UK Supreme Court Issues Landmark Ruling on the Principle of Reflective Loss

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Not often do English judges liken a question of law to a "*ghastly legal Japanese knotweed*", but Lord Reed PSC said just that when handing down judgment in *Sevilleja v Marex Financial Ltd.*[1] The knotweed in question is the "reflective loss" principle and, in a case which Lord Reed said "*raises one of the most important and difficult questions of law to come before the Supreme Court for some time*", the UK Supreme Court has overruled a number of recent decisions and brought some much-needed clarity to the law. Whether this judgment is a complete solution, however, remains uncertain.

Overview

The English law "rule against reflective loss" states that shareholders cannot bring a claim for damages merely because the company in which they hold shares has suffered damage. In particular, they cannot claim for a diminution in the market value of their shares, or a diminution in distributions they receive from the company, because such diminutions are merely a "reflection" of the loss suffered by the company. Instead, the company is the proper claimant for that loss.

The principle, while superficially straightforward, has caused significant difficulties for shareholders trying to recover damages from wrongdoers where the company in which they hold shares has a claim relating to the same loss, even where the company has not itself brought any claims against the wrongdoer. In recent years, the principle has also been expanded to broad categories of claims, including claims by creditors who are also shareholders and, most controversially, by creditors who are not shareholders in the company at all.

In *Sevilleja (Respondent) v Marex Financial Ltd* [2020] UKSC 31 the UK Supreme Court has unanimously rejected and over-ruled this expansion. It has confirmed that the reflective loss principle has no application at all to claims brought by creditors of a company, irrespective of whether they are also shareholders in that company.

[1] [2020] UKSC 31.

However, there was no consensus as to how far the principle should be limited. The majority judgment, led by Lord Reed, held that the principle retains a place in the law, but confined it to cases where the value of shareholders' shares, or of distributions they might receive as shareholders, is reduced because of actionable loss suffered by their companies. The minority, however, led by Lord Sales, went further and concluded that the rule is unprincipled and ought to be rejected entirely. Although the majority's decision prevails, the strength of the minority judgment may indicate that this decision will not be the last word on this important topic.

Background

Facts

Marex Financial Limited ("**Marex**") obtained a judgment from the English court against two companies incorporated in the in the British Virgin Islands owned by Mr Sevilleja. Between the judgment being provided in draft to the parties and the judgment being officially handed down, Mr Sevilleja removed some US$ 9.5 million from the companies into his personal control. The companies are now in liquidation.

In 2016, Marex obtained permission to serve further proceedings outside of the jurisdiction on Mr Sevilleja. Marex claims that Mr Sevilleja: (i) induced or procured the violation of Marex's rights under the English judgment debt, and (ii) intentionally caused Marex to suffer loss by unlawful means, by procuring the companies, in breach of his duties as director, to transfer their assets to his personal control and so frustrate the judgment debt.

Mr Sevilleja challenged the jurisdiction of the English courts. He contended, amongst other things, that the rule against the recovery of reflective loss barred Marex's claim, because the damages Marex claimed to have suffered were ultimately a complaint about a diminution in the assets of the companies, and so merely a reflection of the losses that had been suffered by the companies themselves.

Decisions in the Courts Below

Mr Sevilleja's application to challenge jurisdiction was rejected at first instance by Knowles J., who doubted that the reflective loss rule had any application to creditors who were not shareholders of the relevant company, and said that he was satisfied that Marex had demonstrated a "*good arguable case*" that its claim was not precluded by the reflective loss principle.

The Court of Appeal granted Mr Sevilleja's appeal. Lewison, Lindblom and Flaux LJJ held that the reflective loss principle applied to claims by any unsecured creditors of a company where the loss claimed was a reflection of a loss suffered by the company

as a consequence of wrongdoing by the defendant. In *Gardner v Parker*[2] the Court of Appeal had previously determined that the reflective loss rule would prevent a creditor from making a claim against a wrongdoer with respect to the creditor's inability to recover a debt owed to it by a company in which the creditor was also a shareholder. However, in *Marex*, the Court of Appeal went further: "*As a matter of logic and principle, it is difficult to see why a claim by a creditor who has one share in a company should be barred by the rule against reflective loss whereas a claim by a creditor who is not a shareholder is not*".[3] For the first time, the Court of Appeal therefore said that the reflective loss principle could apply to a claimant who was purely a creditor of a company.

On that basis, the Court of Appeal found that Marex's claim to recover damages from Mr Sevilleja equivalent to the amount of the judgment debt against the companies, plus interests and costs, was legally barred. Only the portion of Marex's claim against Mr Sevilleja that related to the costs incurred in trying to enforce the judgment debt in various jurisdictions, which was not reflective of the companies' loss, could continue.

The Supreme Court Judgment

The Supreme Court unanimously allowed Marex's appeal from the decision of the Court of Appeal. It held that Marex is not subject to the reflective loss principle, which only applies to certain claims made by shareholders. The Supreme Court was split, however, on the justification for the reflective loss principle, and whether it should remain at all.

The Majority

Since its exposition in 1981 in *Prudential Assurance Co v Newman Industries (No. 2)*,[4] the reflective loss principle has expanded in scope. It started life by barring claims by shareholders for diminution in the value of their shares, or other distributions shareholders might receive in that capacity, as a result of actionable wrongs against companies in which they are shareholders. Subsequently, it was expanded to cover claims brought by creditors who were also shareholders (even when claiming in their capacity as creditors). At its broadest, it extended (according to the Court of Appeal in *Marex*) to claims by non-shareholder creditors.

The Supreme Court found that this expansion was unjustified; that the reflective loss principle had "*broken from its moorings in company law*".[5]

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[2] [2004] EWCA Civ 781.

[3] [2019] QB 173 [33].

[4] [1982] Ch 204 (CA).

[5] *Marex*, Lord Hodge, [95].

Speaking for the majority, Lord Reed identified Lord Millett's judgment in *Johnson v Gore Wood & Co*[6] as the beginning of the divergence. Lord Millett had justified the reflective loss rule largely on two bases: (i) the need to avoid double recovery, that is, a defendant being liable twice for the same loss, to claims from both the company and a shareholder; and (ii) the need to ensure that shareholders in a company are not able to circumvent the company and take its assets for themselves, to the detriment of its creditors. Subsequent cases, reasoning from these two justifications, had greatly expanded the scope of the reflective loss rule.

However, the majority in *Marex* considered that this approach was misconceived. Referring to the judgments given in *Prudential*, and to the speech of Lord Bingham in *Johnson v Gore Wood*, Lord Reed rejected the notion that the foundation of the reflective loss rule was the need to avoid double recovery. Double recovery was an issue to which the courts needed to be alive, but it could be addressed through a number of procedural or substantive means without resorting to reflective loss.

Instead, Lord Reed said that the basis for the reflective loss principle is that, where a shareholder has suffered a diminution in the value of its shares, or a reduction in the amount of distributions that it receives from the company, as a result of actionable damage caused to the company by a wrongdoer, English law does not recognise that the shareholder has suffered a loss that is separate and distinct from the loss suffered by the company itself.

Since in such case the shareholder has not suffered a loss, it follows that it cannot bring any claim against the wrongdoer in its own right. Under the rule in *Foss v Harbottle*,[7] the only proper claimant who may recover such loss is the company itself. If the company refuses to bring a claim with respect to the loss, then the shareholder cannot claim for the loss itself, but it may instead have rights under the usual company law protections: a majority of shareholders can usually force the company to act by passing an appropriate resolution at a general meeting; a minority shareholder may be able to bring a derivative action, apply for relief against unfair prejudice, or potentially apply for a winding up on the just and equitable ground.

Accordingly, the majority held the speech of Lord Millett in *Johnson v Gore Wood* should not be followed.[8] Subsequent cases which had relied upon this reasoning were held to be wrongly decided, including expressly *Giles v Rhind*,[9] *Perry v Day*[10] and *Gardner v Parker*.[11]

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6 [2002] 2 AC 1.

7 (1834) 2 Hare 461.

8 Lord Reed at [89].

9 [2003] Ch 618 (CA).

10 [2004] EWHC 3372 (Ch).

11 [2004] EWCA Civ 781.

The majority therefore concluded that the reflective loss principle is of limited application. It will apply only to prevent a shareholder in a company from claiming in respect of a diminution in the value of its shares, or a diminution in distributions it would otherwise receive from the company, where such diminution results from a wrong done to the company in respect of which the company can bring its own claim. In such case, English law will not regard the shareholder as having itself incurred any loss, and therefore the only legitimate claimant will be the company.

Lord Reed concluded that in all other cases, where a claim is brought by a shareholder or anyone else for any other types of losses, the reflective loss rule will not apply. This is so even "*where the company has a right of action in respect of substantially the same loss*".[12] Where this means that multiple parties may have claims in respect of the same loss, the amount of damages recoverable by each of them may need to be reduced to prevent double recovery against the defendant,[13] but that is not a bar on bringing a claim.

The Minority

The minority (Lord Sales, Lady Hale and Lord Kitchen) took a more radical approach, stating that they would have, in effect, abolished the reflective loss principle entirely.[14] Speaking for the minority, Lord Sales said that none of the policy considerations previously advanced in support of the reflective loss principle justified the existence of a general rule which effectively frustrated shareholders' claims.[15] He said that the "bright line" rule supported by the majority 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*".[16]

Instead, the minority considered that if shareholders have a cause of action against a wrongdoer, they should be free to claim for whatever losses they have suffered, including the diminution in the vale of their shares or reductions in distributions. Emphasising that the English courts are familiar with working through complex and overlapping claims to reach pragmatic conclusions, the minority said that any concerns about double recovery against a wrongdoer could be dealt with by judges on the facts with the assistance of procedural tools and expert evidence where necessary.[17]

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12 Ibid.
13 *Marex*, Lord Reed, from [84] – [88].
14 *Marex*, Lord Sales [194] – [197].
15 *Marex*, Lord Sales [186].
16 *Marex*, Lord Sales [167].
17 Ibid.

Comment

The Supreme Court's long-awaited decision has brought welcome clarity to a difficult area of English law. It has reverted to the principles expounded in *Prudential* nearly 40 years ago, over-ruled many more recent decisions which had expanded and complicated the reflective loss rule, and confirmed that it only applies to a narrow category of claims. However, it remains to be seen how readily claims by shareholders to recover for diminutions in the value of their shares or reductions in distributions can be distinguished from other claims in practice, and what further rules will need to be developed by the courts to avoid the risks of double recovery that the Supreme Court was unanimous in highlighting.

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Should you wish to ask any questions regarding this bulletin or the principles it discusses, please feel free to contact any of the authors below.

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