Addisons Contractual Interpretation Series – Relationship clauses – can fiduciary obligations be avoided?

Date : 4 June 2014
Author/s : David Ferguson, Chuanchan Ma

Summary

Relationship clauses are commonly used in commercial contracts to define the legal nature of the relationship between the parties, and to disclaim any relationship other than that intended.

Often the clause will expressly state the legal relationship created by the contract, for example that the relationship between the parties is that of principal and independent contractor. In other cases, the clause will adopt a negative approach by stating the range of relationships that are not created. The following is an example of the negative approach:

“This agreement does not create any employment, partnership, joint venture, fiduciary, agency or other relationship between the parties.”

A key aim of this negative approach is to avoid the imposition of duties of loyalty and propriety that equity applies to fiduciaries.

This style of clause can be effective to exclude a fiduciary relationship arising between parties if they are not within one of the established fiduciary categories. However, the effectiveness of the clause will depend on the time at which it is revealed or communicated, as pre-contractual dealings can, in the context of certain relationships, give rise to fiduciary obligations. If this is the case, a retrospectively implemented relationship clause will not be able to prevent fiduciary obligations arising.

These issues and the general principles arising out of two significant cases dealing with corporate and financial advisers, namely ASIC v Citigroup Global Markets Australia Pty Ltd [No 4] and Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liq), are explored further in the following discussion.

Scope and content of fiduciary obligations

The obligations owed by a fiduciary are expressed in proscriptive terms. That is, a fiduciary is prohibited from engaging in certain conduct that is inconsistent with a standard of undivided loyalty. In particular, the obligations embody the “twin themes” of preventing undisclosed conflict of duty and interest and of prohibiting misuse of the fiduciary’s position.

The scope and content of any fiduciary obligation will depend on the circumstances of the relationship and the facts of each particular case. It will also depend on the terms of the engagement or agreement entered into by the parties. For example, the scope of the fiduciary duty of an agent is determined by the express or implied terms of the contract of agency.

The court will examine the extent of the undertaking made by the fiduciary and nature of the activity to which the fiduciary obligations relate. References might be made to relevant documents, such as employment contracts or a partnership deed. However, as noted by Dixon J in Birtchnell v Equity Trustees, Executors & Agency Co Ltd, these are not definitive of the scope of the fiduciary’s obligations:

“The subject matter over which the fiduciary obligations extend is... to be ascertained, not merely from the express agreement of the parties, whether embodied in written instrument or not, but also from the course of dealing actually pursued by the firm.”

Established categories of fiduciary relationships

There are certain roles and relationships that have been recognised by the courts as automatically giving rise to fiduciary obligations. These are trustees, agents, solicitors, employees, company directors and partners. The scope and content of the fiduciary duties will depend on which of these relationships exists and the terms of the agreement between the parties.
The demanding nature of the duties that may exist was illustrated, in the context of the solicitor–client relationship, by the case of Law Society of New South Wales v Foreman. In that case, the entry into a time-charging costs agreement was characterised by the NSW Supreme Court as giving rise to a conflict between the solicitor’s personal interest to earn fees and the interests of the client. Further, as the solicitor was held to be a fiduciary prior to entering into any retainer, the solicitor was required to make full disclosure to the client of the implications of entering into the time-charging costs agreement. That is, the fiduciary obligations, including the duty of full disclosure, were held to exist not only in the carrying out of an agreement already made between a solicitor and a client “but also in respect of the making of it”.

Ad hoc fiduciary relationships

Outside the established categories of fiduciary relationships, Australian courts have refrained from providing a general test for determining when a person stands in a fiduciary relationship. The courts have instead preferred to develop the law on a case by case basis. Perhaps the most that can be said is that a fiduciary relationship exists where a person has undertaken to act in the interests of another and not in his or her own interests.

However, the courts have identified a number of factors as pointing to the existence of a fiduciary relationship. As Professor Finn (as his Honour then was) noted in “The Fiduciary Principles”, these factors will be important only to the extent that they disclose an expectation in one party that the other will act in his or her interests:

What must be shown, in the writer’s view, is that the actual circumstances of a relationship are such that one party is entitled to expect that the other will act in his interests in and for the purposes of the relationship. Ascendancy, influence, vulnerability, trust, confidence or dependence doubtless will be of importance in making this out, but they will be important only to the extent that they evidence a relationship suggesting that entitlement. The critical matter in the end is the role that the alleged fiduciary has, or should be taken to have, in the relationship. It must so implicate that party in the other’s affairs or so align him with the protection or advancement of that other’s interests that foundation exists for the ‘fiduciary expectation’.

Where an arrangement between parties is of a pure commercial kind and they deal at arm’s length and on an equal footing, generally a court will be reluctant to find that a fiduciary relationship exists. However, all of the facts and circumstances must be carefully examined to see whether the relationship is, in substance, fiduciary. For example, participants in a joint venture cannot simply assume that by having a “joint venture agreement”, they will necessarily be treated differently from partners in a partnership. Depending on the circumstances, joint venturers can also owe fiduciary duties to one another and they will, of course, owe fiduciary duties if their relationship is in substance a partnership.

The Citigroup case

The Citigroup case, which attracted considerable media and industry attention when the judgment was handed down in 2007, illustrates the role a relationship clause can play in shaping a contractual relationship and defining the scope of the duties and obligations (including any fiduciary duties) of the contracting parties.

Citigroup Global Markets Australia Pty Ltd (Citigroup) conducted business through various divisions and business segments, including the Investment Banking division (IBD), the Equity Capital Markets division (ECM) and the equities trading department (Equities). The employees of IBD and ECM were exposed to confidential, market sensitive information (“private side employees”) whilst the employees of Equities were not exposed to such information (“public side employees”). Citigroup had established “Chinese walls” to restrict the flow of information between different business divisions.

The proceedings against Citigroup, commenced by ASIC, arose after an Equities employee purchased a significant amount of shares in Patrick Corporation Limited (Patrick) on the ASX. This was done at a time when the IBD and ECM were acting for Toll on a proposed takeover bid for Patrick. The shares were purchased on the last trading day before Toll announced its bid for Patrick.

One of the allegations made by ASIC was that Citigroup, as an adviser to Toll, was in a fiduciary relationship, and that by purchasing the Patrick shares, Citigroup placed itself in a position where its duty of loyalty to Toll conflicted with its own interests (and had therefore breached certain statutory provisions regulating financial services providers).

Importantly, the engagement letter under which Toll retained Citigroup as its adviser expressly excluded the existence of a fiduciary relationship, through the following clause:

The Company acknowledges that Citigroup has been retained hereunder solely as an adviser to the Company ... and that the Company’s engagement of Citigroup is as an independent contractor and not in any other capacity including as a fiduciary.

ASIC sought to overcome the effect of this clause by arguing that the entirety of the relationship between Citigroup and Toll, including events preceding the signing of the mandate letter, ought to be considered to determine whether the “hallmarks” of a fiduciary relationship existed. Based on the existence of a fiduciary relationship, ASIC argued that Citigroup had a duty to
obtain Toll’s prior consent to proprietary trading in Patrick shares.

In reaching the conclusion that Citigroup did not owe a fiduciary duty to Toll, Jacobson J identified that, where a fiduciary relationship is said to be founded upon a contract, the ordinary rules of construction of contracts apply. Thus, whether a party is subject to fiduciary obligations is to be determined by construing the contract as a whole in the light of the surrounding circumstances known to the parties and the purpose and object of the transaction. In other words, the effectiveness of the exclusion of or the scope of the modification to the fiduciary relationship between Citigroup and Toll had to be determined by the proper construction of the mandate letter between them. Here, the words in the mandate letter could only be given their plain meaning – Citigroup was retained as an adviser to Toll, in the capacity of an independent contractor and not as fiduciary. The express statement that Citigroup was an “independent contractor and not in any other capacity” suggested that the parties had in mind the distinction between independent contractors and other relationships that may give rise to fiduciary obligations.

But for the express terms of the mandate letter, the pre-contractual dealings between Citigroup and Toll would have pointed strongly toward the existence of a fiduciary relationship in Citigroup’s role as an adviser.

The Lehman Brothers case

Five years after the Citigroup case, the Federal Court again had the opportunity to consider whether an investment bank owed fiduciary duties to its clients. In this instance, Rares J found that the Australian branch of Lehman Brothers, formerly Grange Securities Ltd (Grange), had breached its fiduciary duty in providing financial and investment advice to local councils.

The three plaintiff Councils, Wingeacarribee, Swan and Parkes were representative applicants in a class action for 72 Australian investors who lost approximately $250 million on their investments during the global financial crisis (GFC). The Councils sought to recover losses they had suffered due to their acquisition, through Grange, of synthetic collateral debt obligations and other complex financial products (SCDOs).

Prior to dealing with Grange, the Councils had conservative investment policies, investing in relatively low-risk bank products such as bank bills, term deposits and bank issued floating rate notes (FRNs). None of the Councils had any significant experience with investment in complex financial instruments. Each Council was conscious of its legislative and policy-based duties to avoid risk of loss to public money.

Grange began selling SCDOs to Parkes and Swan in 2003 on an ad hoc basis and both Councils traded in a significant number of SDO products between then and 2008. In early 2007, Wingeacarribee and Swan also entered into individual managed portfolio agreements (IMP agreements) with Grange, which permitted Grange to trade in SCDOs on their behalf.

At the time the SCDOs were issued, these products had credit ratings which were better or equivalent to the credit rating of the four major Australian banks, and offered interest rates better than that of most products issued by Australian banks. Grange’s marketing strategy consistently represented to each of the Councils that SCDOs were FRNs, and suggested that there was no real likelihood of the products’ default or the council suffering any loss.

As a result of the GFC in mid-2007, the value of the SCDOs plummeted, with several SCDOs wiped out completely. The Councils claimed against Grange in respect of their losses on a number of grounds, including breach of contract, negligence, misleading or deceptive conduct and breach of fiduciary duties. All claims succeeded.

In relation to the Councils’ claim for breach of fiduciary duty, Rares J held that Grange owed fiduciary obligations in equity to each Council as a financial adviser, independent of any contractual obligation owed by Grange to the Councils.

Rares J found that Grange owed fiduciary obligations to Swan and Parkes since the inception of the financial dealings between them, prior to entry in the IMP agreements. These obligations required the fiduciary not to obtain any unauthorised benefit from the relationship unless informed consent has been provided by the person to whom the obligations are owed, and not to be in a position where the interests or duties of the fiduciary conflict (or there is a real or substantial possibility they may conflict) with the interest of the person to whom the duty is owed.

By portraying itself as, and in fact acting as, a financial adviser to each Council, Grange “voluntarily assumed the well established obligations such a person owes to its client to the extent that it did not exclude those obligations contractually”.

Rares J observed that the Councils had made clear to Grange that in arriving at a decision about investing the Council’s funds in sophisticated financial products, they were dependent on Grange’s advice. Grange held itself out to Swan and Parkes at all times from about mid-2003 as an adviser on matters of investment and undertook to advise on those matters. The Councils had reposed trust and confidence in Grange acting as its investment adviser. Grange undertook, from when it negotiated the SCDO transactions, to act in the interests of the Councils.

Grange sought to rely on disclaimers in its product presentations to the Councils, which typically warned the reader not to act on any recommendation contained in the presentation slides without first consulting their investment adviser. While accepting that the terms of a contract can modify or extinguish a fiduciary obligation, Rares J found that Grange did not draw the disclaimers to the attention of any of the Councils or tell any of them that it was not acting as their financial adviser.
Importantly, Grange never suggested that it might be in a position of conflict, as the Councils’ financial adviser for the transaction it was proposing and that the Councils should obtain independent financial advice.\(^{25}\)

Grange also contended that a number of provisions in the IMP agreements operated to exclude the existence of a fiduciary relationship between it and each of Swan and Wingecarribee. Clause 2.5 of the IMP agreement recorded that each Council consented to Grange entering into transactions as a principal with the Council and also on the opposite side to the Council. Schedule 3 to the IMP agreement disclosed that Grange may be entitled to fees paid by the issuer of a security in relation to its placement.

Rares J found that these provisions modified the fiduciary obligation that Grange would otherwise owe to Swan and Wingecarribee, with the result being that the Councils were not entitled to complain that Grange breached its fiduciary obligation merely by acting as a buyer or seller to the Council of financial products or receiving payment from its sales to them of SCDO products.\(^{24}\) However, as his Honour pointed out, they did not operate to extinguish or exclude all the fiduciary obligations Grange owed to each Council.\(^{26}\)

Conclusions and some practical lessons

As a general proposition, parties in a commercial relationship that is not within one of the established fiduciary categories can, through a provision in their contract, define the relationship between them and expressly agree that it is not fiduciary in nature.\(^{26}\) In other words, an appropriately drafted relationship clause can be effective to exclude fiduciary obligations. In this respect, it is prudent to include in the relationship clause an express statement that negates a fiduciary relationship. Parties to a relationship that is within one of the established fiduciary categories (including a relationship that is, in substance, within one of these categories) cannot avail themselves of this approach and must work within the principles of informed consent to make any modification to their fiduciary duties.

As illustrated by the Lehman Brothers case, the time at which a contract that expressly negates a fiduciary relationship is put in place can be critical to its effect. Accordingly, the first practical lesson is that, where a contract that expressly negates a fiduciary relationship is put in place can be critical to its effect. The risk in delay is that the pre-contractual dealings between the parties may already establish a fiduciary relationship. If this is the case, the subsequent relationship clause will not be able to prevent fiduciary obligations arising.

The practical significance of a relationship clause that negates fiduciary duties was clearly demonstrated in the Citigroup case. For Citigroup, it meant that their group activities were not constrained by those duties. However, from the perspective of a client, it means that they do not have the benefit of the obligations of loyalty and propriety that they might have assumed existed.

Accordingly, a further practical lesson is that, where a party is establishing a commercial relationship (such as a corporate advisory relationship) in which it has expectations that might broadly be identified as loyalty or exclusivity, it needs to carefully consider the implications of a relationship clause that negates fiduciary obligations. It should also recognise that, in order to give effect to its relationship expectations, it will need to include appropriate express provisions in the contract regulating that relationship.

David Ferguson, Partner
Phone +61 2 8915 1053
Email david.ferguson@addisonslawyers.com.au

Chuanchan Ma, Solicitor
Phone +61 2 8915 1003
Email Chuanchan.ma@addisonslawyers.com.au

© ADDISONS. No part of this document may in any form or by any means be reproduced, stored in a retrieval system or transmitted without prior written consent. This document is for general information only and cannot be relied upon as legal advice.

---

1 Trustees, agents, solicitors, employees, company directors and partners.
3 Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liq) [2012] FCA 1028 (Lehman Brothers case).
4 (1929) 42 CLR 384.
5 Hospital Products Ltd v United States Surgical Corporation (1984) 156 CLR 41 at 96-7 (Hospital Products case).
6 (1994) 34 NSWLR 408 (Foreman case).
7 Foreman case at 435.
8 Hospital Products case at 71-2.
10 See, eg, United Dominions Corporation Ltd (known as AMEV-UDC Finance Ltd) v Brian Pty Ltd and Ors (1985) 60 ALR 741.
11 Corporations Act 2001 (Cth), s.912A(aa). ASIC also alleged that Citigroup had engaged in insider trading in Patrick shares. These claims are not discussed for the purposes of this paper.
12 However, ASIC did not conduct its case on the basis that a fiduciary relationship preceded the execution of the mandate letter. It meant that the case focussed on whether the exclusion clause was effective, rather than on whether a fiduciary relationship had been created through the conduct and representations of Citigroup on the one hand and the expectations of Toll on the other.
13 Citigroup case at [281] and [322].
14 Citigroup case at [324].
15 Citigroup case at [325]. See also footnote 12 above.
16 Curiously, Rares J’s lengthy judgment did not refer to the Citigroup case.
17 Lehman Brothers case at [729] – [731].
18 The investment dealings between Grange and Wingecarribee took place after the entry into the Wingecarribee IMP agreement.
19 Lehman Brothers case at [732].
21 Lehman Brothers case at [725].
22 Lehman Brothers case at [729].
23 Lehman Brothers case at [726] - [727].
24 Lehman Brothers case at [768] – [776], [782].
25 Lehman Brothers case at [783].
so long as the relationship, when viewed in light of all the surrounding circumstances and the purpose and object of the transaction, is not something completely different in substance.