CLEVELAND & CO

External in-house counsel

SPL Private Finance (PFI) IC Ltd v Arch FP LLP [2014] (Commercial Court)

May 2015

CASE DIGEST

INTRODUCTION

The recent case of SPL Private Finance v Arch FP 2014 has served as somewhat of a reminder that investment managers are not always outside of the scope of fiduciary obligations, despite attempts to exclude such in contract. In particular, the decision in Arch brings some needed clarification to a topic that is generally surrounded by uncertainty. Below we have provided a summary of the facts of the case and the key take away points that should be noted by investment managers.

BACKGROUND

Arch FP was the investment manager responsible for managing the Arch-Cru Funds through an incorporated cell company which comprised of a number of cells, each a separate legal entity managing its own assets. Some of the cells had a focus on private finance and others on real estate. 18 of the cells, having entered into IMAs with Arch, brought claims concerning a student housing business known as “Club Easy” – these were called the Lonscale claims.

The Lonscale claimants were most concerned about Arch FP’s motives for investing in Club Easy. The Lonscale claimants argued that Arch FP’s decision to invest was driven by Arch’s own financial interest as their position as investment manager allowed them to obtain illegitimate payments. Moreover, they alleged that Arch had not taken proper consideration of the merits of the investment in Club Easy, and had not taken into account the interest of the cells. The Lonscale claimants believed that Arch were in breach of their fiduciary duties, in breach of contract and had acted negligently.

THE ISSUE AT TRIAL

It was asserted that Arch acted in breach of the fiduciary duties that it owed to the Lonscale claimant cells.

The claim for breach of fiduciary duties consisted of two main aspects, both of which, are considered central to such duties:

- breach of the duty to avoid actual or potential conflicts of interest – Arch had much to gain by facilitating the Lonscale claimant cells to invest in the notes to which they subscribed because the investment would lead to Arch receiving payments of £3 million; and

- continuous breach of the duty not to profit from its position - the £3 million payment was directly funded by the investments in the cells.

In light of the above aspects, Justice Walker concluded that Arch FP owed a duty of loyalty towards the Lonscale claimants, and was in serious breach of that duty as a result of its conduct.

FIDUCIARY DUTIES AND THE AGENCY PRINCIPLE

Justice Walker considered the agency principle as key in establishing a fiduciary relationship between parties. Agency can be identified where one (the "**agent**") undertakes to act for another (the "**principal**") in circumstances giving rise to a relationship of trust and confidence. That agent owes duties of loyalty to give preference to the principal's interests over the agent's own interests. In the case of a client and investment manager, the investment manager usually acts as agent for the client and the duties described above are referred to as fiduciary duties[1]. The scope of these fiduciary duties encompasses the duty to avoid conflicts of interest and the no secret profit rule. In most investment management agreements ("**IMA**"), unless deviations of the duties of loyalty are permitted under the IMA, there would be a fiduciary relationship.

In its defence, Arch sought to rely on the case of Springwell[2] in relation to excluding fiduciary duties under contract. In Springwell it was held that the relationship in question had to be understood in the context of the contractual documentation between the parties, the mere fact that one party trusts another does not give rise to a fiduciary relationship. However, the facts of Springwell and Arch differ in the sense that in Springwell, there was no good reason to expect that in the commercial transaction the alleged fiduciary would have taken the other party's best interests into consideration. By contrast, consideration of what to do in the best interests of the Lonscale claimant cells lay at the heart of the IMAs in question. As discretionary investment manager, Arch was given exclusive control over the assets of the Lonscale claimant cells and therefore acted as agent for the cells and in a fiduciary capacity.

[1] Chitty on Contracts, 31st edition, paragraph 31-119.
[2] Springwell Navigation Corporation v JP Morgan Chase Bank and others [2010] EWCA Civ 1221

EXCLUSION OF FIDUCIARY DUTIES BY CONTRACT

The IMA between Arch and the Lonscale claimant cells included explicit wording seeking to permit conduct that would otherwise constitute a breach of fiduciary duties. Moreover, there was a specific clause seeking to prevent the rise of any fiduciary relationships as a result of the services provided under the IMA.

Arch based its defence on the following clauses of the IMA:

> **13.1** *The Investment Manager may without prior reference to the Company, effect transactions in which or provide services in circumstances where the Investment Manager has, directly or indirectly, a material interest or relationship of any description with another party which may involve a potential conflict with the Investment Manager's duty to the Company.*
>
> **13.2** *The Investment Manager shall not be liable to account to the Company for any profit, commission or any connected transactions and the Investment Manager's fees shall not, unless otherwise provided, be abated thereby.*
>
> **13.4** *However, the Investment Manager shall at all times have due regard to its duties owed to the Company and where a conflict arises it will endeavour to ensure that it is resolved fairly.*
>
> **18.2** *None of the services to be provided hereunder or any other matter shall give rise to any fiduciary or equitable obligations.*

Generally, English Law's approach to fiduciary duties of investment managers is very contract based, and establishing a fiduciary relationship in a commercial contract is taken as dependent on the terms of the contract itself. This would in some cases allow for breaches of fiduciary duties in a commercial contract, as Arch argued was the case in its IMA.

In this particular case, despite the above discussion, Justice Walker held that Arch was indeed to be considered a fiduciary. Justice Walker held that there is an overriding obligation to manage conflicts fairly, which is required under FCA Principle for Businesses 8 and which was also incorporated in Clause 13.4 of the IMA. The exclusions of liability (Clause 13.2) would only apply where the overriding obligation to manage conflicts fairly has been complied with. In the case of the Lonscale cells, there hadn't been sufficient disclosures made in order to manage the arising conflicts of interest fairly, and so the obligation had not been complied with. Arch was held to have acted negligently, in breach of its fiduciary duties (that had not been successfully excluded under contract) and breach of contract.

ANALYSIS & CONCLUSION

There are 5 key points we can draw from the Arch case:

- the agency principle plays a central role in determining a manager's duties, including whether they are acting in a fiduciary capacity. Investment firms act as agents of their clients, and as such, they need to exercise a degree of skill and diligence as is appropriate for the performance of their duties. When exercising discretionary powers as, for example, in a discretionary IMA, a risk/reward analysis needs to be made in order to achieve the necessary degree of care towards clients;
- the duties of loyalty are core to the agency principle and they are supplemented by (i) the duty to avoid conflict of interests, and (ii) the no secret profit rule and these are strictly operating fiduciary duties;
- only full disclosure around a potential or actual conflict of interest will be sufficient in order to avoid being in breach of the no conflict and no profit rules - they are strictly operating fiduciary duties;
- exclusive control over assets is indicative of the existence of a fiduciary relationship; and
- regulatory principles regarding conflicts of interest are overriding on contractual obligations.

To conclude, the decision and reasoning in the Arch case provides a helpful reminder to investment managers of the obligations they owe to their clients and the fact that they are often acting in a fiduciary capacity. It also serves to show that in situations where the scope of fiduciary duties is in question, the courts have the ultimate discretion to establish the extent of that scope. The presence of contractual provisions attempting to govern the relationship between a client and an investment manager will not be conclusive and fiduciary duties may not always be excluded by contract. A contract, and as was the case in Arch - an IMA, is to be observed not only in the context of its terms and wording but also in line with the surrounding circumstances and related obligations.

Although the circumstances in the Arch case are a deviation from standard practices, and Arch is indeed an extreme case of misconduct, investment managers and investment firms should seek to ensure that they do not fall within the scope of uncertainty and should always seek compliance with regulatory rules and principles instead of mere reliance on their contractual wording. Moreover, investment managers and investment firms should ensure that their IMAs reflect the actual relationship between them and their clients and are also in line with commercial realities.

Cleveland & Co has extensive experience with drafting, reviewing and negotiating IMAs and is here to help you with any related matters.