UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

IN RE J. EZRA MERKIN AND BDO SEIDMAN SECURITIES LITIGATION	08 Civ. 10922 (DAB)

DECLARATION OF THOMAS LOWE IN OPPOSITION
TO MOTION OF BDO LIMITED AND BDO TORTUGA TO DISMISS

Thomas Lowe, QC, declares under penalty of perjury under the laws of the United States that the following is true and correct:

1. I am a barrister-at-law generally admitted to practice as an independent barrister in the Grand Court of the Cayman Islands. As such I am self-employed and unattached to any firm. I was admitted to practice in 1985 in England and appointed as Queen's Counsel in 2007. A copy of my curriculum vitae is attached hereto as Exhibit 1.

2. I obtained my undergraduate degree from the London School of Economics in 1984 (LLB 2.1), was called to the bar of England and Wales in 1985 and obtained a master's degree ("LLM" 1st class) from Cambridge University in 1986. I was awarded prizes for papers in contract, tort, equity and conflict of laws and received the Queen Elizabeth major scholarship from the Inner Temple in 1987.

3. I have been in continuous practice since qualifying. Since 1996, I have appeared and advised with increasing regularity in cases and trials in the Caribbean, particularly in the Cayman Islands and the British Virgin Islands. I have also appeared in Courts in Bermuda, Jersey and acted as counsel in Hong Kong, Singapore and Malaysia.

4. Having been repeatedly admitted on an ad hoc basis to appear in the Grand Court of the Cayman Islands, I was generally admitted to practice as an independent barrister in 2010. I

believe I am the second barrister so admitted, and am currently one of three Queens Counsel practicing independently.

5. My practice in the Cayman Islands and elsewhere consists of a wide variety of commercial and insolvency disputes. In particular, a substantial part of my practice involves the bankruptcy of complex financial structures and investor litigation arising therefrom. My experience also includes commercial fraud matters, trust litigation, professional negligence, financial services, banking and probate.

6. I have served as an expert witness on Cayman Islands and British Virgin Islands ("BVI") law in federal bankruptcy proceedings in the Southern District of New York (most recently in the matter of *In re Refco, Inc.*, 05-BR-60006) and the Channel Islands, and am frequently retained to advise on Cayman Islands and Virgin Islands law in proceedings brought in England.

7. The purpose of this declaration is to provide my opinion on aspects of Cayman Islands and BVI law relevant to the Third Consolidated Amended Class Action Complaint dated 18 June 2010 ("TAC"), and to respond to the declarations of Graeme Halkerston sworn 30, July 2010 and Eliot Simpson sworn 30 July 2010. The facts and matters to which I depose herein are true and represent my opinion.

8. I have been provided with and reviewed the following material documents in order to submit this declaration, namely:

(1) The TAC;

(2) The Memorandum of Defendants BDO Cayman Islands and BDO Limited in Support of Motion to Dismiss dated 30 July 2010 ("the Defendant's Memorandum");

(3) The Declaration of Eliot Simpson dated 30 July 2010 ("the Simpson Declaration"); and

(4) The Declaration of Graeme Halkerston of 30 July 2010 (the "Halkerston Declaration");

9. I set out my opinion on Cayman Islands and BVI laws relating to the following claims asserted in the TAC against BDO Cayman:

(1) Fraud/Deceit;

(2) Negligent Misrepresentation/Misstatement;

(3) Aiding and Abetting Breach of Fiduciary Duty/Dishonest Assistance in a Fraudulent Design; and

10. I will also opine on the issue of shareholder standing under Cayman Islands and BVI law.

The Judicial System in the BVI and the Cayman Islands

11. The Simpson Declaration accurately describes the Court system in the BVI in paragraph 6. However he omits to mention that the BVI has a specialist financial services court with a specialist judge, Bannister J, who presides over cases such as this. The same is true of the Cayman Islands which has financial services division.

12. Appeals in the BVI will be heard by the Eastern Caribbean Court of Appeal, whereas appeals from the Grand Court of the Cayman Islands will be heard by the Court of Appeal of the Cayman Islands. Frequently, the same judges will form part of the panel used for both courts of appeal. Appeals from either Court of Appeal will then be heard in the Privy Council in London.

13. I disagree with the suggestion in paragraphs 11 and 12 of the Halkerston Declaration that the Courts of the Cayman Islands are "strongly pro-business", if that is intended to mean that this would make any difference to the standard of care applied by the Courts or affect the type of duties imposed on them. Since appeals are not heard by local judges and since

the Privy Council is the final court of appeal in London, no predisposition by judges of the Grand Court would have such an effect.

14. That is not to say that the Courts of the BVI and the Cayman Islands do not recognize the need to uphold the reputation of the financial system in those jurisdictions. However, in my experience they accomplish this by ensuring that standards are exacting and not seen as lax or overly permissive.

15. It is also true that it is becoming increasingly possible for the Courts of offshore jurisdictions to be influenced by each other's decision but that is in principle nothing new. This is mainly due to the fact that the legal issues arising in respect of a number of financial products (such as the redemption rights of investors in hedge funds and the statutory provisions relating to segregated portfolio companies) have only recently become the subject of case law.

16. Both the BVI and the Cayman Islands adopt the common law of England but in neither jurisdiction are English decisions binding precedent. Only decisions from the same jurisdiction are treated as precedents and decisions from the Privy Council are only binding when they result from appeals from the relevant jurisdiction. The Privy Council in England and English House of Lords do not treat each other's decisions as binding even though a majority of the Privy Council judges will be drawn from the Courts in the United Kingdom.

17. Just as in England, Courts in the BVI and the Cayman Islands look to other common law jurisdictions in the Commonwealth for persuasive effect. English authorities are frequently cited and relied upon but that will not necessarily be the case if there is a contrary but suitably well-reasoned Commonwealth decision. This is frequently the case with insolvency cases from Australia and New Zealand.

18. Although Courts in the BVI, the Cayman Islands and England broadly share the same legal heritage their statutes are different. For that reason different considerations will apply in each jurisdiction and different considerations will shape duties of care and the standards to which professional and service providers in the industry will be held. This follows from legal principle and not from any protectionist disposition such as to project the jurisdiction as being "business-friendly".

Fraud and Deceit

19. Under Cayman Island and BVI law, where a defendant makes a false representation, knowing it to be untrue, or being reckless as to whether it is true, and intends that the plaintiff should act in reliance on it, then if the plaintiff does so act and suffers loss, the defendant is liable for that loss: *Clerk & Lindsell on Torts, 19th ed.* ¶ 18-01 (attached hereto as Exhibit 2).

20. The Halkerston Declaration sets out (paragraph 20): *"[D]eceit, requires, with certain limited exceptions (none of which are applicable here), that the defendant have made an affirmative misrepresentation to plaintiff. As a general proposition, a failure to disclose knowledge of the fraudulent statement of another cannot found the basis for a claim in deceit."*

21. Whilst I agree with that I do not agree that this is relevant. BDO Cayman provided an audit report containing an audit opinion. If that report contained false statements then that is capable of amounting to the affirmative statement required. Statements of belief or opinion generally carry an implication that the belief or opinion is reasonably held. A defendant who confirms a belief while failing to disclose information in his possession indicating that it is not reasonably held is guilty of a misrepresentation and may, if the applicable state of mind is shown, be guilty of deceit *(Clerk & Lindsell* 18-08) (attached hereto as Exhibit 3). I therefore

disagree with the assertion in paragraphs 20-21 of the Halkerston Declaration that the deceit claim in the TAC is not predicated on the affirmative misrepresentations of BDO Cayman. The TAC alleges that BDO Cayman and BDO Limited: *"knowingly or recklessly misrepresented that they conducted their annual audits of the financial statements of the Funds in compliance with GAAS (or ISA, as applicable)."* (¶¶ 241, 277). These allegations are not incompatible with any actionable theory of deceit under Cayman Islands law.

22. The real question is whether these statements were intentionally made to the Claimants if they were not the direct addressees of the audit opinion. What matters in the tort of deceit is whether the person making the statement intends that it will be passed on and relied upon by a third party. He does not need to know the identity of the third party. It is a question of fact whether the Defendant had such intention but foreseeability is not sufficient (see Clerk & Lindsell paragraphs 18-30 and 18-31) (attached hereto as Exhibits 4).

Duty of Care to Shareholders of the Ariel Fund

23. The TAC alleges that BDO Cayman failed to exercise due professional care in the manner in which it carried out its engagement as auditor (¶¶ 211-224). It is also alleged (¶ 223) that BDO employees recommended the Fund entities to their own clients. At issue is whether BDO Cayman owed a duty of care to investors in respect of non-contractual misrepresentations in the audit report which accompanied offering memoranda.

24. In England, Caparo Industries plc v. Dickman [1990] 1 AC 605 (attached hereto as Exhibit 5), decided that an auditor owes a duty of care to the company for whom the audit report is prepared and not to individual shareholders or prospective investors, but the facts and circumstances in that case are different than those alleged in the TAC. The Caparo decision is not based on the reasoning in Johnson v. Gore-Wood & Co [2002] 2 A.C. 1 (attached hereto as

Exhibit 6), and I disagree in this respect with the Halkerston Declaration in paragraph 15 where the principles of these two cases are said to be joint. Moore Stephens v. Stone Rolls Ltd [2009] UKHL 39, is not concerned with the duty of care on an auditor but with an aspect of the application principle known here as *non-oritur action ex turpi causa* (which I understand to be the *in pari delicto* rule).

25. Caparo was concerned with the question whether a duty of care could be owed in respect of non-contractual misrepresentations to a person in receipt of a communication containing that misrepresentation. The principles in England are well-established in Hedley Byrne v Heller [1964] AC 465, which is referred to repeatedly in Caparo (see e.g. pp. 632-3, 634, 637).

26. The English Companies Acts (at the time it was the Companies Act 1985) had a long history of requiring auditors to make reports to the shareholders in general meeting. The most influential judgment is that of Lord Oliver (see pp. 629, 645, 649H-650A). He explained that the purpose of the audit report was nothing more than to fulfill the statutory function required by the Companies Act which contained a detailed statutory code (see also Lord Bridge at pp. 624C-G and Lord Jauncey pp. 658 to 662).

27. There is no comparable statutory code in either the BVI or the Cayman Islands. In both jurisdictions an audited report for a mutual fund must be filed with the regulatory authority (see e.g. Section 8 of the Mutual Funds Law of the Cayman Islands). The auditors report is not prepared by virtue of any statutory provision for the purpose of being presented at general meeting of shareholders. A fundamental plank of the reasoning in Caparo is not present in either the BVI or the Cayman Islands.

28. In Re Omni Securities [1998] CILR 275 at pages 283 and 286 (attached hereto as exhibit 7) in which the Chief Justice did not apply Caparo in such a way as to preclude liability of accountants but applied general principles to determine whether a duty of care could be said to exist. Caparo is authority for a number of other the general propositions and I am not surprised to see that it has been referred to in other Caribbean jurisdictions.

29. One principle I would expect to be followed from English Courts in both the Cayman Islands and the BVI is that the existence of a duty of care outside established categories is fact sensitive and rarely lends itself to a summary legal argument for the dismissal of the claim. The principle that duties of care should be incrementally recognized in particular factual circumstances and therefore depend on careful evaluation of facts was itself stated by Lord Bridge in Caparo (p. 618). In Omni Securities the head-note shows that the Courts are reluctant to dismiss cases of this kind without a full examination of facts at trial.

30. I would expect an important question to be the purpose for which the audit report had been prepared and whether the auditor had known or expressly permitted its inclusion or reference to it in offering memoranda. There might be other consideration. Indeed frequently a requirement to audit financial statements is imposed by the by-laws or Articles of Association. These are contractual documents which vary from entity to entity. Whilst I agree that the Articles of Association *might* affect the duty of care that is not necessarily so. The circumstances in which BDO Cayman was engaged may be much wider.

31. I consider that the TAC sets out facts which are not inconsistent with a finding of a negligent misrepresentation based on a duty of care, As I have said above, I do not consider that Caparo is a general bar applicable in a Court in the Cayman Islands or the BVI as is suggested in paragraph 18 of the Halkerston Declaration. Whether a duty of care is owed by

BDO Cayman will depend on a full examination of the facts in order to determine whether (a) the auditors knew and understood that their audit opinion would be passed on and relied upon (b) they realized that the audit opinion would be relied upon to make investments decisions so that the scope of the duty is sufficiently wide to encompass the claims and (c) there is no ground of public policy militating against liability.

Aiding and Abetting a Breach of Fiduciary Duty

32. I disagree with the Halkerston (paragraph 25) and Simpson (paragraph 14) Declarations where they assert that there is no cause of action of "aiding and abetting a breach of fiduciary duty". There is such a claim but it is known as "dishonest assistance in a fraudulent design" and derives from derived from the English decision of Barnes v Addy (1874) 9 Ch App 244) (attached hereto as Exhibit 8). This is a form of accessory liability. The Plaintiff must show that the Defendant assisted the fiduciary in committing of concealing the breach of duty. Dishonesty needs to be shown but this is determined objectively and equated with conduct which is commercially unacceptable (see Barlow Clowes v Eurotrust [2006] 1 AER 333).

Derivative or Direct Claims

(a) General Considerations

33. It is a consequence of the principle that a corporation has a legal personality separate and distinct from its shareholders that a shareholder cannot sue for wrongs done to the company. The claims for those wrongs represent choses in action belonging to the Company and not the shareholder. Hence, the proper plaintiff in an action with respect to a wrong allegedly done to a company (whether by management or otherwise) is, with some exceptions, the company itself and not an individual shareholder: Foss v. Harbottle (1843) 2 Hare 461; Edwards v. Halliwell [1950] 2 All ER 1064 at 1066 and Prudential Assurance Co Ltd v. Newman Indus.

Ltd. (No 2) [1982] Ch 204. This principle was specifically approved by the Cayman Islands Court of Appeal in Svanstrom & ors v Jonasson 1997 CILR 192 (at 195-196) and referred to in the BVI in the Y2K decision, and is therefore clearly incorporated into the law of the Cayman Islands.

34. The Halkerston Declaration relies on Johnson v Gore Wood & Co [2002] 2 AC 1 ("*Gore Wood*"). However, Mr. Halkerston presents an incomplete and over-simplified summary of the House of Lord's findings in relation to the nature and recoverability of reflective losses by shareholders in that case and the principles that govern such claims. Lord Bingham in *Gore Wood*, with whom Lord Cooke agreed in the same case, after reviewing the earlier authorities, concluded (at pp. 35-36):

> *"These authorities support the following propositions. (1) Where a company suffers loss caused by a breach of duty owed to it, only the company may sue in respect of that loss. No action lies at the suit of a shareholder suing in that capacity and no other to make good a diminution in the value of the shareholder's shareholding where that merely reflects the loss suffered by the company....(2) Where a company suffers loss but has no cause of action to sue to recover that loss, the shareholder in the company may sue in respect of it (if the shareholder has a cause of action to do so), even though the loss is a diminution in the value of the shareholding.... (3) Where a company suffers loss caused by a breach of duty to it, and a shareholder suffers a loss separate and distinct from that suffered by the company caused by breach of a duty independently owed to the shareholder, each may sue to recover the loss caused to it by breach of the duty owed to it but neither may recover loss caused to the other by breach of the duty owed to that other."* (Underlining added)

35. As can be seen Lord Bingham outlined three different situations. In the first case the claim or chose in action as a matter of property belongs only to the company. In the second it belongs only to the shareholder. The third situation deals with the case where the company and the shareholder each have a right of action as a matter of property. In that situation the concern is to avoid double recovery.

36. Lord Millett in *Gore Wood*, with whom Lord Goff agreed in the same case, also addressed Lord Bingham's first two categories of case. He held (at pp. 61-62) that:

> *"where a company suffers loss as a result of an actionable wrong done to it, the cause of action is vested in the company and the company alone can sue. No action lies at the suit of a shareholder suing as such, though exceptionally he may be permitted to bring a derivative action in right of the company and recover damages on its behalf.... Correspondingly, of course, a company's shares are the property of the shareholder and not of the company, and if he suffers loss as a result of an actionable wrong done to him, then prima facie he alone can sue and the company cannot. On the other hand, 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. The correspondence may not be exact, especially in the case of a company whose shares are publicly traded, since their value depends on market sentiment. But in the case of a small private company like this company, the correspondence is exact. This causes no difficulty where the company has a cause of action and the shareholder has none; or where the shareholder has a cause of action and the company has none.... Where the company suffers loss as a result of a wrong to the shareholder but has no cause of action in respect of its loss, the shareholder can sue and recover damages for his own loss, whether of a capital or income nature, measured by the diminution in the value of his shareholding. He must, of course, show that he has an independent cause of action of his own and that he has suffered personal loss caused by the defendant's actionable wrong. Since the company itself has no cause of action in respect of its loss, its assets are not depleted by the recovery of damages by the shareholder."*

37. This passage deals with the uncontroversial distinction between claims which belong either to the Company or to the shareholder but not both. In such a case the derivative action rule does not operate as a bar against a shareholder.

(b) Overlapping Duties and Double Recovery

38. The situation where a duty is owed to both is, as observed above the subject of Lord Bingham's third category, the case of affirmative duties owed to both company and shareholder. In that situation any rule excluding recovery is not solely based on a determination of substantive property rights in a claim. The practical procedural need to guard against double recovery comes into play. Lord Millett said:

> *"The position is, however, different where the company suffers loss caused by the breach of a duty owed both to the company and to the shareholder. In such a case the shareholder's loss, in so far as this is measured by the diminution in value of his shareholding or the loss of dividends, merely reflects the loss suffered by the company in respect of which the company has its own cause of action. If the shareholder is allowed to recover in respect of such loss, 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. Neither course can be permitted.* (Underlining added)"

39. It will be observed that Lord Millett and Lord Bingham both expressed concern as to the possibility of double recovery but did not rule that such loss would be irrecoverable by a shareholder absent a risk of double recovery. Lord Millett's approach is more restrictive than Lord Bingham's as was noted in a subsequent case. It is Lord Bingham's view that prevailed.

40. Where losses are separate and distinct there is no risk of double recovery. The Supreme Court of Canada accepted that *a shareholder could bring a claim when he could show loss separate and distinct from that of the Company.* In Hercules Managements Ltd. v. Ernst & Young [1997] 2 S.C.R. 165, 146 D.L.R. (4th) 577, it was alleged that the defendant auditors had negligently prepared financial statements for a company in which some of the plaintiffs owned shares. However, the statements had been prepared under the direction of the company's management and had not been relied on directly by the plaintiffs for investment purposes. La Forest J. reasoned:

> *"One final point should be made here. Referring to the case of Goldex Mines Ltd. v. Revill (1974), 7 O.R. (2d) 216 (C.A.), the appellants submit that where a shareholder has been directly and individually harmed, that shareholder may have a personal cause of action even though the corporation may also have a separate and distinct cause of action. Nothing in the foregoing paragraphs should be understood to detract from this principle. In finding that claims in respect of losses stemming from an alleged inability to oversee or supervise management are really derivative and not personal in nature, I have found only that shareholders cannot raise individual claims in respect of a wrong done to the corporation. Indeed, this is the limit of the rule in Foss v. Harbottle. Where, however, a separate and distinct claim (say, in tort) can be raised with respect to*

a wrong done to a shareholder qua individual, a personal action may well lie, assuming that all the requisite elements of a cause of action can be made out."

The facts of Haig, supra, provide the basis for an example of where such a claim might arise. Had the investors in that case been shareholders of the corporation, and had a similarly negligent report knowingly been provided to them by the auditors for a specified purpose, a duty of care separate and distinct from any duty owed to the audited corporation would have arisen in their favour, just as one arose in favour of Mr. Haig. While the corporation would have been entitled to claim damages in respect of any losses it might have suffered through reliance on the report (assuming, of course, that the report was also provided for the corporation's use), the shareholders in question would also have been able to seek personal compensation for the losses they suffered qua individuals through their personal reliance and investment. On the facts of this case, however, no claims of this sort can be established. [At ¶¶ 62-3; emphasis added.]

41. Therefore, four out of the five Law Lords (Lord Hutton did not address the point specifically) agreed in *Gore Wood* and the Supreme Court of Canada held in Hercules Management that a shareholder can recover in three circumstances, namely:

(1) Where the claim belongs solely to the shareholder and, even though a company suffers loss, it has no cause of action to sue to recover that loss. The shareholder can sue and recover damages for his own loss, even when measured by the diminution in the value of his shareholding, as long as the shareholder has an independent cause of action. This is Lord Bingham's second category.

(2) In addition, where the company and the shareholder are both owed duties, the shareholder can recover loss suffered as a result of a breach of a duty either where the loss is "separate and distinct" from that of the loss suffered by the company.

(3) In addition Lord Bingham with whom Lord Hutton agreed in *Gore-Wood* both considered that the only real objection to depriving a shareholder of his own proprietary right to his own claim was when there was a risk of double recovery. When that risk disappears so does the objection to the shareholder pursuing his claim. That reasoning has been developed in subsequent case law.

42. Lord Bingham did not explain the circumstances in which the risk of double recovery had been successfully avoided and the objection to a shareholder suit thus overcome. Soon after *Gore-Wood* it was recognized that even in the case of overlapping duties owed both to

a company and shareholder there was no hard and fast rule excluding recovery by shareholders. For example, in the case of Day v Cook [2001] EWCA Civ 592 ("*Day*") Arden LJ (at paragraph 41 onwards) noted:

> "*However, it is apparent that there are limits to the application of the no reflective loss principle. The principal limit is that the no reflective loss principle does not apply where the company has no claim and hence the only duty is the duty owed to the shareholder (Lord Bingham's proposition (2)). Likewise it does not apply where the loss which the shareholder suffers is additional to and different from that which the company suffers and a duty is also owed to the shareholder: see Lord Bingham's proposition (3) and see Heron International v Lord Grade, Associated Communications Corp plc and others [1983] BCLC 244, as explained by Lord Millett in Johnson v Gore Wood. There may well be other limits.* (Underlining added).

43. This was taken further by Peter Gibson LJ in delivering the decision of the English Court of Appeal in Shaker v Al-Bedrawi & ors Shaker v Masr [2003] Ch 350 ("*Shaker*"),. He made the point that (at ¶ 85):

> *In circumstances where the Prudential principle applies to bar a viable claim on the footing of the company's cause of action which it does not assert, the application of the principle can work hardship. Moreover in this case the application of the principle might serve to leave the trustee holding a profit without being accountable for it to his beneficiary, and that may run counter to a basic equitable principle."*

44. Soon afterwards the English Court of Appeal returned to the subject. This time it was made clear that if the Company had been disabled by the Defendant from proceeding (such that the risk of double recovery had been eliminated), a shareholder's claim against that Defendant would not fail. Waller LJ in Giles v Rhind [2003] Ch 618 ("*Giles*") (attached hereto as Exhibit 9), which was an appeal from an assessment of damages, liability having been established at trial distinguished the facts in *Giles* from *Gore Wood* in five important respects:

> "*First,* Johnson v Gore Wood & Co *was a case, as emphasised by Lord Bingham of Cornhill and Lord Millett, where Mr Johnson carried on his business through a small private company. His position was practically indistinguishable from that of his company. It was a case where the depletion in the value of the assets reflected*

in the diminution in the value of the shares was likely to correspond exactly (in the words of Lord Millett, at p. 62B)."

"Second, W Ltd had brought an action and compromised the same; indeed Johnson was the directing mind of the company when it agreed to the compromise. There is no reason to think that the company would not have recovered if it had chosen to do so precisely that value which would have reflected the diminution in value of the shares which Johnson was claiming. There was no question of W Ltd having been disabled from bringing the claim by the very wrongdoing which by contract the defendant had promised the plaintiff he would not carry out."

"Third, the action was tried on the assumption that the solicitors owed an independent duty to Johnson, but the nature of the case was such that it was not easy to assume such a totally independent duty."

"Fourth, it could not be argued ultimately that the loss of value was other than reflective of the company's loss despite the way the claim was pleaded. But, so far as the damage in relation to investment in shares in this case is concerned, Mr Giles's losses are not as it seems to me "merely reflective". The shares became valueless on his case because the company's business as a whole was destroyed. Obviously the value of his shares reflect to some extent the value of the assets of the company but in his case they also reflect what Lord Millett described as market sentiment or what would have been considered their value because of the potential which the business had."

"Fifth, it certainly is not in my view in reality a case where Mr Giles is seeking to recover as damages damages which the company could have recovered. The company's claim for damages for breach of contract would have been of a quite different nature based on an assessment of profits lost by virtue of the confidential information being used to take the Netto contract. Mr Giles's loss relates to the fact that the business as a whole was totally destroyed. Indeed even if the company had recovered damages the Netto contract would never have been restored, the business would never have been the same and Mr Giles's share would inevitably have been devalued by Mr Rhind's activities. The value of the shares when Mr Rhind obtained £300,000 for them in 1993 reflected not only the assets of the company but the good prospects of the company into the future and that loss of value could not be recovered by SHF in any action that it might have brought."

45. Waller LJ (at paragraph 35) then turned to Lord Bingham's third category in *Gore-Wood* and addressed the double recovery risk as follows:

"In my view there are two aspects of the case which Mr Giles seeks to bring which point to Mr Giles being entitled to pursue his claim for the loss of his investment. First, as it seems to me, part of that loss is not reflective at all. It is a

personal loss which would have been suffered at least in some measure even if the company had pursued its claim for damages. Second, even in relation to that part of the claim for diminution which could be said to be reflective of the company's loss, since, if the company had no cause of action to recover that loss the shareholder could bring a claim, the same should be true of a situation in which the wrongdoer has disabled the company from pursuing that cause of action. I accept that on the language of Lord Millett's speech there are difficulties with this second proposition, but I am doubtful whether he intended to go so far as his literal words would take him. Furthermore it seems to me that on Lord Bingham of Cornhill's speech supported by the others, it would not be right to conclude that the second proposition is unarguable. (emphasis added)"

46. Chadwick LJ (who is now a judge of the Court of Appeal of the Cayman Islands) also endorsed the criticism of Lord Millett's stricter exclusionary rule in *Gore-Wood* added (at paragraphs 73 to 74):

"As Waller LJ has said, it is difficult to do justice to Lord Millett's speech in Johnson v Gore Wood & Co by citing passages selectively. Waller LJ has set out substantial passages from that speech, and it is unnecessary for me to repeat that exercise....In the first of those passages, at p 62, Lord Millett explained the general rule in terms which present no difficulty in the context of the present appeal:

"In such a case [where the company suffers loss caused by the breach of a duty owed both to the company and to the shareholder] the shareholder's loss, in so far as this is measured by the diminution in value of his shareholding or the loss of dividends, merely reflects the loss suffered by the company in respect of which the company has its own cause of action. If the shareholder is allowed to recover in respect of such loss, 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. Neither course can be permitted. This is a matter of principle; there is no discretion involved. Justice to the defendant requires the exclusion of one claim or the other; protection of the interests of the company's creditors requires that it is the company which is allowed to recover to the exclusion of the shareholder."

The premise which underlies that passage is that the company has, and can pursue, its own cause of action. Absent that premise there would be no danger of double recovery at the expense of the defendant; and no occasion to protect the interests of the creditors and other creditors of the company. It is, I think, clear that Lord Millett was not addressing his observations, in that passage, to a case where the company has abandoned its cause of action against the wrongdoer; a fortiori, he was not addressing those observations to a case where the company has had to abandon its cause of action because of the wrong done to it by the wrongdoer." (emphasis added)

47. Referring to Lord Millett's observations in *Gore Wood* (at page 66) that *"the disallowance of the shareholder's claim in respect of reflective loss is driven by policy considerations"*, Chadwick LJ (at ¶ 79) noted that:

> *"...[t]he policy consideration to which, as it seems to me, Lord Millett is referring in that passage is the need to avoid a situation in which the wrongdoer cannot safely compromise the company's claim without fear that he may be met with a further claim by the shareholder in respect of the company's loss....If that is a correct analysis of that passage, then the passage presents no difficulty in the case where the company has not settled its claim, but has been forced to abandon it by reason of impecuniosity attributable to the wrong which has been done to it. In such a case the policy considerations to which Lord Millett referred are not engaged. And it is difficult to see any other consideration of policy which should lead to the conclusion that a shareholder or creditor who has suffered loss by reason of a wrong which, itself, has prevented the company from pursuing its remedy should be denied any remedy at all."* (Underlining added)

48. This approach was reaffirmed by Neuberger LJ (now Lord Neuberger and a judge of the Supreme Court) in Gardner v Parker [2004] EWCA Civ 781 (paragraph 49), where he concluded that:

> *"[i]t is clear, from the analysis and discussion in the cases to which I have referred, that the rule against reflective loss is not concerned with barring causes of action as such, but with barring recovery of certain types of loss."*

49. It is now settled in England that the principles of the rule against reflective loss set out in *Gore Wood,* as qualified by the Court of Appeal in *Giles*, are binding on the English courts (Webster v Sanderson [2009] EWCA Civ 830, per Lord Clarke of Stone-cum-Ebony MR at paragraph 36, where he refused to follow Lord Millett in the Hong Kong case of Waddington Ltd v Chan Chun Hoo Thomas [2009] 2 BCLC 82, who had used the occasion to reiterate his view in *Gore Wood* and expressed doubt about the Court of Appeal's decision in *Giles*). Lord Clarke also explained why he favoured the earlier English Court of Appeal cases and disagreed with Lord Millett. The decisions in *Giles* and the cases which follow it are highly persuasive

authorities in the courts of the Cayman Islands and are likely to be followed by those courts, particularly since the principle was strongly advocated by one of its own judges.

50. Accordingly, the policy behind the rule against reflective loss is to prevent a situation giving rise to double recovery, by the person bringing claims, either against the company or a party against whom the company has claims. The policy behind the rule determines the "limits" on the rule such that loss can be recovered either where both the company and the claimant have a claim but the claimant's loss is separate and distinct to that of the company or where there will be no recovery by the company for the loss for which the claimant claims.

(c) Fact Sensitive Inquiry

51. If the Defendant to an action relies on the reflective loss principle it will require some proof that the Company is owed a duty or overlapping duty. The shareholder will seek to establish that his loss is separate or distinct from that suffered by the Company or that there is on the facts no risk of double recovery. It is nevertheless clear that a Cayman or BVI Court would hesitate before striking out a claim on this ground.

52. These types of allegations are fact sensitive and seldom ventilated in pleadings. The inquiry as to whether the risk of double recovery has been eliminated is fact sensitive. Similarly, the loss suffered by the shareholder needs to be carefully examined before a Court shuts out a claim. It is much more usual for this to be debated at a time when the Court is in a position to determine questions of fact either at a trial or by way of preliminary issue. It is therefore rare for a Defendant to make this application in an application to dismiss a claim unless the Court is in a position to determine disputed facts.

53. In regard to an application to dismiss claims before trial Lord Bingham of Cornhill observed in *Gore Wood* (at page 36):

> *"These principles do not resolve the crucial decision which a court must make on a strike-out application, whether on the facts pleaded a shareholder's claim is sustainable in principle, nor the decision which the trial court must make, whether on the facts proved the shareholder's claim should be upheld. On the one hand the court must respect the principle of company autonomy, ensure that the company's creditors are not prejudiced by the action of individual shareholders and ensure that a party does not recover compensation for a loss which another party has suffered. On the other, the court must be astute to ensure that the party who has in fact suffered loss is not arbitrarily denied fair compensation. The problem can be resolved only by close scrutiny of the pleadings at the strike-out stage and all the proven facts at the trial stage: the object is to ascertain whether the loss claimed appears to be or is one which would be made good if the company had enforced its full rights against the party responsible, and whether ... the loss claimed is "merely a reflection of the loss suffered by the company". In some cases the answer will be clear, as where the shareholder claims the loss of dividend or a diminution in the value of a shareholding attributable solely to depletion of the company's assets, or a loss unrelated to the business of the company. In other cases, inevitably, a finer judgment will be called for. At the strike-out stage any reasonable doubt must be resolved in favour of the claimant.".* (Underlining added)

54. The case of *Day* (at ¶¶ 41-42) noted:

> *Accordingly the Court must consider carefully such issues as whether the defendant owed a duty to the company as well as the shareholder, and whether, if both the company and the shareholder have a cause of action, the loss which they can claim is the same. In some cases these issues may not be difficult to determine, but it is difficult here because the companies are not parties to these proceedings and because Mr Day was closely identified with the companies. Mr Hughes accepted that the onus of proof was on the defendant in this respect.* (Underlining added)

55. Peter Gibson LJ in delivering the decision of the English Court of Appeal in *Shaker*, after first cautioning that *"commendable though the attempt was to secure a saving in time and costs through a preliminary issue at the commencement of a lengthy trial, this case provides an example of the difficulties inherent in such a course and of the complications which may result"* (¶ 49) made the point that (¶ 83):

> *"As the Prudential principle is an exclusionary rule denying a claimant what otherwise would be his right to sue, the onus must be on the defendants to establish its applicability. Further, it would not be right to bar the claimant's action unless the defendants can establish not merely that the company has a claim to recover a loss reflected by the profit, but that such claim is available on the facts....*

56. The concerns expressed by Peter Gibson LJ in *Shaker* were echoed by Waller LJ in *Giles* (¶ 17), which was an appeal from an assessment of damages, liability having been established at trial:

> *"It must be remembered that the court is concerned simply with a preliminary issue. One does not know what evidence would be available to establish what. To a large extent the court is seeking to analyze recoverability of damage in the context of assertions by one side as against the other. Only if it is clear that Mr Giles cannot succeed in recovering any of the heads of loss flowing from what is now an established breach of contract should the court prevent the assessment of damages going ahead."* (Underlining added)

57. On the Plaintiffs' claims for fraud, negligent misrepresentation and aiding and abetting a breach of fiduciary duty, in each case it is possible to determine that the facts pleaded are capable of giving rise to a cause of action belonging to the Plaintiffs as opposed to the fund entities and loss and damage separate and distinct from that of entities. Accordingly, the Plaintiffs' claims more than meet the threshold required at the "*strike out stage*".

58. In addition it may be the case on examination of all available facts that, even if the fund entities have their own claims against the Defendants to recover loss in the same circumstances as the Plaintiffs, there will in fact be no recovery on such claims by the fund entities. Accordingly, if that happens to be the case there would be no need to apply the rule against reflective loss in order to avoid double recovery.

59. Therefore, in relation to the Plaintiffs' claims set out in the TAC, a consideration of all the facts and circumstances relevant to those claims is needed at trial after full disclosure

before a court could be in a position to determine that the Plaintiffs' claims are not separate causes of action seeking redress for loss or damage that is separate and distinct from the harm suffered by the company.

(d) Private International Law Considerations

60. I understand that if the Courts of New York were to look to the law of the Cayman Islands or BVIs in order to determine whether the Plaintiffs' claims are derivative, in looking to the substantive law of the Cayman Islands or BVIs, the New York Court would examine all substantive rules which would be applied by the Cayman or BVI system of law, including the associated conflict of law rules. However, according to their own conflict of law rules the Cayman and BVI courts would consider that matters of procedure are matters for the lex fori.

61. It is therefore a matter of some surprise to be asked in relation to foreign proceedings about the operation of the BVI or Cayman reflective loss principle. I say this because that principle would most probably be characterized as procedural: it only arises in proceedings, which are in Cayman or the BVIs. As I have explained above, the first two of Lord Bingham's cases concern a straightforward case where either the Company or the shareholder owns the chose in action as a matter of property. The difficult case is where both hold such property interests and there is an element of "competition" to avoid double recovery. I believe a Cayman or BVI Court would characterize this bar to relief to prevent double recovery as being procedural. The availability of damages or some alternative remedy is typically a matter for the lex fori.

62. The alterative remedy, driven by need to avoid double recovery is the procedural device of "a derivative action". Many systems have different procedures for such claims. For

example, under the common law in the Cayman Islands and the BVIs, the standing to bring derivative proceedings depended on proof that there had been fraud on the minority and that the wrongful action was incapable of ratification. Other systems such as England now have much wider statutory to bring such claims. This shows that the way in which the courts deal with standing of shareholders may vary from forum to forum.

63. The first case in which this view was expressed was Heyting v. DuPont [1964] 2 All E.R. 273, 1 W.L.R. 843 (C.A.), where a shareholder of a Jersey company sought to sue, in England, a corporate director for misfeasance. The question was whether the Plaintiff could bring a derivative suit. At the outset of his reasons, Russell L.J. said this:

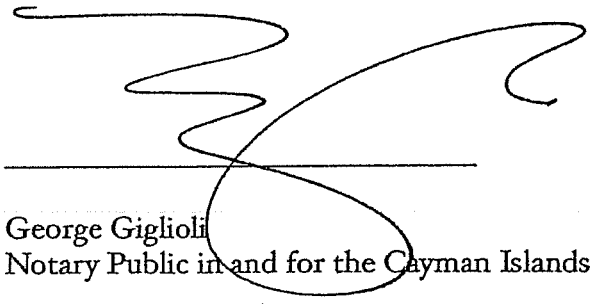
> "This appeal is from a decision of Plowman J. that a claim, asserting liability of a director of a Jersey incorporated limited liability company, to the company for damages for misfeasance, could not be put forward by a shareholder suing on behalf of himself and shareholders other than the allegedly liable director, who held the majority of shares and could therefore control a vote on whether the company should be a plaintiff in such a claim. It thus appears that the question is whether this is a case in which a departure from the rule in Foss v. Harbottle is required. I dare say that the rule in Foss v. Harbottle is a conception as unfamiliar in the Channel Islands as is the Clameur de Haro in the jurisdiction of England and Wales. But clearly this is a matter of procedure to be decided according to the law of this forum. "[At 848; emphasis added.]

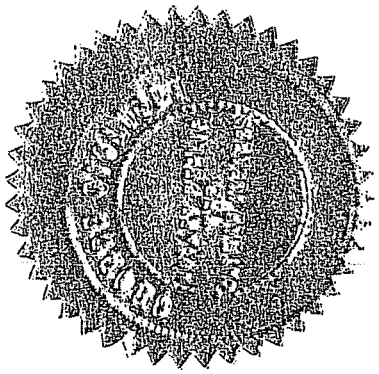
64. Although this case did not address the much newer jurisprudence on reflective loss it demonstrates that it is left to the forum to decide as a matter of procedure how to handle the competition between companies and shareholders seeking to recover the same loss. In my view this principle would mean that the Court in the BVI and Cayman Island would look back to New York as forum to decide whether the Plaintiffs should be allowed to sue and, if so, on what terms.

Executed on October 22, 2010

THOMAS LOWE

This Declaration of Thomas Lowe QC dated 22nd October, 2010 was sworn to at George Town, Grand Cayman before me





George Giglioli
Notary Public in and for the Cayman Islands

22nd October, 2010