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COMMENTS

ADEQUATE AND JUST COMPENSATION FOR FRAUD-INDUCED ACQUISITION OF SHARES:

Smith New Court v *Citibank NA*[1]

THE decision of the House of Lords in *Smith New Court* v *Citibank NA* is significant for aligning the legal rule to be applied for assessing damages arising from fraud-induced acquisition of shares to that for other heads of deceit. The importance of the decision, however, extends beyond establishing the correct principle of assessment. It demonstrates the sensitivity that one should always have toward the fundamental aim of tort law – adequate compensation. It also affirms the role that moral considerations play in fashioning remedies for tort. The decision is a timely reminder that discerning application of principles rather than mechanical computational formulas are the order of the day. One must therefore have a strong grasp of the theoretical bases of doctrines like causation and remoteness before one can apply them purposefully.

The Facts

The second defendants, Scrimgeour Vickers (Assets Management) Ltd, were brokers to the first defendants, Citibank NA, who was looking for buyers for its shares in Ferranti International Signal Inc. On 21 July 1989, an employee of Scrimgeour represented to the plaintiffs, Smith New Court, that Smith would be competing with two other bidders for the Ferranti shares; the truth was that there were no competing bidders. The trial court found that the misrepresentation was fraudulently made (hereinafter the "Roberts fraud"), and that it had induced Smith to enter into the contract to buy 28,141,424 Ferranti shares at 82.25p each. The trial judge also found that in the absence of the misrepresentation, the Smith would have offered only 78p for each Ferranti share.

[1] [1996] 3 WLR 1051.

Unknown to the market in general and the parties in particular, a fraud had earlier been perpetrated upon Ferranti by a Guerin (the "Guerin fraud"); the value of the Ferranti shares quoted on the stock exchange on the date that Smith bought them was therefore inflated. The trial court found that had the Guerin fraud been known, the market valuation of each Ferranti share at the date of transaction would have been around 44p. When the Guerin fraud was subsequently discovered in September 1989, the market value of Ferranti shares fell significantly. By November 1989, Smith had found out about the Roberts fraud. They liquidated their positions in small parcels between 20 November 1989 and 30 April 1990; the difference between what Smith paid out for the shares and the total of what they received from their disposal was £11.3m.

Smith successfully sought damages against Citibank and Scrimgeour for fraudulent misrepresentation. The defendants appealed on the question of liability and on the issue of the correct measure to apply in assessing damages. The former centred on factual findings and the proper inferences to be therefrom. The more interesting issues of law were raised by the latter issue: how should damages be assessed against a defendant whose fraud induced the plaintiff to enter into a contract where the loss arising upon the disposal of assets acquired is also attributable to an independent cause (fraud) unknown to the parties at the time of the transaction?

Choosing between the Bases of Assessment

There are a few possible bases by which damages may be quantified for Smith. The first measure applies what may be termed the "date of transaction" rule. In this measure, the court quantifies the damages by reference to the difference between the price paid and the value of shares received at the date of transaction. This rule is of considerable vintage. It gained currency in a line of nineteenth century English cases;[2] despite some doubts cast by Lord Atkin in *Clarke* v *Urquhart*,[3] the rule – the best summary of which is found in *McConnel* v *Wright*[4] – was taken as the proper rule to be applied in cases involving fraud-induced purchase of shares. Thus the High Court

2 *Pearson* v *Wheeler* (1825) Ry & M 303 (KB) (sale of business); *Davidson* v *Tulloch* (1860) 3 Macq 783 at 790 (HL) (sale of shares); *Waddell* v *Blockey* (1879) 4 QBD 678 (CA) (sale of paper); *Arkwright* v *Newbold* (1880) 17 ChD 301, reversed on liability (1881) 17 ChD 313 (CA) (sale of shares); *Peek* v *Derry* (1887) 37 ChD 541 at 578 (reversed on liability (1881) 14 App Cas 337 (sale of shares); *Broome* v *Speak* [1903] 1 Ch 586 (affirmed *Shepheard* v *Broome* [1904] AC 342) (sale of shares).

3 [1930] AC 26 at 67.

4 [1903] 1 Ch 546 at 554 (CA).

of Australia adopted the date of transaction rule although it had some misgivings over its merits.[5] Indeed, in *Smith New Court,* the arguments before Chadwick J at first instance and before the Court of Appeal proceeded on the basis that the date of transaction rule was the proper rule to be applied. The Court of Appeal differed from Chadwick J only as to how the value of the shares at the date of transaction was to be arrived at. Whereas Chadwick J took the value to be that which the market would have attributed to the shares had it known about the fraud (44p),[6] the Court of Appeal took the value to be that which the shares would have fetched in the absence of the Roberts fraud (78p).[7]

The second measure is that found in *Doyle* v *Olby*[8] – all actual losses directly flowing from the fraud are recoverable. In the context of Smith, the quantification formula would be the difference between the price paid and the aggregate total amount of all subsequent realisation of the shares. The House of Lords, led by Lord Steyn and Lord Browne-Wilkinson, unanimously repudiated the mechanical application of the date of transaction rule and held that the *Doyle* v *Olby* rule was the only true measure of damages for deceit. In the words of Lord Steyn, "the plaintiff is entitled to recover as damages a sum representing the financial loss flowing directly from his alteration of position under the inducement of the fraudulent misrepresentation of the defendants."[9]

The Proper Place of the Date of Transaction Rule Within the Fundamental Principle Aim of Adequate Compensation

Lord Browne-Wilkinson began his judgment on the issue by returning to the basic compensatory principle for torts stated by Lord Blackburn in *Livingstone* v *Rawyards Coal Co*; one "should as nearly as possible get that sum of money which will put the party who has been injured ... in the same position as he would have been in if he had not sustained the wrong for which he is now getting his compensation or reparation."[10]

5 *Potts* v *Miller* (1940) 64 CLR 282 at 296-300; *Toteff* v *Antonas* (1952) 87 CLR 647. The application of the rule in *Toteff* v *Antonas* is significant because the rule was extended to the context of sale of shares to one involving the sale of a business *cf. Doyle* v *Olby*, *infra* note 8).

6 *Smith New Court Securities* v *Scrimgeour Vickers (Assets Management) Ltd* [1992] BCLC 1104.

7 [1994] 1 WLR 1271.

8 [1969] 2 QB 158.

9 P 1076H, *per* Lord Steyn.

10 (1880) 5 App Cas 25 at 39.

The date of transaction rule takes leave of this fundamental principle. By requiring credit to be given for the value of the shares at the date of the transaction, it disregards the reality that the loss from the subsequent liquidation is very much due to the deceit. The deceit continues to operate beyond the date of transaction. It is the reason why the deceived party came to hold the asset. It is responsible for locking the deceived party into an asset which is later discovered to be a lemon. Implicit in the date of transaction rule, therefore, is the notion that the deceit is not causative of the subsequent loss. That is not reflective of the reality of the cause for the victim's loss. By absolving the tortfeasor of the responsibility for the subsequent loss, it places the loss on the victim. Thus the date of transaction rule under-compensates the victim because the difference between the value at the date of transaction and the value at the subsequent date of realisation is borne by the victim. And this in the context of a wilful wrong. The merits of the date of transaction rule thus leaves much to be desired.

Another flaw in the date of transaction rule is the implicit assumption that the victim received something of value on the date of the transaction and should be made to give credit for it. While it is certainly true that the victim received an asset of some market value on the date of transaction, that value was not realised by him then. One wonders about the principle on which this unrealised value should be credited against the price given. It is certainly not the duty to mitigate – for the law's prescription that the victim should take reasonable steps to reduce his losses only comes into play when he becomes aware of the breach.[11] Truly the date of transaction rule sat most incongruously with modern tort law and was in dire need of being put in its proper context.

The repudiation of the date of transaction rule as a rule of general application comes as a welcome relief. Until the House of Lords' decision, the basis for computing damages for deceit depended on whether the facts fall within a sale of shares scenario or otherwise. If one acquired a business through an acquisition of shares, the line of precedents dictated the application of the date of transaction rule; on the other hand, if one acquired a business through the sale of assets, the *Doyle* v *Olby* basis could be applied. The inconsistency in result was a difference without an intelligible differentia. The decision in Smith New Court has therefore the merit of resolving the previous incongruous state of affairs.

Despite the repudiation of the date of transaction rule as a rule of general application, both Lord Steyn and Lord Browne-Wilkinson clearly saw it as a rule of some continuing validity – though one to be applied in more circumscribed circumstances. Lord Steyn made it clear that the date of

[11] See p 1060F, *per* Lord Browne-Wilkinson.

transaction rule continues to stand as a second order rule. Lord Browne-Wilkinson put it in more explicit terms; its application is subject to the adequate compensation principle. The next question is: when would it be appropriate to apply the date of transaction rule? Perhaps the direction of this inquiry will be clearer if one were to ask when it is proper to credit against the money paid the value of the asset at the date of the transaction. The House of Lords was careful to underscore the finding that Smith New Court acquired the Ferranti shares as a market making risk rather than as a "bought deal". That is, the Court found that the plaintiffs acquired the shares with a view of holding them on at least a medium term basis rather than for immediate resale to their customers. Had the finding of fact been the latter and Smith had subsequently changed its mind to hold on to the shares despite finding out about the Roberts fraud, one could with some justification take the position that the plaintiff's change in mind was the effective cause of the subsequent loss so as to break the chain of causation started by the fraud. In such a circumstance, there would be an arguable case for the application of the date of transaction rule. Certainly this could fit within Lord Browne-Wilkinson's dictum that the date of transaction rule should not be applied where the misrepresentation continues to operate so as to induce the misrepresentee to retain the asset; in the scenario postulated, the retention of the asset could be attributed to the change of mind to hold on to it as a market making risk rather than the original deceit.

Lord Browne-Wilkinson was of the view that credit to be given against the price paid should "as a general rule" be the market value of the property acquired at the date of acquisition. His qualifications of this general rule – first by what he calls the adequate compensation principle, and second by its displacement in circumstances where the deceit continues to cause the victim to retain the asset or where the victim is locked into property – makes one wonder whether this general rule is really a general rule.[12] He clearly foresaw many circumstances where this general rule would be displaced. Indeed there are many cases where application of the date of transaction rule would be inappropriate. Take the case of a deceived party who finds out about the fraud but elects to keep the asset rather than not realise it. Should one credit against the price paid the (unrealised) value at the date of the transaction or the (unrealised) value at the date when he could reasonably have realised the asset? Lord Browne-Wilkinson indicated that in such a circumstance, the victim would be required to bring the value of the property into account "at the date when he discovered the fraud or shortly thereafter."[13] The mitigation principle imputes to the victim

[12] P 1060G-1061B.

[13] P 1060D-G.

losses attributable to events occurring after the reasonable opportunity to mitigate the effects of the wrong; this would mean that the wrongdoer should be responsible for the decline in the value of the assets up to the time when the victim could have mitigated his loss. The scope for application of the rule is so narrow that it would be misleading to describe it as any manner of general rule at all.

It is important to note that the House of Lords did not repudiate *in toto* the date of transaction rule. What it did was to remind lawyers that quantification of damages should not be carried out in a mechanical fashion; rather there should be a discerning application of the rules for quantification of damages, always bearing in mind the principle of adequate compensation for the victim.

The decision of the House of Lords represents a triumph of principle over formalism. The formalism of the date of transaction rule has the convenience of dispensing with the somewhat thorny issue of where the chain of causation ends.[14] Convenience, however, is not justice; the principal judgements delivered by Lord Browne-Wilkinson and Lord Steyn made clear where the balance should tilt. They should be applauded for so deciding.

Wilful Wrongdoing, Remoteness and Causation

In recent years, reasonable foreseeability has assumed increasing currency as the limiting principle to the recoverability of losses suffered. Originally conceived for the tort of negligence,[15] it has been increasingly received into other torts like nuisance and defamation.[16] As Lord Steyn pointed out, there is a case to be made for adopting a non-punitive stance to civil remedies and therefore the adoption of a uniform standard of remoteness.[17] However the test of reasonable foreseeability, first formulated in *The Wagon Mound*, was borne out of a moral consideration – the fairness of the burden to be borne by the defendant.[18] Thus if one recalls the original motivation to the conception of reasonable foreseeability as the test of remoteness, one

14 P 1060D, *per* Lord Browne-Wilkinson.

15 *The Wagon Mound (No 2)* [1967] 1 AC 617 (PC).

16 Nuisance: see *Cambridge Water Co Ltd* v *Eastern Counties Leather plc* [1994] 2 AC 264 (HL), *Burnie Port Authority* v *General Jones Pty Ltd* (1994) 68 ALJR 331 (High Court of Australia). See also M Fordham, '*The Demise of Rylands* v *Fletcher*' [1995] SJLS 1. Defamation: see *Slipper* v *BBC* [1991] 1 QB 283 (CA).

17 P 1072F.

18 "...[i]t is a principle of civil liability ... that a man must be considered to be responsible for the probable consequence of his act. To demand more of him is too harsh a rule, to demand less is to ignore that civilised order requires the observance of a minimum standard of behaviour." *The Wagon Mound (No 1)* [1961] AC 388 at 422-423 *per* Viscount Simonds.

would have no difficulty denying the consideration of fair burden to the fraudulent misrepresentor. It is therefore appropriate that explicit affirmation was made of Lord Denning's dictum in *Doyle* v *Olby* that "it does not lie in the mouth of the fraudulent person to say that [the losses] could not reasonably have been foreseen."[19]

The use of "directness" rather than "reasonable foreseeability" as the test of remoteness for deceit results in a conflation of the limiting principles of remoteness and causation. These two principles are of course conceptually distinct. Causation is concerned with the common sensical view of the connection between the wrongdoing and the loss.[20] Remoteness finds its motivation in the legal attribution of the extent of responsibility.[21] However the use of "directness" as the test of remoteness for deceit is little different from ascertaining the causal link between the tort and the loss. However Lord Steyn opined that even if a sufficient causal link is shown, there must still be demonstrated that entire loss suffered is a direct consequence of the fraudulently induced transaction.[22] One wonders how "directness" is different from "sufficient causal connexion". Even if they are different in form, it is difficult to see how they are different in substance. It is regrettable that Lord Steyn did not explain why one should go through a dual inquiry when the answer to one will effectively answer the other.

Morals, Risk Placement and Causation

The loss suffered by Smith New Court had two causes: the Roberts fraud which is attributable to the defendants, and the Guerin fraud which has no connexion with the defendants. In making the defendants responsible for the entire loss suffered by the plaintiffs, the court acknowledged that it was placing the pre-existing extraneous risk onto the defendants. Both Lord Steyn and Lord Browne-Wilkinson sought to justify the placement of this extraneous risk on the moral element in the law of tort. Lord Steyn cited Cockburn CJ's dictum in *Twycross* v *Grant* that:

> If a man buys a horse, as a racehorse, on the false representation that it has won some great grace, while in reality it is a horse of very inferior speed, and he pays ten or twenty times as much as the horse

19 See p 1048B, *per* Lord Browne-Wilkinson.

20 P 1077B-F, *per* Lord Steyn. Lord Steyn was not unmindful of the difficulties of formulating a coherent theory of causation. He preferred to resolve the issue of causation in a pragmatic if intuitive fashion.

21 John Cartwright, "Remoteness of Damage in Contract and Tort: A Reconsideration" (1996) 55 CLJ 488.

22 P 1077G.

> is worth, and after the buyer has got the animal home it dies of some latent disease inherent in its system at the time he bought it, he may claim the entire price he gave; the horse was by reason of the latent mischief worthless when he bought it; but if he catches some disease and dies, the buyer cannot claim the entire value of the horse, which he is no longer in a condition to restore, but only the difference between the price he gave and the real value at the time he bought.[23]

He then discussed the justification for distinguishing between deceit and negligence. In doing so, he affirmed the deterrent purpose of remedies for deceit and the role of morality in the law of torts. One may therefore infer that the placement of the pre-existing extraneous risk on the defendants is borne out of moral considerations. This risk is placed on the defendants because the law wishes to show its disapproval of the defendant's conduct and seeks to deter such conduct by punishing the tortfeasor with the consequences of this pre-existing extraneous risk.

This explains the repudiation of Hobhouse LJ's qualification on the *Doyle* v *Olby* measure in *Downs* v *Chappell*. Hobhouse LJ's approach was to ask the following question after ascertaining the losses directly flowing from the fraud: "whether the loss can properly be treated as having been caused by the defendants' torts, notwithstanding that the tort caused the plaintiffs to enter into the transaction."[24] In other words, before the final determination of the damages payable, the court would compare the losses consequent to entering into the transaction with the position had the state of affairs represented been true; the aim of this exercise was to "test the acceptability of the factual conclusion that the assessed consequential loss was truly consequential upon the fault for which the other party is liable."[25] Hobhouse LJ's qualification finds its motivation in limiting the damages payable by the defendant to that attributable to his contribution to the diminution in the value of the assets.[26] It attempts to draw the link between the wrongdoer and his contribution to the loss in value. However, this can result in the inequity similar to the date of transaction rule; the loss attributable to the pre-existing risk is thrust upon the victim. To address the concern that it is the deceit that locks the victim into the flawed asset,

[23] (1877) 2 CPD 469 at 544-545 (CA).

[24] *Downs* v *Chappell* [1996] 3 All ER 344 at 361H (CA).

[25] *Ibid,* p 362C.

[26] Hobhouse LJ's qualification was prompted by a submission made on behalf of the tortfeasor that if the victim were to be compensated for the fall in value of the asset, they would be compensated for a loss which they would have suffered even if the defendants had not been at fault: *supra*, note 24, at 361J.

Hobhouse LJ attempted to widen the causation test to take this into account. Because of this, the nature of his qualification gets confusingly convoluted.

The House of Lords disapproved of Hobhouse LJ's qualification.[27] The risk of pre-existing defects – albeit an extraneous one not created by the defendant – is cast upon the defendant. It is not a factual causation question. Rather it is a question of legal policy motivated by the moral dimension of the law of torts and the deterrent purpose it serves.

While the House of Lords does clear the air with regards to pre-existing extraneous risks, it provides less guidance for post-transaction risks. Lord Steyn's quotation of the above passage from *Twycross* v *Grant* appears to suggest that post-transaction risks should be borne by the victim – at least those unconnected with original content of the deceit. If that is the correct position, the placement of pre-existing risks will be determined by the moral consideration whereas the placement of post-transaction risks will be determined by the test of causation. In this regard, mention must be made of the House of Lords decision in *Banque Bruxelles SA* v *Eagle Star Insurance Co.*[28] The plaintiff-lenders were misled by the defendant-valuers' negligent valuation to lend money on insufficient security; when the market fell and the borrowers defaulted, the plaintiffs sought to make the defendants liable for the difference between the amount disbursed and the amount recovered. Lord Hoffman, delivering the judgment of the House, held that the loss recoverable must be attributable to the wrongful act; thus the plaintiffs were only entitled to claim for the losses attributable to the negligent valuation but not the losses due to the subsequent fall in market value. *Quaere:* might not an argument be made to extend the moral consideration to post-transaction risks? After all, if the deceit is what exposes the victim to the post-transaction risks, might not the defendants be made to bear the post-transaction risks (like market falls) which are reasonably foreseeable? In *Smith New Court*, Lord Browne-Wilkinson (and indeed Lord Steyn) appeared to approve of a generous treatment for consequential losses arising from deceit;[29] it may yet be that losses arising from the fall in market value of the asset may be recovered as consequential losses. In *Banque Bruxelles*, Lord Hoffman though applying a strict loss attribution approach to negligent misstatements, appeared to approve of placing the *whole* risk of loss on the maker of the fraudulent statement.[30] There is no reason why the deterrence rationale should stop short of post-transaction risks. There are therefore some nuances, albeit not entirely clear

[27] P 1075H-1076D *per* Lord Steyn; p 1061B-D *per* Lord Browne-Wilkinson.

[28] *Banque Bruxelles SA* v *Eagle Star* [1996] 3 WLR 87 (HL)

[29] P 1061B and p 1075A-B respectively.

[30] *Supra,* note 28, at 96G.

ones, that losses from a subsequent market fall may be attributed to the maker of the fraudulent statement.

Some Questions for the Future

In reiterating the link between moral considerations and the test of remoteness, the House of Lords also cast doubt on the ruling in *Royscott Trust* v *Rogerson*[31] that damages under section 2(1) of the Misrepresentation Act 1967 are to be calculated as if the misrepresentation were made fraudulently.[32] While it is technically correct to say that the House of Lords did not disapprove of *Royscott Trust* v *Rogerson*, they were plainly open to reconsider the issue at the appropriate occasion. One should therefore treat the present interpretation of section 2(1) more tentatively.

Lord Browne-Wilkinson also indicated his inclination to reopen the question of whether the subsequent sale of shares bought under a rescissible contract bars the rescission.[33] Shares are after all no more than a bundle of rights *vis-à-vis* the company; they are fungible assets.[34] Restitution should not be barred just because the shares originally bought have been sold. Replacement shares can be bought and returned. Future litigants should take to heart Lord Browne-Wilkinson's invitation to reconsider the question.

Endnote

In repudiating the mechanical application of the date of transaction rule, the House of Lords in *Smith New Court* has returned to the fundamental principles governing the assessment of tortious damages. The inquiry should be directed at securing just and adequate compensation for the victim's losses. The present approach of the House shows that the limiting principles of remoteness and causation should be applied in a discerning and common sensical manner.

The explicit embracement of the role of morality in compensation helps explain many rules: the use of directness rather than reasonable foreseeability as the test of remoteness, the placement on the defendant of pre-existing risks not created by him, the merits of Hobhouse LJ's qualification to *Doyle* v *Olby* in *Downs* v *Chappell*. It also points the way to a future reconsideration of the present interpretation of section 2(1) of the Misrepresentation Act. If a similarly discerning and principled approach is adopted in construing

31 [1991] 2 QB 297.
32 See especially Lord Steyn at p 1075F-G.
33 P 1056F-G.
34 *Hunter* v *Moss* [1994] 1 WLR 452 (CA).

Section 2(1), one would eschew the present mechanical linguistic oriented approach in favour of one more in tune with the rationale for the different remoteness tests.

Some questions are left unanswered by the House of Lords in *Smith New Court*. However the pragmatic yet principled manner in which the House has tackled the issues raised before it does certainly go a long way toward illuminating the answers to these questions.

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