

# Forget who owns the client, who

What happens if an adviser leaves and the trail income follows?

**Who owns the client is a concept that has hit a new high in the financial services industry. The tax office is keen to know. It believes the answer is the dealer. This, it argues, is why the new Alienation of Personal Services Income Taxation Rules apply to the income earned by a financial planner. Unless, of course, the planner has sold their business in which case the tax office wants capital gains tax from the planner for their goodwill represented in the clients they own.**

Can anybody own the client other than the client? This is the wrong way to look at the issue. Are you interested in owning the client or are you interested in earning the fees that result from the client relationship? If it is the latter, then aren't you really interested in the trail income? If the answer is yes, this begs the question as to whether you can control and own trail income. Is it an asset in its own right? If it is, it can be transferred, in which case it can be sold and other rights can be made to arise in respect of it.

This issue arose recently in the following sequence of events: in July 1992, two advisers formed a partnership and bought another's financial services business, the price was predominantly a capitalisation of the trail commissions. In July 1996, a third adviser joined the business. They all decided it was right for them to incorporate and all three became directors and held other statutory roles in the company.

In April 2000, one of them had had enough. He gave notice that he wanted to leave at the end of the financial year, and that he wanted to take his clients with him. Following the announcement, there was some heated discussions that led to an in-principle agreement that he

could take his one third of the assets of the company net of liabilities. If he took more in value he had to pay for it.

What then happened? He moved out and certain clients transferred. Some weeks later there was a refusal to pay for the more than one-third of assets (including trail commission flow of clients) that left to a new dealer relationship. By number of clients, few left but those that did were among the most valuable to the financial services business. And the remaining liabilities left the business in a near crippled state.

Can anything be done? The starting point is to understand at law whether trail commission is an asset. The departing adviser argued that the fact that clients followed him was not a matter for the control of anybody but the client. At best, they followed because of his personality and personal skill as an adviser, both of which are not attributes that can be regarded as assets that he should pay for. Besides, he said, where is the agreement that requires me to pay?

It is clear that trail commission is income but can it also represent an asset in its own right? This question turns largely on whether the rights and entitlements that the trail commission represents amounts to a chose-in-action.

A chose-in-action is used to refer to all property rights of which it is impossible to take physical possession. "Present" or "existing" choses may include listed rights that can only be enforced, or even precisely determined upon the happening of a future contingency. A "future" chose is the prospect or possibility of becoming entitled in the future to a proprietary right, such as a right to dividends not yet recommended or declared, that may arise in the future.

A chose-in-action is an asset or property and, subject to the law relating to maintenance, may be secured in the same way as another asset or property although not all choses-in-action are capable of assignment.

The ability to assign a chose-in-action is, of course, important for valuing it. A chose-in-action that is not capable of assignment has less value than one that is capable. Common Law does not permit the assignment of any but a few types of legal choses-in-action, which do not include trailing commissions, with the result that an assignee under any attempt to assign the entitlement to trailing commissions at law is not entitled, without more, to sue at law in the assignee's own name to enforce rights under the assignment.

Equity, however, comes to the assistance of the assignee of a legal chose-in-action where the assignor refuses to do whatever is necessary to enable the assignee to get the benefit of a purported assignment. From the above, the entitlement to trail commission is, unless some element of the agreement that gives rise to it impacts on the issue, an assignable chose-in-action and as such it is an asset.

Others have drawn the same conclusion based on similar analysis of the legal principles. This is the reasoning behind the comments of the Australian Securities and Investment Commission (ASIC) in interim policy statement 161 at paragraph 37: "If a person is providing broking services to clients as a representative of a registered broker, the clients remain at all times the clients of that broker. It is the registered broker who provides broking services to the clients, although the service is provided through a representative. Therefore, all

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# who owns the trail?



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client information [the chose-in-action rights] such as client files and lists generally belongs to the registered broker and not to the representative.”

The same reasoning was applied by the tax office in Taxation Ruling IT 2000/1 at paragraph seven:

“In Taxation Ruling IT 2408 we accepted that an insurance register was an income-producing asset in its own right. Consequently, a register [comprising the right to future renewal, CPI and orphan policy commissions] could be effectively assigned for income tax purposes.”

Once it is determined that trail

commission is an asset of the company, it is appropriate to review the obligations of the officers of the company in respect of its assets.

#### Fiduciary duties of directors to a company: general

It is well established in law that partners in a partnership owe each other fiduciary obligations in relation to the conduct of the business and in respect of the assets of the partnership. The exact subject matter of the mutual obligations will be determined by the venture or undertaking for which the partnership exists. Fiduciary obligations are duties of

trust and confidence. A person under a fiduciary obligation must not allow his personal interest to conflict with his duty. The very nature of a fiduciary obligation is to place a greater responsibility upon the fiduciary because he has a special opportunity to exercise a power or discretion to the detriment of the other person.

Similarly, directors owe fiduciary obligations to the company. A director cannot appropriate for himself an opportunity or benefit that arises from his position as a director. Fiduciaries must avoid situations of conflict of interest between the personal interest of



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the director and interest of the company. Work performed in the course of an employee's employment is property of the company.

It is also well established that directors have a fiduciary duty to avoid conflicts of interest. Lord Cranworth LC expresses the principle that directors cannot allow their own interests to conflict with their duties to the company in a classic speech in *Aberdeen Railway Co v Blaikie Brothers*:

"...it is a rule of universal application that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect."

Apart from the equitable duty to avoid conflicts of interest, the Corporations Law also regulates misuse of position and company information; see sections 182 and 183 of the Corporations Law.

**Fiduciary duties of directors to the company: corporate opportunity principle**

Directors who exploit an opportunity or knowledge gained as a result of their office breach their fiduciary duty to the company and may be liable to account for any profit made or to compensate the company for any loss it has suffered. This is the case even where the company itself was unable to take advantage of the opportunity. It has also been held that the nature of this burden is greater

for a person who is an executive director and/or an original promoter of the company. The prohibition also continues where the director resigned to pursue the opportunity.

There is yet further support for the above comments in *Saxby Bridge Mortgages Pty Ltd v Saxby Bridge Pty Ltd*. The court in that case examined the fiduciary duties owed by parties to a commercial agreement who were separate legal entities.

In that case, Hamilton J alluded to the possibility of a fiduciary relationship between separate legal entities that were parties to a commercial agreement in which the defendant intermediary agreed to recommend to its clients that they use the services of the plaintiff mortgage provider.

His honor relies upon the High Court's decision in *United Dominions Corporation Ltd v Brian Pty Ltd* to find that: "there is an arguable case that there is a fiduciary relationship between the plaintiff and the defendant in relation to this income stream [the income stream being trail commissions] and that the fiduciary obligation in relation to that income stream may be breached if the defendant were to seek to divert that stream from the plaintiff."

**Where does this leave us?**

There are a range of other facts that may impact on the final views, notably

the existence of explicit contractual arrangements, however, in the absence of such information, there is legal reason why the entitlement to receive trailing commission is an asset of the company and any activity designed to divert that income is, if without consent, a potentially actionable breach of fiduciary duty to the company.

Given the low threshold set by Hamilton J in *Saxby* for conduct to constitute a breach of fiduciary duty owed by unrelated legal entities, in the example of inter-related relationships built firstly on joint purchase from a third party, then mutual ownership through a partnership and finally entitlement within a company, it seems that the onus on the departing adviser to prove his alleged entitlement will be a heavy one.

Notwithstanding that no written document appears the law looks at the subject matter of the relationship and is likely to conclude that the trail commission was a company asset not subject to a prior or greater right of any of the advisers, indeed, all had an obligation in respect of it to the benefit of the company and fellow directors and shareholders.

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