Fountain Court
CHAMBERS

Recent reflections of the Supreme Court on Reflective Loss

27 JULY 2020

On 15 July 2020, the Supreme Court handed down its landmark judgment in *Sevilleja v Marex Financial Ltd* providing much needed clarification as to the narrow scope of the principle of "reflective loss".

The Facts

Mr Sevilleja owned and controlled two companies incorporated in the BVI. The appellant, Marex Financial Ltd ('Marex'), brought proceedings against the Companies for sums due under a contract and obtained judgment for $5.5 million plus costs of £1.65 million. After the confidential draft judgment had been provided to the parties, Mr Sevilleja allegedly procured the transfer of over $9.5 million from the Companies' accounts into his personal control with the result (Marex alleged, intended) that the judgment debt and costs would not be paid. Subsequently the Companies entered liquidation. Other than Marex, the creditors were connected with Mr Sevilleja. The liquidator had taken no action to recover the monies from Mr Sevilleja.

Marex sought damages from Mr Sevilleja in tort for: (1) inducing or procuring violation of Marex's rights under the Commercial Court judgment; and (2) intentionally causing Marex to suffer loss by unlawful means. Mr Sevilleja contended that the claims were precluded by the "reflective loss" principle. The Court of Appeal agreed as regards the majority of Marex's claims.

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Call Date: 1989
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The Reflective Loss Principle

It is not uncommon for concurrent claims to arise where A and B suffer loss as a result of the conduct of a third party, C. In principle, if C has breached his obligations owed to each of A and B, then both A and B are at liberty to sue C and to be compensated by him. Is the position any different where A is a company?

The reflective loss principle has its judicial origins in the decision in *Prudential Assurance Co Ltd v Newman Industries Ltd (No. 3)* [1982] Ch 204 which decided that a shareholder cannot bring a claim in respect of a diminution in the value of his shareholding, or a reduction in the distributions which he receives by virtue of his shareholding, which is merely the result of a loss suffered by the company in consequence of a wrong done to the company by the defendant (frequently a director). That is so even if the defendant's conduct also involved the commission of a wrong against the shareholder. Where it applies, the shareholder's claim is excluded even if the company does not bring proceedings itself.

In *Johnson v Gore Wood & Co* [2002] 2 AC 1, the House of Lords considered the reflective loss principle. Its approach led to an extension in the application and effect of the reflective loss principle. Lord Millett in particular advanced justifications for the exclusion of a shareholder's claim whenever the company had a concurrent claim available to it. The application of the principle reached its highpoint in the Court of Appeal in *Sevilleja v Marex* which concluded that the reflective loss principle precluded a claim by Marex, an ordinary unsecured creditor which held no shares in the Companies at all.

The Supreme Court was invited to clarify and if necessary depart from the approach adopted in *Johnson* and to overrule later authorities. A seven-member court was convened, underlining the importance of the decision.

The Majority

Lord Reed (with whom Lady Black, Lord Lloyd-Jones and Lord Hodge agreed) concluded that *Prudential* laid down a rule that where a company suffers actionable loss, and that loss results in a fall in the value of its shares (or in its distributions), the fall in share value (or distributions) is not a loss which the law recognises as being separate and distinct from the loss sustained by the company. As such it does not give rise to an independent claim to damages on the part of the shareholders. Further, the company's failure to recover its loss from the wrongdoer, or in settling for a lesser sum than the full value of the claim is irrelevant: the failure of the company to pursue its claim could not entitle a shareholder to recover the company's loss for itself.

Fundamental to the analysis is an understanding of the nature of a share. It is not a proportionate part of the Company's assets: it confers a right of participation in the company, in accordance with the articles of association. Where a company suffers a loss it may affect its ability to make distributions, and the value of the shares but that will not inevitably be the case. Other market forces may come into play. The correlation is not a necessary one, or exact.

To permit a shareholder a personal action

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would subvert the rule in *Foss v Harbottle*: First, the proper plaintiff in an action respect of a wrong alleged to have been done to a company is the company itself, and secondly, when a shareholder invests in a company, he accepts the fact that the value of his investment follows the fortunes of the company and that he can only exercise his influence by the exercise of his voting rights. A minority shareholder has other remedies available to him if the company’s management is acting improperly in not pursuing the company’s rights, including a derivative action and unfair prejudice proceedings.

Lord Reed observed that the reflective loss principle as explained in *Prudential*, and properly understood, had no application to losses suffered by a shareholder which were separate and distinct from the company’s loss. Such claims should not be excluded.

Lord Reed noted that the decision in *Johnson v Gore Wood* underpins much of the expansion of the principle of “reflective loss” as applied in later case law. In that case, Lord Bingham summarised three principles: (1) Where a company suffered loss caused by a breach of duty owed to it, only the company may sue in respect of that loss; (2) Where a company suffers loss but has no cause of action to sue to recover that loss, a shareholder in the company may sue in respect of it (if the shareholder has a cause of action to do so) even though his loss is a diminution in the value of the shareholding; and (3) Where a company suffers loss caused by a breach of duty to it, and a shareholder suffers a loss (caused by breach of a duty independently owed to the shareholder) which is separate and distinct from that suffered by the company, 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. Lord Reed considered these principles to be consistent with *Prudential*.

Lord Reed considered that Lord Millett’s judgment proceeded on the basis of a false assumption: that a diminution in the value of the company’s net assets would necessarily be reflected in the value of the shares. Lord Millett had concluded that the problem which arose was the risk of double recovery on the one hand, or a risk to the company’s creditors through the depletion of its assets on the other, and that justice required that it is the company which is allowed to recover to the exclusion of the shareholder. Lord Reed identified a number of difficulties with Lord Millett’s approach. The most obvious difficulty with the avoidance of double recovery as the justification for the decision in *Prudential* was its unrealistic assumption that there is a universal and necessary relationship between changes in a company’s net asset value and changes in its share value when there is not. It also does not explain why the rule precludes a shareholder from bringing proceedings where the company declines to do so or settles so that there is no risk of double recovery. He viewed the most serious difficulty as being that the possibility of double recovery can arise wherever concurrent clams exist at the instance of companies, and of persons who suffer loss other than as shareholders.

Lord Millett's judgment has underpinned the extension of the reflective loss principle: (1) beyond shareholders; and (2) to all other payments which a shareholder might have obtained from the company if it had not been deprived of its funds: *" … even if the plaintiff would have received them qua employee and not qua shareholder and even if he would have had a legal claim to be paid. His loss is still an indirect and reflective loss which is included in the company's claim"*.

Lord Reed concluded that Lord Bingham's judgment was the only judgment that was consistent with the reasoning in *Prudential*: the remainder should not be followed, and Lord Millett went too far.

Lord Reed went on to consider later decisions. In his view, the limited exception in *Giles v Rhind* (which permitted a shareholder to pursue a claim where the wrongdoer has made it impossible for the company to pursue its remedy) does not exist: *"The basis of the decisions in Prudential and Johnson is that a shareholder whose shares have fallen in value as the consequence of loss suffered by the company for the recovery of which it has a cause of action, has not suffered a recoverable loss. … If the shareholder has not suffered a recoverable loss, he has no claim for damages, regardless of whether, or why, the company may have failed to pursue its own cause of action."* Lord Reed concluded that the claim brought by a creditor who also happened to be a shareholder in *Gardner v Parker* did not fall within the proper scope of *Prudential* and ought not to have been barred.

Lord Reed reviewed the cases since *Gardner v Parker* which had treated the "reflective loss" principle as being based primarily on the avoidance of double recovery and the protection of a company's unsecured creditors, and as being applicable in all situations where there are concurrent claims and one of the claimant's is a company. He considered the views of academics who regarded the principle as threatening to distort large areas of the ordinary law of obligations.

Lord Reed considered that it is necessary to distinguish between: (1) cases where claims are brought by a shareholder in respect of loss which he has suffered in that capacity in the form of a diminution in share value or distributions, as a consequence of loss sustained by the company and in respect of which the company has a cause of action against the same wrongdoer; and (2) cases where claims are brought, whether by a shareholder or by anyone else, in respect of loss which does not fall within that description, but where the company has a right of action in respect of substantially the same loss.

In cases of the first kind, only the company has a cause of action. If the recovery by the company of its loss will restore the value of the shares, the only remedy is an award of damages to the company. In circumstances where the company's right of action is insufficient to ensure the value of shares is fully replenished, or the company does not pursue its rights, the answer is that the shareholder has entrusted the affairs of the company to its management team. The critical point is that the shareholder has not suffered a loss which is regarded in law as being separate and distinct from the company's loss, and he has no claim to recover it. If a decision is taken by the Board other than in the proper exercise of the relevant powers, the shareholder has a number of remedies provided by law such as a derivative action or an unfair prejudice petition.

In cases falling within the second category, there is nothing to prevent a creditor pursuing a claim. A creditor's relationship with the company is not analogous with that of a shareholder and there is no conflict with the rule in *Foss v Harbottle*. There may be a risk of double recovery, but that does not necessarily mean that the company's claim must be given priority.

In conclusion, Lord Reed confined the application of the rule in *Prudential* to *"claims by shareholders that, as a result of actionable loss suffered by their company, the value of shares, or of the distributions they receive as shareholders, has been diminished. Other claims, whether by shareholders or anyone else, should be dealt with in the ordinary way"*.

Lord Hodge regarded the articulation of the rule in the *Prudential* case (properly understood) as *"a principled development of company law which should be maintained"*.

The Minority

Lord Sales (with whom Lady Hale and Lord Kitchin agreed) adopted a rather more radical approach. Whilst reaching the same conclusion his analysis was fundamentally different. In contrast to the majority, he considered that the issue of double recovery is of fundamental importance in relation to shareholder claims. In his view, the loss suffered by a shareholder is manifestly not the same as the loss suffered by the company: there is no necessary direct correlation between the two, and the use of the term "reflects" is "deceptive". A shareholder ought not to be prevented from pursuing a valid personal cause of action. Any risk of double recovery can be managed by effective case management. Whilst accepting that the imposition of the *"bright line"* favoured by the majority would eliminate the need for debate about the interaction of the company's cause of action and shareholder's action, he considered that the rule would *"produce simplicity at the cost of working serious injustice in relation to a shareholder who (apart from the rule) has a good cause of action and has suffered loss which is real and is different from any loss suffered by the company"*.

Comment

It is not every day that a redline is scored through a raft of previously binding authority on such a fundamental principle. The clarification provided by the Supreme Court was much needed and has returned the reflective loss principle to the narrow bounds envisaged in *Prudential*. The reflective loss principle has no application to creditor's claims. Shareholders whose claims for loss can be framed as other than for diminution of share value or distributions consequential on the company's loss, and separate and distinct from that of the company will not be precluded by the principle from pursuing their claims. The prospect of becoming embroiled in prolonged and expensive, satellite strike-out litigation as to the applicability of the reflective loss principle has receded. Commercial certainty (and common-sense) has been restored.

If you have any enquiries, please contact our clerking team.

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Bridget is a "team player and experienced advocate" who applies a commercial, common sense approach. She has a broad commercial/chancery practice and specialises in civil fraud, company and insolvency law. She appears for individuals, corporations and officeholders, and is regularly retained in cases involving serious allegations of misconduct including breach of fiduciary duty, wrongful and fraudulent trading claims, and disqualification cases. She frequently appears in unfair prejudice proceedings and boardroom, joint venture and LLP disputes. She acts on breach of warranty and misrepresentation claims arising out of business purchases and investments.

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