Case Note

CREDITORS AND THE PRINCIPLE OF REFLECTIVE LOSS

Townsing Henry George v Jenton Overseas Investment Pte Ltd [2007] SGCA 13

This note examines the Court of Appeal's observations in *Townsing Henry George v Jenton Overseas Investment Pte Ltd* [2007] SGCA 13 on the application of the principle of reflective loss to creditors. It is argued here that the principle should not apply to creditors because the loss that they suffer as a result of a depletion of a company's assets flowing from a breach of duty owed to the company is not really reflective of the company's loss. In addition, the policy arguments supporting the application of the principle to shareholders do not support a similar application of the principle to creditors.

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I. Introduction

1 It is not often that an appellate court invites counsel to submit arguments on an issue that had not been pleaded nor relied upon by the parties themselves. This occurred in the Court of Appeal's decision of *Townsing Henry George v Jenton Overseas Investment Pte Ltd*[1] ("*Jenton*") in relation to what has been aptly described as a "difficult and developing topic"[2] – the reflective loss principle (or the "no reflective loss rule").[3] The origin of the reflective loss principle may be traced to the English Court of Appeal's judgment in *Prudential Assurance Co Ltd v Newman Industries and Others (No 2)*[4] ("*Prudential*") in which the court held that a shareholder "cannot recover a sum equal to the diminution in the market value of his shares, or equal to the diminution in dividend, because such a

1 [2007] SGCA 13.
2 Per Neuberger LJ in *Gardner v Parker* [2005] B C C 46 ("Gardner") at 72.
3 The case also provides illuminating guidance on directors duties and the law surrounding the raising of new points on appeal. However, it is not the intent to discuss these aspects of the case in this comment.
4 [1982] 1 Ch 204.

loss is merely a reflection of the loss suffered by the company."[5] This principle was upheld by the English House of Lords in *Johnson v Gore Wood*[6] ("*Johnson*").

II. The scenario in *Jenton*

2 *Jenton* involved a director (Townsing) being sued, *inter alia*, for breach of director's fiduciary duties owed to the plaintiff company (Jenton). The company was in liquidation at the relevant time and the action was brought by the liquidator. Jenton was part of a group of companies referred to as the "Newman group" which included Jenton and its wholly owned subsidiary, NQF Ltd ("NQF"). The group had entered into a joint venture headed by a UK company ("Normandy"). Townsing was appointed as Normandy's corporate representative in the Newman group. He was also appointed as director of Jenton and NQF as Normandy's nominee pursuant to the joint venture arrangement between the parties.

3 The allegation of breach of duties arose in relation to a series of intricate funding transactions for the venture. Essentially, it was alleged that Townsing had paid out sums belonging to NQF to Normandy even though Normandy had no legal right to receive the payment. At the time of the payment, Jenton was not only the sole shareholder of NQF, but was also its sole creditor. Jenton's liquidator asserted that, because the relevant sums were wrongly paid out to Normandy, NQF did not have sufficient funds to repay the debt owed to Jenton.

III. The issue of reflective loss and its application to creditors

A. The decision

4 Prior to discussing whether Townsing was in breach of his duties to Jenton, the court observed that Townsing appeared to have been in breach of his directorial duties to NQF by paying the relevant sum to Normandy, which the court found had no claim to the sum as against NQF. However it refused to speculate why Jenton, and not NQF had sued

5 *Id*, at 222-223.
6 [2001] A C 1.

Townsing.[7] After summarising the duties which Townsing was alleged to have breached, the court ruled that Townsing had also breached the directorial duties owed to Jenton.

5 The court then discussed the principle of reflective loss and concluded that the principle was applicable in Singapore.[8] It went on to hold that the principle would have been applicable to Jenton's claim but for the fact that it had not been raised at the trial and that it would have been unfair and prejudicial for the court to apply the principle to the action at such a late stage.[9] However, the court was of the opinion that had the principle been applicable, it would have precluded Jenton from recovering its losses from Townsing despite the latter's breach of duties. The learned Chief Justice said:

> Jenton's losses, in relation to its inability to recover its loan of $4,542,286 from NQF and the diminution of its 100% shareholding in NQF, as a result of the appellant wrongfully paying the Relevant Sum (NQF's asset of NZ$2,677,300) to Normandy, are merely reflective of the loss suffered by NQF. The losses suffered by Jenton mirrored an equivalent loss by NQF. Jenton's inability to recover the Relevant Sum from NQF, whether in the form of share dividends or as repayment of its loan, was clearly a consequence of the corresponding diminution in NQF's assets.[10]

6 The court took the position that the reflective loss principle applied not only to shareholders (which was the main finding in *Prudential*) but also to losses suffered by creditors on the basis that "there is no logical reason why it should not apply to a shareholder in his capacity as a creditor of the company expecting repayment of his debt".[11] It accepted the *dicta* in *Gardner v Parker*[12] which had facts which were largely similar to those in *Jenton*. The court's decision is also supported by *Johnson* where the principle was applied to disallow the plaintiff's claim, *inter alia*, for amounts owed to him as an employee. The facts in *Jenton, Gardner* and *Johnson* all concerned shareholders who were also making a

7 *Jenton*, *supra* n 1, at [56].
8 The Court of Appeal preferred to follow *Johnson*, *supra* n 6, over the New Zealand Court of Appeal's decision in *Christensen v Scott* [1996] 1 NZLR 273 and affirmed the decision of Lai Kew Chai J in *Hengwell Development Pte Ltd v Thing Chiang Ching* [2002] 4 SLR 902.
9 *Jenton supra* n 1at [80]-[89].
10 *Id*, at [72].
11 *Id*, at [70] and [72].
12 [2005] B C C 46.

claim *qua* creditor and a strict interpretation of these cases would confine it to such situations. Nevertheless, the judgments in all these cases did not appear to suggest that this was a key factor in the application of the reflective loss principle to a creditor's claim. This point was emphasised by Neuberger L J in his delivery of the judgment in *Gardner*.[13] There is thus every likelihood that *Jenton* may be cited as authority for the proposition that the reflective loss principle may be applied to creditors in much the same way as it applies to shareholders, regardless of whether or not the creditors themselves hold shares in the company.

B. Disapplication of the principle where double recovery avoided

7 While the court in *Jenton* was of the view that creditors' claims also came under the purview of the reflective loss principle, the court went on to suggest that it may be willing to disapply the principle if the plaintiff was able to show that steps had been or would have been taken to avoid the possibility of double recovery.[14] Such steps may include the plaintiff procuring an undertaking from the company not to sue the wrongdoer.[15] In the words of the learned Chief Justice:

> Such an undertaking would have disapplied the principle of reflective loss as there would be no possibility of double recovery. It is arguable that there would have been no reason why the court would not have accepted such an undertaking since NQF was a wholly-owned subsidiary of Jenton and no third party had a claim to the Relevant Sum as a creditor or shareholder.[16]

8 This approach deviates somewhat from the reflective loss principle as it has developed in England. The English cases appear to regard the possibility of double recovery as a policy argument for disallowing reflective loss altogether regardless of whether or not double recovery may be averted in a particular case. Thus, the English Court of Appeal in *Gardner* and the House of Lords in *Johnson* made it clear that the principle would apply even where the company may have settled the claim for less than it should have done even though there would, in such circumstances, not be any double recovery on the part of the plaintiff.[17]

13 See, in particular, Neuberger L J's observations in *Gardner, supra* n 12, at 77.
14 *Jenton*, *supra* n 1, at [85]-[87].
15 *Id*, at [86].
16 *Ibid*.
17 Per Neuberger LJ in Gardner, *supra* n 12, at [70] and Lord Millett in *Johnson*, *supra* n 6, at 66.

9 It is likely that the Singapore Court of Appeal intended its *dicta* on this issue to be limited to situations where the creditor making the claim is also the sole creditor and shareholder of the company as otherwise, the rights of the company's other creditors and shareholders would come into play. This is borne out in the Chief Justice's statement quoted in the preceding paragraph. This makes sense as should there be other creditors or shareholders involved, the giving of an undertaking not to sue the wrongdoer may amount to a breach of duties on the part of the parties giving such an undertaking on the company's behalf. In addition, it is submitted that the court's approach in *Jenton* can only be taken where the award of damages is discretionary as is the case for claims for equitable compensation and breach of fiduciary duty (as was the case in *Jenton*). It cannot be adopted where the award of damages is as of right upon the establishment of liability such as under the tort of negligence (as was the case in *Johnson*).

C. Should the reflective loss principle apply to creditors?

10 It is respectfully submitted, however, that the reflective loss principle should not apply to claims made by creditors against a wrongdoer. First, the loss suffered by a creditor in the *Jenton* scenario is not really "reflective" of the loss suffered by the company. Secondly, the "double recovery" policy argument does not carry much weight in relation to creditors. Finally, such a position does not prejudice other creditors.

(1) Creditors do not really suffer "reflective loss"

11 The rationale for the reflective loss principle is closely related to another well known doctrine in company law, the rule in *Foss v Harbottle*[18] or the "proper plaintiff rule". Where a company has suffered a loss, it is the company to which any cause of action pertaining to such loss accrues. Clearly, however, where a company does suffer loss, this will have a impact on the value of the shares of the company. This stems from the direct correlation between the company's nett assets and its share value. The loss suffered by the company is factored into the determination of a company's share price. In this sense, the loss arising from the diminution in value of shares "reflects" the loss suffered by the

18 (1843) 2 Hare 461.

company. A shareholder who sues for losses arising from a diminution of the value of his shares consequent upon losses suffered by a company is in essence suing for the loss on the company's behalf and to permit such a claim would be a circumvention of the proper plaintiff rule. Linked to this is the policy concern that where a shareholder is permitted to make such a claim, "then either there will be double recovery at the expense of the defendant or the shareholder will recover at the expense of the company and its creditors and other shareholders".[19] The same arguments would apply to all payments that a shareholder may have otherwise received from the company if it had not been deprived of its funds, including, for example, the loss of dividends.[20]

12 This makes much sense when applied to shareholders. As pointed out by Lord Millett in *Johnson,* "although a share is an identifiable piece of property which belongs to the shareholder and has an ascertainable value, it also represents a proportionate part of the company's net assets, and if these are depleted the diminution in its assets will be reflected in the diminution in the value of the shares."[21] This is linked to the fact that, conceptually, shareholders have a legal right to the residual value of the company, including any distributable funds. The diminution in a company's assets corresponds directly to a diminution of this residual value.

13 It is argued that losses suffered by creditors as a result of a depletion of a company's assets is different and should not be treated in the same manner. Conceptually, there is no direct correlation between losses suffered by a company (resulting in the depletion of its assets) and the "value" of a debt. Unlike a share, the ownership of a debt does not confer on the creditor any rights to the assets of the debtor (outside of any arrangement for security). Creditors do not have a right to the residual value of the company and a depletion of company's assets *per se* does not affect the value of the debt. Thus, where a creditor is unable to recover a debt, the loss which it suffers is not really reflective of the loss which may have been suffered by the company that resulted in its inability to repay the debt. While the company remains solvent, the

19 Per Lord Millett in *Johnson*, *supra* n 6, at 62. This passage was cited by Chan Sek Keong CJ in *Jenton*, *supra* n 1, at [75] as being the explanation of the policy considerations behind the reflective loss principle.

20 Per Lord Millett in *Johnson*, *supra* n 6, at 66.

21 *Id*, at 62.

creditors clearly suffer no loss even where the company's assets are diminished. Even where a depletion of assets occurs while the company is insolvent or which causes it to become insolvent, there is conceptually no corresponding diminution in the "value" of the creditor's specific debt. No doubt, the ability of the creditor to recover the debt may be affected, but this does not necessarily translate to a diminution in its value in the same manner as the diminution of the value of a share. Recovery of the debt is dependent, not solely on the availability of assets for distribution but also on the rules governing priority of debts and the actions of the liquidator. The depletion of assets and loss suffered by the company may be a causative factor of the creditor's loss. It is, nevertheless, a distinct and separate loss from that suffered by the company.

(2) The "double recovery" concern

14 In addition, it is submitted that the "double recovery" policy argument put forward in support of the reflective loss principle does not carry much weight in its application to creditors. In order for a creditor to succeed in a claim for damages, it is necessary to prove loss. In the context of a debt, this loss would be the *irrecoverability* of the debt. It must also be shown that the inability to recover the debt was caused by the defendant's breach. This will occur where the defendant's breach has depleted the assets of the company in such a way that, but for such depletion, the defendant would have been repaid. Taking this approach will avoid double recovery on the part of the creditor as the creditor's claim is dependent on proof that the creditor cannot recover its debt from the company because of the defendant's breach. It is submitted that the creditor can only prove such loss where the company has undergone insolvent liquidation, the outcome of which results in the creditor still being out of pocket. Prior to this, the creditor's loss (and therefore his claim) has not yet arisen as there is the possibility that the company (or its liquidator) may sue the wrongdoer and thus have sufficient funds to repay the creditor.

15 The success of the creditor's claim is also dependent on the liquidator's actions and their outcomes. If the liquidator takes action against the wrongdoer, the creditor will be repaid if funds are sufficient for this purpose. If funds are insufficient to repay the creditor even after action has been taken against the wrongdoer, then the original breach did

not cause the loss to the creditor.[22] The creditor's direct claim against the wrongdoer will thus arise only where, by the end of the liquidation, the wrongdoer has not been fully taken to task by the liquidator, whether as a result of the liquidator abandoning the claim or settling it. Where the liquidator has acted negligently or in bad faith, the creditor may elect to sue the liquidator.

16 In contrast, a shareholder's claim against a wrongdoer is not premised on the shareholder's inability to recover an amount owed but on the loss in the value of the company. It is not dependent on whether or not steps have been or may be taken by the company to recover the loss from the wrongdoer. Nor is it dependent on the company undergoing insolvent liquidation. Conceptually, the shareholder's claim arises the moment the company suffers the loss in question because the loss suffered by the shareholder is inextricably tied to the loss suffered by the company as highlighted above. Double recovery is therefore a concern if a shareholder's claim were allowed.

(3) No prejudice to other creditors

17 Another policy underpinning the reflective loss principle is the concern that allowing a claim for such loss would permit shareholders to get their hands on funds to the prejudice of creditors[23] Similarly, a concern that may arise by allowing a creditor to succeed in the *Jenton* situation is that the creditor may subvert the priority distribution scheme envisaged by the rules surrounding liquidation and the *pari passu* principle. In this regard, it is not difficult to draw an analogy with circumstances whereby directors of a company are said to owe duties to its creditors. While it is widely accepted that directors owe a duty to look after the interests of a company's creditors when the company is insolvent[24], the prevailing view is that, under the common law, the duty is owed to the company and should be enforced by its liquidators and not by the creditors personally.[25] An indirect consequence of this appears to be that creditors have no personal claim against a director where there is a

22 See Part D of the main text below for more on the issue of causation.

23 *Stein v Blake* [1998] 1 All ER 724. This was also pointed out in *Johnson*, *supra* n 6, by Lord Bingham of Cornhill at 36; Lord Cook of Thorndon at 45; Lord Hutton at 55 and Lord Millett at 63.

24 *Chip Thye Enterprises Pte Ltd v Phay Gi Mo* [2004] 1 SLR 434.

25 *Yukong Line Ltd v Rendsburg Investments Corp* [1988] 2 B C L C 485; *Sycotex v Baseler* [1994] 14 ACSR 766.

breach of duties to the company even where the company is insolvent and the breach is in failing to properly look after the interests of the creditors. The reason for disallowing a direct claim from the creditors may be explained from a legal as well as from a policy perspective. Legally, the underlying principle of claims of this nature is that even though the company's creditors are the ones who are directly affected by the breach of duties, it is the company to which the duties are owed and consequently, only the company (through its liquidator) may seek recourse. Policy-wise, allowing a creditor to bring a direct personal action for the breach would permit the creditor to circumvent the *pari passu* principle and the priority distribution scheme in insolvency. It would also encourage multiplicity of actions by all of the company's creditors.

18 There is, however, a significant difference between the *Jenton* scenario and the situation that usually arises in a situation where there has been a breach of a duty to consider the interests of creditors. In the latter, the creditors' claim stems directly from the rights of the company in that there is no duty owed to the creditor which is separate from the duty owed to the company. Had Jenton sued Townsing in respect of breach of his duties in his capacity as director of NQF, the claim would have fallen into the category of cases dealing with a director's duty to take into account the interests of creditors. Instead, the claim was brought by Jenton against Townsing for breach of his directorial duties to Jenton itself. The court recognised this distinction[26] and went on to find that there was a breach of duties owed to Jenton.[27]

19 In addition to there being a separate and distinct duty owed to the creditor in the *Jenton* scenario, the creditor's claim is, as mentioned earlier, premised on the company not having sufficient funds to pay the creditor concerned. The claim thus already takes into consideration the operation of the *pari passu* principle and the rules surrounding priorities. A creditor who succeeds in a claim in the *Jenton* scenario is not placed in a more advantageous position firstly because he has a separate claim arising from a distinct duty owed to him and secondly because the rules governing priorities in insolvency operate in determining whether or not the creditor has indeed suffered a loss and in calculating such loss.

26 *Jenton*, *supra* n 1, at [56].

27 This was notwithstanding that the acts complained of were alleged to have been committed by Townsing in his capacity as director of NQF; *id*, at [61].

D. Causation

20 A point which was not canvassed before the court in *Jenton* nor dealt with in the case in any detail was the question of whether or not the loss suffered by the plaintiff was in fact caused by the breach. The case appears to have been decided on the assumption that a causal link was present. However, had the matter been raised, the court would have had the opportunity to address Lord Millett's opinion in *Johnson,* that where the company failed to pursue its remedy or settled for less than it might otherwise have done, it would be the company's actions which would have caused the creditor's loss and not the original breach.[28] It is also unfortunate that Lord Millett did not elaborate on why he opined as he did as *Johnson* also proceeded on the basis that a causative breach was present.[29]

21 It was argued earlier that in order for a creditor to succeed in a claim in the *Jenton* scenario, the creditor would have to prove that had the breach not occurred, the company would have had sufficient funds to repay its debt. In so doing, the creditor would have already satisfied the "but for" test.[30] The only other question that then needs to be addressed is whether the act of the company, or of a liquidator acting on its behalf, in failing to pursue the original claim would be sufficient to break the chain of causation so as to relieve the defendant from liability. Clearly, the failure by the liquidator to pursue a remedy should not be regarded as a *novus actus interveniens* where such failure was also caused by the original breach, for example, where the breach caused the company to be unable to pursue the claim due to its impecuniosity.[31] Similarly, where the decision not to pursue the claim was made *bona fide* and without negligence, it is unlikely for a court to conclude that the failure to pursue

28 *Johnson*, *supra* n 6, at 66. His Lordship approved the observation of Hobhouse LJ in *Gerber Garment Technology Inc v Lectra Systems Ltd [1997] RPC 443* at 471. *Cf* Lord Hutton's view that causation was not an issue, *Johnson* at 54.

29 It should be noted that Lord Hutton in *Johnson* did not agree with Lord Millett on this point and opined that the ruling in *Prudential* that the shareholders could not recover damages could not be explained on the ground of causation: *Johnson*, *supra* n 6, at 54.

30 It has been accepted that this is the test for causation in respect of claims for equitable compensation pursuant to a breach of fiduciary duties: see *Permanent Building Society v Wheeler* (1994) 14 ACSR 109.

31 See *Giles v Rhind* [2003] BCC 79.

the claim under these circumstances is a wholly independent cause[32] of the damage suffered.

22 Lord Millett's observation, however, was in relation to situations where the liquidator negligently failed to take action. His Lordship suggested that in these situations, "(s)hareholders (and creditors) who are aggrieved by the liquidator's proposals are not without a remedy; they can have recourse to the Companies Court, or sue the liquidator for negligence."[33] With respect to his Lordship, such a view while defensible as a practical solution is not conceptually tenable. Taken to its logical conclusion, a wrongdoer who is being sued by a creditor would be able to raise as a defence that he should not be liable to the creditor because the company's liquidator negligently failed to sue him. In essence, the wrongdoer would be arguing that the cause of the loss was not his wrongful act but the failure of the liquidator to take him to task for the wrongful act. The end result would be a "transfer" of the original liability for the loss to the liquidator. It is submitted that the *Jenton* scenario is more akin to the cases in tort "in which the claimant's loss was caused by cumulative causes attributable to the separate carelessness of multiple defendants".[34] The English courts have held that under such circumstances, both defendants may be held liable for the plaintiff's loss.[35] The creditor should be permitted to elect to sue either the liquidator or the wrongdoer under these circumstances.

IV Summary

23 Having regard to the widespread use of corporate groups, it is envisaged that there would be other instances where facts similar to those in *Jenton* may occur. It is anticipated that in the majority of these cases, the liquidator of the company whose assets have been depleted following a breach of duty owed to it will initiate a claim in respect of the breach. Creditors will not be prejudiced under these circumstances and will not need to make a direct claim against the wrongdoer. The situation is

32 See *Muirhead v Industrial Tank Specialities Ltd* [1986] QB 507 for a discussion of this interpretation of the test for *novus actus interveniens*.

33 *Johnson*, *supra* n 6, at 66.

34 As characterised in Deakin, Johnston and Markesinis, *Markesinis and Deakin's Tort Law* (Clarendon Press, 5th Ed 2003) at p 193.

35 See, *eg*, *Fitzgerald v Land* [1987] QB 781 and *Fairchild v Glenhaven Funeral Services Ltd* [2003] 1 AC 32.

different where the liquidator does not pursue the claim on the company's behalf or settles the claim against the wrongdoer. This will have a direct impact on the creditor where the actions of the liquidator deprive the company of funds to which the creditor would have been entitled pursuant to the distribution regime in insolvency. Here, the creditor in the *Jenton* situation has several options. First, it may sue the liquidator should it be able to prove that the liquidator acted negligently or in bad faith. Secondly, it can try to persuade the liquidator to take action against the wrongdoer and agree to fund the cost of the action. Thirdly, the creditor can, as suggested by Neuberger L J in *Gardner*, procure an assignment of the company's claim against the wrongdoer and pursue the claim accordingly.[36] The second and third options should be pursued prior to the dissolution of the company. These options arise out of the rights that the creditor has against the company in relation to the debt owed taken in conjunction with the claw-back rights of the company.

24 The creditor may, however, wish to take action against the wrongdoer directly in respect of the breach of the separate duty owed to it. This might be a more practical option, for example, where the company is incorporated and based outside of Singapore and where the wrongdoer is resident in and has assets in Singapore. It has been argued that the reflective loss principle should not apply to a creditor in the *Jenton* scenario because the loss suffered by the creditor under such circumstances is not really reflective of the company's loss but a separate and distinct loss. A creditor should thus be able to succeed in a direct claim against the wrongdoer. The weight of the authorities, however, favours the position that the creditor should not succeed in its claim because of the reflective loss principle. Nevertheless, the Court of Appeal in *Jenton* did leave the option of a direct action open to creditors who are able to show that arrangements have been made or that circumstances are such that there would be no possibility of double recovery by the creditor.

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36 *Gardner*, *supra* n 2, at 78. Presumably, the consideration given in return for the assignment is the release of the debt owed to the creditor.