Directors and Officers Fiduciary and Best Interest Duties – Navigating a Legal Minefield

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Dr David Millhouse, Senior Honorary Adjunct Research Fellow, Faculty of Law at Bond University, shares his insights into navigating the legal difficulties around fiduciary and best interest duties. He will delve further into this at the In-House Counsel Conference 2021 on Wednesday 17 March, 2021.

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'Fiduciary' and 'best interest' are commonly used terms interpreted differently in the law and often misunderstood by the legislature, media, in the investment chain and in corporate governance. Their heritage lies in equity, meaning a duty to give undivided loyalty to the vulnerable whom they serve. That is where divergence begins. Similarly, the confused use of 'fiduciary' the adjective by politicians and lobbyists has resulted in a mismatch of community expectations and the legal reality of fiduciary law in Australia. 'The noun 'fiduciary' dates to the mid-19th century with the advent of limited liability companies. A fiduciary is not subject to fiduciary obligations because the person is a fiduciary — a person subject to fiduciary obligations is a fiduciary.

The first essential insight is to not assume that fiduciary and best interest duties are the same. They are not. Fiduciary obligations are largely prohibitive, whereas best interest obligations rely on prioritisation of interests not prohibitions. It is this distinction that led to egregious behaviours in the financial industries, and for some, exposure before the Hayne Royal Commission. However, that was the tip of the iceberg. Empirical analysis by this author demonstrates that expectations of fiduciary obligations have been usurped by reliance on best interest duties found not to be implemented in practice. It led to failure of the Wallis principles and substantial negative economic consequences.

The second essential insight is that fiduciaries are concurrently responsible for the prosecution of their fiduciary obligations and their non-fiduciary obligations. The application of best interest duty is often the responsibility of fiduciaries. Whilst the intent of best interest duties is inherently fiduciary, best interest duties also arise in the duty of good faith.

Both duties are incurred throughout the investment chain and elsewhere. For instance, in financial advice, best interest duties are heavily prescriptive and process driven, supplemented but not replaced by the former FASEA standards (itself now abolished with the standards remaining extant). These standards better reflect equitable principles but do not use fiduciary either as noun or adjective. The original fiduciary relationship between adviser and client is eclipsed by multi-layered statutory best interest duties — other than pre-advisory contract interactions or unless clients contract otherwise.

Other insights for counsel include —

- Different jurisdictions apply the same legal terminology differently;
- Fiduciary obligations arise where there is vulnerability, confidence trust, reliance, influence, information, requiring loyalty;
- There are status-based tests for fiduciaries, these remain flexible based on the facts of the case, including in employment;
- There is limited settled definition of fiduciary duties — the general law evolves;
- Fiduciary obligation (depending on its interpretation) is a more powerful source of law than best interest obligation;
- Fiduciary duties can apply to almost all commercial and legal relationships and can collide with other bodies of law including contract (a contested zone);

- Fiduciary obligation is imposed by public policy — it is not a choice although in Australia companies have contracted out of their fiduciary obligations;
- These duties are not 'one size fits all';
- Directors and trustees are status-based fiduciaries — employees can also incur fiduciary liability but there is a legal distinction between the two.
- The application of fiduciary law must be consistent with contract for maximum effectiveness;
- Best interest duties are a basket of duties, some of which are fiduciary, some not;
- Concurrent exercise of both types of duty by fiduciaries with other non-fiduciary duties does not mean a breach of fiduciary duty if those other duties are breached;
- The intrusion of politically contested statutes continues particularly for best interest duties;
- 'Best interest' is not the same as 'interest';
- Some statutory best interest duties (particularly in superannuation and financial advice) apply to directors and others personally;

One line of Australian authority of fiduciary law requires prohibition without informed consent for conflicts of interest and unauthorised profits, being proscriptions. But in Australia, there is continued debate and judicial divergence whether-or-not positive actions to fulfill the proscriptive duties and the objective of undivided loyalty are fiduciary or otherwise. For instance, fiduciary law requires the obtaining of informed consent from the vulnerable, but that positive process is not unanimously regarded as a fiduciary duty. There is limited judicial or statutory unanimity and positive prescriptive fiduciary duties may arise.

Some litigants favour such an approach since equitable restorative remedies are enlivened. This echoes the position in the United States or Canada, themselves distinguishing between fiduciary and best interest duties, where fiduciaries have proscriptive and prescriptive duties sometimes requiring an 'absolute punctilio of honour'. It further echoes the position for directors of UK companies, where directors' duties are codified, defined as being fiduciary, are pro- and prescriptive, bring into the fiduciary fabric legal principles with different origins, use the language of the general law and rely on that for their interpretation. In the civil law countries, the duties are essentially fiduciary-like but derived pro- and prescriptively from the duty of care. It is also consistent with evolving global fiduciary standards of which Australia should take note if it aspires to be a global financial centre.

Some argue that the superlative 'best interest' has no legal meaning. This has some support in case law with conflicts of interest provisions being more effective rather than prioritisation in best interest interpretations. 'Best interest' requires prescriptive action, not process alone. Australian statutory interventions have resulted in eleven different best interest duties in different legal contexts. These are supplemented by six additional best interest duties for 'relevant providers' in the former FASEA standards. Relevant providers are defined as 'any person or entity licensed and engaged in transactional personal advice to 'retail' clients. This definition includes stockbrokers, accountants, mortgage brokers, sales representatives, and financial advisers. The FASEA interpretation of 'retail' client is broader than in other sources of Australian law.

In superannuation, the existing best interest duties (they are different for default and choice funds), are proposed to be replaced by a new 'best financial interest' test. This better reflects the present default fund interpretation (which requires 'best long-term financial interest'). The new law extends previous personal liability personally to the trustee directors, including those of SMSF's, with reversal of proof accompanied by strict liability. Hitherto, the trustee company was the fiduciary and the directors owed a fiduciary duty to it. As fiduciaries, both the directors and the trustee must exercise the statutory best interest duty to the beneficiaries. If enacted, the new law will still rely on general law analysis and interpretations of the case facts and circumstances to interpret what 'best financial interest' means.

Modern commerce relies heavily on the digital economy and confidential information. There is an historical distinction between confidence/confidential information as an equitable principle (not as 'property') and trade-secrets and other intellectual assets as 'property'. As the digital economy develops this distinction is becoming blurred. The duty of confidence and the protection of confidential information from unauthorised use results in fiduciary obligation being better served if contracts of service or employment impose express terms. Broadening the scope of contractual duty broadens the scope of fiduciary obligation. The legal position is different for employees (who may be fiduciaries but are often not) and directors (who are fiduciaries as officers of a company).

In Australia, employees can be status-based fiduciaries with fiduciary duty imported into employment contracts either through implication in general law or express terms. This may not be the case in other jurisdictions. In those circumstances, there may be a co-existing fiduciary relationship. Fiduciary obligations can arise from the employment relationship but are not inherent in that relationship. An employment contract may contain best interest and good faith provisions, but that does not amount to a fiduciary relationship. An employee only has responsibility for acting in the employer's best interest if the employment contract requires it. The distinction is the fiduciary quality of acting in the interests of another versus having regard to the

interests of another. Such terminological inexactitude is to be found in Australian law where the same terms can mean different things.

Employment contracts where the employer may wish to import fiduciary obligations include situations where there is control of property, senior management decision making, discretion, autonomy, client interaction, supplier interaction (especially unsupervised), possibilities for theft of property or confidential information, inducement opportunities, related parties and potential conflicts of interest, hiring or other approval delegations, lack of trust to disclose, and specific skills influences. Directors normally are required to maintain a conflicts of interest register — this can be extended to senior employees and include disclosure of personal relationships of relevance to the employer.

Ultimately the ability to enliven fiduciary obligations will depend on the drafting of the employment or services contract. The substance of those obligations need to be expressly defined in the contract and enforceable in contract rather than in equity. This would enable the contractual imposition of positive duties rather than rely on the contested equitable position.

Recent statutory amendments and proposed amendments in respect of class action litigation financing add some complexity to the legal position of both the promoter of the litigation funding scheme (now a Managed Investment Scheme requiring a licensed Responsible Entity), the capital provider to the scheme, and those law firms advising. It is long established that a lawyer has a fiduciary relationship with, and a best interest duty to the client. It is also established in general law that the promoter of a scheme is a fiduciary. Both are required to prioritise best interest duties to the members of the scheme, but this may not apply to a third-party litigation funder. In these cases, the Federal Court has significant powers of intervention which do not apply to other schemes — but their regulatory requirement is to protect members 'interests' which may be different from their 'best interests'. Some law firms provide litigation funding themselves of various forms. This can generate an unmanageable conflict of interest where the litigation is 'lawyer funded, lawyer managed, and lawyer settled' and result in breaches of fiduciary and best interest duties. It is likely in 2021 that there will be significant reform of class action financing and litigation.

That is but one example of persons categorised as fiduciaries being subject to a public policy environment which prefers bespoke statutory and regulatory interventions which are contextually specific, and whilst they often use the terminology of general law antecedents, subsume its application beneath multiple ever-changing layers of regulation. Indeed, it has been known for parliamentarians to self-measure their utility by the volume of regulation generated. Australia is not alone in the generation of complexity. Proposed best interest duties in the United States consumed some 400 pages of regulation.

Those counsel advising boards, directors, and trustees, all of whom are fiduciaries with contemporaneous best interest duties, need clear-eyed analysis not only of the law in all its Gordian complexity but also the application of Occam's Razor to its unravelling. This seminar may assist in that process.

David Millhouse *has been a serial entrepreneur in international private equity, venture capital and funds management sectors in Chief Executive and board roles since 1983. David holds a Ph.D in Law from Bond University entitled 'Systemic and Cyclical Failure in the Australian Financial Products and Financial Services Sectors: Have weaknesses in corporate law contributed to these failures? His PhD has been publicly recognised by the Australian Financial Review (AFR Chanticleer 16th January 2019), television (7th March 2019, ch 601). He is the author of three scholarly articles published in the Law and Financial Markets Review ('Empirical analysis supports the Hayne long run reform thesis' LFMR 13:2-3, (2019) and 'From Campbell to Hayne: W[h]ither Australia? Australian financial regulation and supervision at a cross-roads' LFMR 13:2-3, (2019)) and 'W[h]ither Australia? Will Parliament Act?' LMFR 1492) (2020)). His book 'Corporate Governance in Non-Bank Financial Entities' is published by LexisNexisButterworths (October 2019). His most recent publications 'Best Interest Duties of Financial Advisers – More Law, More Confusion' February 2020 and Directors & Officers —Strategic Leadership or Bondage? are published in the Corporate Governance e-Journal at the Centre for Commercial Law, Bond University. He is a regular speaker at law and financial conferences.*

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