Alert

Reflecting On Reflective Loss

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Primeo Fund (In Official Liquidation) and Bank of Bermuda (Cayman) Limited, HSBC Securities Services (Luxembourg) SA **(Cayman Islands Court of Appeal 13 June 2019)**

The common law principle of reflective loss has been judicially described as a "perplexing and developing area". The most recent decision of the Court of Appeal in the Cayman Islands has highlighted the importance of paying close attention to the scope and application of the principle.

On 13 June 2019 the Cayman Islands Court of Appeal gave judgment in *Primeo Fund (In Official Liquidation) and Bank of Bermuda (Cayman) Limited, HSBC Securities Services (Luxembourg) SA* in which it held that recovery by Primeo of losses caused by the administrators and custodian of the feeder funds, through which they were invested in Bernard L Madoff Investment Securities LLC ("BLMIS"), were barred by the principle of reflective loss, even though wrongdoing had been established.

Originally Primeo had invested directly in BLMIS, but later, in 2003, it had changed to investing indirectly through two feeder funds, Herald Fund SPC ("Herald") and Alpha Prime Fund Ltd. ("Alpha"). At first instance, the Judge had held that it was irrelevant that when the cause of action arose Primeo was not a shareholder in Herald or Alpha, and that, provided there was a real prospect of success of a claim by Herald or Alpha succeeding, Primeo's claim would be barred by the principle of reflective loss. This decision was upheld on appeal.

The reflective loss principle applies where a shareholder[1][2] and a company both have a claim against a defendant arising out of the same facts. Unless all or part of the shareholder's loss is separate and distinct from the loss suffered by the company it will not be recoverable in an action brought by the shareholder against the defendant.

The classic formulation of this principle is that of Lord Bingham in *Johnson -v- Gore Wood*[3]

> "*Where a company suffers loss caused by a breach of duty owed to it, only the company may sue in respect of that loss. No action lies at the suit of a shareholder suing in that capacity and no other to make good a diminution in the value of the shareholder's shareholding where that merely reflects the loss suffered by the company. A claim will not lie by a shareholder to make good a loss which would be made good if the company's assets were replenished through action against the party responsible for the loss, even if the company, acting through its constitutional organs, has declined or failed to make good that loss.*"

He went on to identify two exceptions:

> "*Where a company suffers loss but has no cause of action to sue to recover that loss, the shareholder in the company may sue in respect of it (if the shareholder has a cause of action to do so), even though the loss is a diminution in the value of the shareholding.*"

and

> "*Where a company suffers loss caused by a breach of duty to it, and a shareholder suffers a loss separate and distinct from that suffered by the company caused by breach of a duty independently owed to the shareholder, each may sue to recover the loss caused to it by breach of the duty owed to it but neither may recover loss caused to the other by breach of the duty owed to that other.*"

[1] Per Neuberger J (as he then was) in Humberclyde Finance Group Ltd v Hicks (unrep. 14.11.01) approved by Sir Bernard Rix JA in Xie Zhikun & ors v Xio GP Limited & anr. (CICA unrep. 14.11.18)

[2] The principle also applies to creditors see *Carlos Sevilleja Garcia v Marex Financial Ltd* [2018] EWCA Civ 1468 (awaiting Judgment on the appeal to Supreme Court which was heard on 8 May 2019)

[3] [2002] 2 AC 1 (HL) at 35F

In *Garcia -v- Marex Financial Ltd*[4] Flaux LJ identified[5] four policy justifications for the principle which were accepted by the Court of Appeal in Primeo:

(i) the need to avoid double recovery by the claimant and the company from the defendant;

(ii) causation, in the sense that if the company chooses not to claim against the wrongdoer or settles for less than it ought to have done, the loss is caused by the decision of the company and not by the defendant's wrongdoing;

(iii) the public policy of avoiding conflicts of interest in the sense that if the claimant had a separate right to claim it would discourage the wrongdoer from settling with the company;

(iv) the need to preserve company autonomy and avoid prejudice to minority shareholders and other creditors.

Although Flaux LJ referred first in his list to double recovery, the Cayman Islands Court of Appeal has previously pointed out that this is not the primary consideration and the principle may apply even where there is in fact no risk of double recovery.

In *Xie Zhikun & ors -v- Xio GP Limited & anr.*[6] Rix JA observed that the primary consideration could be seen to be the fourth one – the need to preserve company autonomy and avoid prejudice to minority shareholders and other creditors. In *Primeo* this analysis was approved by a differently constituted Court of Appeal and, as between these two linked reasons, it was said that "if there is an "*underlying reason*", it is the need to avoid prejudice to minority shareholders and other creditors", rather than merely to preserve company autonomy.

These were the legal principles which the Court of Appeal applied to reject the two arguments of Primeo as to why the principle did not apply to the losses it claimed.

The first argument, referred to as the "timing" question, was that for the reflective loss principle to apply it was necessary that the plaintiff be a shareholder at the time the cause of action accrued. Thus the principle only applies if the plaintiff is in substance claiming in its capacity as a shareholder for the diminution of the value of its shares in the company (the "capacity point") and by definition it cannot be claiming in that capacity for losses incurred before it became a shareholder (the "pure timing point"). The nature of a loss sustained which is separate and independent cannot change and become reflective of a company's loss just because the plaintiff later becomes a shareholder (the "no-change" point).

The Court of Appeal rejected the capacity point. It held that the references in *Johnson -v- Gore Wood* to a shareholder "*suing in that capacity*" and "*as such*" and to "*a diminution in the value of the shareholder's shareholding*" was not a condition required for the principle to be engaged, but rather a description of the typical scenario in which the principle applies.

As for the pure timing point, the Court of Appeal also rejected that argument. The authorities focus on "*the loss claimed*" and whether such loss would have been made good if the company had enforced its rights. This had to be tested at the time the claim was made, and not at the time the cause of action arose. As stated by Neuberger LJ in *Gardner -v- Parker*[7] "*the rule against reflective loss is not concerned with barring causes of action as such, but with barring recovery of certain types of loss*".

Primeo's argument based upon *Johnson v Gore Wood* was inconsistent with the judgment of Lewison LJ in *Garcia*[8]:

> "…*the decision of the House of Lords in Johnson establishes that a claim brought by a shareholder, even if not in his capacity as such, is barred by the rule against reflective loss if the loss that he himself has suffered would have been made good by restoration of the company's assets ….*"

In principle the no change point is self-evidently correct and the Court of Appeal agreed with it. However, the real issue is whether the plaintiff would be made whole if the company had enforced its right, and that is to be tested at the time the claim is made. Furthermore, on the facts, the nature of the transaction by which Primeo transferred its assets from its own account to a Herald account with BLIMIS in exchange for shares in Herald was an additional reason why any loss ceased to be separate and distinct.

Finally, if Primeo were allowed to recover then there would be a risk of it "scooping the pool" ahead of the companies' claims and thereby prejudicing other shareholders and creditors and because of the impact of the proceedings on the ability of the defendants to settle the companies' claims.

The Court of Appeal having rejected the timing question turned to consider Primeo's second argument, referred to as the "merits test" question, which was that the principle was not in fact engaged because on a balance of probabilities the companies claims would not succeed. The Judge had applied a lower test of whether the company's claim had a realistic prospect of success.

The Court of Appeal considered that this question was not firmly settled by authority, but had to be decided according to policy. It was held that policy favoured the lower threshold of "realistic" claim, and not the higher threshold of "likely to succeed".

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[4] See fn 2 above
[5] at [32]
[6] See fn 1 above
[7] [2004] EWCA Civ. 781 at [49]
[8] At [70]

The main policy consideration identified was the fact that claims with a reasonable prospect of success, particularly in complex commercial litigation, are seen to have a value which can be realised and which the company should be entitled to realise. Setting the threshold higher would make it difficult for the company to settled such claims and would increase the risk of an individual shareholder "scooping the pool" at the expense of other shareholders or creditors.

The Court of Appeal also pointed out two significant practical difficulties with a higher threshold. First the merits of a company's claim would have to be determined in proceedings to which the company was not a party. Secondly, the court may have little assistance from the parties because a shareholder will have no incentive to argue that the company's claim will succeed because that would bar its own claim. The defendant will not do so because it would be admitting liability in another claim.

It is important to note the emphasis placed by the Court of Appeal on the underlying policy justification for the reflective loss principle as being to avoid the risk of the claim by the individual shareholder prejudicing other shareholders and creditors of the company by scooping the pool. It follows that if the loss claimed by the shareholder would have been made good by a successful claim by the company then the individual shareholder's claim will be barred by the reflective loss principle. Whether that is so is to be assessed at the time the claim is made.

A failure by a plaintiff to take into account the reflective loss principle may result in a very expensive pyrrhic victory if wrongdoing is established after a lengthy trial on the merits, but the losses caused thereby are held not recoverable in law.

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