Disclosure and the Director's Fiduciary Duty of Loyalty: *Item Software v (UK) Ltd v Fassihi* [2005] 2 B.C.L.C. 91

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Introduction

Where a director breaches his duty to the company by making a secret profit, company law provides a simple solution in the form of an action for damages in which the director is called to account for any profit made. Where a director takes steps to make a secret profit in circumstances where the company sustains damage, but where the director does not succeed in making that secret profit the remedy for the company was, prior to the Court of Appeal decision in *Item Software*, less clear cut. It is now clear that a claim based on a fiduciary duty of loyalty will provide that remedy.

The Facts

In this case the facts, as opposed to the law, were relatively straightforward. The business of the claimant, I Ltd, was the distribution of software products for a company, A Ltd. I Ltd's managing director was D and its sales and marketing director was F, the defendant. F's employment contract expressly provided that he should not use confidential information belonging to I Ltd for his own purposes. In 1998 I Ltd started to negotiate more favourable terms for its distribution contract with A Ltd while, at the same time and unbeknown to D, F made secret approaches to A Ltd with his proposals to establish his own company to take over the distribution contract. There was no explanation provided in the reported decision for such an obvious breach of duty in circumstances where it was highly likely that D would discover the breach. In any event, F encouraged D to press A Ltd for improved terms but, because I Ltd insisted in the negotiations on terms that A Ltd was not prepared to accept, the latter terminated the contract by giving 12 months' notice. I Ltd later discovered F's misconduct and he was summarily dismissed. I Ltd then brought proceedings against F alleging that he was in breach of duty as a director and as an employee in seeking (a) to divert the contract to his own company (the diversion claim); (b) pressing D to take a hard line in the negotiations in order to improve his own chances of obtaining the business for himself (the sabotage claim); and (c) in failing to disclose to I Ltd his own wrongdoing (the disclosure claim).

Decision at First Instance

The judge at first instance (reported at [2003] 2 B.C.L.C. 1) found that the cause of the failure of negotiations was I Ltd's insistence on terms that A Ltd found unacceptable and he did not find that D would have negotiated any more cautiously if F had not pressed him to seek those better terms. Consequently he rejected the diversion and sabotage claims and, because there was no appeal against that part of his decision, there was no opportunity for the Court of Appeal to examine that conclusion further. However, the judge did find that F was in breach of duty in failing to disclose to I Ltd his own wrongdoing, and added that "it is highly probable that had F disclosed what he had done, this would indeed have changed D's attitude to the negotiations radically … I have little doubt that D would have been severely shocked by F's conduct and that this would have led him to accept [A Ltd]'s proposal instead of indulging in the further brinkmanship which caused [A Ltd] to lose patience and serve notice of termination" [35]. The judge held that F's misconduct gave rise to a "superadded" duty of disclosure because he was involved in the negotiations, and his contractual obligations of fidelity and care required him to disclose important information known to him which was relevant to those negotiations. He held that F was in breach of his duties both as an employee and as a director, and that I Ltd was entitled to recover from him damages for breach of that duty suffered as a result of the termination of the contract. The trial had been on liability only and consequently a further hearing on damages was required. F appealed against that decision, as well as against a decision on apportionment of salary which is outside the scope of this commentary. He was, interestingly in the context of a commercial dispute, represented by the Bar Pro Bono Unit.

The Law

The duties of a director imposed by law are generally higher than those imposed on an employee because he is more than simply a senior manager of company—he is a fiduciary who, with his fellow directors, is responsible for the success of the company's business (Arden L.J. in *Item Software* at [34]). Certain fiduciary duties imposed by law on directors are not rules of law which can be contracted out of but are mandatory rules of law.

Relevant to the *Item Software* scenario is s.310 of the Companies Act 1985, which makes void:

"(1) … any provision, whether contained in a company's articles or in any contract with the company or otherwise, for exempting any officer of the company or any person (whether an officer or not) employed by the company as auditor from, or indemnifying him against, any liability which by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company."

In addition section 317 of the Companies Act 1985 provides:

"(1) It is the duty of a director of a company who is in any way, whether directly or indirectly, interested in a contract or proposed contract with the company to declare the nature of his interest at a meeting of the directors of the company."

The comprehensive nature of the director's fiduciary duties is emphasised by the fact that, where a director is acting otherwise than as a director in making a secret profit there will be no answer to a claim by the company to recover the profits: directors of a company will be liable for profits resulting from the acquisition of a property neighbouring that of their company even though they obtained that information not as directors but as passers-by (*Bhullar v Bhullar* [2003] 2 B.C.L.C. 241), and a director will be liable to account for the profits which he makes from exploiting a commercial opportunity, offered by a customer of the company, which he learned about before resigning on the grounds of alleged ill-health (*Industrial Development Consultants Ltd v Cooley* [1972] 1 W.L.R. 44). Both cases concerned the director's liability to account for profits where "the existence of the opportunity was information which it was relevant for the company to know, and it follows that [the directors] were under a duty to communicate it to the company", Parker L.J. in *Bhullar* at [41].

Court of Appeal (Mummery and Arden LJJ, Holman J.)

Arden L.J. emphasised at [39] that *Item Software* was concerned with a claim for compensation for loss sustained by I Ltd resulting from F's breach of the duty to disclose rather than to recover profits made by F. She held that she did not consider that it was correct to infer from the *Bhullar* line of cases "that a fiduciary owes a separate and independent duty to disclose his own misconduct to his principal or more generally information of relevance and concern to it … [so] to hold would lead to a proliferation of duties and arguments about their breadth" [41]. She instead based her conclusion on "the fundamental duty to which a director is subject, that is the duty to act in what he in good faith considers to be the best interests of his company" [41], which she described as a duty of loyalty which was "dynamic and capable of application in cases where it has not previously been applied but the principle or rationale of the rule applies", reflecting "the flexible quality of the doctrines of equity" [41].

She added that merely because the duty of loyalty had not in any previous cases required a fiduciary to disclose his own misconduct was not a good reason for failing to uphold that duty in this case. There was no basis on which F could reasonably have come to the conclusion that it was not in the interests of Item to know of his breach of duty so that he could not fulfil his duty of loyalty in this case except by telling I Ltd about his setting up of his own competitor company and his plan to acquire the contract for himself [44].

Arden L.J. also found that policy reasons supported her conclusion in holding that a director's duty of loyalty required him to disclose his misconduct since there was no "legitimate entrepreneurial activity" to be discouraged, and economic efficiency would be encouraged because in this case the consequence of non-disclosure had been that the company made an erroneous business decision because it lacked essential information [63]–[66]. Her decision to reject F's appeal on this issue was supported by Mummery L.J. and Holman J.

Conclusion

Item Software usefully demonstrates the width and flexibility of the general fiduciary duty owed by a director and emphasises that a director will have nowhere to hide if the company discovers a breach of duty, whether or not the director made a secret profit from that breach. The brazen nature of the breach in this case suggests that the courts will have little difficulty in allowing the company a remedy in similar situations, but it is to be hoped that equitable principles will not punish a director if the breach occurred in more innocent circumstances such as in *Bhullar*.