JONES DAY

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COMMENTARY

Reflective Loss, Trusts and Australian Class Action Settlements

Key Points

- Class actions brought by beneficiaries or unitholders of a trust are problematic as they encounter the reflective loss principle, which means that even though a unitholder might have a personal loss, he or she may not recover if it was reflected in a loss by the trust. The principle aims to avoid double recovery.
- The application of the reflective loss principle, while settled in company law, is unresolved in Australia in relation to a trust. The position was not determined here due to the settlement of the proceedings. However, the consideration of prospects of success as part of the settlement approval process suggests that the court thought the reflective loss principle applied to a trust.
- A judicial advice application pursuant to s 63 of the *Trustee Act 1925* (NSW) may be heard by the Federal Court where there is a sufficient link between the federal law claims in the substantive proceeding, or the judicial advice is in relation to the compromise of federal causes of action.
- A trustee will be justified in entering into a settlement in circumstances in which unitholders of trust property are treated differently where it is in the best interests of the unitholders as a whole to do so.

Proceedings	Claimants	Prospects	Settlement Approval
Hodges v Waters—Class action	Persons who purchased units in the MFS Premium Income Fund during the period 1 January 2007 to 15 October 2008, i.e. present and former unitholders	Reflective loss principle—beneficiaries of trust (unitholders) cannot sue for the same loss suffered by the trust	*Federal Court of Australia Act 1976* (Cth) s 33V—settlement requires court approval
Wellington Capital Limited v Waters—Trustee / responsible entity claim	Brought on behalf of fund—benefits present unitholders	Statute of Limitations	*Trustee Act 1925* (NSW) s 63—judicial advice as whether trustee was justified in settling the claim

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Background

In 2008, the value of units of the MFS Premium Income Fund (the "Fund"), a property trust, diminished in value following the tightening in credit markets as a result of the global financial crisis.

It transpired that the Fund had entered into a number of loss-making transactions that were not in accordance with its "Compliance Plan". The Compliance Plan governed the internal compliance arrangements under which the Fund was to be conducted. An external person had been appointed to audit the Fund's observance of the Compliance Plan but, among other things, had failed to detect that a number of the loss-making transactions were with related parties to the Fund.

In 2009, the applicants, a group of present and former unitholders in the Fund, commenced an open-class representative proceeding against Waters (the external auditor), the audit team of which Waters was a member, persons involved in the management of the Fund and Octaviar Limited (the Fund's former responsible entity) (the "class action proceedings").

The class was defined to consist of persons who had purchased units in the Fund between 1 January 2007 and 15 October 2008. Excluded from the class were current unitholders who had not purchased the units during the relevant time.

The prospects of success for the class action proceedings turned on whether the reflective loss principle—beneficiaries of a trust (unitholders) cannot sue for the same loss suffered by the trust—applied.

In 2013, the current responsible entity of the Fund, Wellington Capital Limited, was persuaded to commence its own action (the "Trustee's proceedings"). The prospects of success for the Trustee's proceedings were significantly hampered by the statute of limitations.

Approval was sought for the settlement of the class action proceedings and for judicial advice as to whether the trustee was justified in settling the Trustee's proceedings. Both required consideration of the prospects of success of the respective claims.

Prospects of Success–Reflective Loss and the Statute of Limitations

To avoid double recovery, the right to sue for harm done to a trust is vested in the trustee. The beneficiaries of a trust (in this case, the unitholders in the Fund) cannot sue in their own names. However, the class members sought to evade the restriction on standing by seeking compensation for their individual harm but then confronted the reflective loss principle. In company law, the reflective loss principle means that even though a shareholder might have a personal loss, he or she could not recover if it was reflected in a loss by the company for which it could sue. The issue in the class action was whether the reflective loss principle applied to a unit trust such as the Fund.

Perram J determined in *Mercedes Holdings Pty Ltd v Waters (No 8)* [2013] FCA 601 that the class members had made no non-reflective loss claims and declined an application to amend to raise such claims. The class members appealed this decision, but on the day the appeal was to be heard, the in principle settlement of both the class action proceedings and the Trustee's proceedings was announced.

Perram J was of the view that there was a "substantial chance"[1] that the class members would lose in relation to the reflective loss issue and their claim would be dismissed, exposing them to pay costs since 2009.

The Trustee's proceedings did not have the same issues in relation to reflective loss; Wellington unquestionably had standing to pursue claims about harm done to the Fund.[2] However, many of the causes of action which Wellington Capital had obtained upon its succession to the trusteeship of the Fund were arguably statute barred by the time it commenced its proceeding.

Perram J found that:

> In my opinion, the most likely outcome to this litigation was that it would be lost. There was a high risk that the applicants had no standing to proceed and a good chance the bulk of the trustee's claim was statute barred.[3]

Issues from the Combined Settlement

The combined settlement of the class action proceedings and the Trustee's proceedings created a difficulty as the positions of each of the persons involved in the settlement were not the same. Perram J explained:

> (a) any money obtained by the trustee for harm done to the trust assets will increase the value of the units which are held by the present unitholders. Not all of those unitholders, however, acquired their units during the class definition period of 1 January 2007 to 15 October 2008, i.e., not every current unitholder in the Fund is a class member;
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> (b) the class action claim is principally for reflective loss suffered by persons who were unitholders in the class definition period. They claim for the diminution in the value of their units;
>
> (c) those class members need not have retained their units, i.e., not all class members are present unitholders. Worse, amongst those that have sold their units, they will have sold at different times and for different prices; and
>
> (d) for those class members who remain unitholders they will also be enriched by any funds recovered by the trustee in its action as well as by their class action claim, i.e., they recover twice.[4]

To address these issues, the settlement was constructed so that payments were made only to individuals and not to the Fund. Further, payments were made only to class members, so that some current unitholders were excluded from any recovery. The unequal treatment of current unitholders, some being class members and some not, then had to be addressed as part of the judicial advice application. However, from the class action position, limiting compensation to only the group members meant the settlement conformed with the usual approach in class actions.

Approval of the Class Action Settlement

Class action settlements must be fair and reasonable for the court to grant approval. Perram J considered the prospects of success of the claims and was of the view that the proposed settlement stood a significant chance of being the class members' best outcome due to the substantial chance that the determination of the reflective loss issue would lead to the dismissal of the applicants' claim and ensuing costs orders.

The court did not disclose the quantum of the settlement but based on the judge's view that the claim was worth $80 million and the probable, although not certain, outcome that the case would be lost, the payment was considered to be "a good settlement".[5]

The court also considered the expenses incurred in relation to legal fees and litigation funding.

Judicial Advice Application—s 63 of the Trustee Act 1925 (NSW)

By reaching a settlement of the claims, Wellington Capital, as trustee, exposed itself to the potential risk that present unitholders would view the settlement as a breach of trust. A trustee confronted by a difficult or controversial decision is permitted in the State of New South Wales to approach the Supreme Court of that State for judicial advice. To prevent liability for a breach of trust, Wellington Capital sought judicial advice pursuant to s 63 of the *Trustee Act 1925* (NSW).

Judicial advice pursuant to s 63 is usually dealt with by the Supreme Court of New South Wales. However, Perram J reasoned that as the claim for judicial advice arose from the same substratum of facts as its actual claim, the link between the actual claim and the application for judicial advice was sufficient to allow it to be heard by the Federal Court within its accrued jurisdiction. Perram J then went further and held that any claim for judicial advice in relation to the compromise of federal causes of action is in federal jurisdiction.

A key issue for consideration under the application was the unequal treatment of current unitholders. The assets of the trust include the choses in action against Ms Waters and the audit team. Those assets will be extinguished as part of the settlement but the non-class member unitholders will receive nothing as a result of the settlement. However, the trustee was required by the constitution of the Fund to treat unitholders equally.

Perram J considered that the difference in treatment between the class members and unitholders that were not members of the class was not a bar to finding it reasonable to enter the settlement. This was because the settlement was in the best interests of the unitholders as a whole for two reasons:

- The trustee's case was weak and the most likely outcome was a loss; and
- The trustee's case, in practical terms, could not be settled unless at the same time the class action was settled.[6]

Perram J was also of the view that the settlement protected the fund from the real risk of an adverse costs order against the trust assets.

Perram J gave advice that Wellington Capital would be justified in settling the proceedings.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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Endnotes

1 *Hodges v Waters (No 7)* [2015] FCA 264 at [28].

2 *Hodges v Waters (No 7)* [2015] FCA 264 at [21].

3 *Hodges v Waters (No 7)* [2015] FCA 264 at [89].

4 *Hodges v Waters (No 7)* [2015] FCA 264 at [56].

5 *Hodges v Waters (No 7)* [2015] FCA 264 at [92].

6 *Hodges v Waters (No 7)* [2015] FCA 264 at [83].