BUDDLE FINDLAY

UK Supreme Court clarifies and reduces ambit of "reflective loss" principle in "one of the most important company and commercial law decisions of the last thirty years"

Scott Barker, Seb Bisley, Willie Palmer, Susan Rowe, David Broadmore, Kelly Paterson, Peter Niven, Anita Birkinshaw, Bridie McKinnon, Oliver Gascoigne, Olly Peers, Luke Sizer, Annie Cao

24 July 2020

The Supreme Court in *Sevilleja v Marex Financial Ltd* [2020] UKSC 31 has brought much needed clarity to the legal basis and scope of the so-called 'reflective loss' principle. The effect of the decision is a 'bright line' rule that bars claims by shareholders for loss in value of their shares arising as a consequence of the company having suffered loss, in respect of which the company has a cause of action against the same wrong-doer.

The main issue before the Court was whether the reflective loss principle prevented claims by a creditor of a company against a director of that company in circumstances in which the company itself had claims against the same director in respect of the same loss. The Court unanimously held that such claims were not barred. Prior cases that had been decided to the contrary have been overturned.

The decision will be welcomed by many, especially by creditors of companies who may have been prevented from recovering their losses when their claims were concurrent to those of companies. The decision also clarifies that claims brought by shareholders in a different capacity (such as a creditor or an employee) will not be barred.[1]

Facts

Marex Financial Limited (Marex) brought proceedings against two companies for amounts due under contract. Marex obtained judgment for over US$5.5m. The respondent, Mr Sevilleja owned and controlled the two companies. After receiving a copy of the draft judgment, Mr Sevilleja allegedly transferred large amounts of money from the companies' accounts into his personal control. The companies' assets were diminished and they were unable to pay Marex the judgment debt and costs. Mr Sevilleja then placed the companies into liquidation. According to Marex, the liquidator had not taken any steps to investigate claims submitted by Marex or to issue proceedings against Mr Sevilleja.

Marex then brought proceedings against Mr Sevilleja seeking damages in tort for inducing or procuring the violation of its rights under the judgment.[2] Mr Sevilleja argued that Marex's claim was barred by the 'reflective loss' principle. Mr Sevilleja was successful in the Court of Appeal, which held that the principle applied to about 90% of Marex's claim.

What is the "reflective loss" principle?

The two main cases said to have established the 'reflective loss' principle are *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 and *Johnson v Gore Wood (No 2)* [2002] 2 AC 1 (HL).

In *Prudential*, the court determined that a shareholder cannot bring a claim for the diminution in value of its shares that results from a loss suffered by the company as a consequence of a wrong done to the company by the defendant. *Prudential* laid down the principle that the shareholder's loss in these circumstances is not separate and distinct from the damage suffered by the company and is not therefore recoverable.

Prudential was discussed and upheld in *Johnson*. Lord Millett, in his judgment in *Johnson*, suggested that the principle was based on the avoidance of double recovery, which "paved the way" for the expansion of the principle beyond the narrow ambit of the rule in *Prudential*.

Lord Millett's judgment has been particularly influential in subsequent cases that extended the principle to bar claims brought by creditors of the company (who may or may not be shareholders as well).

Supreme Court decision

The full Court was in agreement that the reflective loss principle has had "unwelcome" effects on the law which, if adopted to bar Marex's claim, would result in injustice.

The majority judgment issued by Lord Reed distinguished 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 in distributions, which is the consequence of loss sustained by the company, 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.

The first kind of case is barred by the rule of company law laid down in *Prudential*. The 'critical point' is that the shareholder has not suffered a loss that is separate and distinct from the company's loss. However, the shareholder has other rights, such as the right to bring a derivative claim or to seek relief in respect of unfairly prejudicial conduct.[3]

The *Prudential* rule does not apply in the second kind of case involving shareholders who has a separate and distinct claim in a different capacity, or when claims are brought in respect of loss suffered by a creditor of the company. Double recovery should be avoided, however it is not necessarily engaged merely because the company and the creditor have concurrent claims against the same defendant.

In the minority, Lord Sales, with whom Lady Hale and Lord Kitchin agreed, held that *Prudential* did not establish any rule of law that would exclude a shareholder's claim when, factually, the loss was different from that of the company. If the shareholder has a distinct and valid cause of action in respect of a different loss to the company, that claim is permitted in principle, with concerns about double recovery to be dealt with through case management.

Lord Sales criticised the use of the word "reflective" and pointed out while there is some relationship between the loss suffered by the company and the loss suffered by a shareholder, the loss suffered by the shareholder is not the same as the loss suffered by the company. It does not follow that recovery by the company will eliminate the loss suffered by the shareholder. Lord Sales went on to say that if the shareholder's right to bring its own cause of action is denied, that erodes the principle of separate legal personality of the company.

Comment

Commentators in England have said this is one of the most important company and commercial law decisions of the last thirty years.

The decision may not however resolve all issues in relation to claims brought by shareholders in their capacity as shareholders.

In New Zealand, s 169(2) of the New Zealand Companies Act 1993 (which partly reflects *Prudential*) provides:

(1) A shareholder or former shareholder may bring an action against a director for breach of a duty owed to him or her as a shareholder.

(2) An action may not be brought under subsection (1) of this section to recover any loss in the form of a reduction in the value of shares in the company or a failure of the shares to increase in value by reason only of a loss suffered, or a gain forgone, by the company.

Section 169(2) does not apply when a shareholder seeks to bring a claim against a party who is not a director. Lord Sales found "considerable force" in the reasoning in *Christensen v Scott* [1996] 1 NZLR 273. In that decision, a five-judge bench of the Court of Appeal declined to apply the reflective loss principle to strike out a claim brought by shareholders against professional advisors for damages represented by the diminution in the value of their shares. The company's claim against the advisors had settled but the plaintiffs considered that settlement was wholly inadequate. The Court considered that:

"… it is certainly arguable that, where there is an independent duty owed to the plaintiff and a breach of that duty occurs, the resulting loss may be recovered by the plaintiff. The fact that the loss may also be suffered by the company does not mean that it is not also a personal loss to the individual. Indeed, the diminution in the value of Mr and Mrs Christensen's shares in the company is by definition a personal loss and not a corporate loss. …"

Subsequent New Zealand decisions have recognised the inconsistency between *Christensen v Scott* and *Prudential* and *Johnson*. Nevertheless, the issues have not been grappled with in any detail. The New Zealand courts will not be bound to follow the majority judgment in *Sevilleja*. Nevertheless, it will be highly persuasive; in particular, Lord Sales' judgment that endorses *Christensen v Scott*.

We will watch with interest how *Sevilleja* will be applied in the context of the CBL shareholder class actions, which seek to hold the directors of the failed company to account for their actions and to gain compensation for the shareholders who have suffered significant financial losses as a result of the collapse of CBL. The courts will need to grapple with whether the former directors owed the shareholders a duty that was separate and independent from the duty owed to the company, whether any resulting loss can be recovered or will the claim be barred by the reflective loss principle.

See the Court's decision here.

This article was written by Scott Barker (Partner) and Annie Cao (Senior Solicitor).

[1] See also *Sons of Gwalia Ltd v Margaretic* (2007) 232 ALR 232 (HCA) and *Soden v British & Commonwealth Holdings Plc* [1998] AC 298.

[2] Note in New Zealand, s 301 of the Companies Act 1993 provides a “procedural short cut by which a liquidator, creditor or shareholder may pursue claims that a company in liquidation may have against, inter alios, its former directors”: *Robb v Sojourner* [2007] NZCA 493, [2008] 1 NZLR 751 (CA) at [53].

[3] In New Zealand, whether a shareholder can bring a derivative action once a company is in liquidation is unsettled: *Ballantyne Trustees Ltd v Papprill Hadfield & Aldous Solicitors Nominee Company Ltd* [2015] NZHC 2294.

Auckland

188 Quay Street
Auckland 1010

PO Box 1433
Auckland 1140
New Zealand

P: +64 9 358 2555
F: +64 9 358 2055

Wellington

Aon Centre
1 Willis Street
Wellington 6011

PO Box 2694
Wellington 6140
New Zealand

P: +64 4 499 4242
F: +64 4 499 4141

Christchurch

83 Victoria Street
Christchurch 8013

PO Box 322
Christchurch 8140
New Zealand

P: +64 3 379 1747
F: +64 3 379 5659