or indeed any part of them. The breaches must, as I have already said, be looked at in the context of his employment as a whole. Mr Jaffery worked long hours over several years for the Bank. It would be both disproportionate and inequitable in the circumstances of this case to require Mr Jaffery to repay some 5 years of salaries and bonuses in addition to disgorging his profits or paying equitable compensation."

Cf CASE WHERE FORFEITURE WAS ALLOWED (1)

- This contrasts with the later decision of Newey J (not referred to in Snell) in *Avrahami v Biran* [2013] EWHC 1176 (Ch) in which the judge distinguished the decision in *Jaffery*
- (at paragraph 345):

> "in these circumstances, it seems to me that the present case is readily distinguishable from the Jaffery case. On the particular facts, forfeiture of the management fees would be neither disproportionate nor inequitable; to the contrary, it would accord with the case law and the policy underlying it."

Cf CASE WHERE FORFEITURE WAS ALLOWED (2)

- The facts to which he refers in the previous paragraph, which seem to be the basis for this finding are:

> "the present case involves a relationship that endured for a number of years: the fiduciary duties that Mr Biran accepts that he owed to CLP, Mr Avrahami and Be-Ready must have lasted from 2002 to 2009. On the other hand, Mr Biran was guilty of dishonest conduct throughout this period. He misappropriated some of the money Mr Avrahami and Be-Ready lent in December 2002, and the last of the misappropriations took place in 2009. In the interim, there had been numerous other misappropriations amounting, in total, to substantial sums. It is also relevant to note that Mr Biran (or rather the trust to which Mr Biran has transferred his interest in CLP) stands to benefit from the success of the Farringdon Road project regardless of whether the management fees are forfeited".

WHAT MIGHT WE DEDUCE?

- The contrast between those two cases does suggest that there is a qualitative and quantitative analysis being conducted as to the gravity of the conduct of the agent.
- In *Hosking* itself: “the Arbitrator considered whether forfeiture would be ‘proportionate and equitable’ and decided that it would, noting, among other things, that ‘one is dealing with a series of serious breaches of fiduciary duty’”
- It is an equitable remedy the purpose of which is to deter bad behaviour, so it makes sense to ask ‘is it bad enough to engage the remedy?’....
- Newey J observed in *Avrahami* that: "the principle [forfeiture] is more obviously apt in the context of one-off transactions than long-term relationships. A director who has loyally served his company for years before, say, submitting a single dishonest expenses claim should not be equated with an estate agent who commits a breach of duty in relation to a single transaction he was asked to undertake“ (nb however, of course, *Avrahami* was a case of forfeiture in the context of a long-term relationship).

IS IT AN ALL OF NOTHING PRINCIPLE?

- If forfeiture is engaged, then what? Does it mean one should (or must?) forfeit the whole of what would otherwise have been due by way of remuneration?
- In *Hosking* what was forfeit was the whole of the element representing remuneration (being 50% of the total).
- In *Imageview* the forfeiture was of the whole of the commission, despite the fact that clearly the agent (C) had provided considerable services (ie C had managed to find D a UK football club to play at and obtained a work permit for D).
- Whilst the analysis cannot logically be based upon principles of total failure of consideration, that would appear to have been a part of the decision in *Jaffery*

PARTNER PROFIT SHARE DIFFERENT?

- In *Hosking*, Mr Hosking argued (unsuccessfully) that:

  - it cannot be assumed from the fact that a rule applies to one species of agent that it is also applicable to another: the obligations of a fiduciary and their incidents depend on the particular context.
  - D's argument was "remuneration" refers to money payable in exchange for services as an expense prior to the division of profits and irrespective of the profitability of the firm, while the profit share of a partner or member reflects his status as a partner or member and his ownership interest. A profit share does not lose its character as such and become remuneration merely because the partner or member is required to provide his services: the profit share remains payable to the partner or member as a partner or member, and in consequence of his interest in the partnership or LLP, and not as remuneration for his services, even if from a commercial point of view it also compensates the partner or member for his services.

APPROPRIATELY DESCRIBED AS “REMUNERATION”

- Marathon argued (successfully) that:

> “any **payment** made to a partner in a partnership or a member of an LLP **in return for services** represents remuneration and is potentially susceptible to forfeiture. Mr Kitchener maintained that, as a matter of language, **profit share payable for undertaking specific duties can appropriately be described as "remuneration"** and that it would make no sense to exclude rewards from the forfeiture principle just because they happened to be conferred by way of profit share. To do so, Mr Kitchener said, would involve preferring form to substance”.

HOWEVER NOTE THE CONCLUSIONS AT PARAGRAPH 43(i) & (ii) OF THE JUDGMENT (CLEAR AS MUD!) (1)

43(i) "....Supposing, therefore, that the arrangements relating to a partnership or LLP provided for a partner or LLP member **to receive a set sum for undertaking particular services regardless of the profitability of the firm or LLP, it would, in my view, be susceptible to forfeiture**. In fact, I did not understand Mr Saini to submit to the contrary"

HOWEVER NOTE THE CONCLUSIONS AT PARAGRAPH 43(i) & (ii) OF THE JUDGMENT (CLEAR AS MUD!) (2)

"43(ii) The **distinction that Mr Saini draws between profit share and remuneration is not, in my view, well-founded**. While it will often (**typically, I suspect**) be impossible to characterise all **or any particular part** of the profit share of a partner or LLP member as "remuneration", I do not see why that should **always** be the case. As a matter of language, it can sometimes be appropriate to speak of a person being remunerated by way of "profit share", as section 2(3)(b) of the 1890 Act and the textbook quoted in *M Young Legal Associates Ltd v Zahid* illustrate (see paragraphs 24 and 41 above). There is, moreover, no good reason to treat profit share differently from other forms of remuneration in the (**probably unusual**) cases where it can be identified as reward for undertaking specific duties. As Mr Kitchener said, it would make no sense for the law to be that forfeiture was available if a partner were entitled to an extra £10,000 for certain services but not if he were instead to be awarded extra points for the purpose of calculating how profits should be divided. Profit share may usually reflect the interest of the partner or member in the firm, but it is possible to envisage cases in which it rather represents compensation for certain services and, **where that is so, profit share can fairly be viewed as remuneration and within the scope of the forfeiture principle.** The law should here be concerned with substance rather than form;"

PARTNER IN A TRADITIONAL PARTNERSHIP AS A FIDUCIARY

- a fiduciary relationship
- the key duty is a duty of good faith to fellow partners (act in the best interests of the partnership)
- arises from partners being agents of each other (section 5 of the Partnership Act 1890)
- honesty
- duty to account
- not to benefit yourself at the expense of your co-partners

MEMBER OWING FIDUCIARY DUTIES?

- remember LLPA 2000 s.6(1): "every member of a limited liability partnership is the agent of the limited liability partnership". The key relationship between LLP and member is one of agency, BUT....
- a member is not acting as an agent for all purposes
- if a member is acting as agent he owes his principal fiduciary duties
- otherwise apply the key test that emerges from *F&C Alternative Investments (Holdings) Ltd v Barthelemy* [2012] Ch 613 at para 212:

> "Fiduciary obligations arise from particular circumstances, where a person assumes responsibility for the management of another's property or affairs." [per *White v Jones* [1995] 2 AC 207, 271D-G].

MEMBER OWING DUTY OF GOOD FAITH?

Unlike for a traditional partnership in an LLP there is:

- no duty of good faith owed automatically between members
- no duty of good faith owed automatically by the members to the LLP [See the decision of Sales J in *F&C Alternative Investments (Holdings) Ltd v Barthelemy* [2012] Ch 613 (at paras 207-216)]
- often a duty of good faith is expressly included in the LLP agreement – usually owed to the LLP only
- If it's an express term, that is a contractual not fiduciary duty

WHAT MIGHT AMOUNT TO BREACHES OF FIDUCIARY DUTY?

The type of breaches that might amount to a breach of fiduciary duty could include for example:

- Orchestrating a team move (as in *Hosking*)
- Making a personal undeclared profit from his position
- Diverting business opportunities from the firm to himself personally
- Setting up a competing business
- Misusing confidential information to personal financial advantage

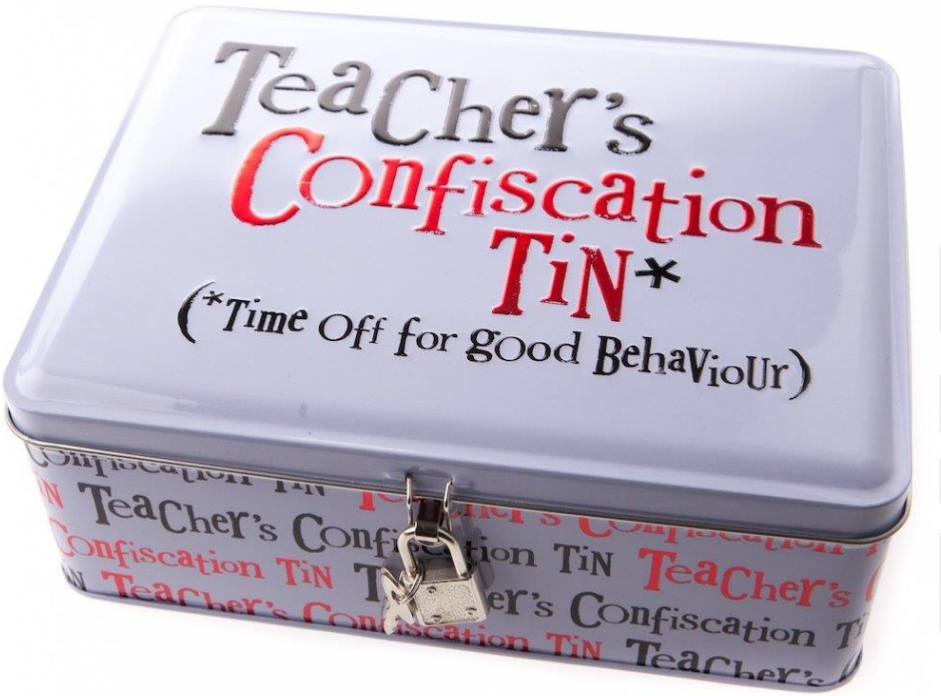
WHAT THEN WOULD THE KEY QUESTIONS BE TO DECIDE WHETHER OR NOT TO FORFEIT?

- Does the partner or member owe a fiduciary duty in the circumstances?
- Has there been a breach of fiduciary duty?
- On the particular setup of this partnership/LLP, can one characterise profit share as being remuneration (in an identifiable part or entirely)?
- Was the breach of fiduciary duty nevertheless an honest breach?
- Was forfeiture excluded by the LLP or partnership agreement? (nb paragraph 43(iv) of the judgment specifically says "while the forfeiture principle can doubtless be excluded by contract, it has been taken to apply when there is no reference to it in a relevant contract")
- Would it be proportionate and equitable to exercise the forfeiture power?
- If so, does one go on to forfeit the whole, or only a part of remuneration and if so how does one determine what part?
- Lots of happy uncertainty!

PRACTICALITIES?

- Look out for partners who have committed fiduciary breaches
- Do you retain any funds (capital paid in? Undrawn profits?)
- What about claw back?
- Additional to damages
- A useful pressure tactic for firms?
- An extra reason for partners/members to be careful about fiduciary breaches

SO NOW IT'S TIME...



And now it is time to …….

Jeremy Callman

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