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Cayman Islands' Privy Council clarifies reflective loss principle

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The Judicial Committee Privy Council (the **Privy Council**) has handed down its long awaited judgment in *Primeo Fund (in official liquidation) v Bank of Bermuda (Cayman) Ltd and another* [1] in which it has clarified, as a matter of Cayman Islands law, the scope and application of the reflective loss principle (also referred to as the Rule in Prudential).

Following the decision of the United Kingdom's Supreme Court in *Sevilleja v Marex Financial Ltd* (**Marex**), [2] the Privy Council has affirmed that the reflective loss principle is a "bright line" legal rule and is intended to prevent a shareholder from bringing a claim against a wrongdoer in respect of a diminution in the value of his shareholding, or a reduction in his distributions, which is the result of a loss suffered by the company in consequence of a wrong done to it by the same wrongdoer. The principle is not, as it may have been previously understood, merely a procedural rule against double recovery by a shareholder, but is instead a "rule of substantive company law" whose focus is the nature of the loss and the capacity in which it has been suffered by the shareholder.

Background

Primeo Fund (**Primeo**) is a Cayman Islands incorporated company which carried on business as an open-ended investment fund from 1994.

From its inception, Primeo invested in Bernard L Madoff Investment Securities (**BLMIS**), the company through which Bernard Madoff conducted his fraudulent Ponzi scheme; both directly through a "managed account" held with BLMIS and indirectly through two feeder funds, Herald Fund SPC (In Official Liquidation) (**Herald**) and Alpha Prime Fund Limited (**Alpha**).

On 1 May 2007, Primeo's direct investments with BLMIS were restructured. By way of an in specie transfer, Primeo's direct investments with BLMIS were transferred to Herald in consideration for new shares in Herald (the **Herald Transfer**). Following this in specie transfer, Primeo no longer had any direct investments in Herald.

At all material times the Respondents, Bank of Bermuda (Cayman) Ltd (the **Administrator**) and HSBC Securities Services (Luxembourg) SA (the **Custodian**) were service providers to Primeo.

Following the discovery of Bernard Madoff's Ponzi scheme in December 2008, Primeo was placed into voluntary liquidation in 2009 (and ultimately official liquidation thereafter). In 2013, Primeo's liquidators issued legal proceedings in the Grand Court of the Cayman Islands for breach of duty against the Administrator and the Custodian (together, the **Respondents**) in respect of losses suffered as a result of the Madoff fraud.

Primeo alleged that the Respondents had breached their duties and, had they not done so, Primeo would have withdrawn their investments from BLMIS. However, as a result of the Respondents' breaches, Primeo not only lost the sums invested but also the opportunity to invest those monies elsewhere; losses which Primeo suggested amounted to approximately US$2 billion.

Decisions of the Grand Court and Court of Appeal

The Grand Court of the Cayman Islands dismissed Primeo's claim in its entirety finding, amongst other things, that the claim infringed the reflective loss principle. The Grand Court considered that, as Primeo was a shareholder in Herald and Alpha, its losses were not separate and distinct from the losses claimed, or capable of being claimed, by Herald and Alpha. Moreover, as Herald and Alpha had each commenced their own proceedings in Luxembourg in respect of those losses, Primeo should be barred from recovery.

Primeo's liquidators appealed to the Cayman Islands Court of Appeal (**CICA**) on a number of grounds, including as to the findings on reflective loss. By a judgment handed down on 13 June 2019, the CICA upheld the decision of the Grand Court on various grounds, including on the basis that Primeo’s loss was reflective of the loss suffered by Herald and Alpha, so that Primeo had no right of recovery against the Respondents in respect of either its direct or indirect investments in BLMIS. It is important to note that, at the time of handing down its judgment, the UK Supreme Court had not yet handed down its judgment in *Marex*.

Decision of the Privy Council

Primeo appealed the CICA's judgment to the Privy Council. That appeal raised various issues and, as a matter of case management, the Privy Council directed that the issue as to the proper application of the reflective loss principle should be determined at a separate hearing before dealing with any of the other issues raised on the appeal.

In allowing Primeo's appeal, the Privy Council affirmed the Supreme Court's statement of the reflective loss principle in *Marex.* [3] In so doing, the Privy Council relied upon the statement of the principle by Lord Reed in *Marex* as follows:

> "The fact that a claim lies at the instance of a company rather than a natural person, or some other kind of legal entity, does not in itself affect the claimant's entitlement to be compensated for wrongs done to it [...] There is, however, one highly specific exception to that general rule. It was decided in the case of *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] Ch 204* that a shareholder cannot bring a claim in respect of a diminution in the value of his shareholding, or a reduction in the distributions which he receives by virtue of his shareholding, which is merely the result of a loss suffered by the company in consequence of a wrong done to it by the defendant, even if the defendant's conduct also involved the commission of a wrong against the shareholder, and even if no proceedings have been brought by the company."

As the reflective loss principle was an aspect of the rule in *Foss v Harbottle* (1843) 2 Hare 461, the Privy Council considered that it should apply to only those cases brought by a shareholder against a wrongdoer for losses suffered by him in his capacity as a shareholder, where those losses are for a diminution in share value or in distribution, which is the product of loss suffered by the company, in respect of which the company has a claim against the same wrongdoer. [4]

In this respect, Lord Reed distinguished such cases from cases "where claims are brought, whether by a shareholder or by anyone else, in respect of loss which does not fall within that description, but where the company has a right of action in respect of substantially the same loss". In those instances, the reflective loss principle would have no application.

Having affirmed the scope of the reflective loss principle in this way, the Privy Council went on to hold that the principle, properly understood, would not have any application to Primeo's claims made prior to the Herald Transfer. It considered that those losses were not suffered by Primeo in its capacity as shareholder but instead were separate and distinct losses suffered by it as a result of its direct investment in BLMIS at a time when Primeo was not a shareholder in Herald. In reaching this conclusion, the Privy Council provided guidance on two issues which had not been the subject of consideration in *Marex*:

1. what is the relevant time to determine whether the reflective loss principle applies; and
2. the limits of the definition of a "common wrongdoer" for the purposes of the reflective loss principle.

The timing issue

With respect to the timing issue, the Privy Council found that the reflective loss principle is one of substantive law and not simply procedure. It is a rule concerned with the recognition of particular types of law and not a rule against double recovery.

It concluded that the relevant time to assess whether the reflective loss principle should be applied is when the claimant suffers the loss arising from the actions of the common wrongdoer. To apply the reflective loss principle by reference to the date when proceedings were commenced would allow the application of the rule to be decided by reference to circumstances which are "adventitious happenstance" and "have nothing to do with the operation of the rule".

As Primeo was not a shareholder in Herald at the time it suffered the losses claimed, ie when it made its direct investments into BLMIS or lost the opportunity to redeem its BLMIS investments, it was not barred from pursuing its claims.

As part of its reasoning, the Privy Council also addressed whether Primeo's ability to bring those claims was affected by the Herald Transfer. It held that, while Primeo no longer held any direct BLMIS investments following the Herald Transfer, this did not mean that Primeo did not suffer loss prior to the Herald Transfer being effective.

As a shareholder's bargain with a company was to "follow the fortunes" of the company, it was necessarily forward looking, not backward. As this bargain was the foundation for the rule in *Foss v Harbottle* and, in turn the reflective loss principle, to apply the rule to losses which were suffered by a shareholder prior to him becoming such would deprive him of property rights, in the form of choses in action, and would be an unwarranted extension of the scope of the rule.

The common wrongdoer issue

In its judgment, the CICA held that Primeo's claims against its Administrator would be barred despite the fact that neither Herald nor Alpha had any claims against that entity. It did so on the basis that the effect of certain contractual arrangements was that the Custodian was delegated the administration functions for both Herald and Primeo with the result that a claim by Primeo against the Administrator would, in substance, be passed through as a claim to the Custodian.

Primeo submitted that the CICA was wrong to do so. The Privy Council agreed.

It held that an inherent part of the reflective loss principle was that the rule only applies to exclude a claim by a shareholder where what is in issue is a wrong committed by a person who is a wrongdoer both as against the shareholder and as against the company. It did not apply to cases where the company had no cause of action against the wrongdoer in question.

The CICA was therefore wrong to apply the reflective loss principle in relation to Primeo's claims against the Administrator in circumstances where neither Herald nor Alpha had claims against that entity. In this respect, the Privy Council emphasised that each of the Respondents was a separate legal entity with its own fund of assets available to meet claims made against it and each having their own separate decision making organs.

If the reflective loss principle were to be applied in these circumstances, this would amount to a significant and unjustifiable extension of the rule and would ignore the relevance of the separate legal personalities of the Administrator and the Custodian. Instead, such an application would be dependent upon an "ill-defined" test based on the potential economic effects of contractual arrangements, where such potential effects may in any given case be uncertain. [5]

Conclusion

The judgment provides welcome clarification on the operation of the reflective loss principle, whose application was previously unclear and often difficult to understand. The Privy Council's emphasis on ensuring that the reflective loss principle is kept within its proper bounds and given limited scope, particularly with respect to the determination of the timing issue, is a positive development for investors of a company who had previously been prevented from pursuing personal claims against a wrongdoer when the company in which they are invested may also have a claim in respect of substantially the same loss.

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[1] [2021] UKPC 22.

[2] [2020] UKSC 31.

[3] This is perhaps unsurprising as the composition of the judicial panel in both *Primeo v HSBC* and *Marex* was identical.

[4] Also referred to as a "common wrongdoer".

[5] In the present case, the Privy Council found that there was nothing automatic or certain about passing through the liability of the Administrator to the Custodian. It also made the same finding with respect to Primeo's claim against the Custodian, so far as it relates to Primeo's indirect investment in BLMIS through its acquisition of shares in Alpha because Alpha has no claim against the Custodian (notwithstanding that Alpha's own administrator may have an onward claim against the Custodian in respect of the losses suffered by Alpha).

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