

Primeo v HSBC: Privy Council further narrows the reflective loss principle

In a significant judgment delivered on 9 August 2021,^[1] the Judicial Committee of the Privy Council (the “**Privy Council**”) granted the preliminary limb of a bifurcated appeal by Primeo Fund (in Official Liquidation) (“**Primeo**”), a Madoff feeder fund, against decisions of the Cayman Islands Court of Appeal (“**CICA**”) and the Grand Court which had barred its claims against Bank of Bermuda (Cayman) Ltd (“**BBCL**”) and HSBC Securities Services (Luxembourg) S.A. (“**HSSL**”) (together, the “**Respondents**”) on the grounds that the loss suffered by Primeo was reflective of that suffered by the companies in which Primeo was a shareholder. The balance of the appeal proceedings, involving numerous substantive appeal and cross-appeal grounds, will be heard by the Privy Council over three days in October 2021.

This judgment comes shortly after the recent decision of the UK Supreme Court in *Sevilleja v Marex Financial Ltd* [2020] UKSC 31 (“**Marex**”), which post-dated the judgment of the CICA the subject of this appeal. Unlike *Marex*, which concerned the application of the rule against the recovery of reflective loss to a creditor claim, this case concerned the application of the principle to a claim by a shareholder, albeit in novel circumstances.

The judgment further clarifies the application of the reflective loss principle and, together with *Marex*, demonstrates that the “*bright line*” rule is narrowly drawn. These judgments have returned the reflective loss principle to its origin as established in *Prudential Assurance Co Ltd v Newman Industries Ltd (No. 2)* [1982] Ch 204, and clarified that the principle operates at the time loss is suffered rather than the time at which the claim is commenced, and only in respect of claims against the same wrongdoer.

Background

Primeo, a Cayman Islands investment fund, was established and managed by Bank Austria. From 1993 until December 2008, Primeo invested with Bernard L Madoff Investment Securities LLC (“**BLMIS**”), the company through which Bernard Madoff perpetrated his infamous Ponzi scheme. Between 1993 and 2003, Primeo invested ‘directly’ with Madoff via a managed account with BLMIS. From 2003, Primeo began investing some of its funds with BLMIS ‘indirectly’, via shareholdings in two other Madoff feeder funds, Herald and Alpha. Following an *in specie* transfer on 1 May 2007 (the “**Herald Transfer**”), all of Primeo’s investments with BLMIS were ‘indirect’, through shareholdings in Herald and Alpha.

Primeo appointed BBCL and HSSL as its administrator and custodian respectively at a time when both entities were part of the Bank of Bermuda group of companies, the entirety of which was subsequently acquired by HSBC in 2004.

Upon Madoff's arrest in 2008, Primeo entered liquidation and in 2013 the joint official liquidators of Primeo sued the Respondents for the alleged losses suffered by Primeo as a result of the Madoff fraud.

As against the custodian, Primeo alleged that HSSL breached its contractual duties concerning the appointment and supervision of BLMIS as its sub-custodian, and that HSSL was in any event strictly liable for the wilful default of BLMIS. As against the administrator, Primeo alleged that BBCL breached its obligations to maintain Primeo's books and records, and to determine its net asset value ("**NAV**") per share. Primeo alleged that, had the Respondents complied with their obligations, Primeo would have withdrawn its investments with BLMIS prior to the fraud being uncovered and reinvested the proceeds elsewhere, generating a significant profit.

Grand Court and Court of Appeal decisions

At a twelve-week trial in 2016/2017, Mr Justice Jones QC heard evidence from more than 25 factual and expert witnesses including three of Primeo's former directors and a number of experts in the fields of custody and fund administration. In its judgment delivered in August 2017, the Grand Court dismissed Primeo's claims in their entirety, on the grounds of reflective loss, causation and limitation. In any case, the Judge determined that he would have reduced any damages awarded against BBCL by 75{92e447aa5ae4509d19f58c4a2ed7ec0dbb286610ae15b33d823e9409689b2d4a} on account of Primeo's contributory negligence because Primeo was "*to a very substantial degree, the author of its own misfortune*".^[2]

On its appeal to the CICA, Primeo had mixed success in respect of the Judge's substantive findings, however the CICA upheld the Judge's decision that the entirety of Primeo's claim was barred by the reflective loss principle.^[3] In doing so, the CICA rejected Primeo's arguments that the principle did not apply since Primeo was not a shareholder in either Herald or Alpha at the time it invested directly with BLMIS (the "**timing question**") and that the Judge applied the wrong test when assessing the merits of Herald's and Alpha's own claims on the basis of whether they had "a real prospect of success" rather than a more stringent merits threshold of whether the company's claims were "likely to succeed" (the "**merits test question**").

The CICA's judgment contained a detailed exposition of the law on reflective loss, citing numerous authorities including the then recent English Court of Appeal decision that was subsequently, after the CICA's judgment, successfully appealed to the Supreme Court in *Marex*. Citing recent case law, the CICA emphasised the need to respect the principle of company autonomy, ensure that the company's creditors are not prejudiced by the action of individual shareholders, and prevent a party from recovering compensation for a loss which another party has suffered. In other words, a shareholder such as Primeo could not "*scoop the pool*" by bringing its own competing claim against a defendant, where the company's claim has a real prospect of success. This was consistent with the well-known rule in *Foss v Harbottle* to the effect that the proper claimant for loss suffered by a company is the company and not a shareholder therein.

Privy Council decision

The preliminary issue of reflective loss was heard by five Justices of the Privy Council, all of whom had also heard and determined the appeal to the Supreme Court in *Marex*, in April 2021.

In overturning the formerly orthodox approach adopted by the CICA and the Grand Court on the timing question, the Privy Council held that the question of whether a loss had been suffered "*in the capacity of*

shareholder” was to be determined as at the point in time when the loss was first suffered, rather than when the claim is commenced. Accordingly the leading judgment, written jointly by Lords Kitchen and Sales (with whom the other Lords agreed) held that:

“Applied as a substantive rule of law, whether the reflective loss rule is applicable or not falls to be assessed at the point in time when the claimant suffers loss arising from some relevant breach of obligation by the relevant wrongdoer. In this case, on each occasion when Primeo suffered loss on placing funds with BLMIS for investment it did so in circumstances where the law recognises its loss as real and of a type which is recoverable. In principle, on each occasion Primeo invested by paying money to BLMIS and had its money misappropriated ... Primeo could have sued [the Respondents] in respect of their breaches of duty which caused such loss, which was of a form recognised in law according to ordinary principles and did not arise in circumstances which brought the exclusionary reflective loss rule into operation.”^[4]

Thus, on the basis of an assumption for the purposes of this preliminary appeal that Primeo had suffered losses on its direct investments with BLMIS as soon as those investments were made (a point which remains subject to a cross-appeal by the Respondents), the Privy Council held that any such losses were not suffered by Primeo in the capacity of shareholder in Alpha or Herald, and were therefore not barred by the reflective loss principle.

The Privy Council also explained its decision on the basis that, when Primeo invested with BLMIS, it had not made any bargain to “*follow the fortunes*” of any company, arising from membership of the company, which is the foundation and justification for the reflective loss principle. Indeed, the timing of the bringing of a claim and the circumstances (such as the investment structure) which may pertain at that point in time are “*adventitious happenstance and have nothing to do with the operation of the rule*”. Thus the Privy Council held there was no sound basis to bar Primeo’s claims on the grounds of reflective loss, notwithstanding (in particular) that the Herald Transfer meant that by the time it claimed against the Respondents, Primeo no longer held any direct investments with BLMIS but rather was a shareholder in Herald and Alpha, both of which have pending claims in respect of their loss. This was expressly subject to the preservation of an argument, to be heard together with the second limb of the appeal, that Primeo had impliedly assigned its right to pursue claims against the Respondents to Herald via the Herald Transfer.

This decision marks a departure from the previously well-settled approach whereby the applicability of the reflective loss principle was determined at the time the relevant claim was commenced. It represents a further curtailing of the reflective loss rule that had been significantly narrowed by the Supreme Court in *Marex*.

On the facts, recognising that its decision might give rise to double recovery by Primeo (i.e. potential recovery via its claims against the Respondents, and further potential recovery via distributions made to the shareholders of Herald and Alpha if they were to recover from the Respondents), the Privy Council indicated that case management arrangements would need to be implemented to preclude any such double recovery, though it did not specify what those arrangements might be.

Having decided the reflective loss issue on the timing question as regards both Respondents, the Privy Council declined to rule upon the merits test question.

Next steps

As the appeal in respect of reflective loss was a preliminary issue in the Privy Council appeal proceedings, the balance of the appeal and cross-appeal issues will be heard by the Privy Council in October 2021. Those issues include substantive questions of breach of duty by BBCL as administrator, causation of loss, and limitation. If and to the extent Primeo succeeds on this second appeal, the matter will be remitted to the Cayman Grand Court for the quantification of Primeo's loss, if any.

Please do not hesitate to contact the authors should you have any questions concerning this matter, in which Campbells represents the Respondents.

[1] *Primeo Fund (in Official Liquidation) v Bank of Bermuda (Cayman) Ltd and Anor* [2021] UKPC 22.

[2] Campbells' client advisory concerning the Grand Court's judgment is accessible [here](#).

[3] Campbells' client advisory concerning the CICA's judgment is accessible [here](#).

[4] Judgment, at [55].



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