Breach of fiduciary duty at the heart of banking scandal

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Corporate Crime analysis: What can be learned from the historic decision of the Privy Council to order the return of $190m worth of misappropriated funds to the Central Bank of Ecuador? John D. Magnin, litigation partner at K&L Gates LLP, explores the implications of this important judgment.

Original news

Central Bank of Ecuador and others v Conticorp SA and others [2015] UKPC 11, [2015] All ER (D) 270 (Mar)

The Privy Council held that the respondents were jointly and severally liable to the second appellant mutual fund, Interamerican Asset Management Fund (IAMF), for dishonestly procuring and assisting IAMF's sole director and nominated investment advisor in breaches of duty towards IAMF in entering into three transactions. Consequently IAMF was entitled to recover from the respondents the face value of the cash, loans (with accrued interest) and shares it had transferred or surrendered by those transactions.

What is the background to this case?

This appeal was heard over four days by the Privy Council in November 2014. It is an appeal from the decision of the Court of Appeal of the Commonwealth of the Bahamas. The Court of Appeal dismissed the Central Bank of Ecuador's appeal from the decision of Adderley J dated 3 June 2010. The trial judge had dismissed the Central Bank of Ecuador's claim following a 42-day trial which took place between January and April 2010.

The Central Bank of Ecuador, two other banks (one in Ecuador and one in Curacao) and a Bahamian mutual fund were the claimants and successful appellants. The court action in the Bahamas originally arose from the failure in 1996 of Banco Continental, which was then Ecuador's fourth-largest bank.

The claim involved serious allegations against members of a prominent Ecuadorian family called Ortega Trujillo. The Ortegas at that time owned and controlled Banco Continental.

This was a complex fraud action alleging that the Ortegas siphoned approximately $190m from Banco Continental and its subsidiaries, through procuring the transfer of loans and other assets to other Ortega-controlled companies. This was done in a manner which shielded those companies from subsequent claims when Banco Continental failed and had to be taken over by the Central Bank of Ecuador.

At its heart this case concerns three transactions undertaken by IAMF. IAMF was a mutual fund, the participating shares in which were subscribed by BCO Curacao, using monies raised from Ecuadorian depositors. BCO Curacao was owned by Banco Continental SA, which was the principal subsidiary of Grupo Financiero Conticorp SA (GFC), which was owned by Conticorp. All these companies were ultimately under the control of the Ortega Trujillo family. IAMF's sole director was Mr Taylor, but he acted on the instructions of the Ortegas in entering into the global depository receipt (GDR) transactions and did not exercise independent judgment about what was in IAMF's best interests.

IAMF transferred to Conticorp a portfolio of loans and interests in various companies having a face value in excess of $190m in return for GDRs and shares in GFC which ultimately proved to be worthless.

The GDR transactions took place between December 1995 and March 1996. At that time Banco Continental and GFC were in serious financial difficulty. Banco Continental was taking substantial loans from the Central Bank of Ecuador. In the action IAMF claimed damages from the Ortegas for dishonestly procuring or assisting Mr Taylor to commit breaches of fiduciary duty toward IAMF. The trial court accepted the Ortega's submissions as to the probity of the GDR transactions and found that they were entered into as part of a debt to equity plan. This was said to have been agreed by the bank regulator in Ecuador, the Superintendent of Banks.

What is the significance of this case?

The case is significant for many reasons and represents a historic and important decision for the Republic of Ecuador. The case arises out of a complex fraud involving the 1996 failure of Banco Continental. When this bank failed, many Ecuadorian citizens faced the risk of losing everything they had. To avert systemic financial disaster, the Central Bank of Ecuador took unprecedented steps to rescue Banco Continental through the provision of new capital while also taking control of the bank.

The action involved a three-month trial in Nassau in the Commonwealth of the Bahamas. It was one of the most high-profile cases resulting from a number of bank failures in Ecuador in the late 1990s. The Bahamian trial court found for the Ortegas, as did the Court of Appeal of the Bahamas.

The bank pursued a final appeal to the Judicial Committee of the Privy Council in London. This final appeal is particularly significant because the appellants essentially asked the Privy Council to overturn concurrent findings of honesty of both Bahamian courts and to find that the Ortegas had indeed perpetrated a fraud based solely on the documentary evidence and the objective facts, and without the benefit of any live witness testimony. Overturning concurrent findings in the civil context is rare, but to substitute them for a finding of dishonesty at the highest appellate level is almost unheard of.

After a four-day appeal hearing, the Privy Council entered a judgment in favour of the appellants on their claims for dishonest assistance by the respondents. It awarded IAMF approximately $190m in compensatory damages. In addition, there is pre-judgment interest which is expected to take the total judgment award to at least $400m.

The victory in the Privy Council was hard fought and represents many years of diligent legal work coordinated across a number of offices in different jurisdictions.

What were the key issues the Privy Council was asked to address?

The Privy Council had to consider three key issues:

- Did the Ortegas personally procure Mr Taylor's breaches of fiduciary duty?
- Did the Ortegas' companies dishonestly assist Mr Taylor's breaches?
- What was the quantum of the losses?

After being taken by Richard Salter QC to the transcripts of the evidence at trial, Lord Mance giving the judgment was clear that there had indeed been a breach of fiduciary duty because Mr Taylor entered into the transactions on the instructions of the Ortegas without exercising any independent judgment as to what was in IAMF's best interests. The Privy Council held that Adderley J had been correct to hold that Mr Taylor's duties as a director were the same as under English law:

- a director must act bona fide in the best interests of the company
- he must positively apply his mind to the question what the company's interests are
- he must exercise independent judgment and not fetter his discretion, and

- a nominee director is in no different position to an ordinary director in these respects

The Privy Council was also satisfied that the Ortegas had personally procured Mr Taylor's breaches. The Court of Appeal had been wrong to find that they could only be liable if the corporate veil was pierced so as to render them personally liable for Conticorp's actions. The Privy Council decided that this was a misapplication of the *Salomon* doctrine (*Salomon v A Salomon & Co Ltd* [1896] UKHL). Lord Mance deals with this briefly:

'Acting as an officer of one company, a person may dishonestly procure or assist a breach of duty by the director of another company, in which case such person may make liable for dishonest assistance both himself personally and the company of which he is an officer.'

Lord Mance was clear that the Ortega companies had assisted in these breaches of fiduciary duty.

As to the question of whether the Ortegas had acted dishonestly, the test was whether they could honestly have believed that the GDR transactions were in IAMF's best interests. Were the GDRs and GFC shares received from Conticorp worth at least what IAMF arranged to pay for them?

Lord Mance said the Ortega companies could not honestly have believed that they were, or that the GDR transactions were part of a structural reorganization plan approved by the Ecuadorian Superintendent of Banks, Dr Intriago. Crucially, Lord Mance said the trial judge's contrary findings were unsustainable when he examined the transcript of the cross examination of Dr Intriago. Instead, Lord Mance said the transactions were entered into when there was no realistic prospect of IAMF reselling or making any profit out of acquiring GDRs or shares in GFC and there was no sensible commercial purpose for IAMF to enter into these transactions.

Moreover, the prices at which the GDRs were sold provided further evidence of dishonesty, with Lord Mance commenting:

'The conclusion that the Board reaches is that the prices assigned to each share under the three transactions were related not to any objective valuation of GFC or its shares in the interests of arriving at a price fair to IAMF, but were simply arrived at with a view to matching in approximate value the assets which it had been determined that IAMF should transfer to Conticorp under those transactions. Further, the prices were far in excess of any which it could sensibly have been believed should be paid by IAMF for parting with such assets at the times when they were transferred. The transactions effectively emptied IAMF and left it exposed to the risks of Banco Continental's liquidation.'

Finally, Lord Mance said there was no independent or impartial consideration given to IAMF's interests before it entered into these transactions. He said the effect was to shift the risk that Banco Continental and BCO Curacao would fail from Conticorp to IAMF, while giving Conticorp the benefit of IAMF's valuable assets.

On quantum of losses, Snell's Equity 33rd edition paras 30–80 indicates that once liability for dishonest assistance is established, the defendant may be required to compensate the trust for losses following from his assistance. However, until this case there had been no real issue as to the principles applicable to the assessment of loss.

In March 1997 all existing shares in Banco Continental, pursuant to the terms of a subordinated loan agreement, were cancelled. On that basis, the Privy Council accepted that the GDRs and shares in GFC had in fact proved to be worthless. Because of this, IAMF is entitled to recover the face value of the cash, loans and shares it transferred or surrendered to Conticorp by the three transactions, which the Privy Council calculated to be $191,953,517.50. The Privy Council held that the Court of Appeal had been wrong to find that there had been no evidence of the loss suffered and that, even if it had been necessary to carry out any independent valuation of IAMF's portfolio of loans, the evidence would have justified no more than a modest discount.

Any thoughts or comments on the case now that it's concluded?

It is highly unusual to be able to persuade an appeal court, let alone a final appeal court, to re-examine the evidence presented at trial—still more to persuade an appeal court to overturn these findings of fact. The door to this approach appeared to have been closed 20 years ago by Lord Hoffman in *Biogen Inc v Medeva plc* [1997] RPC 1, where he said:

'I am bound to say that I regret the decision of the Court of Appeal to revisit the evidence upon which the judge made his finding of fact. For the reasons given earlier in relation to the issue of obviousness, I think that this was a question on which greater respect should have been paid to the judge's findings…The House was invited to undertake a minute examination of the facts with a view to restoring the findings of the judge…But I think that your Lordships learned enough of the detailed facts to form the view that the judge's decision was one which was open to him upon the evidence and should not have been disturbed.'

Although the case concerned losses caused ultimately to the Central Bank of Ecuador, the claim was heard in the Bahamas with the final appeal to the Privy Council in London. There was a lot of investigation required to get to the bottom of what really happened. The trial was conducted by our Boston office with the final appeal involving our London office.

Does this case leave any grey or unresolved areas?

The extent of the duties of directors of offshore companies is a matter which continues to be explored by the courts on a case-by-case basis.

What should lawyers do next?

There is still a high threshold to cross to persuade an appellate court to overturn the evidential findings of fact made by a fact finding tribunal or court. However, it is not an impossible one and lawyers acting for appellants will draw some comfort from Lord Mance's approach.

The transactions that caused the losses took place between December 1995 and March 1996. The banks claimed losses based on fraud committed by or on behalf of the Ortegas. The Limitation Act 1980, s 32 provides that the period of limitation shall not begin to run until a claimant has discovered fraud, concealment or mistake or could with reasonable diligence have discovered it. Lawyers who are advising (be it claimants or defendants) in other financial cases involving LIBOR, swaps or derivatives should consider that where fraud is alleged then a limitation defence is unlikely to succeed.

The judgment sum awarded by the Privy Council is very large and it will be interesting to see how the banks proceed next in enforcing this against the Ortegas.

K&L Gates LLP

Partners Michael DeMarco and John Blessington and associate Lindsay Bishop in Boston and partner John Magnin and associate James Boyd in London and partner Christopher Tillson in Miami.

3VB Chambers

Barristers Richard Salter QC and Matthew Parker in London.

Interviewed by David Bowden.

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