Creditors Welcome UK Supreme Court's Reflective Loss Decision

By **Robert Fidoe, Jack Moulder and Leah Alpren-Waterman** (September 11)

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On July 15, the U.K. Supreme Court handed down judgment on what it described as "one of the most important and difficult questions of law to come before it in some time" — the scope of the reflective loss principle.

The court unanimously concluded in the case of Sevilleja v. Marex Financial Ltd.[1] that the rule against the recovery of reflective loss, which precludes claims by third parties that merely reflect the loss suffered by a company, should only apply to claims by shareholders of the company based upon diminution in the value of their shares or distributions.

The Supreme Court's decision has brought welcome clarity to the application of the reflective loss principle, strictly confining its scope in a manner that will be welcome news to creditors and other company stakeholders whose claims may have been threatened by the previous formulation of the principle. The decision does, however, also leave certain questions unanswered that the courts may well have to address in the coming years.

The Reflective Loss Principle

It is a long-standing principle of English law, established in Foss v. Harbottle,[2] that where a company has a cause of action, the only person who can seek relief for injury done to the company is the company itself.

That principle was applied in Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No 2),[3] where it was decided that a shareholder could not bring a claim against a third party for a diminution in value of its shareholding or a reduction in the distributions received by virtue of its shareholding which merely reflected the loss suffered by the company as a consequence of wrongdoing by the third party.

Subsequently, in Johnson v. Gore Wood & Co.,[4] Lord Peter Millett commented that a share "represents a proportionate part of the company's net assets, and if these are depleted the diminution in its assets will be reflected in the diminution in the value of the shares." He went on to characterize the principle set out in Prudential as one precluding double recovery by shareholders and the company for the same loss.

This formulation of the principle resulted in a steady expansion of its application to claims by shareholders — as well as to claims by other creditors where they were not based on any share ownership — in a way which one academic commentator likened to "some ghastly legal Japanese knotweed."

The Decision in Marex

In Marex, Justice Robert Reed, with whom the majority of the Supreme Court agreed, departed from the premise of Lord Millett's speech in Johnson v. Gore Wood that a share in a company reflects a proportionate part of the company's net assets. Justice Reed instead observed that a diminution in value of a company's net assets will not necessarily be reflected in the value of its shares.

Justice Reed also disagreed that the avoidance of double recovery was a satisfactory explanation of the rule in Prudential. In his view, the unique position of the shareholder by virtue of the rule in Foss v. Harbottle is a critical part of the explanation. He commented:

> By treating the avoidance of double recovery … as sufficient to justify the decision in Prudential, Lord Millett paved the way for the expansion of the supposed reflective loss principle beyond the narrow ambit of the rule in Prudential.

In Justice Reed's view, those resulting cases had been wrongly decided. He considered that the critical point in Prudential was that the shareholder had not suffered a loss that was regarded by the law as being separate and distinct from the company's loss, and therefore had no cause of action to recover it.

However, where a claim is brought by a creditor, or indeed by a shareholder for something other than a diminution in share value or distributions, Justice Reed considered that the rule in Prudential would not apply since there is no correlation between the company's loss and the creditor's loss.

While acknowledging that the risk of double recovery may arise, Justice Reed considered that the question of how it should be avoided would depend on the circumstances and that the risk of double recovery would not necessarily mean that the company's claim should be given priority.

Justice Philip Sales, with whom two other justices agreed, concurred with this conclusion but for different reasons. In his view, Prudential did not lay down a rule of law that the court deems loss suffered by a shareholder in relation to diminution in share value or loss of dividends to be irrecoverable where a company has a parallel claim against an alleged wrongdoer.

Instead, the question was whether the shareholder had suffered a loss as a matter of fact; while a shareholder's claim for diminution in share value might have some relationship to the losses suffered by the company, Justice Sales did not consider they were the same.

He considered that Justice Reed's bright-line rule gave undue priority to the interests of other shareholders and creditors of the company, and while it might allow for a simple and speedy resolution of disputes, the price to be paid was too high.

Nevertheless, he concluded that even if the reflective loss principle were to be preserved in relation to claims by shareholder claimants, it should not exclude otherwise valid claims made by a creditor of the company.

Having thus concluded that the rule in Prudential uniquely applies to a shareholder in its capacity as a shareholder, the Supreme Court found that Marex's claim — brought on the basis of Marex's position as a creditor of the relevant company — fell outside the rule against recovery of reflective loss.

Implications

The Supreme Court's decision makes clear that the reflective loss principle will only apply to claims by shareholders of a company that has suffered loss, which are based upon diminution in the value of those shareholders' shares or distributions.

As such, the decision has clarified and narrowed the scope of the principle and represents a significant and valuable development in company law.

In the past, aggrieved shareholders have been allowed to pursue claims against third parties for diminution in value of their shareholdings or distributions even where the company itself has been barred from continuing its own claim arising out of the same harm,[5] while other creditors have been prevented from recovering debts owed to them by a company of which they happen to be a shareholder.[6]

As demonstrated in Marex itself, even nonshareholder fraud claimants had previously been faced by reflective loss arguments. The Supreme Court's decision has ruled out raising the rule against recovery of reflective loss as a defense in such circumstances. However, the decision does leave certain questions unanswered which may be further litigated in the years to come:

1. It is now clear that the principle only excludes claims brought by shareholders on the basis of a reduction in the value of their shares or distributions. The precise meaning of "distributions" to shareholders for these purposes is, however, a question for the future. While it seems clear that the rule will apply to dividends, it is less clear how the courts will treat other forms of contingent rewards to which shareholders may be entitled.

For example, in Johnson v. Gore Wood the claimant, being sole shareholder of the company that had suffered loss, sued the defendant for — among other losses — loss of pension contributions which the company would otherwise have made into a pension fund for him. As Lord Thomas Bingham observed in that case, "this claim is merely a reflection of the company's loss." Yet it is unclear whether such losses, on the Supreme Court's formulation of the reflective loss principle in Marex, would still be caught.

2. The rule appears to apply only to current shareholders. It may therefore be that where the value of a shareholder's shares or distributions have been affected by a third party's conduct, the shareholder could simply sell up and then claim against that third party for the crystallized loss that it incurred at the point of sale. It is particularly unclear how the courts might deal with the situation where such a shareholder sells its shares to a corporate entity that the shareholder wholly owns, or to some other affiliated person or entity.

3. There are other types of stakeholder whose interests may resemble those of shareholders very closely. One example, depending on the rights arising under the particular instrument in question, may be noteholders. If the courts are to uphold a bright-line rule that treats shareholders as a distinct class, as the Supreme Court has set out in Marex, it remains to be seen how they will sustain a principled distinction between shareholders and such "quasi-shareholders."

Similarly, the courts might face a claim by a holder of convertible bonds in circumstances where the bondholder's loss reflects the loss in value of the right to exchange those bonds for shares, itself deriving from speculation based on the diminution in share value. On the face of the rule in Marex, such a claim would appear to fall outside the reflective loss principle, despite the bondholder's loss arguably reflecting the value of its prospective shareholding.

4. Further, the Supreme Court left open the question of whether the reflective loss principle is a substantive or a procedural rule. That question is particularly significant in the cross-

border context where the company, shareholder and dispute resolution forum may each be in different jurisdictions and substantive and procedural questions may be determined according to different legal systems.

5. Finally, though the Supreme Court was unanimous in its conclusion, the reasoning of its members differed materially, and serious doubt was cast upon the preservation of the principle even in this more limited form by some of the members of the court. It remains to be seen when — or indeed if — they will have their chance to reexamine the issue further.

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[1] Sevilleja v. Marex Financial Ltd. [2020] UKSC 31.

[2] Foss v. Harbottle (1843) 2 Hare 461.

[3] Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No 2) [1982] Ch 204.

[4] Johnson v. Gore Wood & Co. [2002] 2 AC 1.

[5] Giles v. Rhind [2002] EWCA Civ 1428.

[6] Gardner v. Parker [2004] EWCA Civ 781.