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The Liability of Asset Managers in Scots Law

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Abstract

This paper discusses the liability of asset managers in Scots private law. It is a contribution to a pan-European Study on that topic.

Keywords

Liability of Asset Managers, Scots Law, Private Law, Financial Services Law

*Scotland***Outline**

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I Introduction

17-01 The asset management sector is an important component of the Scottish economy and the Scottish financial services industry with a number of large, successful investment management firms and companies headquartered in Edinburgh, Glasgow, Aberdeen and Dundee. The asset management industry employs approximately 3,300 people in

Scotland and around 13,000 worldwide and has a venerable pedigree, stretching back to the 1870s.¹ The sector is principally comprised of a broad mix of large businesses specializing in individual discretionary portfolio asset management on behalf of institutional clients. Such services are regularly exported to clients outside Scotland. However, smaller employee-owned businesses deliver a wide variety of innovative investment services to institutional and personal clients around the world. It is uncommon for Scottish asset management firms and companies to undertake custody, execution and brokerage services for their institutional clients. Instead, these functions are either delegated by the asset management firm to several asset servicing firms (many of which are based in Scotland) or the client will appoint its own custodian, execution agent and/or broker/dealer. It is routine for the custody, execution and brokerage arrangements to be clarified in the asset management agreement.

17-02 The principles and rules on the liability of asset managers are moulded by the various sources of Scots law. The works of the Scottish institutional writers,² the common law of Scotland and legislation (passed by the UK Westminster Parliament or the Scottish Parliament) are the three principal sources of Scots law which operate to impose, and regulate, the liability of asset managers conducting business in Scotland. Notwithstanding the fact that Scotland forms an integral part of Great Britain and the United Kingdom, the Act of Union in 1707 specifically recognized the continued existence and future role of Scots law as an independent and distinctive legal system. In 1999, the UK Westminster Parliament brought sections 28 to 30 of, and Schedules 4 and 5 (Section A3) to, the Scotland Act 1998 into force, which reserved legislative competence in the field of financial services law to the UK Westminster Parliament, but devolved legislative competence in the field of private law to the Scottish Parliament which sits in Edinburgh. The private law of Scotland is grounded in Roman law and the Civilian tradition, but since 1707, there has been a steady reception of doctrines and concepts from the English common law system. The effect has been that the grammar and juridical apparatus of the English common law have exerted a tight grip over Scots law institutions, e.g. the doctrine of *stare decisis*³ and the adversarial system are embedded in the Scottish legal system. Nevertheless, despite the strong influence of English law, Scots law has never known and does not know a separate body of rules by the name of 'Equity'. Scots law can be classified as one of the

¹ See <http://www.sfe.org.uk/about-industry/> (last visited 3rd January 2011).

² Stair, *The Institutions of the Laws of Scotland* (1681); Erskine, *An Institute of the Laws of Scotland* (1772); and G J Bell, *Principles of the Law of Scotland* (10th edition, T&T Clark, Edinburgh, 1890).

³ T B Smith, *A Short Commentary on the Law of Scotland* (W. Green, Edinburgh, 1962) 33.

17-03 Legislation is by far the most important source of regulation of the asset management industry. The Financial Services and Markets Act 2000 ("FSMA") is an important piece of legislation which governs the conduct of the asset management sector in Scotland. FSMA extends to England, Wales and Scotland and comprehensively sets out the regulatory framework for the whole of the financial services industry in the UK. The tentacles of FSMA extend very widely, ranging from the small independent financial adviser residing on the banks of Loch Ness, to the large investment management firms located in Edinburgh. Since FSMA applies in each of the constituent jurisdictions of the UK, on the public law definition of asset management and its correlation to the definition in MiFID, there is no divergence between the legal position in Scotland and England and Wales. Therefore, for a full picture of the means by which FSMA and the Handbook of the Financial Services Authority⁵ ("FSA") regulate the business of asset management in Scotland, please refer to Chapter ____.

17-04 The role of the private law of Scotland in regulating the liability of asset managers is not quite as significant as FSMA. There is a dearth of Scottish case law on the duties of asset managers in contract. Moreover, there is no statutory regulation of the private law of asset managers in Scots law. However, a central role undoubtedly exists for Scots private law in the fields of the law of delict,⁶ fiduciary duties and unjustified enrichment (i.e. the law of restitution) which impinge on the relationship between the asset manager and the client, since these can be divorced from the duties and obligations which arise in the private law of contract, i.e. the Scots common law of agency. On balance, these areas of private law largely operate to impose obligations on asset managers by operation of law, independent of consensus or the intention of the asset manager and the client of the asset manager (hereinafter referred to as the "Principal", "claimant" or "client"). The relationship between each of them and the circumstances in which liability arises pursuant to such discrete legal bases is a particularly beguiling area which will be discussed in greater detail below.

4 G.L. Gretton, 'Mixed Systems: Scotland' in J.J. Norton and M. Andenas (eds.), *Emerging Financial Markets and Secured Transactions*, (Kluwer Law International, 1998), 279; R. Zimmermann, "'Double Cross': Comparing Scots and South African Law" in R. Zimmermann, D. Visser & K. Reid, *Mixed Legal Systems in Comparative Perspective* (2004, OUP) 1; K.G.C. Reid, 'The Idea of Mixed Legal Systems', 78 *Tulane Law Review* 5 (2003).

5 See <http://fsahandbook.info/FSA/html/handbook/> (last visited 3rd January 2011).

6 The law of delict is the equivalent of English tort law.

17-05 It should not be forgotten that the obligations and rights of asset managers and their clients will also be conditioned by the contents of the investment management agreement (“IMA”) concluded between them. Asset management firms based in Scotland routinely enter into relationships with their clients on the basis of the Investment Management Association’s (“IMAssoc”) industry model Investment Management Agreement (“Model IMA”). It is important to stress that clause G4 of the Model IMA provides for a choice of English law and the significance of this issue will be explored in more detail below.

II Definitions and qualifications

1. Regulatory characterization of asset management

17-06 For the public law characterization of asset management, please refer to Chapter _____. The legal position in Scots law and the law of England and Wales is identical.

2. Private law characterization of asset management

17-07 Turning to the private law field, akin to the civilian legal systems, Scots law classifies an asset management contract – known in the industry as an investment management agreement (“IMA”) - as a contract of agency rather than a contract for services. The contract of agency developed in Scots law from the mainly gratuitous contract of mandate,⁷ in terms of which the asset manager is the agent and the client is the Principal on whose behalf the agent is acting. The investment objectives of the asset manager are set out in the IMA and agreed with the Principal. It is standard practice for Scottish asset management firms to conclude an IMA with their clients which is based on the Model IMA. The legal relevance of agency as the contractual basis of the relationship between the asset manager and the Principal is that – on the face of matters⁸ - the rules and principles of the law of agency will apply to impose obligations upon the asset manager, namely the duty to exercise care and skill, the obligation to follow the Principal’s instructions and the obligation to maintain accounts and records. The obligations tend to be lop-sided so that the agent owes a greater number of duties to the principal than the principal owes to the agent.

⁷ See the institutional writers Stair, *Institutions*, I, 12; Erskine, *Institute*, III, 3, 31-41; Bell, *Principles*, §§ 216-218.

⁸ This caveat is struck for the reasons which will be discussed in paragraph 17-17 below.

Therefore, although the IMA imposes reciprocal obligations on the agent and the principal, it cannot be categorized as a synallagmatic contract where the duties owed by the parties to each other are the same or broadly similar in number or burden.

17-08 Since the relationship between the asset manager and the Principal is based on the law of agency, Scots private law does not require the relationship to be created, recognized or captured in writing and an oral agency is valid.⁹ An agency may be created by conduct where the agent commences acting on behalf of a principal. The effect of that rule is that the agency relationship may be constituted expressly (ie in writing or orally) or impliedly (ie by conduct).¹⁰ However, one must recall that the public law regulatory system does indeed require a written agreement to be entered into between the asset manager and the Principal.¹¹ In practice, as noted above, an IMA is concluded which is based on the Model IMA.

17-09 On the basis that the law of agency derived from the contract of mandate, one would be less than amazed to learn that the Scottish institutional writers treated the private law of agency as being grounded in and constituted by contract, rather than by virtue of a gratuitous relationship or a legally imposed relationship arising by operation of law.¹² However, as matters currently stand, it is not wholly clear whether the relationship is simply contractual or non-consensual in basis, ie, arising from the agent's office, since Scots law recognizes that an agent such as an asset manager can continue to owe obligations to a Principal in the law of agency subsequent to the termination of an express or implied contract,¹³ that agents appointed under a valid contract of agency may owe no fiduciary duties at all on the basis that their agency is limited in compass,¹⁴ and that a sub-agent may owe fiduciary obligations to a

⁹ Bell, *Commentaries*, III, I, 508. However, where the relationship between an agent and a principal is one of commercial agency under regulation 2(1) of the Commercial Agents (Council Directive) Regulations 1993 (SI 1993/3053) ("the Regulations"), Regulation 13 of the Regulations confer upon either party the right to call on the other to produce a written signed document setting out the terms of the agency contract including any terms subsequently agreed.

¹⁰ See *Whitbread Group plc v Goldapple Ltd* 2005 SLT 281, *Laurence McIntosh Ltd v Balfour Beatty Group Ltd and the Trustees of the National Library of Scotland* [2006] CSOH 1907, *John Stirling t/a M & S Contracts v Westminster Properties Scotland Ltd* [2007] CSOH 117; 2007 BLR 537 and *Ben Cleuch Estates Ltd v Scottish Enterprise* [2006] CSOH 35 at para [143] (per Lord Reed).

¹¹ Article 19(7) MiFID.

¹² Bell, *Commentaries*, I, III, 506 and *Graham & Co v United Turkey Red Co* 1922 SC 533, 546 (per Lord Salvesan) and 549 (per Lord Ormidale); *Lothian v Jenolite Ltd* 1969 SC 111, 120 (per Lord Milligan); *Trans Barwil Agencies (U.K.) Ltd v John S. Braid & Co Ltd* 1988 SC 222, 230 (per Lord McCluskey); *Connolly v Brown* 2007 SLT 778, 785 (per Lady Dorrian) at para [54].

¹³ *Connolly v Brown* 2007 SLT 778, 784 at para. [49] (per Lady Dorrian).

¹⁴ *Sao Paulo Alparagatas SA v Standard Chartered Bank* 1982 SLT 433, 436 (per Lord Grieve).

principal despite the absence of any contractual nexus between them.¹⁵ Nevertheless, on balance, there are strong reasons to conclude that the relationship is primarily based on the consensus model, whilst at the same time possessing a degree of inderogable content which is attributable to the fiduciary nature of the agent's office. Although this discussion might seem abstract and somewhat irrelevant, the juridical basis of the relationship between the asset manager and the Principal is of great practical significance for the purposes of evaluating the validity of exculpatory clauses in IMAs or clauses in IMAs which seek to exclude or limit certain obligations of the asset manager to the Principal. If the relationship between the asset manager and the Principal is categorized as a contractual relationship based on consensus, then exculpatory clauses in IMAs which disapply the asset manager's liability for breach of duties arising from the IMA or the general law of agency undoubtedly will have legal effect. However, if the relationship is grounded in something other than the consensus of the parties, then a different complexion on the legality of exculpatory clauses in IMAs will emerge. This point will be explored further in Part IV below.

- 17.10 It is also crucial to ascertain whether the asset manager is a fiduciary. This is a matter of fact and is to be assessed independently of the contractual relationship between the asset manager as agent and the client as Principal. For a fiduciary relationship to arise, a party A must repose confidence or delegate power in favour of party B whom A has employed to act on his/her behalf.¹⁶ The greater the amount of power delegated or trust and confidence which the client (A) reposes in the asset manager (B), the more likely it is that the asset manager (B) will be treated by Scots law as a fiduciary owing fiduciary obligations to the client (A).¹⁷ In the context of an asset management firm specializing in individual discretionary portfolio asset management on behalf of institutional clients, a wide degree of discretion and power will be conferred on the asset manager in the IMA. For that reason, it is undoubtedly the case that the asset management entity will owe fiduciary obligations to the Principal. The Scottish courts are extremely likely to follow the reasoning of Rix J in the case of *Ata v American Express Bank Ltd*.¹⁸ that an asset manager with a discretionary right to trade on a client's behalf is in a fiduciary position. The relevance of the asset manager being a

¹⁵ *Liverpool Victoria Legal Friendly Society v Houston* (1900) 3 F 42.

¹⁶ *The York Building Co v Mackenzie* (1795) Paton's Appeal Cases 378.

¹⁷ *The Huntingdon Copper and Sulphur Company Limited v Henderson* (1877) 4 R 294, 299 (per Lord Young).

¹⁸ Unreported, 7 October 1996. This part of Rix J's judgment was not disturbed by the Court of Appeal in its judgment reported in the Times, 26 June 1998.

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fiduciary assumes importance when it comes to the remedies which are available to the
Principal on the occurrence of a breach of fiduciary duty.

III. The regulatory framework

17-11 For the regulatory framework applicable under the FSMA, please refer to Chapter ____.
The legal position in Scots law and the law of England and Wales is identical.

IV. The private law duties of an asset manager

1. Duties of the asset manager prior to the asset management contract

17-12 Turning to the duties of the asset manager which arise prior to the formation of the asset management contract by virtue of private law, one has to look to the general Scots common law of agency and the Scots common law of delict for guidance. In practice, it is standard procedure for an asset management firm in Scotland to negotiate and enter into a non-legally binding agreement with its institutional investment clients which is known as a 'Progress on Report for Proposals' ("PRP").¹⁹ The PRP captures the main commercial terms of the IMA which it is envisaged will follow shortly after the conclusion of the PRP. The PRP will set out the investment objectives and bases upon which the parties intend to enter subsequently into a legally binding relationship with each other. When the terms of the non-legally binding PRP have been concluded and one of the parties subsequently withdraws from the relationship prior to the conclusion of a legally binding IMA, there is scope under Scots law for the withdrawing party to be held liable on the basis of the somewhat strained Scots law equivalent of *culpa in contrahendo*. The Scots law concept which imposes pre-contractual liability is known as 'Melville Monument liability' after the facts of *Walker v Milne*.²⁰ The rule in *Walker v Milne* imposes liability on the withdrawing party for the innocent party's pre-contractual wasted expenditure in negotiating and concluding the PRP and taking steps

¹⁹ However, any provisions in the PRP relating to the confidentiality of information exchanged will be specifically narrated to impose legally binding non-disclosure and non-exploitation covenants, and, likewise, any provisions concerning exclusivity, governing law, and/or jurisdiction.

²⁰ (1823) 2 S 379. A landowner raised a claim for reimbursement of expenditure incurred in preparing the land for the construction of a monument in honour of Viscount Melville. Due to lengthy delays in preparing the land, the monument subscribers decided to change the location of the monument to another site in Edinburgh (St. Andrew's Square). Although no binding contract had been entered into between the landowner and the monument subscribers, the court held that the latter were liable for the landowner's wasted expenditure. 'Melville Monument liability' arises where there is an agreement between two parties, one of the parties acts in reliance on the other party's assurances that the agreement is a binding contract, and the other party withdraws in bad faith in full knowledge of the other party's reliance.

to prepare for the IMA. Such liability for wasted expenditure will attach to the asset manager when it withdraws in bad faith prior to the conclusion of the IMA with the Principal. Conversely, the rule in *Walker v Milne* will also impose pre-contractual liability on the client to make good the asset manager's pre-contractual wasted expenditure in negotiating and concluding the PRP where the client has withdrawn in bad faith. This is one area where clear water divides the approaches in Scots law and English law because in *Walford v Miles*,²¹ the House of Lords held that English law does not subject a party to pre-contractual liability by imposing an obligation to negotiate in good faith to conclude a contract. However, the latitude of pre-contractual liability in Scots law pursuant to the rule in *Walker v Milne* has been constrained²² to the point that the Scottish judiciary recently doubted whether it remained good law.²³ Nevertheless, there are persuasive reasons to suggest that 'Melville Monument liability' should not be abandoned or excised from the common law of Scotland, bearing in mind that it performs a wider role than that of estoppel in English law and is likely one of the many manifestations or instantiations of a wider concept of good faith which permeates throughout Scots contract law.²⁴

17-13 When the parties enter into a contractual relationship with each other by concluding an IMA subsequent to the PRP, the asset manager's contractual, fiduciary, and delictual duties will serve to impose obligations on the asset manager prior to the formation of the contract. For example, the asset manager's duty of skill and care which is based on the law of agency will function to enjoin the asset manager to exercise a degree of care before entering into the IMA which is consistent with that of a prudent man in managing his own affairs²⁵ or if higher, the standard of a reasonably competent and careful asset manager.²⁶ Furthermore, since the asset manager is a professional person, a concurrent duty of skill and care will arise in the law of delict via the medium of the law of professional negligence. Such a duty will be relevant whether or not there is a contractual relationship in the law of agency between the asset manager and the client. The latter point is significant, since in the absence of any contract

21 [1992] 2 AC 128, in which the House of Lords held that English law recognizes no obligation on parties to negotiate in good faith.

22 See *Dawson International plc v Coats Paton plc* 1988 SLT 854 (OH), 866A per Lord Cullen, holding that the parties must have concluded their negotiations and settled the terms of their non-legally binding agreement for such liability to arise.

23 *Khaliq v Londis* 2010 SC 432, 442-443 and 444-445 at paras. [26] and [35]-[39] (per Lords Osborne and Marnoch).

24 See M. Hogg and H. MacQueen, 'Melville Monument Liability: Some Doubtful Dicta' (2010) 14 *Edinburgh Law Review* 451-455 and W. M. Gloag and C. Henderson, *The Law of Scotland*, (12th edition, Edinburgh: W Green/Thomson 2007) at para. 3.02, 81.

25 *Bell Commentaries* I,516. See also *Bell Principles* s 221; *Erskine* III,3,37

26 *Cooke v Falconer's Representatives* (1850) 13 D 157 at 172 (per Lord Fullerton).

grounded in Scots law between the asset manager and the client, no contractual duty of skill and care will be applicable. This point is particularly important when a governing law clause in the IMA, such as clause G4 of the Model IMA, stipulates that Scots law is disapplied and the proper law of the IMA will be English law or the law of some other jurisdiction. Notwithstanding such a clause opting into English law as the governing law of the IMA, for the reasons adumbrated below in paragraph 17-18, the asset manager's duty of care and skill in the Scots law of delict will continue to assume relevance when the *lex loci delicti* is Scotland for purposes of the relevant private international law rules.²⁷

17-14 The basic component of the standard of care which the asset manager is expected to discharge in the Scots law of professional negligence in delict prior to the formation of the IMA was examined in the case of *Stewart v McLean, Baird & Neilson*.²⁸ The asset manager must provide to the client a sufficient explanation of the true nature of the investment service and its attendant risks and dangers as well as its temptations and advantages. The amount, nature and kind of explanation to be given by the asset manager to the client must be tailored according to the client's intelligence and experience and the nature of the subject which is being discussed. Thus, the steps which the asset manager must take will vary according to the nature of the client. The less experienced the client, the more explanation, disclosure and risk warnings that must be given and the more information about the client which will be required. The end result is that the liability of the asset manager will be conditioned by the steps which the asset manager took and in turn, the depth of the steps which it must take will be carved by reference to the sophistication of the client.

17-15 Unlike English law,²⁹ in Scots law, there is no authority for the proposition that the standard of care in the law of agency or the law of delict which the asset manager is expected to discharge in order to comply with its private law duty to exercise due skill and care will incorporate the obligations of the asset manager under the Conduct of Business Sourcebook (COBS),³⁰ which forms part of the Handbook of the FSA and implements MiFID into UK law. However, it is highly likely that a Scottish court

27 See Article 4 of Regulation (EC) No 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations ("Rome II") (OJ [2007] L199/40).

28 1915 SC 13, 19 (per Lord Dundas).

29 See *Gorham v BT plc* [2000] 4 All ER 868, 878c (per Pill LJ) and *Seymour v Caroline Ockwell & Co (a firm)* [2005] EWHC 1137 (QB) at para. [77] (per H.H. Judge Havelock-Allan Q.C.)

30 See <http://fsahandbook.info/FSA/html/handbook/COBS> (last visited 3rd January 2011).

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would reach the same conclusion as H.H. Judge Havelock-Allan Q.C. in *Seymour v Caroline Ockwell & Co (a firm)*³¹ where he stated that the obligations of asset managers under the regulatory regime in the FSA Handbook will ‘afford strong evidence as to what is expected of a competent advisor’ for the purposes of the content of the common law duty of care and skill in the law of delict. Therefore, prior to the formation of any IMA with the Principal, the asset manager’s common law obligations as set out in *Stewart v McLean, Baird & Neilson* are likely to be informed, refined and supplemented by the ‘know-your-customer’, ‘suitability’ and retail/professional categorization requirements in Rules 3.4, 3.5, 3.6 and 9 of COBS which transpose Article 19 of MiFID into UK law.³² For example, the asset manager will be required to undertake due diligence on the Principal by categorizing it as a retail client, professional client or eligible counterparty in terms of Rules 3.4, 3.5 and 3.6 of COBS. When the Principal would have been classified as a retail client pursuant to Rules 3.4, 3.5 and 3.6 of COBS, reflective of the requirements under COBS, the standard of care imposed on the asset manager in the law of agency and delict will be higher than if the Principal had been a professional client or eligible counterparty. The end result is that the private law duties of care in agency and delict will be breached when an asset manager fails to comply with the regulatory rules in COBS prior to the conclusion of the IMA. Furthermore, in order to ensure compliance with its private law duties of care and skill, the manager will be enjoined to obtain information from the Principal which enables it to comply with its suitability and ‘know-your-customer’ obligations under Rule 9 of COBS, i.e. to be able to assess its Principal’s knowledge and experience in the relevant investment field, financial situation and investment outlook and objectives, as well as to determine whether the investment process or model offered by the asset manager as a service is suitable to achieve those investment objectives, compatible with the Principal’s experience and knowledge and commensurate with the degree of financial risk which the Principal is willing to bear. However, that is not to say that compliance with all of the regulatory rules in COBS prior to the formation of a contract will offer a sufficient defence to an asset manager who has been sued for a breach of its delictual duty of care. The point is moot in Scots law, but it is unlikely that a court would exonerate an asset manager on the sole ground that it had complied with COBS requirements in the FSA Handbook. The key test for establishing liability for a breach of the duty of care in delict remains that

31 [2005] EWHC 1137 (QB).

32 Please refer to Chapter ____.

17-16 Since the asset management firm engaged in individual discretionary institutional portfolio asset management services is a fiduciary, it will owe fiduciary duties to the Principal prior to the formation of the IMA. For example, the asset manager will be under a duty in pre-contractual negotiations which amounts to a form of good faith disclosure of any potential conflict of interest and duty, as well as prohibiting any misrepresentation or concealment of material information.³⁴ Moreover, the asset manager is bound not to disclose or use information of the Principal which is confidential in nature which may have come into its possession prior to the formation of the contract.³⁵ It should be stressed that such a fiduciary duty will be applicable irrespective of whether a contractual relationship is formed by the asset manager and the Principal pursuant to an IMA. Therefore, the fiduciary duty is imposed by law independent of the contract of agency and by virtue of the relationship of trust and confidence between the parties.

2. Duties of the asset manager during the asset management contract

17-17 Turning to the obligations of the asset management firm during the course of the IMA, one must distinguish among its contractual/agency, delictual, and fiduciary obligations. It is industry practice in Scotland for Scottish asset management firms to enter into an IMA with their clients on the basis of the Model IMA. Clause G4 of the Model IMA is extremely important and provides as follows

“The Agreement will be governed by and construed in accordance with English law. The English courts will have exclusive jurisdiction to settle any disputes or claims which may arise out of or in connection with the Agreement for which purpose all parties agree to submit to such jurisdiction.”

Therefore, Clause G4 excludes Scots law as the governing law and opts into English law as the proper law of the agency contract. Therefore, in accordance with Article 3(1) of Regulation (EC) No 593/2008 of the European Parliament and of the Council

³³ 1915 SC 13, 19 (per Lord Dundas).

³⁴ *McPherson v Watt* (1877) 3 App Case 254 (HL), 266 (per Lord O’Hagan) and *McGarvey Construction Ltd. v Shanks* 2007 SLT 537.

³⁵ *Liverpool Victoria Legal Friendly Society v Houston* (1900) 3 F 42.

University of Edinburgh School of Law Working Paper 2011/16 of 17 June 2008 on the law applicable to contractual obligations (“Rome I”),³⁶ the applicable law of contract/agency which governs the relationship between the asset manager and the Principal will be English law. A critical matter which must be resolved is whether the disapplication of Scots law as the applicable law of the contractual relationship between the asset manager and the Principal is also sufficient to dislodge Scots law as the law applicable to the delictual and fiduciary obligations of the asset manager. Each of these issues will now be addressed in turn.

17-18 The position concerning the law of delict and the delictual obligations of the asset manager is now governed by Articles 4 and 14 of Rome II. Article 14 of Rome II directs as follows:

“The parties may agree to submit non-contractual obligations to the law of their choice... where all the parties are pursuing a commercial activity... by an agreement freely negotiated before the event giving rise to the damage occurred. The choice shall be expressed or demonstrated with reasonable certainty by the circumstances of the case and shall not prejudice the rights of third parties.”

In Scots law, prior to the coming into force of Rome II on 11th January 2009, unlike the Continental Civilian jurisdictions, there was no freedom to select the governing law of disputes grounded in the law of delict. Therefore, there is no case law on how the Scottish courts would determine whether the clause in a freely negotiated IMA would be sufficiently wide to cover an obligation in delict. However, it is very likely that the Scottish judiciary would adapt the rules which are applied in the context of choice of jurisdiction/forum clauses, when it must determine whether the parties have prorogated a particular jurisdiction to hear a dispute of a particular type, i.e. whether the clause is sufficiently wide to cover a dispute arising in relation to a non-contractual obligation. In the case of *Mackays Stores Ltd. v Topward Ltd.*,³⁷ the Court of Session held that the matter was to be resolved by reference to the ordinary rules of contractual interpretation. The relevant clause in *Topward* stated that ‘any disputes or differences of whatsoever nature arising out of the order, the contract or the delivery of the goods’ would be governed by Scots law and subject to the jurisdiction of the Scottish courts. The Court of Session held that this clause was sufficiently wide to cover disputes in

36 (OJ [2008] L177/6).

37 2006 SLT 716.

the law of unjustified enrichment as well as those arising in contract law. It is likely that the Scottish courts would distinguish clause G4 of the Model IMA from the relevant contractual provision in *Topward*. In *Topward*, the clause related to disputes of ‘whatsoever nature arising out of’ their commercial relationship and the relevant contract. This can be contrasted with clause G4 which is restricted to the ‘Agreement’ between the parties. For that reason, one would expect a Scottish court to confine clause G4 to contractual disputes only and not to construe it in a fashion which extends its compass to disputes arising in delict and other non-contractual areas of the law. Therefore, Article 4 of Rome II will assume importance when it is claimed that an asset management firm established in Scotland has breached an obligation in delict (such as the duty of care and skill). The governing law of the dispute will be the *lex loci delicti*, i.e. the country where the damage occurs. Since the ‘damage’ suffered by the Principal as a result of a breach of a delictual obligation is likely to be economic or financial in nature, the place where the Principal is established will more often than not be the *lex loci delicti*. This may or may not be Scots law depending on the facts and circumstances of the case. However, for the sake of argument, the remainder of this Part IV assumes that the Scots law of delict is indeed the *lex loci delicti*.

17-19 With regard to the impact of an English governing law clause (such as clause G4 of the Model IMA) on the asset manager’s fiduciary obligations, the juridical basis of the fiduciary obligations of the asset manager will assume importance, whether they have their foundation in the law of contract/agency or whether the fiduciary office and obligations of the asset manager arise by operation of law or on some other basis independent of contract, such as the law of unjustified enrichment. Although the matter is not wholly free from doubt, the most persuasive and orthodox view is that the fiduciary duties of the asset manager in Scots law arise by operation of law where the client reposes trust and confidence in the asset manager, independently of the contractual relationship established between the asset manager as agent and the client as Principal.³⁸ Crucially, the fiduciary duties do not arise in Equity.³⁹ Therefore, if the parties select the English law of contract to govern their agency relationship, one could argue that it would stand to reason that the governing law clause would be insufficient to displace the Scots law of fiduciary duties which arise separately, and are distinct from, the general contractual duties of the agent.⁴⁰ However, it is by no

38 See *The York Building Co v Mackenzie* (1795) Paton’s Appeal Cases 378 and *The Huntingdon Copper and Sulphur Company Limited v Henderson* (1877) 4 R. 294, 299 per Lord Young.

39 Unlike English law, on which see E. McKendrick, *Goode on Commercial Law* (4th edn, Penguin, 2010) 187.

40 The fiduciary duties of the asset manager in Scots law are often said to be equitable in nature, but this is

means certain that Scots law would analyse the position in this way. No case law in Scotland resolves the matter. At this juncture, Rome II is of crucial significance.⁴¹ Article 10 of Rome II provides that the applicable law in the case of ‘a non-contractual obligation arising out of unjust enrichment, including payment of amounts wrongly received’ will be the same law which governs any contractual relationship between the parties. Therefore, where the remedy sought for a breach of an asset manager’s fiduciary obligation is an account of the profits gained by the asset manager and the contractual relationship between the parties is based on the Model IMA, the effect of clause G4 will be that the governing law of the fiduciary obligation will also be English law. Scots law recognises that the remedy of an account of profits for a breach of fiduciary duty is based on the law of unjustified enrichment, i.e. that it is restitutionary in nature.⁴² However, where the remedy sought by the Principal is the recovery of losses which it has sustained as a consequence of the asset manager’s breach of fiduciary duty, Article 10 of Rome II will not apply since the remedy is not grounded in the law of unjustified enrichment and is not restitutionary by nature. How Scots law would choose the governing law of the dispute in such a case is unclear, but it may well be that Scots law would apply and clause G4 would be ineffective to invoke English law. The result is that the remedy sought in a claim of breach of fiduciary duty will dictate whether the governing law follows the choice of law of the contractual relationship in the IMA. For that reason, it may be that the governing law of the claim for a breach of fiduciary duty is indeed Scots law. On that basis, the remainder of this Part IV assumes that Scots law is the governing law of any such dispute, notwithstanding the existence of clause G4.

17-20 In summary, the duties of the asset manager in the law of agency will be governed by English law when the relationship between the asset manager and the Principal is based on the Model IMA. Scots law will have no part to play in defining the agent’s contractual duty of care and skill, the duty not to exceed authority, and the duty to comply with the Principal’s instructions. Moreover, breach of warranty of suitability

distinct from the English concept of Equity because Scots law does not recognize the separation of law and Equity.

⁴¹ The law of New Zealand is also instructive. In *Attorney General for England and Wales v R* [2002] 2 NZLR 91, Keith J held that the proper law of the agency contract dictates the proper law of the fiduciary obligation in Equity. Thus, it is impracticable for the governing law of the contractual duties and fiduciary duties to diverge. The New Zealand rule is predicated on the distinction between Law and Equity in common law systems such as New Zealand and England and, for that reason, one cannot necessarily reach the conclusion that Scots law would follow the same path bearing in mind that the law of Scotland does not recognise any such separation. See also *Dicey, Morris and Collins on the Conflict of Laws*, 14th edn (2006), Vol.II, at p.1884.

⁴² *Style Financial Services Ltd v Bank of Scotland (No 1)* 1996 SLT 421, 426J-K and *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 164 at para. [20] (per Lord President Hamilton).

claims in contract will be governed by English law. Therefore, one should refer to Chapter ___ for an exposition of the contractual duties of the asset manager. Meanwhile, for the reasons articulated at paragraphs 17-18 and 17-19 above, it is assumed that the Scots law of delict is indeed the *lex loci delicti* and that it governs any dispute in relation to a breach of the asset manager's fiduciary duties.

17-21 Turning to the Scots law of delict, since the asset manager will be in a contractual relationship with the client, the criteria in *Caparo Industries plc v Dickman*⁴³ for establishing a duty of care will be met. The asset manager is likely to be classified as a 'professional' in Scots law and so the rules on professional negligence in the seminal case of *Hunter v Hanley*⁴⁴ will apply. It will be incumbent on the client to satisfy a three-pronged test in relation to the standard of care expected of the asset manager. First, the client must establish that the asset management profession applies a usual and normal practice in the context of individual discretionary portfolio asset management services to institutional clients. Secondly, it must be proved that the asset management firm has not adopted that practice and finally, it must be established that the course the asset manager adopted is one which no professional asset manager exercising ordinary skill would have taken if he had been acting with ordinary care.

17-22 Since the test in *Hunter v Hanley* requires a deviation from a usual and normal practice to be established and it is compulsory for asset managers to be authorized to conduct such business under FSMA, a failure to be so authorized under section 19 of FSMA will undoubtedly amount to a deviation from normal practice. The same result is likely when the asset manager is guilty of an abject failure to abide by the initial capital requirements in the Prudential Standards of the Handbook of the FSA,⁴⁵ the organisational requirements including rules about the handling of client money and the segregation of assets under management in the Client Assets Rules of the Handbook of the FSA ("CASS"),⁴⁶ and the best execution and client order handling requirements in Rules 11.2, 11.3 and 11.4 of COBS.⁴⁷ Hence, in consequence of such a material deviation, the *Hunter v Hanley* test will not have been satisfied and the asset manager will be deemed to be liable, ie professionally negligent in the law of delict. Of course,

43 [1990] 2 AC 905, followed by the Court of Session in *Weir v National Westminster Bank plc* 1993 SC 515.

44 1955 SC 200.

45 See <http://fsahandbook.info/FSA/html/handbook/D166> (last visited 3rd January 2011). The General Prudential Standards transpose article 12 of MiFID into UK law.

46 Rules 6, 7 and 8 of CASS implements articles 13(7) and (8) of MiFID into UK law. See <http://fsahandbook.info/FSA/html/handbook/CASS> (last visited 3rd January 2011).

47 See <http://fsahandbook.info/FSA/html/handbook/D166> (last visited 3rd January 2011). Rules 11.2, 11.3 and 11.4 of COBS transpose articles 21 and 22 of MiFID into UK law.

such an eventuality is unlikely, since it is common practice for asset managers authorized under FSMA to (a) diversify the portfolio amongst suitable asset classes and avoid over-exposure to certain instruments, (b) monitor the portfolio and the relevant market, (c) comply with the investment objectives and overall strategy agreed in the IMA, (d) instruct broker-dealers to sell and acquire assets and securities, and (e) report to clients on portfolio performance. The failure of an asset manager to do any of (a) to (e) above will undoubtedly amount to professional negligence on the ground that it is an extreme deviation from the ordinary practice of asset managers. However, when the client seeks to establish liability on the ground that the manager undertook any of (a) to (e) in a professionally negligent manner, matters will be more complicated. Much will come down to the evidence of professional expert asset managers in court. Where such evidence is given in court about the usual and normal practice but it is conflicting, the Scottish courts are generally reluctant to conclude that the asset manager has not been professionally negligent simply because the asset manager has been able to lead the testimony of a professional expert who would have done what it did. Instead, the court will enquire on an objective basis whether the practice which responsible professional experts support stands up to rational analysis. Therefore, if a court is satisfied that a body of opinion, on which the asset manager relies, is not reasonable or responsible, it may find the asset manager guilty of negligence. Similarly, if the court were to conclude that an expert's opinion was based on a mistaken or incomplete understanding of the facts or lacked a logical basis, it could reject the opinion supporting the asset manager.⁴⁸

17-23 As noted above, the asset manager will owe fiduciary obligations to the client. The fiduciary obligations owed are more or less identical to the fiduciary duties which arise in English law. Indeed, this is unsurprising since many of the seminal cases which have served to draw the content of the fiduciary duties in English law are in fact Scottish cases which were decided on appeal to the House of Lords.⁴⁹ Therefore, an asset manager is impressed with a duty of undivided loyalty⁵⁰ which mirrors the asset manager's duty under Rule 2.1.1 of COBS to act honestly, fairly and professionally in accordance with the best interests of its client. The asset manager also owes the client

⁴⁸ *WTL International Ltd Retirement Benefits Scheme (Trustees of the) v Edwards* [2010] CSOH 34; 2010 G.W.D. 16-319 at para. [74] (per Lord Hodge).

⁴⁹ For example, *York Building Co v Mackenzie* (1795) Paton's Appeal Cases 378, *Aberdeen Railway Co. v Blaikie* (1854) 1 Macq 461 and *McPherson v Watt* (1877) 3 App Case 254 (HL).

⁵⁰ *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 177 (per Lord Nimmo Smith), approving the judgment of Millet LJ in *Bristol and West Building Society v Mothew* [1998] Ch 1, 18B-D.

a duty of confidentiality,⁵¹ a duty to avoid conflicts of interest and duty,⁵² a duty of good faith,⁵³ a duty not to self-deal,⁵⁴ and a duty not to make a secret profit⁵⁵ or compete with the client⁵⁶ without the client's prior disclosure and consent. Such duties are manifestations or facets of the broader principle that a client is entitled to the unadulterated loyalty of the asset manager⁵⁷ and are wholly inflexible. However, if the asset manager gives full disclosure and the Principal provides express or implied consent, the asset manager will be entitled to take the proposed course of action which otherwise would have been in breach of duty.⁵⁸ The principal differences between Scots law and English law concern the legal basis for the fiduciary duties⁵⁹ and the remedies which flow from a breach of duty.⁶⁰ It is extremely likely - albeit not settled law in Scotland - that the content of the asset manager's fiduciary duty to avoid conflicts of interest will mirror and be influenced by the provisions in the public regulatory system, i.e. Rule 10 of the Senior Management Arrangements, Systems and Controls (SYSC),⁶¹ which forms part of the Handbook of the FSA and implements Article 18 of the MiFID into UK law. Indeed, rule 10.1.3 of SYSC sets out the steps which the asset manager must take to identify conflicts. Additionally, rule 10.1.4 of SYSC specifies the most common types of conflicts which may arise.⁶² This is instructive since Scots common law is not particularly enlightening as to the precise circumstances in which an asset manager will be in a conflict situation.⁶³ That said, it cannot be stressed enough that the content of the asset manager's fiduciary obligations,

51 *Liverpool Victoria Legal Friendly Society v Houston* (1900) 3 F 42.

52 *Aberdeen Railway Co. v Blaikie* (1854) 1 Macq 461, 471 (per Lord Chancellor Cranworth).

53 *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 177 (per Lord Nimmo Smith), approving the judgment of Millet LJ in *Bristol and West Building Society v Mothew* [1998] Ch 1, 18B-D.

54 *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 177 (per Lord Nimmo Smith), approving the judgment of Millet LJ in *Bristol and West Building Society v Mothew* [1998] Ch 1, 18B-D.

55 Lord Kames, *Principles of Equity* (2nd edn) 255 and *York Building Co v Mackenzie* (1795) Paton's Appeal Cases 378, 398-399 (per Lord Chancellor Loughborough).

56 *Huntingdon Copper and Sulphur Co v Henderson* (1877) 4 R 294, 299 per Lord Young and *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 160 at para. [5] per Lord President Hamilton.

57 *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 177 (per Lord Nimmo Smith), approving the judgment of Millet LJ in *Bristol and West Building Society v Mothew* [1998] Ch 1, 18B-D.

58 *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 161 at para. [10] (per Lord President Hamilton).

59 In English law the fiduciary obligations are based on Equity, whereas in Scots law they arise by operation of law.

60 Discussed at paragraphs 17-41 and 17-44 to 17-46 below.

61 See <http://fsahandbook.info/FSA/html/handbook/SYSC/10/1> (last visited 3rd January 2011).

62 Rule 10.1.4 of SYSC directs that the asset manager must take into account, as a minimum, whether it or a person directly or indirectly linked to it (1) is likely to make a financial gain or avoid a financial loss at the expense of the client, (2) has an interest in the outcome of a service provided to the client or of a transaction carried out on behalf of the client, which is distinct from the client's interest in that outcome, (3) has a financial or other incentive to favour of the interest of another client or group of clients over the interests of the client, (4) carries on the same business as the client, or (5) receives or will receive from a person other than the client an inducement in relation to a service provided to the client in the form of monies, goods, or services, other than the standard commission or fee for that service specified in the IMA.

63 The law says no more than to command that an asset manager not put itself in a position with a real sensible possibility of conflict between its interest and duty, *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 159 at para. [3] (per Lord President Hamilton).

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including the duty to avoid a conflict of interest and duty, will be fashioned by the provisions of G13 of the Model IMA. Clause G13 is very important and is discussed in more depth at paragraphs 17-25 to 17-28 below.

3. Duties of the asset manager after the asset management contract has ended

17-24 Once the contractual relationship between the asset manager and the client has terminated, one would think that the fiduciary obligations of the asset manager would be extinguished. Indeed, this is the position in English law. In *Ata v American Express Bank Ltd*,⁶⁴ Hirst LJ in the Court of Appeal held that the fiduciary duty of the asset manager ceased once the IMA came to an end because the discretion conferred on the asset manager by the client no longer arose. However, there is authority in Scots law that the fiduciary duties of an agent can continue after the contract has been determined. In *Connolly v Brown*,⁶⁵ Lady Dorrian preferred the view that what mattered was whether the trust and confidence reposed in the asset manager by the client still existed subsequent to the termination of the contractual relationship.⁶⁶ This will be dependent on the facts and circumstances of the case and it is perhaps too simplistic to take the view that the fiduciary duties fly off as soon as the discretion conferred by the IMA is extinguished. On that reasoning, the duty of undivided loyalty, the duty of confidentiality, the duty of good faith, the duty not to self-deal, the duty to avoid conflicts of interest and duty, and the duties not to make a secret profit or compete with the client continue once the contract has been determined.

4. Validity of contractual derogations from regulatory and private law duties

17-25 The asset manager's private law duties in the law of delict will also be shaped by the obligations specifically provided for in the IMA. For example, under clause G17 of the Model IMA, the asset manager accepts responsibility for its own negligence and that of its delegates and employees in the law of contract or delict, but excludes liability for the under-performance of the fund under management in the law of contract or delict in the following terms:

“The [asset m]anager accepts responsibility for loss to the Customer to the extent that such loss is due to the negligence, wilful default or fraud of itself or

⁶⁴ The Times, 26 June 1998.

⁶⁵ 2007 SLT 778.

⁶⁶ 2007 SLT 778, 784.

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any delegates appointed pursuant to paragraph G7(a) above or that of its or their employees. Without prejudice to paragraph G2 above [which sets out the details on the categorisation of the Customer in terms of the COBS], the [asset m]anager will not otherwise be liable for any loss to the Customer. No warranty or undertaking is given by the [asset m]anager as to the performance or profitability of the Fund (or any part of it) or that the investment objectives stated in item G3 of the Schedule will be successfully achieved.”⁶⁷

Moreover, clause G13 of the Model IMA is particularly interesting since it seeks to exclude and modify the asset manager’s fiduciary obligations to avoid a conflict of interest and duty and not to make a secret profit. It provides as follows:-

“The [asset m]anager and any [company or other person connected to the [asset m]anager or, where relevant, the Custodian] (“the Associate”) may effect transactions in which the [asset m]anager or Associate or another client of the [asset m]anager or an Associate has, directly or indirectly, a material interest or a relationship of any description with another party which involves or may involve a potential conflict with the [asset m]anager’s duty to the Customer. The [asset m]anager will ensure that such transactions are effected on terms which are not materially less favourable to the Customer than if the conflict or potential conflict had not existed. Conflicts, if any, which the [asset m]anager is not able to manage effectively, are disclosed in... the Schedule. Neither the [asset m]anager nor any Associate shall be liable to account to the Customer for any profit, commission or remuneration made or received from or by reason of such transactions or any connected transactions nor will the [asset m]anager’s fees, unless otherwise provided, be abated. The [asset m]anager’s Conflicts of Interest Policy sets out the types of actual or potential conflicts of interest which affect the [asset m]anager’s business, and provides details of how these are managed. The [asset m]anager will normally act as the agent of the Customer, who will therefore be bound by its actions under the Agreement. To the extent that any fiduciary or equitable duties arise as a result of the services to be provided hereunder such duties shall not prevent or hinder the [asset m]anager, or any Associate, in effecting transactions with or for the Customer.”⁶⁸

⁶⁷ Writer’s annotations in square brackets.

⁶⁸ Writer’s annotations in square brackets.

The efficacy of clauses such as G13 and G17 takes us on neatly to the question of whether or not contractual derogations from the fiduciary duties of the asset manager or its duties in delict in such terms are effective. The purpose of clause G13 is twofold. First, it purports to enable the asset manager to enter into transactions with third parties notwithstanding the fact that such transactions may entail a conflict of interest and duty on the part of the asset manager, but provided that such a transaction is not materially less favourable to the client than if the conflict or potential conflict had not existed. Secondly, if any profit, commission, or remuneration is generated or received by the asset manager as a result of a transaction giving rise to a conflict of interest, the clause gives the asset manager the right to retain those sums without accounting for them to the client. Therefore, the clause indirectly operates to exclude the asset manager's liability for breach of the fiduciary duties to avoid a conflict of interest and duty and not to make a secret profit. The question is whether such a clause G13 is valid.

17-26 Clause G13 is potentially vulnerable to three lines of attack. First, Rule 2.1.2 of COBS stipulates that any clause which seeks to exclude or restrict the asset manager's public law or regulatory duty in Rule 2.1.1 of COBS to act honestly, fairly, and professionally in accordance with the best interests of its client will be a breach of the FSA Handbook. The question is whether clause G13 duties an attempt to do so. On a cursory glance of clause G13, the asset manager seems to be saying that it has the right to breach its duties to avoid conflicts of interest and duty and not to make a secret profit. That is suggestive of a breach of Rule 2.1.1 of COBS, since that can hardly be something which is fair and in the best interests of the client. However, on closer reflection, clause G13 probably does not amount to a breach of Rule 2.1.1 of COBS since it builds in certain safeguards for the client in the event that a transaction is entered into which gives rise to a conflict of interest or generates a secret profit for the asset manager. For example, the client is protected by prior disclosure of the asset manager's conflict of interests policy which describes the circumstances in which it will be unavoidable for the asset manager to avoid a conflict or generate a profit and how this situation will be managed. Moreover, the client has the comfort of knowing that the asset manager is under a contractual obligation to ensure that any transaction which produces a conflict of interest will be effected in a way that is not materially less favourable to the client than if the conflict or potential conflict had not existed. The question then is whether these contractual protections are consistent with the asset

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manager's regulatory duty under Rule 2.1.1 of COBS to act 'honestly, fairly, and professionally in accordance with the best interests of its client'? On balance, it is submitted that the requirements of Rule 2.1.1 of COBS are satisfied by the protections for the client included within clause G13 as the asset manager is being upfront and fair about the position.

17-27 Secondly, section 16 of the Unfair Contract Terms Act 1977 ("UCTA") subject terms in contracts which seek to exclude liability for breach of duty arising in the course of any business to a 'fair and reasonable' test. Section 16 of UCTA will control delictual as well as fiduciary duties and has the capacity to strike down clauses which purport to displace them. However, since the asset management industry in Scotland centres around the provision of individual discretionary portfolio asset management services to large institutional clients, both parties clearly will be large commercial players and the inequality in bargaining power between contracting parties which the fair and reasonable test in section 16 of UCTA is designed to address is clearly absent. In a number of cases, the courts have emphasised that they will be very slow to apply the statutory 'fair and reasonable' test in UCTA to strike down contractual provisions in commercial contracts agreed between sophisticated commercial organizations.⁶⁹ For that reason, it is submitted that a court will not rule clause G13 to be ineffective on the basis of section 16 of UCTA, since the fair and reasonable standard is of limited application in contracts concluded between experienced businesses such as asset management firms and their institutional clients.

17-28 Thirdly, whilst the fairness and reasonableness test in UCTA will not function to invalidate the asset manager's delictual or fiduciary duties, one must ask whether it is permissible to oust or derogate fiduciary duties in Scots law. In English law, Lord Mustill in *Re Goldcorp Exchange*⁷⁰ stated that the fiduciary obligations are of a different nature from contractual obligations. When one considers that the latter are subject to disapplication, the implications of that statement are clear. However, the dictum of Lord Browne-Wilkinson in *Kelly v Cooper*⁷¹ suggests otherwise, i.e. that the modification of fiduciary duties is indeed allowed, and in *New Zealand*

⁶⁹ See *Ata v American Express Bank Ltd.*, the Times, 26 June 1998 in the case of an asset manager and sophisticated client and more generally, see *Photo Productions Ltd. v Securicor* [1980] AC 827, 843D-E (per Lord Wilberforce), *Granville Oil & Chemicals v Davis Turner* [2003] 2 Lloyd's Rep 356 at para. [31] (per Tuckey LJ), *IFE Fund SA v Goldman Sachs International* [2007] 1 Lloyd's Rep 264 at para. [54] (per Toulson J), *Grimstead v McGarrigan* [1999] EWCA Civ 3029 at para [29] (per Chadwick LJ) and *Watford Electronics v Sanderson CFL Ltd.* [2001] 1 All ER (Comm) 696 at para. [55] (per Chadwick LJ).

⁷⁰ [1995] 1 AC 74, 98E (per Lord Mustill).

⁷¹ [1993] AC 205, 213H-214B (per Lord Browne-Wilkinson).

Netherlands Society “Oranje” Incorporated v Kuys,⁷² Lord Wilberforce also adopted the position that commercial parties have the power to exclude or limit in scope and intensity the operation of fiduciary duties.⁷³ Indeed, in the case of *Henderson v Merrett Syndicates Ltd.*,⁷⁴ Lord Browne-Wilkinson expressed the view that the extent and nature of fiduciary duties will vary depending on the contractual context and that the contract modifies and shapes the content of the fiduciary duties which arise. Turning to Scots law, unlike English law (where the role of Equity is stressed), the degree and content of the fiduciary obligations impressed upon the asset manager in Scots law are predicated on the amount of discretion, power and trust reposed by the client in the asset management firm, independent of the contractual relationship in agency. For that reason, fiduciary obligations arise by operation of the common law rather than by virtue of the terms of the contract of agency, and one might argue that it follows that modification or exclusion of liability for breach of fiduciary duty is disallowed. That would suggest that clause G13 would be invalid insofar as the exclusion of liability for breach of fiduciary obligations is concerned. However, it is submitted that such an analysis is too simplistic and indeed that is misconceived. Instead, it is abundantly clear that fiduciary duties can be waived or modified by the clients of an agent (such as an asset manager) by full disclosure on the part of the asset manager of the potential breach of fiduciary duty and the subsequent express or implied informed consent of the client.⁷⁵ It should be stressed that Scots law has no particular definition of what constitutes the requisite ‘express consent’ of the client and a broad-brush approach to the matter is usually adopted. Taking into account and paying close attention to the language of clause G13, it is more probable than not that it amounts to the express authorisation on the part of the client to the asset manager breaching its fiduciary duties to avoid a secret profit and a conflict of interest and duty. For that reason, as a general proposition, exculpatory clauses such as G13 undoubtedly will be valid.

5. Contractual clauses, market practice and model agreements

17-29 As noted above, the private law duties of the asset manager in the law of delict will

72 [1973] 1 WLR 1126.

73 [1973] 1 WLR 1126 at 1131-1132, (per Lord Wilberforce).

74 [1995] 2 AC 145, 206B-D. However, see J Getzler, “Excluding Fiduciary Duties: The Problems of Investment Banks” (2008) 125 *LQR* 15.

75 See *Mactaggart & Mickel Homes Ltd. v Hunter* [2010] CSOH 130 at para. [107] (per Lord Hodge), *Johnston v MacFarlane’s Trs.* 1986 SC 298, 301 (per Lord Wylie), and *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 161, 177 and 179 (per Lord President Hamilton and Lord Nimmo Smith), approving the judgment of Millet LJ in *Bristol and West Building Society v Mothew* [1998] Ch 1, 18B-D.

also be shaped by the obligations specifically provided for in the IMA. The Model IMA is the model agreement used by asset managers to enter into IMAs with their clients in Scotland. We have already encountered and discussed the validity of clauses G13 and G17 of the Model IMA. Attention should also be drawn to a series of other clauses in the Model IMA which serve to mould the asset manager's duties. Clause G5 of the Model IMA is headed 'Investment Discretion' and provides as follows:

“The [asset m]anager will manage the Fund with a view to achieving the investment objectives and within any restrictions stated... the Schedule and will act in good faith and with reasonable skill and care. Subject to such objectives and restrictions, the [asset m]anager, normally acting as agent, will have complete discretion over the account of the Customer (without prior reference to the Customer) to buy, sell, retain, exchange or otherwise deal in investments and other assets, make deposits, subscribe to issues and offers for sale and accept placings, underwritings and sub-underwritings of any investments, advise on or execute transactions (including transactions in, or relating to, unregulated collective investment schemes), effect transactions on any markets, negotiate and execute counterparty and account opening documentation, take all routine or day to day decisions, and otherwise act as the [asset m]anager judges appropriate in relation to the management of the Fund, but always subject to the applicable obligations of the [asset m]anager under the FSA Rules regarding suitability and best execution. The investment objectives and restrictions [in] the Schedule will not be breached as a result of any events or circumstances outside the reasonable control of the [asset m]anager including, but not limited to, changes in the price or value of assets of the Fund brought about solely through movements in the market.”⁷⁶

Clauses G11, G14, G15, G19 and the schedule to the Model IMA are also significant. They address the frequency of fund valuations, the provision of periodic statements and communications to the client, the disclosure of fees, charges and commissions, and the disclosure of dealing arrangements to the client. Clause G12 enjoins the asset manager to arrange for the execution of trades in the best interests of the client, to comply with all applicable obligations regarding best execution under the handbook of the FSA, and to allocate all executed transactions on a fair and reasonable basis in accordance with the requirements of the said handbook.

⁷⁶ Writer's annotations in square brackets.

V. Liability of an asset manager

1. Liability of an asset manager for its own acts towards clients and third parties

A. Legal basis

17-30 An asset manager may be liable in contract, delict, or the law of fiduciary duties. However, as explored above, the Scots law of contract will not apply by virtue of clause G4 of the Model IMA. Therefore, the requirements for a breach of the asset manager's contractual duties are not considered below.

B. Requirements

17-31 In theory, it is possible for an asset manager to be held liable in delict under the law of professional negligence or for a breach of its fiduciary duty. However, in practice, as far as professional negligence is concerned, given the strict nature of the test in *Hunter v Hanley*,⁷⁷ it is not surprising that there are no reported cases of an asset manager being held liable to a client under Scots law for poor decision-making, portfolio management, stock selection, or fund underperformance. Provided that the asset manager pursues the investment objectives agreed with the client in the IMA, follows the investment process of the asset management firm, and can show that the practice it adopted is not one which no professional asset manager exercising ordinary skill would have taken if it had been acting with ordinary care, there will be no scope for a client to attain legal redress from the asset manager on the grounds of poor performance, portfolio management, or judgment. The position will be the same where the asset manager acts in contravention of the terms of the mandate agreed with the Principal in the IMA.⁷⁸ To establish liability in professional negligence in such a case, the client would need to demonstrate that no professional asset manager exercising ordinary skill would have (i) breached the terms of a mandate agreed with a client in an IMA and (ii) acted in the way the asset manager did (e.g. by managing the portfolio or by selecting certain stocks for investment in the way it did), if such a professional asset manager had been acting with ordinary care.

⁷⁷ 1955 SC 200.

⁷⁸ For example, when the asset manager invests the client's money in collective investment schemes in complete disregard of instructions in the mandate not to do so.

17-32 Although the level at which the standard of care is pitched will also depend on the sophistication of the client,⁷⁹ this is unlikely to affect matters by rendering it easier to establish that an asset manager is liable in professional negligence. For example, in the case of a retail client, it will be likely that evidence in court will reveal that the expectations of an asset manager are much higher than in the case of professional clients, with an obligation to explain the nature of an investment to the client and to undertake more extensive prior diligence in a stock prior to its selection. The threshold of liability will then depend on whether the asset manager's deviation from that industry expectation is one which no professional asset manager exercising ordinary skill would have taken if he had been acting with ordinary care. This test will be extremely difficult to satisfy. Once again, the provisions of the regulatory rules in COBS such as the 'know-your-customer', 'suitability' and retail/professional categorization requirements will have a bearing on the standard of care imposed on the asset manager in the law of professional negligence. Of course, if an asset manager engages in activities such as insider dealing or market abuse which are civil and criminal wrongs in terms of Part V of the Criminal Justice Act 1993 and sections 118-131A of FSMA, this would furnish strong evidence of a departure from the practice which a professional asset manager exercising ordinary skill would have taken if he had been acting with ordinary care. Therefore, this could lead to a finding of professional negligence, but it should be stressed that liability in the law of delict in such circumstances would by no means be automatic.

17-33 With regard to the asset manager's fiduciary duties, the client would be required to satisfy the court that there had been a breach of the duty of undivided loyalty,⁸⁰ the duty of confidentiality,⁸¹ the duty of good faith, the duty not to self-deal, the duty to avoid conflicts of interest and duty⁸² and/or the duty not to make a secret profit⁸³ or compete with the client⁸⁴ without prior disclosure and informed consent from the client. A breach of any one of those duties entitles the client to recover any losses occasioned, as well as to attain restitutionary damages from the asset manager. It

⁷⁹ By virtue of the tests in *Stewart v McLean, Baird & Neilson* 1915 SC 13, 19 (per Lord Dundas) and the 'know-your-customer', 'suitability' and retail/professional categorization requirements in Rules 3.4, 3.5, 3.6 and 9 of COBS.

⁸⁰ *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 179 (per Lord Nimmo Smith), approving the judgment of Millet LJ in *Bristol and West Building Society v Mothew* [1998] Ch 1, 18B-D.

⁸¹ *Liverpool Victoria Legal Friendly Society v Houston* (1900) 3 F 42.

⁸² *Aberdeen Railway Co. v Blaikie* (1854) 1 Macq 461, 471 (per Lord Chancellor Cranworth).

⁸³ *York Building Co v Mackenzie* (1795) Paton's Appeal Cases 378, 398-399 (per Lord Chancellor Loughborough).

⁸⁴ *Huntingdon Copper and Sulphur Co v Henderson* (1877) 4 R 294, 299 (per Lord Young) and *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 160 at para. [5] (per Lord President Hamilton).

would also be possible to annul contracts entered into by the asset manager with third parties on the client's behalf. These remedies are explored in more detail at paragraphs 17-44 to 17-46 below.

17-34 A professional negligence claim by a third party against the asset manager (such as a beneficiary of a client or a shareholder of, or investor in, the client) confronts major challenges. The third party must first establish that the asset manager owed it a duty of care in negligence and that such a duty had been breached. This would be extremely difficult for the third party to do since it would be required to show that the asset manager had impliedly assumed responsibility to it in providing the asset management services and that it was reasonable for it to rely on the special skill and care of the asset manager.⁸⁵ Since the asset management services are provided to the client pursuant to terms in the IMA, rather than to the third party, there will commonly be no proximity between the asset manager and the third party to satisfy the requirement for an implied assumption of responsibility and reasonable reliance. Furthermore, since no trust has been reposed directly by the third party in the asset manager, no fiduciary relationship will arise, making it extremely unlikely that any fiduciary duty will be owed by the asset manager.

2. Liability of an asset manager for acts of delegates towards clients and third parties

A. Legal basis

17-35 Once again, an asset manager may be liable in delict or the law of fiduciary duties in respect of the acts of its delegates, sub-contractors or sub-advisers.

B. Requirements

17-36 Clause G7 of the Model IMA specifically empowers the asset manager to delegate and outsource some of the investment management services and/or some of its powers to third parties and sub-advisers. The asset manager is also given the power to employ agents to perform any administrative, dealing or ancillary services required to enable it to perform the investment services in terms of the IMA. Clause G7 of the Model IMA directs that the asset manager will act in good faith and with reasonable skill and care

⁸⁵ *Henderson v Merritt Syndicates Ltd.* [1995] 2 AC 145, followed by the Court of Session in *Hines v King Sturge LLP* [2010] CSIH 86; 2010 GWD 38-780 and *Caparo Industries plc v Dickman* [1990] 2 AC 605, followed by the Court of Session in *Weir v National Westminster Bank plc* 1993 SC 515.

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in the selection, use and monitoring of any agents which it appoints. This contractual provision mirrors the terms of Rules 8.1.7 and 8.1.8 of SYSC,⁸⁶ which forms part of the Handbook of the FSA and implements Article 14 of the MiFID Implementing Directive into UK law. Rules 8.1.7 and 8.1.8 of the SYSC impose an obligation on the asset manager to exercise due skill and care and diligence when entering into, managing, or terminating any arrangement for the outsourcing to a delegate of critical or important operational functions or of any relevant services and activities. The same Rules 8.1.7 and 8.1.8 of the SYSC provide that the asset manager must ensure that the delegate has the ability, capacity, and any authorization required by law to perform the outsourced functions, services, or activities reliably and professionally, as well as to monitor, assess, and supervise the standard of performance of the delegates.

17-37 As for the liability of the asset manager for the negligence, wilful default or fraud of its delegates, clause G17 of the Model IMA stipulates that the asset manager will accept full responsibility in the event that losses are suffered by the client as a result thereof. The asset manager assumes such liability irrespective of whether the delegate is a third party or a group company of the asset manager. However, the presence of clause G17 does not mean that the asset manager will automatically be liable for the delegate's negligence, willful default, or fraud. To determine whether the asset manager will be held liable in the law of delict for professional negligence when the delegate underperforms or is alleged to have been guilty of misjudgment, the test in *Hunter v Hanley*⁸⁷ will apply. Therefore, it is unlikely that the asset manager will be liable to the client or a third party where it is able to demonstrate that it supervised, assessed, and monitored the activities of its delegates in accordance with Rules 8.1.7 and 8.1.8 of the SYSC, performed the investment objectives agreed with the client in the IMA, and followed its own investment process. Liability will only attach to the asset manager if the client is able to satisfy a court that the practice the asset manager adopted in appointing, monitoring, and supervising the delegate is one which no professional asset manager exercising ordinary skill would have taken if it had been acting with ordinary care. As explained above, this is a very difficult standard for the client to meet.

17-38 Where the asset manager delegates or sub-contracts a function of the investment process to a delegate or sub-agent, since clause G17 of the Model IMA directs that the

⁸⁶ See <http://fsahandbook.info/FSA/html/handbook/SYSC/8> (last visited 3rd January 2011).

⁸⁷ 1955 SC 200.

asset manager will only be liable for the negligence, wilful default, or fraud of its delegates, the implication is that the asset manager's liability for breach of fiduciary duty to the Principal or any third party is excluded. As noted above, the fiduciary obligations of asset managers may be excluded or limited by express consent of the parties in the agency contract and, for that reason, clause G17 is likely to be effective.⁸⁸ However, matters by no means end there. Like the law of agency in the United States⁸⁹ and South Africa,⁹⁰ Scots law recognises that a sub-agent appointed by the asset manager will owe fiduciary duties direct to the Principal of the asset manager notwithstanding the absence of any contractual relationship between them. This can be contrasted with English law where the position is currently unclear, albeit that commentators have expressed the view that it would be desirable were a sub-agent under a duty to account to the principal.⁹¹ In *Liverpool Victoria Legal Friendly Society v Houston*,⁹² it was held that a sub-agent of a friendly society owed a fiduciary obligation to that friendly society not to exploit or disclose its confidential information. Indeed, the fiduciary duties owed by the sub-agent will be the same as those which would have been impressed upon the asset manager absent the provision of clause G17,⁹³ i.e. the client would be required to satisfy the court that there had been a breach of the duty of undivided loyalty,⁹⁴ the duty of confidentiality,⁹⁵ the duty of good faith,⁹⁶ the duty not to self-deal,⁹⁷ the duty to avoid conflicts of interest and duty,⁹⁸ and/or the duty not to make a secret profit⁹⁹ or compete with the

⁸⁸ However, it should be stressed that clause G17 will be ineffective to disapply Rule 2.1.1 of COBS, which enjoins the asset manager to act honestly, fairly, and professionally in accordance with the best interests of its client because it is an inderogable obligation under Rule 2.1.2 of COBS.

⁸⁹ Restatement (Third) of Agency, § 3.15, cmt. d provides that the relationship between the sub-agent and the principal is one of agency and so fiduciary duties are owed by the former to the latter. See also W. A. Seavey, "Subagents and Subservants" (1955) 68 *Harvard Law Review* 658.

⁹⁰ In *Watson v. Sachs & Another* 1994 (3) SA 655 (A), 663 (per Van Heerden JA), it was recognised that the sub-agent could owe fiduciary duties to the principal even in the absence of privity of contract. See also A J Kerr, *The Law of Agency*, (4th edition, Durban, Lexis Nexis Butterworths 2006) 187-189 and A. D. M. Forte and J. P. van Niekerk, "Agency" in R. Zimmermann, D. Visser & K. Reid, *Mixed Legal Systems in Comparative Perspective* (2004, OUP) 256-260.

⁹¹ See P. G. Watts, *Bowstead & Reynolds on Agency* (19th edition, London: Sweet & Maxwell, 2010), para. 5-011 at 167-168 and A. Tettenborn, "Principals, Sub-agents and Accountability" (1999) 115 *Law Quarterly Review* 655.

⁹² (1900) 3 F 42.

⁹³ Of course, the sub-agent and the principal would be free to modify the fiduciary duties in writing.

⁹⁴ *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 179 (per Lord Nimmo Smith), approving the judgment of Millet LJ in *Bristol and West Building Society v Mothew* [1998] Ch 1, 18B-D.

⁹⁵ *Liverpool Victoria Legal Friendly Society v Houston* (1900) 3 F 42.

⁹⁶ *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 177 (per Lord Nimmo Smith), approving the judgment of Millet LJ in *Bristol and West Building Society v Mothew* [1998] Ch 1, 18B-D.

⁹⁷ *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 177 (per Lord Nimmo Smith), approving the judgment of Millet LJ in *Bristol and West Building Society v Mothew* [1998] Ch 1, 18B-D.

⁹⁸ *Aberdeen Railway Co. v Blaikie* (1854) 1 Macq 461, 471 (per Lord Chancellor Cranworth).

⁹⁹ *York Building Co v Mackenzie* (1795) Paton's Appeal Cases 378, 398-399 (per Lord Chancellor Loughborough).

client¹⁰⁰ without prior disclosure to and informed consent of the client. The sub-agent's breach of any of those duties entitles the client of the asset manager to the usual remedies.

3. Causation

17-39 In Scots law, when considering causation one must ask whether the breach of the asset manager's fiduciary duty or its delictual duty of care in professional negligence has caused the loss sustained by the client for which damages are recoverable.¹⁰¹ This is not simply a question of applying a "but for" test because the chain of causation may be severed by an act or omission of the client or a third party.¹⁰² It is well established that one has to look to the law to decide what losses are to be held to have been caused by a particular kind of breach of duty.¹⁰³ The rules on causation in the Scots law of delict and the law of fiduciary duties mirror those in English law. For that reason, reference should be made Chapter ___ for further discussion.¹⁰⁴

17-40 However, Scots law and English law differ in one respect. Where a client seeks to establish that the asset manager has been professionally negligent in the law of delict, unlike English law,¹⁰⁵ there is no difference in the court's approach to causation between a case of negligently giving the wrong advice and a case of a negligent failure to advise. An example of the latter would be when the client alleges that the asset manager omitted to disclose certain aspects of the mandate to him or failed to assess whether the investment objectives in the IMA were suitable for the client under the 'know-your-customer', 'suitability,' and retail/professional categorization requirements in Rules 3.4, 3.5, 3.6 and 9 of COBS. In all cases of causation, the central question is whether the breach of delictual duty caused the loss. When a client

¹⁰⁰ *Huntingdon Copper and Sulphur Co v Henderson* (1877) 4 R 294, 299 (per Lord Young) and *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 160 at para. [5] (per Lord President Hamilton).

¹⁰¹ In delict, the relevant authorities are *Wardlaw v Bonnington Castings Ltd* 1956 SC (HL) 26 and *M'Williams v Sir William Arrol & Co Ltd* 1962 SC (HL) 70. The requirement for causation in the case of a breach of fiduciary duty is illustrated by *Ata v American Express Bank Ltd.*, the Times, 26 June 1998 (per Hirst LJ) and *Swindle v Harrison* [1997] 4 All ER 705, which was considered by Lord Hodge in *WTL International Ltd Retirement Benefits Scheme (Trustees of the) v Edwards* [2010] CSOH 34; 2010 G.W.D. 16-319.

¹⁰² *Gorham v BT plc* [2000] 1 WLR 2129.

¹⁰³ *WTL International Ltd Retirement Benefits Scheme (Trustees of the) v Edwards* [2010] CSOH 34; 2010 G.W.D. 16-319 at para. [78] (per Lord Hodge) referring to *South Australia Asset Management v York Montague* [1997] AC 191.

¹⁰⁴ See L. Van Setten, *The Law of Institutional Investment Management* (Oxford, OUP, 2009) paras. 3.76-3.103 at pages 107-120.

¹⁰⁵ *Bristol and West Building Society v Mothew* [1998] Ch 1, 11B-E (per Millett LJ). See also G. Vos, "Linking Chains of Causation: An Examination of New Approaches to Causation in Equity and the Common Law" (2001) 60 *CLJ* 337, 346-347 and 350-351.

claims that an asset manager was professionally negligent in giving the wrong advice or alleges that the asset manager was culpable of a professionally negligent failure to advise, this may well enjoin the client to establish in both situations that it would not have transacted with the asset manager and act as it did had it been given the correct advice.¹⁰⁶ Therefore, in Scots law it is insufficient for the court to enquire whether the proffering of incorrect advice caused the client to transact with the asset manager when otherwise it would not. When considering causation one must also ask whether the breach has caused loss for which damages are recoverable. In all cases, whether a causative link between the breach of duty and the loss exists requires the court to address what the client's position would have been if the asset manager had not been in breach of his duty.

4. Assessment of damages

17-41 In contractual cases, the role of the court is to award damages in order to place the client in the position he would have been in if the asset manager had performed its obligations in accordance with the contract.¹⁰⁷ However, when a client claims that the asset manager is guilty of professional negligence in the law of delict, damages are designed to place the client in the position he would have been in had the asset manager not breached his duty of care.¹⁰⁸ Damages in the law of delict in Scotland are purely compensatory in nature and so exemplary and punitive damages are unavailable.¹⁰⁹ Beyond that, the rules on the assessment of damages in the law of delict and for breach of fiduciary duties are the same in England and Scotland. Hence, the provisions of Chapter ___ on the quantum of absolute portfolio losses and opportunity costs should be considered at this juncture.¹¹⁰

5. Contributory negligence, duty to mitigate damages and other corrective mechanisms

17-42 Like English law, the Scots law of delict recognises the doctrine of contributory negligence in section 1(1) of the Law Reform (Contributory Negligence) Act 1945.

¹⁰⁶ *WTL International Ltd Retirement Benefits Scheme (Trustees of the) v Edwards* [2010] CSOH 34; 2010 G.W.D. 16-319 at paras. [75]-[79] (per Lord Hodge).

¹⁰⁷ McBryde, *The Law of Contract in Scotland* (3rd edition, Edinburgh, W Green, 2007) para 22.91.

¹⁰⁸ See Stair Memorial Encyclopedia, Vol. 15, "Obligations" at para. 892.

¹⁰⁹ *Black v North British Rly Co* 1908 SC 444, 453 (per Lord President Dunedin).

¹¹⁰ See L. Van Setten, *The Law of Institutional Investment Management* (Oxford, OUP, 2009) paras. 3.105-3.107 at pages 121-122.

Therefore, where a client fails to fully disclose its financial circumstances to the asset manager when the parties are seeking to agree the terms of the investment objectives and process, this may lead to a deduction from the damages awarded on the ground that the client was contributorily negligent. It is not clear at present whether Scots law would recognise an asset manager's plea of contributory fault on the part of the client where the asset manager is in breach of fiduciary duty as there is no case law on the subject. The Scots courts would likely follow English law, but the difficulty is that the position in English law is also in a state of development as there has been little consideration of the situation. That is the case despite the prevalence of a general understanding that contributory fault is irrelevant in the case of a breach of fiduciary duty.¹¹¹ Like most legal systems, Scots law also directs that a client is under a duty to take all reasonable steps to mitigate its losses which were caused as a result of the breach of the asset manager's fiduciary duties or its duty of care in delict.¹¹² In Scots law, there is no equivalent of the rule in Civilian countries that the asset manager is under an obligation to mitigate the extent of the losses suffered by the client. For example, where an asset manager fails to apply a stop-loss on transactions in the portfolio under management, this will be of relevance in determining whether there has been a breach of the asset manager's delictual duty of care in professional negligence and for the purposes of calculating the extent of the damages awarded to the client. However, there is no such a thing as an obligation on the part of the asset manager to take reasonable steps to mitigate the client's loss. The Scots law of contributory negligence and mitigation of losses largely reflects the rules in English law. Once again, reference should be made to Chapter ___ for a full analysis.

6. *Limitation and exclusion of liability*

17-43 For a detailed discussion of the validity of exclusion and limitation of liability clauses in IMAs, please refer to paragraphs 17-25 to 17-28 above.

7. *Restitutionary claims against the asset manager in case of void/voidable asset management contract*

17-44 When an asset manager breaches a fiduciary duty, restitutionary claims are available to the client against the asset manager, including a claim for an account of profits made

¹¹¹ See the interesting discussion in M. Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties* (Oxford: Hart Publishing, 2010) 172-176.

¹¹² *Pomphrey v James A Cuthbertson Ltd.* 1951 SC 147.

by the asset manager,¹¹³ and an action by the client to set aside contracts entered into by the asset manager on its behalf.¹¹⁴ Therefore, it is not necessary for the client to establish that it suffered an actual loss itself in order to attain a remedy. If an asset manager is in breach of its fiduciary duty of loyalty, e.g. by failing to be authorized to conduct business as an asset manager under section 19 of FSMA, the client will be entitled to claim such restitutionary remedies. When the client seeks an account of profits, there is no requirement to demonstrate that any gain made by the asset manager as a result of the breach of fiduciary duty was reasonably foreseeable and the law on the remoteness of damages is generally of no consequence.¹¹⁵ However, when an asset manager failed to consider open positions in a portfolio from time to time so as to decide whether or not to make trades, *Ata v American Express Bank Ltd.* held that the client's restitutionary claim for a breach of fiduciary duty was unsuccessful because no proved recoverable loss arose from that breach. Generally, a client will have no right to make a claim for the loss of a general opportunity to trade, since that is too speculative in nature.

17-45 As noted above, a client will be entitled to attain the annulment of a contract with a third party on the basis that it was entered into by the asset manager on its behalf in breach of fiduciary duty. If any money was paid or property transferred under that contract (which was void/voidable but was erroneously thought to be valid) to the asset manager or the third party, the client will have rights under the law of unjustified enrichment. The client must raise an action of repetition (rather than recompense) under the *condictio indebiti* and satisfy the court that the payment made or property transferred was not due or transferable and that it had been made or transferred on the erroneous assumption that the contract with the third party was valid.¹¹⁶ However, it may be that the contract with the third party cannot be set aside, e.g. on the ground that *restitutio in integrum* is no longer possible. In such circumstances, the client will have a right to take action against the third party to whom property has been transferred in consequence of the asset manager's breach of fiduciary duty and who is in knowing

113 *Style Financial Services Ltd v Bank of Scotland (No 1)* 1996 SLT 421, 426J-K and *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 164 at para. [20] (per Lord President Hamilton).

114 *McPherson v Watt* (1877) 3 App Case 254 (HL), *The Huntingdon Copper and Sulphur Company Limited v Henderson* (1877) 4 R 294 and *The York Building Co v Mackenzie* (1795) Paton's Appeal Cases 378. However, the nature of the invalidity of the contract is obscure in Scots law and it is not wholly clear whether the contract is treated as void or voidable. Some authorities classify the contract as voidable, (e.g. *Gloag on Contract* 2nd ed., (1929) 486), whilst some cases refer to it as a nullity, e.g. *Perston & ors v Perston's Trs* (1863) 1 Macph 245 (per Lord Neaves) at 251 and (per Lord Justice-Clerk Inglis) at 253.

115 *Ata v American Express Bank Ltd.*, the Times, 26 June 1998 (per Hirst LJ) and *Swindle v Harrison* [1997] 4 All ER 705.

116 *Morgan Guaranty Trust Co of New York v Lothian Regional Council* 1995 SC 151.

receipt of such assets. The third party will be in 'knowing receipt' when it has knowledge (1) of the fiduciary relationship between the asset manager and the client, (2) the fact that the assets transferred belong to the client, and (3) the fact that the assets have been transferred to it in breach of the asset manager's fiduciary duty. The property will be treated by the law as being held in a constructive trust by the third party for the client, and the client must raise an action of recompense against the third party to recover it.¹¹⁷

17-46 The restitutionary remedies which a client is entitled to claim when there has been a breach of the asset manager's fiduciary duty can be contrasted with the legal position when the asset manager has breached its delictual duty of care in professional negligence. As articulated above, where there has been a violation of the delictual duty of care, the client's remedy will be restricted to the recovery of damages in respect of the losses which it has sustained as a result of the breach. A claim for an account of profits or the annulment of a contract with a third party is not permitted.

VI. Governing Law and dispute resolution

1. Choice of law

17-47 Please refer to paragraphs 17-17 to 17-20 above for consideration of the effect of clause G4 of the Model IMA on the governing contract law of the IMA and the governing law in the law of delict and the law of fiduciary duties. For the rules on the mandatory application of Scots law (e.g. issues of public policy), the rules are identical to those which apply in English law and reference should be made to Chapter ____.

2. Selection of forum

17-48 Please refer to paragraphs 17-17 to 17-20 above for consideration of the effect of clause G4 of the Model IMA on the jurisdiction for the resolution of a dispute in the law of delict and the law of fiduciary duties. For the rules on the mandatory application of Scots law, the rules are identical to those which apply in English law and reference should be made to Chapter ____.

¹¹⁷ *Commonwealth Oil & Gas v Baxter* [2010] SC 156, 163 at para. [16] (per Lord President Hamilton).

VIII. Conclusions

17-49 The approach of Scots law in regulating the liability of asset managers is similar to the position in English law. However, important distinctions arise because Scots law is a mixed legal system. For example, an asset manager may be liable to a client in pre-contractual liability when the client has incurred wasted expenditure and a legally binding investment management contract has not been entered into between the parties. An important feature of investment management contracts – which are classified as a contract of agency in Scots law - entered into by Scottish investment management firms is clause G4 of the Model IMA. This displaces Scots law as the governing law of the parties' contractual relationship and opts into English contract law. However, for the reasons set out in this Chapter, it is by no means the case that clause G4 is effective to disapply the Scots law of delict, fiduciary duties, or unjustified enrichment. Whilst there are many similarities between Scots law and English law in respect of the law of delict and tort, the law of fiduciary duties, and the assessment of damages, the juridical basis for the fiduciary duties differ (Equity is absent in Scots law) as do the grounds for restitutionary remedies which flow from a breach of fiduciary duty.

