Trusts
Fall Term 2017

Lecture Notes – No. 15

The Remedial Constructive Trust: Equitable Wrongs (Breach of Fiduciary Duty)

As we have seen already, the trustee owes a general duty of care to the beneficiaries in respect of his or her administration of the trust. The trustee is also a fiduciary.

The Extensive Nature of the Obligations of the Trustee as Fiduciary

A fiduciary should not place herself in actual or apparent conflict with the interests of their principal. Where there is an actual or apparent conflict, equity has traditionally regarded any profit taken by the fiduciary as a breach of her duties and imposed a constructive trust over them.

An extreme aspect of the general principle is the rule in **Keech v Sandford (1726) Sel Cas King 61**. Here the trustee took a lease for himself personally when the lessor refused to renew a lease in favour of a minor beneficiary; notwithstanding that the benefit of the lease could not be taken for the beneficiary directly from the lessor, the trustee was held to be liable in breach of his fiduciary duty. The court held that the rule against a fiduciary profiting was intentionally strict and rigid; a bright-line rule was thought necessary to protect the beneficiary from being exploited. In the case itself, the lease was to be held for the beneficiary.

Thus, in **Bray v Ford [1896] AC 44**, Lord Hershell said:

> It is an inflexible rule of a Court of Equity that a person in a fiduciary position, such as the respondent's, is not, unless otherwise expressly provided, entitled to make a profit; **he is not allowed to put himself in a position where his interest and duty conflict. It does not appear to me that this rule is, as has been said, founded upon principles of morality. I regard it rather as based on the consideration that, human nature being what it is, there is danger, in such circumstances, of the person holding a fiduciary position being swayed by interest rather than by duty, and thus prejudicing those whom he was bound to protect.** It has, therefore, been deemed expedient to lay down this positive rule. But I am satisfied that it might be departed from in many cases, without any breach of morality, without any wrong being inflicted, and without any consciousness of wrong-doing. Indeed, it is obvious that it might sometimes be to the advantage of the beneficiaries that their trustee should act for them professionally rather than a stranger, even though the trustee were paid for his services.

It is important to note two variations.

The Self-Dealing Rule**:** this holds that if a trustee purchases trust property, the transaction is voidable by B regardless of the price unless it was implied or authorized under the terms of the settlement, by leave of the court, by pre-existing contract, or with the beneficiary's acquiescence.

The Fair-Dealing Rule: This holds that where the trustee purchases the beneficiary's interest the transaction can be set aside if there was non-disclosure by the trustee. The onus is on the trustee to show that the transaction is fair and honest. In Tito v Waddell [1977] Ch 106, 249, Megarry J said that the rule is one of general equity application: '… the fair-dealing rule is essentially a rule of equity that certain persons (including trustees) are subject to certain consequences if they carry through certain transactions without, where appropriate, complying with certain requirements. The rule seems to me to be a general rule of equity and not a specific part of the law of trusts which lays down the duties of a trustee. Trusteeship is merely one of the categories of relationship which brings a person within the rule.'

Note that not every misdeed is a breach of fiduciary duty:

Southin J. in **Girardet v. Crease & Co. (1987) 11 B.C.L.R. (2d) 361:**

> The word 'fiduciary' is flung around now as if it applied to all breaches of duty by solicitors, directors of companies and so forth. . . . That a lawyer can commit a breach of the special duty [of a fiduciary] . . . by entering into a contract with the client without full disclosure . . . and so forth is clear. But to say that simple carelessness in giving advice is such a breach is a perversion of words.

These remarks were approved by La Forest J. *in LAC Minerals Ltd. v. International Corona Resources Ltd.* (1989) 61 D.L.R. (4th) 14, 28 where he said: "not every legal claim arising out of a relationship with fiduciary incidents will give rise to a claim for breach of fiduciary duty."

How far does the no-conflict rule operate – is it an absolute bar on any possible conflict, or, does it apply more flexibly?

In the following cases, a bright-line ruling against fiduciaries taking opportunities to earn personal profits has been softened somewhat based on context-specific findings of honesty, good faith, and reasonableness. The extent of the softening of the stricter code of conduct of fiduciaries in respect of conflicts may well not accord with contemporary policy on point.

Tornroos v Crocker
[1957] SCR 151

Here shares in a company were owned in equal shares by three parties held subject to the condition that any shareholder who wished to sell or transfer his shares was required to give written notice to the directors who would thereupon give the other shareholders a first opportunity to purchase the shares. A died with his shares forming part of the residue of his estate; the residue was to be held on trust with the trustees being A's widow and C (another shareholder). B (yet another shareholder) died and the executor of his estate offered his shares to A's estate and to C. A's estate refused to purchase on the reasoning that the shares were not authorized investments; C purchased the shares from B personally. After C retired as a trustee, A's widow (as trustee) and the new trustee sued C for breach of fiduciary duty.

It was held in the SCC that there was no breach of fiduciary duty by C because A's estate could not buy the shares – *Keech v Sandford* was softened on the facts of the case on the reason that since A settled the shares knowing that they would be unauthorized investments for the trustees to purchase (and which de-barred the Court from allowing their purchase to effect a 'salvage' the trust property), he must have permitted the trustee to act as he did and purchase the property personally. Thus Kellock J held:

> In drawing his will, the testator clearly had present to his mind his shareholding in the company in question, as he specifically mentions these shares. He must equally be taken to have been well aware of the provisions of the articles of the company, of which he was one of the founders, and that in the event of the death of either Dietrich or Crocker occurring while his own estate was undergoing administration, the shares of either might be offered for sale, in which event his trustees would be entitled to buy. In settling the terms of his will and giving directions to his trustees, it is plain he did not desire that his estate should exercise the right to purchase but was content that his own shares should continue as a minority holding in a company controlled by the one or other of his former business associates, in whom he had such confidence that he desired they should be his trustees. This being so, the case is entirely outside the rule…

Boardman v Phipps
[1967] 2 AC 46 (H.L.)

The Phipps family trust had Boardman as a solicitor. Boardman and a beneficiary under the trust decided to try and rescue a company in which the trust held shares. With the consent of the trustees, they bought shares to control the company. They were able to benefit the trust and take a personal profit. Other beneficiaries sued in breach of fiduciary duty. It was held that it is a fundamental rule of equity that a person in a fiduciary capacity must not make a profit out of his trust, nor place himself in a position where his interest might conflict with his duty to the trust. Though the fiduciaries (here agents of the trustees) acted openly, honestly, and were motivated by the best interests of the beneficiaries did not prevent liability is respect of their personal profits – although they were entitled to payment on a liberal scale for their work and skill. A minority of the House of Lords held that the conduct of the trustees was so impeccable (and the trust had itself refused to purchase) that there was no breach of fiduciary duty.

There were various reasons advanced:

Lords Hodson and Guest preferred a strict reading of the rule in *Keech v Sandford*. Lord Guest said:

> In the present case the knowledge and information obtained by Boardman was obtained in the course of the fiduciary position in which he had placed himself. The only defence available to a person in such a fiduciary position is that he

> made the profits with the knowledge and assent of the trustees. It is not contended that the trustees had such knowledge or gave such consent.

Lord Cohen held that the conflict of interest was one that would occur in the future, and said:

> … an agent is, in my opinion, liable to account for profits he makes out of trust property if there is a possibility of conflict between his interest and his duty to his principal. Mr. Boardman and Tom Phipps were not general agents of the trustees but they were their agents for certain limited purposes. The information they had obtained and the opportunity to purchase the 21,986 shares afforded them by their relations with the directors of the company - an opportunity they got as the result of their introduction to the directors by Mr. Fox - were not property in the strict sense but that information and that opportunity they owed to their representing themselves as agents for the holders of the 8,000 shares held by the trustees. In these circumstances they could not, I think, use that information and that opportunity to purchase the shares for themselves if there was any possibility that the trustees might wish to acquire them for the trust. Mr. Boardman was the solicitor whom the trustees were in the habit of consulting if they wanted legal advice. Granted that he would not be bound to advise on any point unless he is consulted, he would still be the person they would consult if they wanted advice. He would clearly have advised them that they had no power to invest in shares of the company without the sanction of the court. In the first phase he would also have had to advise on the evidence then available that the court would be unlikely to give such sanction: but the appellants learnt much more during the second phase. It may well be that even in the third phase the answer of the court would have been the same but, in my opinion, Mr. Boardman would not have been able to give unprejudiced advice if he had been consulted by the trustees and was at the same time negotiating for the purchase of the shares on behalf of himself and Tom Phipps. In other words, there was, in my opinion, at the crucial date (March, 1959), a possibility of a conflict between his interest and his duty.

Regal (Hastings) Ltd. v Gulliver
[1942] 1 All ER 378

Regal sued its former directors to recover from them profits on the acquisition and sale by them of shares in a subsidiary company. The shares had been acquired so as to allow Regal to take up business opportunities, and Regal itself was a shareholder. Te subsidiary was sold (and the directors profited). Regal was sold and the new directors sued the old directors, who were held liable to account for their profits to Regal.

Per Viscount Sankey:

> In my view, the respondents were in a fiduciary position and their liability to account does not depend upon proof of mala fides. **The general rule of equity is that no one who has duties of a fiduciary nature to perform is allowed to enter into engagements in which he has or can have a personal interest conflicting with the interests of those whom he is bound to protect. If he holds any property so acquired as trustee, he is bound to account for it to his cestui que trust**. The earlier cases are concerned with trusts of specific property: *Keech v. Sandford* per Lord King The rule, however, applies to agents, as, for example, solicitors and directors, when acting in a fiduciary capacity.

Per Lord Russell:

> My Lords, with all respect I think there is a misapprehension here. **The rule of equity which insists on those, who by use of a fiduciary position make a profit, being liable to account for that profit, in no way depends on fraud, or absence of bona fides**; or upon such questions or considerations as whether the profit would or should otherwise have gone to the plaintiff, or whether the profiteer was under a duty to obtain the source of the profit for the plaintiff, or whether he took a risk or acted as he did for the benefit of the plaintiff, or whether the plaintiff has in fact been damaged or benefited by his action.
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> **The liability arises from the mere fact of a profit having, in the stated circumstances, been made. The profiteer, however honest and well-intentioned, cannot escape the risk of being called upon to account.**
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> The leading case of *Keech v. Sandford* is an illustration of the strictness of this rule of equity in this regard, and of how far the rule is independent of these outside considerations. A lease of the profits of a market had been devised to a trustee for the benefit of an infant. A renewal on behalf of the infant was refused. It was absolutely unobtainable. The trustee, finding that it was impossible to get a renewal for the benefit of the infant, took a lease for his own benefit. Though his duty to obtain it for the infant was incapable of performance, nevertheless he was ordered to assign the lease to the infant, upon the bare ground that, if a trustee on the refusal to renew might have a lease for himself, few renewals would be made for the benefit of cestuis que trust. Lord King L.C. said:

> "This may seem hard, that the trustee is the only person of all mankind who might not have the lease: but it is very proper that the rule should be strictly pursued, and not in the least relaxed ..."
>
> One other case in equity may be referred to in this connection, viz., *Ex parte James* decided by Lord Eldon L.C. That was a case of a purchase of a bankrupt's estate by the solicitor to the commission, and Lord Eldon L.C. refers to the doctrine thus:
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> "This doctrine as to purchases by trustees, assignees, and persons having a confidential character, stands much more upon general principles than upon the circumstances of any individual case. It rests upon this: that the purchase is not permitted in any case however honest the circumstances; the general interests of justice requiring it to be destroyed in every instance; as no court is equal to the examination and ascertainment of the truth in much the greater number of cases."

Peso Silver Mines Ltd. v. Cropper
[1966] S.C.R. 673

A company sued a former executive director for purchasing shares in a mining venture personally after the company had refused the purchase. It was held that the subsequent offer to purchase made to the defendant was persona to him and did not involve his appointment with the company; there was no breach of fiduciary duty. It was held that Regal (Hastings) Ltd. v Gulliver could be distinguished as the opportunity could be regarded as coming freshly to the defendant outside the terms of his fiduciary duty; good faith and reasonableness seemed to work to soften the harsh no-conflict rule.

Canadian Aero Service v O'Malley
[1974] SCR 592

Here faithless corporate directors resigned from the company and took a commercial opportunity (that they had been working on for the company) for themselves personally.

Per Laskin J:

> … O'Malley and Zarzycki stood in a fiduciary relationship to Canaero, which in its generality betokens loyalty, good faith and avoidance of a conflict of duty and self-interest. **Descending from the generality, the fiduciary relationship goes at least this far: a director or a senior officer like O'Malley or Zarzycki is precluded from obtaining for himself, either secretly or without the approval of the company (which would have to be properly manifested upon full disclosure of the facts), any property or business advantage either belonging to the company or for which it has been negotiating; and especially is this so where the director or officer is a participant in the negotiations on behalf of the company.**

An examination of the case law in this Court and in the Courts of other like jurisdictions on the fiduciary duties of directors and senior officers shows the pervasiveness of a strict ethic in this area of the law. In my opinion, this ethic disqualifies a director or senior officer from usurping for himself or diverting to another person or company with whom or with which he is associated a maturing business opportunity which his company is actively pursuing; he is also precluded from so acting even after his resignation where the resignation may fairly be said to have been prompted or influenced by a wish to acquire for himself the opportunity sought by the company, or where it was his position with the company rather than a fresh initiative that led him to the opportunity which he later acquired.

…

I need not pause to consider whether on the facts in *Regal (Hastings) Ltd. v. Gulliver* the equitable principle was overzealously applied... What I would observe is that the principle, or, indeed, principles, as stated, grew out of older cases concerned with fiduciaries other than directors or managing officers of a modern corporation, and I do not therefore regard them as providing a rigid measure whose literal terms must be met in assessing succeeding cases. In my opinion, neither the conflict test, referred to by Viscount Sankey, nor the test of accountability for profits acquired by reason only of being directors and in the course of execution of the office, reflected in the passage quoted from Lord Russell of Killowen, should be considered as the exclusive touchstones of liability. In this, as in other branches of the law, new fact situations may require a reformulation of existing principle to maintain its vigour in the new setting.

The reaping of a profit by a person at a company's expense while a director thereof is, of course, an adequate ground upon which to hold the director accountable. Yet there may be situations where a profit must be disgorged, although not gained at the expense of the company, on the ground that a director must not be allowed to use his position as such to make a profit even if it was not open to the company, as for example, by reason of legal disability, to participate in the transaction. An analogous situation, albeit not involving a director, existed for all practical purposes in the case of *Boardman et al. v. Phipps*, [1967] 2 A.C. 46 which also supports the view that liability to account does not depend on proof of an actual conflict of duty and self-interest. Another, quite recent, illustration of a liability to account where the company itself had failed to obtain a business contract and hence could not be regarded as having been deprived of a business opportunity is *Industrial Development Consultants Ltd. v. Cooley*, [1972] 2 All E.R. 162, a judgment of a Court of first instance. There, the managing director, who was allowed to resign his position on a false assertion of ill health, subsequently got the contract for himself. That case is thus also illustrative of the situation where a director's resignation is prompted by a decision to obtain for himself the business contract denied to his company and where he does obtain it without disclosing his intention.

What these decisions indicate is an updating of the equitable principle whose roots lie in the general standards that I have already mentioned, namely, loyalty, good faith and avoidance of a conflict of duty and self-interest. Strict application against directors and senior management officials is simply recognition of the degree of control which their positions give them in corporate operations, a control which rises above day accountability to owning shareholders and which comes under some scrutiny only at annual general or at special meetings. It is a necessary supplement, in the public interest, of statutory regulation and accountability which themselves are, at one and the same time, an acknowledgment of the importance of the corporation in the life of the community and of the need to compel obedience by it and by its promoters, directors and managers to norms of exemplary behaviour.

…

It is a mistake, in my opinion, to seek to encase the principle stated and applied in Peso, by adoption from *Regal (Hastings) Ltd. v. Gulliver*, in the straight-jacket of special knowledge acquired while acting as directors or senior officers, let alone limiting it to benefits acquired by reason of and during the holding of those offices. As in other cases in this developing branch of the law, the particular facts may determine the shape of the principle of decision without setting fixed limits to it. So it is in the present case. Accepting the facts found by the trial judge, I find no obstructing considerations to the conclusion that O'Malley and Zarzycki continued, after their resignations, to be under a fiduciary duty to respect Canaero's priority, as against them and their instrument Terra, in seeking to capture the contract for the Guyana project. They entered the lists in the heat of the maturation of the project, known to them to be under active Government consideration when they resigned from Canaero and when they proposed to bid on behalf of Terra.

In holding that on the facts found by the trial judge, there was a breach of fiduciary duty by O'Malley and Zarzycki which survived their resignations I am not to be taken as laying down any rule of liability to be read as if it were a statute. The general standards of loyalty, good faith and avoidance of a conflict of duty and self-interest to which the conduct of a director or senior officer must conform, must be tested in each case by many factors which it would be reckless to attempt to enumerate exhaustively. Among them are the factor of position or office held, the nature of the corporate opportunity, its ripeness, its specificness and the director's or managerial officer's relation to it, the amount of knowledge possessed, the circumstances in which it was obtained and whether it was special or, indeed, even private, the factor of time in the continuation of fiduciary duty where the alleged breach occurs after termination of the relationship with the company, and the circumstances under which the relationship was terminated, that is whether by retirement or resignation or discharge.