Two wrongs don't make a right

Victor Joffe QC summarises recent case law and the difficulties for shareholders relying on this principle

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In its corporate form, the reflective loss principle is relatively straightforward. If a company suffers loss due to a breach of duty owed to it, a shareholder may also suffer personal loss. The usual form of this loss is a diminution in the value of the shareholder's shareholding, consequent on the loss suffered by the company. Thus the shareholder's loss 'reflects' that of the company. It is of course open to the company to bring proceedings to recover the loss it has suffered. However, even if the shareholder can show that the wrongdoer has acted not only in breach of a duty owed to the company, but also in breach of a duty owed to the shareholder, the shareholder still cannot recover its loss from the wrongdoer.

Applying the principle

This is the 'no reflective loss principle', so-called by Arden LJ in *Day v Cook* [2001]. The leading case, *Johnson v Gore Wood & Co* [2000], makes it clear that the principle is based on the need to prevent double recovery and to provide protection to the company's creditors (who might be prejudiced if the shareholder's claim were to succeed).

The court has no discretion to disapply the no reflective loss principle, even in cases of hardship: see *Day*. The application of the principle can, therefore, lead to unwelcome consequences. In particular, as in *Gardner v Parker* [2004], it can afford a defence to an apparently unmeritorious defendant in the face of an otherwise legitimate claim brought by an apparently meritorious claimant.

There are some limited exceptions to the reflective loss principle. In particular, as noted by Lord Bingham in *Johnson* at 35-36, where the company suffers loss but has no cause of action to sue to recover that loss, a shareholder in the company (who has a cause of action to do so) may sue in respect of a loss, even though it is measured by the diminution in the value of the shareholding. Equally, if the company suffers loss caused by a breach of duty owed to it, and the shareholder suffers a loss separate and distinct from that suffered by the company, which is caused by a breach of duty owed independently to the shareholder, each may sue to recover its own loss (although neither may recover for the other's loss).

Sympathy for the predicament of the meritorious claimant led the Court of Appeal, in *Giles v Rhind* [2002], to devise a more wide-ranging exception to the principle. In that case it was held that the principle had no application where the wrongdoer had, by its wrongdoing, destroyed or disabled the company so that because of the wrongdoing the company could not pursue a claim against it. *Giles* received a less than enthusiastic reception from a subsequent Court of Appeal in *Gardner*, in which the court refused to widen the exception to include cases where the company's inability to sue was caused indirectly, rather than directly, by the wrongdoer's activities.

In any event, *Giles* appears to have been fatally undermined by the Hong Kong Court of Final Appeal in *Waddington Ltd v Chan* [2008]. In *Waddington* the court held that *Giles* was inconsistent with *Johnson* and should not be followed in Hong Kong. Although binding in England unless reversed by the Supreme Court, in the light of *Waddington*, any reliance on *Giles* is now likely to be misplaced.

In one respect however, the courts have been prepared to mitigate the effect of the principle by holding that the burden of establishing that it applies lies on the person seeking to rely on it. In *Shaker v Al-Bedrawi &*

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ors [2003] the Court of Appeal held that the principle would not defeat a claim unless the party relying on it as a defence could show that the whole sum claimed reflected the company's loss and that it had a cause of action to recover that loss.

Trustee shareholders

The reflective loss principle applies equally where a wrongdoer causes loss to a company whose shares are held by the trustees of a settlement. In *Ellis & anor v Property Leeds (UK) Ltd* [2002], Peter Gibson LJ (with whom Wall J agreed) held:

> It is clear that if a shareholder or director of a company or a beneficiary under a settlement the trustees of which are shareholders in the company suffers a loss which merely reflects the loss suffered by the company, for which it can sue, that shareholder, director or beneficiary cannot as a matter of policy be allowed to bring proceedings to recover his loss, but it must be left to the company to take proceedings to recover its loss.

Clearly the court regarded the twin policy bases for the reflective loss principle identified in *Johnson*, namely the need to prevent double recovery and the need to protect creditors of the company, as equally applicable where the shares in the company are held by or on behalf of trustees.

Where the trustee is the wrongdoer

What is the position where the wrongdoer is not a third party, but the trustee itself? In *Shaker*, in essence, the claimant alleged that a beneficial interest in 70% of the shareholding in company A (of which the defendant was sole director) was held on trust for him, and also claimed an entitlement to a 70% share of A's profits. The defendant sold the company's business and, in breach of fiduciary duty owed to the company, dissipated the proceeds of sale. In response to a claim for an account, the defendant relied on the no reflective loss principle. The question for the Court of Appeal was therefore whether the principle applied to a claim against a trustee for an account of profit where the company of which the trustee was a director also had a claim against him for breach of fiduciary duty.

The claimant argued that where a beneficiary under a trust has a proprietary claim against the trustee/director for money for which an account is sought, the principle could have no application. He claimed that the potential claim of the company against the director to that money gave rise to independent competing claims to that money, so that, to the extent that the company's claim did not succeed, the beneficiary's claim should prevail.

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Although holding that the defendant had not discharged the burden of proving that the principle applied on the facts, Peter Gibson LJ, giving the judgment of the court, accepted that if the claim for an account was in substance a claim to money which the company could claim against the defendant, then consistently with *Johnson*, the no reflective loss principle would bar the claim for what in effect reflected the company's loss: it did not matter that the causes of action of the claimant and the company were different.

It is difficult to see why this result should be any different where the claim is for damages rather than for an account of profit, or why it should make any difference if the trust is express or indeed discretionary, rather than a bare trust such as in *Shaker*. Indeed, in *Gardner*, Neuberger LJ held at 565:

> ... it appears clearly to have been determined in Shaker's case that, even when the claim is brought by a beneficiary against a trustee for breach of fiduciary duty, it can be barred by the [no reflective loss principle].

What then of the position where:

- a company owned by a trust suffers loss due to breach of duty on the part of its directors; and
- the trustee, which is not a director of the company, is alleged to have acted in breach of trust by, for example, failing properly to supervise or control the directors of the trust-owned company?

The notion that a trustee in such circumstances might be able to escape liability merely by relying on the reflective loss principle is one which the courts in both England and Jersey have been reluctant to embrace.

Walker v Stones [2001]

In this case, decided before *Johnson* reached the House of Lords, the defendant trustees held all the shares in a company, J, which owned, directly or indirectly, shares in French companies. The trustees gave personal guarantees secured on the shares of J to support bank loans to J, which were used to purchase certain bonds. The claimants, the primary beneficiaries under the settlement, sought to amend their claim for damages to allege that assets belonging to J and its subsidiaries had been wrongly diverted to third parties. They claimed that the defendants had acted in breach of fiduciary duty not to procure any disposition of the assets of the companies which, if the assets had been trust assets, would have involved a breach of duty as trustees; and in failing to preserve the assets or permitting them to be dissipated. At first instance the judge struck out the claim in reliance on, among other things, the no reflective loss principle.

This was not a result that the Court of Appeal found attractive. Sir Christopher Slade (with whom Mantell and Nourse LJJ agreed) held (at p934):

> ... I do not think that any of the policy considerations which influenced this court in reaching its conclusions in the Prudential Assurance case... apply in the present case. On the contrary, the policy considerations in my judgment point strongly the other way... in many, perhaps most, cases where a trustee is found guilty of a breach of his duty to supervise the trust instruments in accordance with the *Bartlett* principle, the company concerned will also have a claim against a director or manager who

> has mismanaged its corporate affairs (*a fortiori* if there has been dishonesty on the part of the trustee). If Rattee J's ruling [at first instance] on this point in this present case were correct, it would appear that the [no reflective loss] principle would always afford a defence to the trustee in this situation. I cannot think that would be right.

The court approached the case on the basis that the defendant trustees were both in breach of duties owed to the beneficiaries, and in breach of fiduciary duty owed to the company. However, allowing the appeal, it held (at 932-933, consistently with the principle as subsequently explained in *Johnson*) that the no reflective loss principle will not deprive a claimant of an otherwise good cause of action in a case where:

- the claimant can establish that the defendant's conduct has constituted a breach of a legal duty owed to it personally (whether under the law of contract, tort, trusts or any other branch of the law); and
- on its assessment of the facts, the court is satisfied that such breach of duty has caused the claimant personal loss, separate and distinct from any loss that may have been occasioned to any corporate body in which it may be financially interested.

Three reasons supported the court's conclusion that the loss in that case was separate and distinct from that suffered by the companies:

(1) the causes of action on which the claimants relied against the trustees were quite different in their nature and would be based on different types of misconduct which might be alleged by the companies;

(2) in regard to the alleged wrongful diversions and transactions, the principal defendants in any claims brought by the companies would not include the trustees, who would be open to attack, if at all, only as accessories; and

(3) although there would be some overlap between the amounts recoverable by the claimants and the companies, they would not necessarily be the same, having regard to the very different nature and origins of the respective claims.

There is considerable scope for doubt about whether these reasons, particularly the first and third, are consistent with the reasoning in *Johnson*. Further, as explained by Arden LJ in *Day*, for a claimant to avail itself of the 'separate and distinct loss' exception to the no reflective loss principle, the loss (and this would apply to a beneficiary as much as a shareholder) must be additional to that suffered by the company. The practical problem in most cases will be to identify the separate and distinct (additional) loss. Without such loss, the no reflective loss principle will apply, as the court in *Walker* affirmed, by applying the principle to bar a claim by the claimants against H, who was neither a director of the companies nor a trustee, but against whom the injured companies would have had a claim for dishonestly assisting in the conduct which caused loss to the companies (thereby exposing himself to liability as a constructive trustee).

But it is the second of the reasons that indicates a real difference in the application of the principle in a trust case: the possibility that the defendant to the company's claim will differ from the defendant to the beneficiaries' claim. However, this appears to be a distinction without a difference. Neuberger LJ in *Gardner* (at 567) appeared to have no doubt that the principle would apply even if the identity of the defendants were not the same.

This is consistent with the general policy behind the principle. Notwithstanding the doubts of the Court of Appeal in *Walker* about the desirability of applying the principle to defeat a claim against a trustee, the foundation of the principle – prevention of double recovery and creditor protection – remains valid just as much for a company owned by a trust as it does for any other company. Nothing in *Johnson* suggests that a different approach should be taken in the latter case. Indeed, as Neuberger LJ stated in *Gardner* at 567:

> ... given that the foundation of the rule is the need to avoid double recovery, there is a powerful case for saying that the rule should be applied in a case where, in its absence, both the beneficiary and the company would be able to recover effectively the same damages from the defaulting trustee/director.

The reflective loss principle applies equally where a wrongdoer causes loss to a company whose shares are held by the trustees of a settlement.

Freeman v Ansbacher Trustees (Jersey) Ltd [2009]

Further consideration was given to whether the no reflective loss principle applies in the trust context in *Freeman*. The assets of a discretionary trust were held by a company, SDR, the shares in which were all held (until it ceased to be trustee of the trust) by the defendant. The plaintiffs sought damages from the defendant in respect of three transactions which had caused loss to SDR (indeed, the third transaction had rendered SDR insolvent). The defendant sought to have the claim struck out, relying, among other grounds, on the no reflective loss principle. The Royal Court proceeded on the basis that the claims raised were reflective of SDR's losses, and held at paragraph 82 that the principle formed part of the law of Jersey. Yet the deputy bailiff refused to strike out the claim.

The defendant relied on *Shaker*, *Ellis* and *Gardner* as establishing that the no reflective loss principle is equally applicable where the plaintiff is a beneficiary under a trust as where it is a registered shareholder. The court declined to accept this argument, holding:

- that the nature of the (bare) trust in *Shaker* was very different from that in *Freeman*;
- Peter Gibson J's remarks in *Ellis* were 'clearly *obiter* and… the point was conceded by counsel'; and
- in *Gardner*, no question of the applicability of the no reflective

> loss principle to a trust arose, and the only fiduciary relationship which did arise was the relationship between a director and the company.

Given the policy reasons behind the principle, the fact that the trust in *Shaker* was a bare trust rather than a discretionary trust is scarcely relevant. Moreover, from the point of view of English jurisprudence at least, it is surprising to see no less than three carefully reasoned judgments of the Court of Appeal dismissed so lightly, at least without any real attempt to explain why the statements of principle contained in them are erroneous, or why the principle would not be applied in England to a discretionary trust. Be that as it may, the deputy bailiff held (at paragraph 96):

> I accept that, if the [no reflective loss] principle applies to the present case, the order of justice should be struck out. However, I am by no means convinced that the principle should necessarily be applied to a situation such as the present involving a discretionary trust. I think it is not entirely clear that the principle would necessarily be applied in England; but even if it were, I consider that there are strong grounds for believing that Jersey law should follow a different path.

The deputy bailiff went on to hold that it was strongly arguable that the two bases of the principle might have no application to a discretionary trust. Since the plaintiff was seeking reconstitution of the trust fund, the remedy (if breaches of trust were proved) was at the discretion of the court, and could be moulded to suit the circumstances. This meant that the court could arguably direct the defendant to reimburse or refinance SDR. Thus SDR would no longer have suffered any loss and could not bring any claim against its directors, thereby removing the danger of double recovery.

Conclusion

Although interesting, these arguments do not accord with principle in England. The English courts have rejected attempts to circumvent the principle by suitably drafted terms contained in the court's order (*Johnson* at 66, indicating also that the company's inability to pursue its remedy is no reason to disapply the principle) or where the claimant seeks to limit its claim to that which it would have recovered had the company recovered substantial damages (*Humberclyde Finance Group v Hicks* [2001]). Equally, the deputy bailiff's suggestion (at paragraph 97(vi)) that the principle may not apply where the defendant to the company's claim is not the same as the defendant to the beneficiaries' claim appears to place more reliance on the doubts expressed by the editors of *Lewin on Trusts* than on the deliberations of the Court of Appeal in *Walker* and *Gardner*.

For a claimant to avail itself of the 'separate and distinct loss' exception to the no reflective loss principle, the loss must be additional to that suffered by the company.

It is perhaps in the consideration of policy that *Ansbacher* departs most sharply from the English cases. The deputy bailiff, adverting to Jersey's substantial trust industry, pointed out that in many cases investments will be held by a company wholly owned by the trust, whose directors would be the same employees of the trustee responsible for administering the trust. So far as the beneficiaries are concerned there would be no difference between the situation where the trustee holds the investments, and where the company does so. But the consequences could be very different if the investments were mismanaged: in the case of investments held by the trustee, the beneficiaries could sue the trustee for reconstitution of the trust fund, but if the investments were held by a trust-owned company the no reflective loss principle would prevent an action being brought. Although the defendant suggested that this result could be avoided (by the beneficiaries either suing the trustee for a new breach of trust if it declined to sue the responsible directors, or bringing proceedings to remove the trustee), the court held that these procedures were complex and 'far removed from the real complaint'.

The deputy bailiff went on to hold:

> … it would not reflect well on the law or on Jersey as a centre for the administration of trusts if beneficiaries had to go through these considerable hoops unless it was absolutely unavoidable… I consider that it is strongly arguable that the law of Jersey provides [a] simple and effective remedy in a case such as the present by enabling the court to order the defaulting trustee to reconstitute the trust fund by reimbursing the company for its losses, thereby removing both reasons for the application of the [no reflective loss] principle.

The difference from English law is stark. English law upholds as paramount the double recovery prevention and creditor protection policy, even where that policy may lead to possible unfairness, or even where it is avoidable on the facts. As a matter of policy, Jersey law – at any rate in the trust context – seemingly requires the principle to give way to the interests of ensuring a fair and accessible remedy for those beneficiaries who have been the victim of trustees' breaches of fiduciary duty. ■

Day v Cook
[2001] EWCA Civ 592
Ellis & anor v Property Leeds (UK) Ltd
[2002] EWCA Civ 32
Freeman v Ansbacher Trustees (Jersey) Ltd
[2010] WTLR 569
Gardner v Parker
[2004] EWCA Civ 781
Giles v Rhind
[2002] EWCA Civ 1428
Humberclyde Finance Group v Hicks
[2001] EWHC 700 (Ch)
Johnson v Gore Wood & Co
[2000] UKHL 65
Shaker v Al-Bedrawi & ors
[2003] WTLR 105
Waddington Ltd v Chan
[2008] HKLR 1381
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[2000] WTLR 975