AUGUST 2021

UPDATE

Privy Council clarifies operation of the rule in *Prudential* (the rule formerly known as the reflective loss principle)

Update prepared by Peter Hayden and Jonathan Moffatt (Cayman Islands)

In a judgment delivered on 9 August 2021, the Judicial Committee of the Privy Council has clarified the operation of the rule in *Prudential*, addressing the nature of the rule, the time at which it should be applied and the scope of the claims caught by the rule. These matters were not fully addressed by the United Kingdom Supreme Court in its decision in *Sevilleja v Marex Financial Ltd* [2020] UKSC 31 last year. The Privy Council held that Primeo's claims against its administrator and custodian for breach of their contractual duties are not barred by the rule, which is to be applied at the time the loss is suffered (not when the claim is brought) and only to claims against the same wrongdoer. The Privy Council left open the merits threshold test because it was not necessary to decide this point in light of the other findings.

Introduction

The Supreme Court's decision in *Sevilleja v Marex Financial Ltd* [2020] UKSC 31 was a landmark decision on the rationale and boundaries of the rule previously known as the reflective loss principle. The majority judgment given by Lord Reed overruled a number of authorities and restated the reflective loss principle as the rule in *Prudential* (**RIP**), holding that it was a rule of substantive company law which should be confined to its narrow origin in the Court of Appeal's decision in *Prudential Assurance Co Ltd v Newman Industries Ltd (No. 2)* [1982] Ch 204.[1] Lord Reed stated that the RIP only barred claims:

> *'brought by a shareholder in respect of loss which he has suffered in that capacity, in the form of a diminution in share value or in distributions, which is the consequence of loss sustained by the company, in respect of which the company has a cause of action against the same wrongdoer.'* (paragraph 79)

However, since *Marex*, there was still some uncertainty as to how the RIP should be applied. In Primeo's appeal from the Court of Appeal of the Cayman Islands, the Privy Council has provided further important guidance on the application of the RIP.[2] In particular, the Privy Council considered the nature of the rule, the time at which it should be applied and the scope of the claims caught by the rule.

Timing issue

Primeo brought claims against its administrator and custodian, which were entities in the same corporate group, for losses arising out of the Madoff fraud.

In the lower courts, Primeo established that the administrator and custodian breached their contractual duties by failing to verify the existence of Primeo's investments with Bernard L Madoff Investment Securities LLC (**BLMIS**), and Primeo suffered loss each time an investment was made with BLMIS. However, Primeo's claims failed in the lower courts because the losses were held to be reflective of losses suffered by two other investment funds. Primeo had initially invested directly with BLMIS but subsequently switched all of its

[1] The minority judgment in *Marex* given by Lord Sales held that the RIP did not exist as a rule of law and that the *Prudential* decision was confined to its own facts.

[2] [2021] UKPC 22.

BLMIS investments into one of these investment funds. The effect of this switch was that Primeo was no longer directly invested in BLMIS but was instead indirectly invested from that point onwards.

Primeo argued that the RIP could not apply to any of its claims because it had suffered the losses before it had switched its investments into the other investment fund. However, the lower courts accepted the administrator and custodian's argument that the time at which to consider the application of the RIP was the time at which the claim was brought, not the time at which the loss was suffered. Applying the RIP at the time the claim was brought, the lower courts held that Primeo would recover its losses if the other investment fund pursued claims against its administrator and custodian, that Primeo's losses were therefore reflective of the loss suffered by the other investment fund and that Primeo's claims were barred by the RIP. Since *Marex*, the timing issue had also been considered by Flaux LJ, sitting as a single judge of the Court of Appeal, in *Nectrus Ltd v UCP Plc* [2021] EWCA Civ 57. Like the lower courts in the Primeo case, Flaux LJ held that the time to consider the application of the RIP was when the claim was brought.

The Privy Council accepted Primeo's arguments, concluding that the RIP did not apply to any of its claims against the administrator and custodian. It reiterated that the RIP is a substantive rule of law and, consistent with the various statements in *Marex*, is to be assessed by reference to the capacity in which the loss is suffered, which therefore requires the application of the RIP to be considered at the time that the loss is suffered. The RIP will only apply if, at that time, the claimant is a shareholder in a company and the other requirements for its application are made out. The timing of bringing the claim has no role in the operation of the rule. *Nectrus* was therefore also wrongly decided.

The Privy Council also highlighted the strange and unprincipled consequences that would follow if the application of the RIP is tested at the time proceedings are issued and where there happens to be some relationship between the recovery by the shareholder and the recovery by the company. For example, the shareholder might succeed in its claim if it commenced proceedings quickly and before the company appreciated it had a claim to make a recovery of its own, which would be contrary to the substantive nature of the rule. A shareholder could easily circumvent the RIP by selling its shares first, which would subvert the intended effect of the rule since wrongdoers would be wary of settling with a company for fear that a shareholder might free itself from the rule in this way to pursue its own claim. A shareholder could also commence a claim after the company's claim had become statute barred, or had settled early, which would again contradict the substantive rule given that that the loss suffered by the shareholder would not have been changed by either of these events. The Privy Council decided that testing the application of the RIP at the time proceedings are brought, rather than when loss is suffered, would discourage settlement and undermine the intended effect of the rule, which was to ensure that the company had a full opportunity to decide how to pursue its cause of action.

The administrator and custodian also argued in the alternative that, even if the RIP did not apply because the relevant time to consider its application was when the loss was suffered, it subsequently came to apply when Primeo switched its investments from direct to indirect investments with BLMIS.

The Privy Council rejected this argument, observing that on the authorities to date the RIP was prospective in effect and applied to causes of action arising after the claimant became a shareholder. It was from this point that the shareholder would '*follow the fortunes*' of the company and be precluded from asserting that it had suffered a separate loss in order to protect the company's cause of action and company autonomy to the extent required by the rule in *Foss v Harbottle*. By contrast, there was no principled basis for depriving a new shareholder from enforcing rights it had accrued in the past. The presumption is that parties do not intend to waive remedies available to them, and this is even more the case where a valid claim against a third party has already accrued to a person before they have become a member of a company.

Common wrongdoer issue

This issue arose because different entities in the same group were involved in the provision of administration and custody services to i) Primeo and ii) the other investment funds through which Primeo ended up being indirectly invested in BLMIS. The entity that acted as administrator to Primeo did not act as administrator to either of the other investment funds. Likewise, the entity that acted as custodian to Primeo only acted as custodian to one of those investment funds but not the other.

The lower courts had rejected Primeo's argument that the RIP could only apply where the shareholder's claim and the company's claim were against the same wrongdoer. Rather, the lower courts had accepted

the administrator and custodian's argument that any administration and custody claims would ultimately be passed through to the same entity, by reason of intra-group claims within the group. The lower courts found that the application of the RIP had to be assessed by reference to the economic effect of the claims rather than by reference to the legal entities involved.

Primeo argued in the Privy Council that, even on the authorities prior to *Marex*, it was not possible to ignore separate corporate entities or to assume, without evidence, that the various companies in the same group could and would sue each other. The Supreme Court in *Marex* had also expressly stated that the RIP only applied to a shareholder's claim where the company had a cause of action against the same wrongdoer (see paragraph 79 quoted above).

The Privy Council accepted Primeo's arguments. It found that the RIP only excluded a claim by a shareholder where the wrong was committed by the same person against the shareholder and the company. Where this was not the case, the shareholder's loss was distinct from the company's loss. Extending the scope of the RIP to include a claim against a different wrongdoer based on interlocking contracts would be contrary to the decision in *Marex* and ignore the critical importance of separate legal personality.

In the Primeo scenario, each claimant had its own cause of action and its own separate decision-making organs for deciding whether to enforce it. There was nothing automatic or certain about liability passing through different wrongdoers and a court could not make an assumption about onward claims being brought or future recoveries being made. This would undermine the clear bright line test that the Supreme Court had laid down in *Marex*, designed to simplify the application of the RIP, not make it more complicated. It would also magnify the scope of the rule to work injustice. The general position is that a claimant is entitled to seek compensation for a wrong and the RIP is a highly specific exception to this.

Merits test issue

This issue concerns how strong the company's claim needs to be to bar the shareholder's claim under the RIP. One would normally expect the merits of both claims to be very similar, assuming the shareholder's claim falls within the narrow ambit of the RIP, in particular as loss suffered in a shareholder capacity. The question of the merits of the company's claim is therefore unlikely to arise frequently in practice and was not considered by the Supreme Court in *Marex*.

The issue did however arise in the Primeo case. Primeo's claims were subject to different contracts, different governing laws and different jurisdictions compared to the claims of the other investment funds.

Primeo argued in the Privy Council that the shareholder's claim should only be barred by the RIP where the wrongdoer could show (in accordance with its burden of proof) that the company had a claim which was likely to succeed on the balance of probabilities. If the company's claim could not be said to be likely to succeed, there was no proper justification for barring the shareholder's claim to the advantage of the wrongdoer. The administrator and custodian argued that there were good practical reasons why the merits test should be set at the lower threshold of real prospect of success: a claim with a real prospect of success had value to the company's management, settlement might be harder to achieve where the wrongdoer was concerned about facing additional claims from shareholders and the company's recovery may be prejudiced by the shareholder scooping the pool. The lower courts accepted their position and decided that the merits test for the company's claim was real prospect of success.

The Privy Council declined to determine the merits test issue. It was not necessary to do so in light of the findings on the other issues which meant that all of Primeo's claims fell outside the RIP. However, it observed that the lower courts' decisions on the merits test issue, which had been decided without the benefit of the Supreme Court's decision in *Marex*, should not be treated as authoritative.

Conclusion

The Privy Council's decision is important in clarifying the application of the RIP. It reinforces the *Marex* decision, stressing that the RIP is a substantive rule that should be applied at the time the loss is suffered, is narrow in ambit and is intended to provide a bright line distinction which gives litigants some certainty around the circumstances in which it applies. The decision is likely to discourage wrongdoers from taking technical arguments in an attempt to avoid liability by reference to the RIP.

Peter Hayden and Jonathan Moffatt successfully acted for Primeo in the Privy Council.

Contacts

Peter Hayden
Partner, Mourant Ozannes
Cayman Islands
+1 345 814 9108
peter.hayden@mourant.com

Jonathan Moffatt
Counsel, Mourant Ozannes
Cayman Islands
+1 345 814 9216
jonathan.moffatt@mourant.com

2021934/81446340/1