Reflective Loss—Further Untangling of the Legal Japanese Knotweed

19 October 2021

In this update, we analyse two further decisions on the scope of the rule against reflective loss, following our previous update on the Supreme Court's significant decision in *Sevilleja v Marex* [2020] UKSC 31, which can be found here. In *Marex* the Supreme Court limited the expanding principle of reflective loss, confirming that the rule prevented only shareholders from bringing a claim based on any fall in the value of their shares or distributions that was the consequence of loss sustained by the company where the company had a cause of action against the same wrongdoer. The Court made it clear that there was no justification for extending the principle to creditors, regardless of whether they were also shareholders in the company, so long as a creditor's claim was not brought in its capacity as a shareholder.

The scope of the principle has been clarified further in two recent decisions, namely by the Court of Appeal in *Broadcasting Investment Group Ltd v Smith* [2021] EWCA Civ 912 and the Judicial Committee of the Privy Council in *Primeo Fund v Bank of Bermuda (Cayman) Ltd & Anor (Cayman Islands)* [2021] UKPC 22. These recent cases have confirmed that:

- The reflective loss rule could apply to both direct and indirect shareholders in a company (*Broadcasting Investment Group v Smith*) as well as to former shareholders of a company (*Primeo Fund v Bank of Bermuda*).

- The rule is a substantive one, as opposed to a "*procedural rule concerned only with the avoidance of double recovery*". In particular, "*the focus is on the nature of the loss, which involves consideration of the capacity in which the claimant suffered the loss and the form of the loss (ie whether it was suffered as a diminution in the value of shares held by the claimant or as a reduction in the dividends payable to them)*". (*Primeo Fund v Bank of Bermuda*, reinforcing the judgment in *Marex*).

- The relevant time to determine whether the reflective loss rule applies is when the claimant suffered the loss arising from the relevant breach of obligation by the relevant wrongdoer, not the time when proceedings are brought. Moreover, the rule cannot preclude a new shareholder from enforcing rights of action which had

already accrued to it before it became a member of the company (*Primeo Fund v Bank of Bermuda*). In other words, the rule does not operate retrospectively.

Broadcasting Investment Group Ltd v Smith [2021]

The factual matrix in this case is complex but is important in order to understand the issues. The Claimants sought to enforce an alleged oral agreement made in October 2012 between Broadcasting Investment Group Ltd ("BIG", the first claimant), Mr Burgess (the third claimant), Mr Smith (the first defendant) and Mr Finch (the second defendant). The agreement concerned the transfer of shares in two broadcasting technology companies to a joint venture vehicle, Streaming Investments PLC ("SS Plc", the fifth defendant) in which Mr Smith, Mr Finch, BIG and one other investor became shareholders (the "Agreement").

In alleged breach of the Agreement, the shares were not transferred to SS plc, and the company subsequently entered creditors' voluntary liquidation; SS Plc took no part in the appeal.

BIG brought a claim against the Defendants for breach of the Agreement, claiming specific performance in respect of the transfer of shares to SS Plc or damages in lieu. In the alternative, BIG claimed that it suffered loss further to a diminution in the value of its shareholding in SS Plc.

Mr Burgess (who was the majority shareholder of VIIL, the second claimant) brought parallel claims to those brought by BIG on the basis that both BIG and Mr Burgess were entitled to enforce the Agreement. Mr Smith applied for strikeout on the basis that BIG and Mr Burgess' claims were barred by the rule against reflective loss.

The High Court held that BIG's claims to enforce the Agreement (including the claims for damages and specific performance) should be struck out. In particular, BIG's claims were barred by the rule in *Prudential* on the basis that SS Plc (in which BIG owned shares) itself had a right to enforce the Agreement under the Contract (Rights of Third Parties Act 1999 (the "1999 Act"). The 1999 Act gave SS PLC a right to enforce the terms of the Agreement even though it was not a party to it. However, the judge declined to strike out Mr Burgess' equivalent claim.

The appeal to the Court of Appeal concerned the following issues:

- **The relationship between section 4 of the 1999 Act and the rule in *Prudential*.** Did the creation of a right in SS Plc as a result of section 1(1)(b) of the 1999 Act destroy BIG's rights to enforce the Agreement?

  - This first ground of appeal was essentially a matter of statutory interpretation. In particular, the proper construction of section 4 of the 1999 Act was that the right conferred upon a third party under section 1 was *additional* to any right the contractual promisee had to enforce the contract.

  - Therefore, the Court of Appeal held that BIG's claims under the Agreement were not, in fact, barred by the rule in *Prudential* and should not have been struck out. To the contrary, these claims were expressly protected by section 4 of the 1999 Act, which preserves the rights of the promisee to enforce any term of the contact. The creation of a right in SS Plc as a result of section 1(1)(b) therefore did not destroy BIG's rights to enforce the Agreement in its capacity as contractual promisee under the Agreement.

- **Directors' fiduciary duties and the rule in *Prudential*.** Did Mr Smith's breach of his personal contractual duty to transfer shares to SS Plc and his subsequent breach of his fiduciary duties to SS Plc mean that the claims were barred by virtue of the rule against reflective loss?

  - Mr Smith argued that the judge's order should be upheld on the additional basis that on the facts (as pleaded by the Appellants), SS Plc would have a cause of action against Mr Smith for breach of his fiduciary duties as a director of SS Plc to promote the success of the company for the benefit of its members; to exercise reasonable care, skill and diligence; and to avoid conflicts of interest.

  - In particular, the Appellants' case was that pursuant to the Agreement, Mr Smith promised to transfer certain shares to SS Plc. Accordingly, Mr Smith argued that if the Appellants' case was correct, then Mr Smith owed a personal contractual duty, enforceable by SS Plc, to transfer shares to SS Plc. Given that he did not do so, and he did not cause SS Plc to take steps to enforce the contractual right against him, the rule in *Prudential* applied to the current claims, and the claims were barred on this basis.

  - The Court of Appeal rejected this argument on the basis that, inter alia, the hypothetical claim was "*fatally flawed*". The fiduciary duty arose *after* the personal obligation upon Mr Smith. Although fiduciary duties were owed by a director of a company to that company, in this case, the alleged content and breach of those duties were "*entirely parasitic*" upon the Agreement and the right of SS Plc to enforce it pursuant to the 1999 Act.

- **Specific performance.** Did the rule in Prudential bar a claim for specific performance?

  - In light of the Court's findings in respect of the first ground of appeal, the Court considered it unnecessary to consider the second ground of appeal.

  - The Court noted that although Lord Reed's reference to a shareholder being unable to bring an action against a wrongdoer to recover damages "*or secure other relief for an injury done to the company*" in *Marex*, together with the application of the principle in *Foss v Harbottle*, "*might on superficial consideration lead one to the conclusion that claims for specific performance (whether with or without seeking additional or alternative relief in the form of equitable damages) also* [fell] *within the rule in Prudential, the matter* [was] *complex*". The Court therefore concluded that the matter was "*best left to a case in which it* [was] *essential to determine the issue*".

- **The "Russian Doll" argument.** Did the rule against reflective loss only apply to direct shareholders in a company?

  - This concerned Mr Smith's cross-appeal against the refusal to strike out the claims by Mr Burgess in respect of the Agreement. Mr Smith argued that because Mr Burgess owned shares in BIG, which in turn held shares in SS Plc, the rule in *Prudential* barred Mr Burgess' claims in contract. He submitted that the rule applied not only to claims brought by the direct shareholders in a company but also to claims brought by those further up the shareholding chain (the "Russian Doll" argument).

  - In light of the conclusions on the first ground of appeal, it was unnecessary to determine the "Russian Doll" argument.

  - However, it is notable that one of the three judges (Arnold LJ) considered it "*well arguable that the rule in Prudential [could] apply to indirect shareholders in appropriate circumstances*". Arnold LJ then went on to say "*[s]uppose A owns 100% of the shares in B Ltd which owns 100% of the shares in C Ltd. Suppose that a wrong is done to C Ltd by D which results in a diminution of the value of B Ltd's shares in C Ltd which in turn results in a diminution of the value of A's shares in B Ltd. Suppose that A has a concurrent right of action and sues D to recover his loss as [a] result of that diminution. I find it difficult to see why, on those hypotheses, the rule should not apply.*" Although Arnold LJ's comments are obiter, they have persuasive value.

Primeo Fund v Bank of Bermuda (Cayman) Ltd & Anor (Cayman Islands) [2021]

The appeal in this case related to loss suffered as a result of Bernard Madoff's Ponzi scheme. Although the appeal gave rise to a number of issues, the Board of the Privy Council gave directions to hear and determine one issue first, regarding the operation of the reflective loss rule on the facts of this case. The Board noted that the reflective loss principle under Cayman Islands law was the same as under English law, as determined by the majority in *Marex*.

The Appellant, Primeo (currently in liquidation) was an open-ended mutual investment fund set up in 1994 and registered in the Cayman Islands. The Respondent acted as Primeo's custodian and administrator from 1993.

From inception, Primeo placed a proportion of funds raised from investors with Bernard L. Madoff Investment Securities LLC ("BLMIS") for investment purposes. Primeo gradually placed more funds with BLIMIS until, by 1 May 2001, the whole of its fund was invested in this way either directly or indirectly through two feeder funds called Herald Fund SPC ("Herald") and Alpha Prime Fund Limited ("Alpha").

On 1 May 2007, Primeo's direct investments with BLMIS were transferred to Herald in consideration for new shares in Herald (the "Herald Transfer"). From that date, Primeo no longer had any direct investments with BLMIS. All investments were held indirectly via Herald or Alpha.

On 11 December 2008, the Ponzi scheme operated by Mr Madoff and BLMIS collapsed. Mr Madoff was subsequently charged with fraud, and Primeo was placed into voluntary liquidation on 23 January 2009.

Primeo subsequently brought claims in the Cayman Islands alleging breaches of duty by its administrators and custodians.

The Grand Court held that the administrators and custodians owed relevant duties to Primeo and had breached their duties. However, Primeo's claims were dismissed on the basis that they infringed the reflective loss rule; in particular, Herald and Alpha also had claims against the same defendants, covering the same loss, and if they made recovery on those claims, that would eliminate Primeo's loss.

Each side appealed to the Court of Appeal of the Cayman Islands. By a judgment handed down on 13 June 2019, before the decision of the Supreme Court in *Marex*, the Court of Appeal dismissed Primeo's appeal against the Grand Court's finding that its claims were barred by the reflective loss rule.

The specific issues for determination by the Board of the Privy Council in the current appeal were as follows:

- **The timing issue.** What was the relevant time to determine whether the reflective loss rule applied (i.e., was it the time of issuing the proceedings or the time when Prime acquired its causes of action against the Respondents)?

  - The Board confirmed that the relevant time to determine whether the reflective loss rule applied was when the claimant suffered the loss arising from the relevant breach of obligation by the relevant wrongdoer as opposed to the time when proceedings were filed. In the present case, the Board explained that the loss suffered by Primeo was not loss suffered in its capacity as a shareholder in Herald.

  - Referring to the judgment in *Marex*, the Board also emphasised that the reflective loss rule was a substantive rule, not a "*procedural rule concerned only with the avoidance of double recovery*". In particular, "*the focus* [was] *on the nature of the loss, which involve*[d] *consideration of the capacity in which the claimant suffered the loss and the form of the loss (ie whether it was suffered as a diminution in the value of shares held by the claimant or as a reduction in the dividends payable to them)*".

  - The Board also discussed the case of *Nectrus Ltd v UCP Plc* [2021] EWCA Civ 57, on which the Respondents relied in their argument regarding timing. The Board helpfully expressed the opinion that that case had been wrongly decided insofar as it held that the reflective loss rule should be assessed when the claim was made rather than when the loss was suffered. The Board noted that this would lead to odd results. The Board explained that "*a shareholder which suffer*[ed] *loss in the form of a diminution in value of its shareholding which* [was] *not recoverable as a result of the application of the reflective loss rule* [could not] *later convert that loss into one which was recoverable simply by selling its shareholding*". Therefore, the reflective loss rule may apply to a former shareholder, provided that the nature of the loss was one which fell within the scope of the reflective loss rule.

- **The Herald Transfer issue.** If the relevant time to determine whether the reflective loss rule applied was the time when Primeo acquired its causes of action against the Respondent, then did Primeo nonetheless lose its right to claim for the losses it suffered and become subject to the reflective loss rule by reason of the Herald Transfer by which it ceased to be a direct investor in BLMIS and became an indirect investor via its replacement shareholding in Herald?

  - Having found that the reflective loss principle was not engaged following analysis of the timing issue (see above), the Board looked at whether the Herald Transfer

precluded Primeo from pursuing the causes of action it had already acquired before the Herald Transfer because of the "follow the fortunes" bargain. As Lord Reed and Lord Hodge explained in *Marex*, the "follow the fortunes" bargain was a justification for the reflective loss rule: by becoming a member of the company, the shareholder agrees to "*follow the fortunes of the company*" in relation to losses suffered by it as a result of wrongs done to the company and agrees that the company will have the right to decide whether claims should be brought in respect of such wrongs.

- The Board considered that this argument was unsustainable, because the "follow the fortunes" bargain was forward-looking, not backward-looking (i.e., it concerned the characterisation of loss suffered by a claimant *after* they became a shareholder in the company).

- In the Board's view, to apply the reflective loss rule to preclude a new shareholder from enforcing rights of action which had already accrued to them before they became a member of the company would be "*an unwarranted extension of the rule*". The Board noted that the issue of possible double recovery by Primeo on the one hand, and Herald and Alpha on the other, would have to be managed by a procedural mechanism.

- **The common wrongdoer issue.** The reflective loss rule operated where there was a common wrongdoer whose actions had affected both the shareholder (Primeo) and the company (Herald/Alpha). Must the claims against the common wrongdoer be direct claims? What degree of overlap between the claims of the shareholder and the company was required?

  - The Board agreed with Primeo that the Cayman Islands Court of Appeal was wrong to apply the reflective loss rule in respect of claims against its former administrator and custodian because neither Herald nor Alpha had any claim against the same corporate entity.

  - The Board explained that it was an inherent part of the reflective loss rule that it only applied to exclude a claim by a shareholder where what was in issue was a wrong committed by a person who was a wrongdoer both as against the shareholder and as against the company. Therefore, in this case, the separate legal identity of the administrator and custodian were of critical importance as far as the application of the reflective loss rule was concerned. Extending the reflective loss rule in these circumstances would be contrary to the decision in *Marex* and to the aim of keeping the operation of the rule within narrow parameters.

- **The merits issue.** Were the judge and the Cayman Islands Court of Appeal correct to say that the reflective loss rule was brought into operation where the company had a realistic prospect of success as opposed to being likely to succeed on the balance of probabilities?

    - In light of the Board's findings above, it was not necessary to decide whether the Grand Court and Cayman Islands Court of Appeal were correct to say that the reflective loss rule was brought into operation where the company had a realistic prospect of success as opposed to being likely to succeed on the balance of probabilities.

    - However, the Board noted that those judgments were reached without the benefit of the decision in *Marex* and adopted a materially different approach to that of the Supreme Court in *Marex*. Therefore, the Board considered that what the Grand Court and Cayman Islands Court of Appeal said about this issue should not be treated as authoritative moving forward.

Commentary

The above cases add further definition to the contours of the rule against reflective loss. For example, they helpfully confirm that the rule applies to former shareholders and may well apply to indirect shareholders in a company. In the case of the latter, however, there is no clear precedential finding, so the issue remains live.

However, these cases also illustrate that, even post-*Marex,* the "*legal Japanese knotweed*" which is the rule against reflective loss still needs untangling, given the complexities involved in applying the rule to novel fact patterns. The calibrating exercise in respect of drawing the limits of the rule is not an easy one; the Court of Appeal and Board of the Privy Council, respectively, in the above cases were conscious of not allowing the rule to be subjected to an unwarranted extension following the decision in *Marex*, and rightly so. It is safe to say that the rule will be subject to more fine tuning and calibrating in the jurisprudence to come; indeed, as set out above, certain issues relevant to the rule against reflective loss were left to be decided in future cases, should it become essential to determine these issues.

Please do not hesitate to contact us with any questions.

LONDON

Christopher Boyne
cboyne@debevoise.com

Catalina Diaconeasa
cdiaconeasa@debevoise.com

Luke Duggan
lduggan@debevoise.com