

## FIDUCIARIES, FRAUD AND THE DIVERSION OF COMMERCIAL OPPORTUNITIES - RECENT DEVELOPMENTS

Commercial parties often engage the services of trusted fiduciaries to deal with the commercial complexities which frequently characterise modern commercial transactions. Some fiduciaries opportunistically redirect or divert existing or maturing commercial opportunities away from their principal to the benefit of third party associates of the fiduciary, or outright misappropriate such opportunities for themselves.

This briefing looks at how the recalcitrant fiduciary may be held to account for their wrongdoing, in light of recent guidance from the Australian courts. The topic is also examined against the approach taken by other leading common law jurisdictions grappling with these issues.

### INTRODUCTION

The misappropriation or diversion of corporate opportunities often arises in the context of a misuse of confidential information belonging to the principal and other associated wrongdoing, including interferences with contractual relations.<sup>1</sup> It can arise in purely commercial contexts or in a broader context, such as the expropriation of assets by a host government where fiduciaries engage in conduct that precipitates or facilitates the loss or damage suffered by the rightful property owner.

The law in this area is complex and has been described as "untidy". In 1985, Australia's former Chief Justice Sir Anthony Mason famously described the law of fiduciaries as a "*concept in search of principle*",<sup>2</sup> and, in many respects, that search continues today.

On 24 November 2022, the Federal Court of Australia in the case of *Directed Electronics OE Pty Ltd v OE Solutions Pty Ltd (No.8)*<sup>3</sup> provided guidance on

#### Key issues

- The Federal Court of Australia recently provided some guidance on the law of fiduciaries, which will be relevant to other common law jurisdictions grappling with this area of law.
- Fiduciaries who act in breach of their fiduciary obligations by diverting or misappropriating commercial opportunities away from their principal may be held to account for their ill-gotten gains.
- A fiduciary's proscriptive duties extend:
  - not only to existing business opportunities, but also to "*maturing*" business opportunities, and
  - not only opportunities which the principal is actively pursuing, but also to opportunities irrespective whether or not the principal could have availed itself of the opportunity.
- This guidance sits well with the privileged position of fiduciaries recognised by other common law countries.

<sup>1</sup> These causes of action are beyond the scope of this briefing note. See however *OBG Ltd v Allan* [2008] AC 1; *Zhu v Treasurer (NSW)* (2004) 218 CLR 530, *Directed Electronics OE Pty Ltd v OE Solutions Pty Ltd (No 8)* [2022] FCA 1404 at [226] where Beach J held that the tort of indirect interference with contractual relations is available under Australian Law, but noted that the relevant intention and the unlawful conduct must both be established as being involved in the interference. See also recent developments in the tort of conspiracy to injure by unlawful means in *Racing Partnership Ltd v Done Bros (Cash Betting) and others* [2020] EWCA Civ 1300, note leave to appeal was recently granted.

<sup>2</sup> Sir Anthony Mason in "Themes and Prospects" in PD Finn Essays on Equity (1985), 246

<sup>3</sup> [2022] FCA 1404.

the law of breach of fiduciary duties by the diversion or misappropriation of commercial opportunities, which is relevant not just in Australia but also in other common law jurisdictions.

As this Federal Court case illustrates, the principal issues for consideration in a case concerning the alleged breach of fiduciary duties are:

- Is the wrongdoer a fiduciary?
- If so, what is the scope of the fiduciary duties owed?
- Did the fiduciary breach those duties?
- What are the consequences of that breach?

Each of these issues will be discussed in turn.

### *Is the wrongdoer a fiduciary?*

A prerequisite for a cause of action for diversion of commercial opportunities is the existence of a fiduciary relationship between the wrongdoer and the claimant. When does such a relationship arise?

There are no fixed rules for determining whether or not an existing relationship is a fiduciary relationship, nor are the categories of fiduciary relationships closed.<sup>4</sup> Whether a relationship is fiduciary in nature depends upon the specific facts of each case, which must be analysed. The starting point is the nature of the parties' relationship and the nature, terms and scope of the promise or undertaking which the fiduciary has (objectively) agreed to perform on behalf of the principal. The existence of such a promise or undertaking agreed to by the fiduciary is an important criterion of a fiduciary relationship. However, it alone will not give rise to a fiduciary relationship.

Other indicia of a fiduciary relationship often include (but are not limited to):

- vulnerability on the part of the principal;
- influence exerted by the fiduciary over the principal;
- dependence by the principal on the fiduciary; and
- trust and confidence either reposed by the principal in the fiduciary (or a reasonable expectation of this) or a mutual expectation of loyalty by both parties.

The fiduciary relationship often arises in the context of a common goal or end,<sup>5</sup> such as a joint activity for the mutual advantage of the parties, with one party reposing trust and confidence in the other to work towards attainment of the mutual objective. An obligation to cooperate alone will not suffice for the imposition of a fiduciary duty. More is required. That additional factor is often found in the promise or undertaking given by the fiduciary (objectively) to the principal, together with one or more of the other indicia referred to above.

The existence of a contractual relationship between the putative fiduciary and the principal is a relevant factor in establishing whether or not a fiduciary relationship exists, but it is not per se determinative of the issue. If on a proper construction of a contract it is clear that the parties intended that the written terms of the contract exhaustively determine the parties' roles and responsibilities, then it may be problematic to suggest that fiduciary duties

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<sup>4</sup> The non-exhaustive list of fiduciaries includes trustees, brokers, partners, directors, agents, employees, guardians, solicitors, to mention a few.

<sup>5</sup> *United Dominions Corp v Brian Pty Ltd*

ought to be superimposed on the existing contractual relationship. In *Streetscape Projects (AUS) v City of Sydney*<sup>6</sup> the New South Wales Court of Appeal held that on a proper construction of the existing contract, the comprehensive terms of a licence agreement left "no room" for the imposition of fiduciary duties - the parties' relationship was exhaustively defined in and governed by the terms of the contract. As such, it could not be said that Streetscape had agreed to subordinate its own interests to those of the City of Sydney, such as would be expected of a fiduciary.

It is worth noting that contractual clauses which purport to expressly exclude fiduciary obligations have, in the past, been upheld as valid by the Australian courts and have been effectively precluded fiduciary obligations from arising.<sup>7</sup>

Hence it is the character of the parties' relationship that will determine whether or not a fiduciary relationship exists, and if so, the scope and extent of the fiduciary duties. The indicia referred to above are helpful in identifying a fiduciary relationship, but they are neither exhaustive nor per se sufficient for the imposition of the duty in all circumstances.

### *Nature and scope of fiduciary duties owed*

Assuming a fiduciary relationship is found to exist, what duties are imposed on the fiduciary? Generally, the duties of a fiduciary are recognised as being twofold, namely:

- not to obtain an unauthorised benefit from or by virtue of the fiduciary relationship; and
- not to act in a position of conflict.

As is evident, both duties are proscriptive (rather than prescriptive) in that they prohibit certain conduct. They do not impose duties of affirmative action on the fiduciary.<sup>8</sup> The aim of the proscriptive duties is to disincentivise a fiduciary from misusing their position to their own advantage.

The precise scope of the fiduciary duty must be tailored to the nature of the relationship and the specific facts of the given case. This includes the functions, responsibilities and promises or undertakings which the fiduciary commits to perform.<sup>9</sup>

The fiduciary is under a proscriptive obligation not to promote their personal interest by pursuing a gain or benefit in circumstances where there is an actual conflict or a real or substantial possibility of a conflict between the fiduciary's personal interests and the interests of the principal. As such, a fiduciary cannot misappropriate or divert to themselves, or others, a "maturing business opportunity", particularly one which the principal is actively pursuing.<sup>10</sup> That prohibition has been found to extend beyond business opportunities which the principal is actively pursuing, to include opportunities that the principal "might reasonably be expected to be interested in" given the principal's line of business. The pursuit of any such business opportunity by the fiduciary which the principal might reasonably be expected to be interested

<sup>6</sup> *Streetscape Projects (AUS) v City of Sydney* (2013) NSWCA 2.

<sup>7</sup> This however depends entirely on the proper construction of the contract in question. Generally the courts are reluctant to superimpose a fiduciary duty in a detailed and negotiated contract where it is clear that on its proper construction the parties intended the terms of the contract to exhaustively govern their relationship.

<sup>8</sup> *Breen v Williams* [1996] HCA 57, where the Court held that a doctor did not owe an affirmative fiduciary duty to provide medical records to a patient, pointing out that the fiduciary's duties owed by a doctor are proscriptive and not prescriptive. This case was followed in *Pilmer v Duke Group* [2001] HCA 31.

<sup>9</sup> *Grimaldi v Chameleon Mining NL (No 2)* [2012] 200 FCR 296 at 177 where the Court said that a person who undertook to perform a particular function "or has assumed such a responsibility to, another as would thereby reasonably entitle that other to expect that he or she will act in that other's interest to the exclusion of his or her own or a third party's interest..."

<sup>10</sup> *Directed Electronics OE Pty Ltd v OE Solutions Pty Ltd (No 8)* [2022] FCA1404 at [242].

in can give rise to a potential conflict between the fiduciary's personal interest and their duty to the principal, and as such is prohibited. For example, senior employees of a company are unable to take advantage of an opportunity which the employees have obtained by reason of their position in the company, even in circumstances where the employer could not have availed itself of that opportunity.<sup>11</sup>

### *Has there been a breach of fiduciary duties?*

As this enquiry is largely fact based, a detailed consideration of the evidence and the surrounding circumstances will largely determine whether or not there has been a breach of the fiduciary's duties.

### *Consequences of breach of fiduciary duty*

A fiduciary who obtains an unauthorised benefit or profit from or by virtue of, or by leveraging their position (that is to say by reason of, or by use of that position, or of the opportunity or knowledge which results from the fiduciary relationship) must account to the principal for the ill-gotten benefit or gains, by disgorging the fruits of their misconduct.

Other potential remedies include (but are not limited to) the imposition of a constructive trust, equitable compensation, declaratory relief, injunctive relief and the like.

## **RECENT ELUCIDATION OF POSITION**

Having set out the underlying issues relating to the cause of action of breach of fiduciary duties in diverting or misappropriating commercial opportunities above, it is now helpful to look at the guidance recently given by the Federal Court of Australia in *Directed Electronics Pty Ltd v OE Solutions Pty Ltd* (No. 8) [2022] FCA 1404. As the imposition and scope of fiduciary duties is heavily fact dependent, it is apt to first summarise the key facts.

A South Korean manufacturer, Hanwha, entered into an agreement with an Australian company, Directed Electronics,<sup>12</sup> for the manufacture and supply by Hanwha to Directed Electronics of equipment for on sale by Directed Electronics to its customers, including various customers known as original equipment manufacturer customers or "OEMs". Directed Electronics was one of Hanwha's largest customers and the two organisations worked closely together to develop equipment for on-sale. Directed Electronics had its own inhouse R&D team that designed, developed and tested equipment, and it employed engineers for that purpose.

Unbeknown to Directed Electronics, two of its employees, Messrs Meneses and Mills, worked in conjunction with Hanwha to set up a rival company to supply the products to OEM in direct competition to Directed Electronics. They were paid secret commissions by Hanwha for their role in this misadventure while they remained in the employ of Directed Electronics.<sup>13</sup> Directed Electronics sued a number of entities associated with the ill-conceived venture, including its recalcitrant employees, Hanwha, and others.

Directed Electronics' case against its two employees (and persons associated with them) largely succeeded, with Justice Beach describing their conduct as "*reprehensible*". The Court found they had appropriated confidential

<sup>11</sup> *Warman International Ltd v Dwyer* (1995) 182 CLR 544 at 558.

<sup>12</sup> Distributed is an automated electronics products and solutions developer specialising in distribution of in-vehicle electronics and technologies. Specifically it designs, sells, and markets audio-visual equipment.

<sup>13</sup> An employment relationship is traditionally recognised as a fiduciary relationship.

information and customer details belonging to Directed Electronics for the benefit of the Hanwha parties and received secret commissions while in the employment of Directed Electronics. Directed Electronics had entrusted them with direct dealings with the company's major customers and granted them autonomy and responsibility in their employment. The employees had attempted to serve "two masters" – both Directed Electronics and Hanwha which gave rise to a conflict of interest, which they failed to disclose to their lawful employer.

Directed Electronics' case against Hanwha (and some entities associated with it) also largely succeed, with Justice Beach finding they were knowingly involved in, and assisted, the wrongful conduct of Meneses and Mills, they misused Directed Electronics' confidential information, and misappropriated customers and products.

The Court had no difficulty in finding that Meneses and Mills were fiduciaries and as such owed fiduciary duties to Directed Electronics, but warned "*it is inappropriate to take a single 'one size fits all' approach to whether an employee owes fiduciary duties to an employer*". The fiduciary duties arose in the specific context of the parties' relationship. The essence of the fiduciaries' relationship was that they exercised power or discharged duties on behalf of Directed Electronics, and in so doing undertook or promised to act in the best interests of Directed Electronics, which they failed to do.

The Court confirmed that the scope of the fiduciary duties is to be tailored "*to the nature of the relationship between the parties and the facts of the case*"<sup>14</sup>. As detailed above, generally a fiduciary's two-pronged proscriptive obligations prohibit the fiduciary from promoting their personal interests or making or pursuing a gain in circumstances where there is an actual conflict or a real or substantial possibility of a conflict. As such, a fiduciary cannot divert to him/herself or to a third party "*a maturing business opportunity*". This includes (but is not limited to) an opportunity which the principal is actively pursuing, and other commercial opportunities irrespective whether or not the principal could have availed itself of that opportunity.<sup>15</sup> As such, the opportunity which the fiduciary is prohibited from diverting or misappropriating need not be one which the principal would necessarily have exploited - it suffices if the opportunity is one in which the principal "*might reasonably be expected to be interested, given its current line of business*".

It is pursuit of the opportunity in such circumstances which gives rise to the possibility of conflict between the fiduciary's personal interest and their ongoing duty to the principal.

The rule of equity is not dependent on a finding of fraud, or an absence of good faith, nor does it depend on whether the profit would otherwise have been made by the principal or whether the fiduciary was under a duty to secure the profit for the principal.<sup>16</sup> The critical question for consideration is whether the fiduciary obtained the benefit "*by reason or by use of*" the relationship between the fiduciary and the principal.<sup>17</sup> If the answer is in the affirmative, then it is not an opportunity in which the fiduciary can partake.

In relation to the often aligned cause of action of misuse of confidential information, the Court found that there had been an unauthorised or

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<sup>14</sup> *Directed Electronics* at [231] and [240].

<sup>15</sup> *Warman International Ltd v Dwyer* (1995) 182 CLR 544 at 558, and *Furs Ltd v Tomkies* (1936) 54 CLR 583 at 592 per Rich, Dixon and Evatt JJ.

<sup>16</sup> The Court noted Lord Russell's observations in *Regal (Hastings) Ltd* at 144 and 145.

<sup>17</sup> Beach J adopted the formulation expressed by the Court in *Howard v Federal Commissioner of Taxation* (2014) 253 CLR 83 at [63] 64] PER Hayne and Crennan JJ

threatened use of confidential information. The Court confirmed that it was not necessary that the recipient of the confidential information appreciate that the information is confidential – it suffices if a reasonable person in their position would have so appreciated. Notably, where a party applies "*skill and ingenuity*" to produce a compilation of information or documents, then equity can treat the entire compilation of information as confidential even if some of it was publicly available.

The Court also found that failure to disclose receipt of the secret commissions was a clear breach of fiduciary duty. The Court went further, finding that the conduct in question was fraudulent and dishonest.

Notably, equitable duties can survive termination of the relationship which gave rise to that duty,<sup>18</sup> so the proscriptive duties imposed on fiduciaries can continue to restrain the conduct of the fiduciary even after termination of the fiduciary relationship.

Finally, the Court made interesting observations on the drawing of inferences in the absence of direct evidence. For an inference to be drawn, it must be "*the more probable inference from the circumstances*", that is to say on the balance of probability, the inference sought to be drawn has a greater degree of likelihood than any other competing inference.<sup>19</sup> This may involve "*an intuitive element that is not susceptible to detailed support or explanation*". However, the Court sounded a reminder that mere conjecture will not be a sufficient basis for an inference to be drawn. The proper inference to be drawn on the balance of probabilities depends upon the reasonable and practicable assessment of the evidence adduced as a whole.

## **COMPARATIVE OVERVIEW WITH OTHER JURISDICTIONS**

It is widely recognised that there is a degree of commonality between the English and some other common law approaches to the law of fiduciaries and therefore the above guidance is relevant outside of Australia.

However, the English courts seem to emphasise the positive obligation of loyalty to which the proscriptive (or negative) duties are ancillary.<sup>20</sup> The obligation of loyalty has been described as the "*distinguishing obligation of a fiduciary*".<sup>21</sup> This emphasis on the positive obligation of loyalty seems to be more a matter of form than substance.

The High Court of England and Wales recently confirmed that (aside from circumstances involving an express undertaking to act for or on behalf of another), the hallmark of fiduciary duties found in authorities is one of "*legitimate expectation*".<sup>22</sup>

Fiduciary duties commonly arise when one party accepts a role that:<sup>23</sup>

- entrusts them with authority to manage the property or affairs of another, and the first party undertakes to do so; and

<sup>18</sup> *Directed Electronics OE v OE Solutions Pty Ltd* at [261] [262]

<sup>19</sup> *Directed Electronics* at [296].

<sup>20</sup> Black J of the Supreme Court of NSW in a paper presented at the University of Oxford, titled "*Comparing English and Australian Approaches to Fiduciary Duties In A Commercial Context*", 6 March 2020.

<sup>21</sup> *Sheikh Tahnoon Bin Saeed Bin Shakhboot Al Nehayan v Ioannis Kent (AKA John Kent)* [2018] EWHC 333 at [159] (*'Al Nehayan v Kent'*).

<sup>22</sup> *Kelly v Baker* [2022] EWHC 1879 (Comm) at [24].

<sup>23</sup> *Al Nehayan v Kent* at [159]-[165].

- empowers the person to make discretionary decisions on behalf of another; and
- involves trust and confidence (legitimate expectation) in the loyalty of the decision-maker (putative fiduciary) to subordinate their own interests and act solely in the interests of the principal.

Similarly, the Singapore and Hong Kong courts have frequently adopted the approach of the English courts, accepting that fiduciary obligations arise in relationships of trust and confidence.<sup>24</sup> Singapore courts have stated the principle of how fiduciary obligations are understood, namely (1) the hallmark of a fiduciary obligation is to act in the best interests of another person (proscriptive and prophylactic); (2) fiduciary obligations are a conclusion rather than a premise; and (3) fiduciary obligations are voluntarily undertaken.<sup>25</sup>

Singaporean courts have also contrasted breaches of fiduciary duties that involve the stewardship of assets on the one hand ("*custodial breaches*") with those that do not involve the stewardship of assets on the other ("*non-custodial breaches*").<sup>26</sup>

Courts in Hong Kong have identified three categories of breaches of fiduciary duties, namely: (1) those directly leading to loss of or damage to trust property; (2) those involving infidelity or disloyalty which engages the conscience of the fiduciary; and (3) those involving lack of appropriate skill or care. The rules of causation are of varying strictness depending on the relevant category of duty and breach.<sup>27</sup>

## CONCLUSION

Recent judicial elucidation and guidance on the nature and extent of a fiduciary's duties to not divert commercial opportunities away from the principal, or to misappropriate such opportunities, is helpful in clarifying and simplifying this complex area of law. It is timely reminder to putative fiduciaries of the standard of conduct and honesty demanded of them in their position of trust and loyalty. The rationale for such high standards finds its genesis in the fiduciary's (objective) agreement to subordinate their personal interests in favour of the interests of the principal.

It is generally accepted that the enquiry is fact specific in each case, while there is a generally recognised commonality of core principles underlying the existence, scope and breach of fiduciary duties.

<sup>24</sup> *SIM POH PING v WINSTA HOLDING PTE LTD & Anor* [2020] SGCA 35 at [246], [253]; *HOW WENG FAN & 2 Ors v PASIR RIS-PUNGGOL TOWN COUNCIL* [2022] SGCA 72 at [170]-[177]; *FUNG TIN YAU (馮天佑) v FUNG TIN SHING (馮天承) & ORS* - [2020] 4 HKC 365 at [30], [58].

<sup>25</sup> *TAN YOK KOON v TAN CHOO SUAN & Anor* [2017] SGCA 13 at [192]-[194].

<sup>26</sup> *SIM POH PING v WINSTA HOLDING PTE LTD & Anor* [2020] SGCA 35 at [88]-[92], [250]-[254].

<sup>27</sup> *AKAI HOLDINGS LTD (In Compulsory Liquidation) v EVERWIN DYNASTY LTD AND OTHERS* [2015] HKCU 3138 at [470].

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