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The UK Supreme Court Seeks to Clarify the Reflective Loss Principle (or Whose Claim is it Anyway?)

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Express Summary

What is the reflective loss principle?

- The English law principle of reflective loss traditionally held that when a company suffered loss as a consequence of the actions of a third party, the loss suffered by its shareholders - by way of diminution in value of their shareholding and/or distributions - constituted 'reflective loss' only, and is not damage which is separate and distinct from that suffered by the company. The principle has therefore generally prevented claims by shareholders to recover such loss directly.
- Over several decades, various extensions to, and observations in relation to, the principle have caused uncertainty regarding whether the principle operates to prevent claims by shareholders claiming in their capacity as creditors, and even creditors claiming as creditors. In Section 2 of this article, we examine the relevant case law in more detail.

What has changed now?

- In *Sevilleja v Marex*, the Supreme Court made clear that the principle of reflective loss does not prevent company creditors from making claims against third parties for causing loss to the debtor company. In so doing, the Court sought to restrict the principle to its company law origins.
- However, a minority of the seven-member panel of the Supreme Court went even further, and questioned whether the operation of the principle as a 'bright-line rule' had ever been correct as a matter of law.
- In Sections 3, 4, and 5, we explain the circumstances of the case, and look at the reasoning of both the majority and the minority of the Court.

Who does this affect?

- This decision affects a range of stakeholders, including potential claimants (the class of which has now widened), and potential defendants, including company directors (who may now be susceptible to claims from a wider class of potential claimants).
- In Section 6, we consider the legal and practical implications of this judgment for (i) company creditors; (ii) shareholders; (iii) potential defendants (i.e. parties alleged to have caused damage to companies); (iv) insurers; and (v) litigation funders.

1. Introduction

On 15 July 2020, an expanded seven-member panel of the UK Supreme Court handed down judgment in *Sevilleja v Marex Financial Ltd [2020] UKSC 31*. In so doing, the Court pulled back the principle of reflective loss whose shadow had been growing across English company law for decades. The principle of reflective loss traditionally held that when a company suffers loss as a consequence of the actions of a third party, the loss suffered by shareholders - by way of diminution in value of their shareholding and/or distributions - constitutes 'reflective loss' only, and is not damage which is separate and distinct from that suffered by the company. The principle has in the past barred claims by shareholders against those third parties causing damage.

The principle of reflective loss had been said to extend so far as to bar some claims against third parties by (non-shareholding) creditors of a company. Although that was the view of the Court of Appeal in *Sevilleja v Marex*, the Supreme Court made clear that the principle does not in fact extend that far.

In this article, we will examine the principle of reflective loss and its evolution through case law. This principle, how it has developed, and where it currently stands, is of real significance to a variety of corporate stakeholders, including creditors, shareholders and company directors, so we will also consider what impact this decision will have for each of them.

2. Evolution of the reflective loss principle

The roots of the rule on reflective loss can be found in the company law case of *Foss v Harbottle* (1843) 2 Hare 461. In that case it was held that where a wrong is inflicted on a company, the proper claimant in a case seeking compensation for that wrong is (with few exceptions) the company itself. The case specifically concerned shareholders attempting to claim for the *company's* loss on behalf of the company, and did not consider whether a shareholder with his or her own cause of action would be able to bring a claim on their own account.

The first formulation of the rule on reflective loss specifically then appears to have emerged in *Prudential Assurance v Newman Industries (No. 2)* [1982] 1 Ch 204. In that case, Prudential brought a claim against the directors of a company in which it held shares, alleging that the directors had made a fraudulent misrepresentation to the shareholders, causing the company to buy assets at an overvalue. Prudential brought both a personal action and an action on behalf of the company (i.e. a derivative action). The Court barred Prudential's personal claim on the basis that a shareholder could not recover damages "*merely because the company in which he is interested has suffered damage…[his] loss is merely a reflection of the loss suffered by the company.*"

In particular, the Court in *Prudential* employed a metaphor of a company whose sole asset is a cash box containing £100,000. It posited a scenario where one shareholder, who holds the key of the cash box, holds 99 of 100 shares in the company. A third party persuades the shareholder to part with the key, and then robs the company of all its money. The Court held that, in this hypothetical situation, although there were two wrongs (the deceit and the robbery), the shareholder would not suffer a loss which is "*separate and distinct*" from the loss of the company. Rather, the shareholder continues to hold the shares "*as his own absolutely unencumbered property*", and only suffers loss "*through the company*".

Prudential was considered by the House of Lords in *Johnson v Gore Wood & Co* [2002] 2 AC 1, in which Lord Bingham set out the principles of reflective loss in the leading judgment. The case concerned a majority shareholder who sued a firm of solicitors for negligently advising the company in which he held shares. However, it is the speech of Lord Millett in that case which "*lies at the origin of the expansion of the supposed "reflective loss" principle in the subsequent case law*" (per Lord Reed in *Marex*). In this speech, Lord Millett argued that the principle extends to all payments which shareholders might have received from the company if it had not suffered loss, including those payments to a shareholder *qua* employee, for instance.

At this stage, the uncertainty surrounding the principle led Arden LJ in *Johnson v Gore Wood (No 2)* [2003] EWCA Civ 1728 to lament "*it is to be hoped that the current will o' the wisp character of the no reflective loss principle will be clarified before long.*"

A series of cases after *Johnson* upheld the existence of the rule (albeit that various exceptions to the rule were established for circumstances where the company did not have, or was not able to or did not pursue, a right of action against the wrongdoer). These cases included *Giles v Rhind* [2002] EWCA Civ 1428, *Perry v Day* [2004] EWHC 3372 (Ch), and *Gardner v Parker* [2004] EWCA Civ 781. In particular, *Gardner* pushed the boundaries of the principle further than ever. In this case, Neuberger LJ noted that it was "*hard to see why the [reflective loss principle] should not apply to a claim brought by a creditor (or indeed, an employee) of the company concerned, even if he is not a shareholder*". That observation was tested in *Sevilleja v Marex*.

3. *Sevilleja v Marex Financial Ltd*: the decision

Marex Financial Ltd ("**Marex**") secured a judgment against two companies owned and controlled by the respondent and prospective defendant, Mr. Sevilleja. The claims were for sums due under a contract. Marex alleged that, while that judgment was still in draft form (and after it had been provided to the parties on confidential terms in advance of it being handed down), Mr. Sevilleja caused the companies to transfer over USD 9.5 million into his personal control, with the result that the companies could not satisfy the judgment debt to Marex. With the companies in liquidation, Marex sought to bring a claim against Mr. Sevilleja in tort for (i) inducing or procuring the violation of its rights under the judgment, and (ii) intentionally causing it to suffer loss by unlawful means. In an application by Marex to serve the claim form out of the jurisdiction on Mr. Sevilleja, the judge at first instance held that Marex had a good arguable case against Mr. Sevilleja and that Marex's claims were not barred by the reflective loss principle. However, the Court of Appeal overturned that judgment, holding that "*[t]he artificial distinction between shareholder creditors and non-shareholder creditors is anomalous*" and that the reflective loss rule should apply to all creditors, regardless of whether they were also shareholders. The Court of Appeal held that 90% of Marex's claim was barred by the reflective loss principle. A seven-member panel (an increase to the usual five-member panel) was subsequently constituted to hear Marex's appeal in the Supreme Court.

The Supreme Court unanimously allowed the appeal and accepted that the reflective loss principle does not apply to the creditors of a company, and that Marex's claims, therefore, were not barred by the reflective loss principle. However, although the panel unanimously upheld Marex's appeal, there was material disagreement between the Justices as to the proper formulation and scope of the reflective loss principle in respect of claims by shareholders, as opposed to creditors. The leading (and majority) judgment was given by Lord Reed, with whom Lady Black and Lord Lloyd-Jones agreed. Lord Hodge gave a separate judgment agreeing with the reasoning of Lord Reed, but with additional observations. Lord Sales delivered a separate judgment, with which Lady Hale and Lord Kitchin agreed.

4. Reasoning of the majority

Lord Reed's judgment, with which Lady Black, Lord Lloyd-Jones, and Lord Hodge agreed, was premised on reflective loss existing as a rule of company law, as laid down in *Prudential*. The majority held that the reduction in value of either (i) a shareholding or (ii) distributions received by virtue of that shareholding, which is the result of damage suffered by the company in consequence of a wrong done to it by a third party, is not considered by the law to be damage which is separate and distinct from the damage suffered by the company. The loss sustained by the shareholder in such circumstances is therefore not recoverable. Lord Reed distinguished this formulation of the reflective loss principle from other formulations which had (in his view, wrongly) sought to bar a wider variety of claims, including claims by both shareholders and other parties where the company had a right of action in respect of substantially the same loss as the claimant. In essence, Lord Reed sought to narrow the limits of the reflective loss principle in contrast to the high watermark which had been previously posited in cases such as *Johnson* and *Gardner.*

5. Reasoning of the minority

Lord Sales' judgment, with which Lady Hale and Lord Kitchin agreed, questioned the very foundations of the principle of reflective loss. Lord Sales' view was that even in cases where a shareholder suffers loss as a result of a wrong done to the company through a diminution in the value of their shareholding, such loss is often factually distinct from the loss suffered by the company. He argued that none of the various justifications which have been invoked to rationalise the principle—including avoidance of double recovery, causation issues, and policy considerations—can justify the 'bright-line rule' of reflective loss, which conceptually subordinates the shareholder's own claim below that of the company. On this view, it should instead be a question of fact in each case, taking into account the value to the company of the cause of action accruing to it, as to whether the shareholder has indeed suffered a loss which is distinct from the loss suffered by the company.

6. Implications for stakeholders

Despite the Supreme Court's attempt to clarify the principles governing the reflective loss principle, given the divergent views amongst the Justices concerning the proper conceptual formulation of the principle, the level of clarity that parties will obtain in practice from the judgment remains to be seen.

In this section, we consider the potential effect of the *Marex* judgment on different types of corporate stakeholders who may be affected by wrongful acts perpetrated against companies.

(i) <u>Company creditors</u>

Non-shareholding creditors appear to be the clearest winners under this judgment. Although the Justices may have disagreed about the conceptual formulation of the reflective loss principle, both the majority and the minority were in agreement that the reflective loss principle did not prevent claims being brought by a creditor of a company. It is clear, therefore, that the principle of reflective loss (however it is to be conceptualised) does not bar claimants with purely a debt interest in a company from pursuing their own cause of action (if they have one) against a party who has caused loss to the company. The judgment will therefore be of interest to, for example, corporate lenders. It will, however, be even more important for creditors to analyse and potentially pursue their litigation options in a timely manner, in case it comes down to a race to judgment against the third party between the creditor and the company.

(ii) Shareholders

The reasoning of the majority affirms that claims by shareholders for a loss in the value of their shareholding, or a reduction in distributions, in each case where these claims arise out of damage caused to the company by a third party, are barred by the reflective loss principle (a position which Lord Sales criticised as a "*crude bright line*"). Shareholders claiming for something other than a diminution in the value of their shareholding (or a reduction in their distributions) will not be barred by the rule. The judgment therefore removes some of the doubt over claims by shareholders *qua* creditors which has existed since at least the *Johnson* case. As a result of the judgment, creditors of a company may become more willing, in some cases, to assume an equity interest in the debtor company. That effect may be particularly important in periods of economic instability, as it removes a potential disincentive for creditors to take part in equity-raisings being conducted by the debtor company.

Even for shareholders claiming *qua* shareholders, although the reasoning of the majority will in most cases prevent their claims in principle, the reasoning of the minority (which promotes a fact-specific approach) may provide useful material in marginal or exceptional cases, particularly in the context of procedural or case management disputes where such parties may be required merely to establish that they have an "*arguable*" case.

(iii) Potential defendants (i.e. parties alleged to have caused damage to companies)

The Supreme Court's confirmation that creditors are not barred from pursuing claims arising out of damage caused to the debtor company by a third party (whether or not such creditors are also shareholders of the company) increases the pool of potential claimants who may seek recompense against the parties alleged to have caused the damage to the company. The potential defendants to such claims are numerous, and may include:

a) directors of the company (particularly where misconduct or breach of duty is alleged against such directors);

b) commercial agents, partners or competitors of the company (for example, where such parties are alleged to have caused losses to the company); and

c) professional service providers (for example, where such parties have caused losses to the company through negligence or professional misconduct).

As noted below, the costs of obtaining insurance for these activities may increase in the event that claims against such parties increase following the *Marex* judgment.

(iv) Insurers

The increased litigation risks for parties acting on behalf of, entering into arrangements with, or providing services to, companies following the *Marex* judgment will have a corresponding effect on those providing insurance for the activities of those parties. For example, as the risks and potential exposure increase, insurance premiums for directors and officers ("D&O") insurance cover, or related cover, may also increase, or insurers may seek to limit the cover available to certain companies' officers.

(v) Litigation funders

With an increase in the pool of potential claimants who may seek recompense for damages suffered by a company through the actions of a third party, litigation funders may now have available to them a greater range of investment options. There may now be a class of untapped, and potentially profitable, cases in which claimants may have previously had doubtful prospects due to the reflective loss principle. Litigation funders will be considering how they can access these potential claimants where, contrary to previous advice they may have received, their claims may no longer be barred.

7. Concluding observations

The Supreme Court in *Marex* sought to clarify the nature and scope of the reflective loss principle. The facts of the case were stark: a United States Court described the alleged actions of the defendant separately as "*the most blatant effort to hinder, delay and defraud a creditor this Court has ever seen*", and absent the Supreme Court determination that the reflective loss principle did not apply to creditors, Marex would have effectively been denied recompense. In the circumstances, the Court unanimously agreed on the result.

Although the Supreme Court clarified the position in relation to claims by creditors, for shareholders the stark differences between the viewpoints of the majority and the minority regarding the conceptual formulation of the reflective loss principle means that some uncertainty remains. In particular, it is possible that shareholders in exceptional or marginal cases seeking to bring claims in respect of damage suffered by the company caused by a third party (whose claims would likely be barred in principle under the majority's reasoning) may seek to deploy the reasoning of the minority to support their ability to bring such claims, particularly in procedural and case management contexts where it may be necessary merely to establish that a case is "*arguable*".

Separately from the findings in respect of the reflective loss principle, the facts of *Marex* provide a reminder of the difficulties which can arise in the period between the circulation of a reserved judgment in draft form and the formal handing down of the judgment. In particular, it provides a reminder of the need to consider whether steps are necessary prior to the circulation of a draft judgment to protect a claimant's ability to satisfactorily enforce any judgment obtained in its favour.

While the focus on this case to date has been on the analysis of the reflective loss principle, overall, the *Marex* judgment has a number of noteworthy legal and practical aspects which are relevant to a wide variety of parties ranging from legal practitioners to stakeholders in companies in whatever capacity. As such, it is likely to have a significant impact on the litigation and corporate landscape in years to come.

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