Reflective loss rule: Supreme Court protects creditors from asset stripping

In an eagerly anticipated decision, the Supreme Court has shone an important light on a genuinely practical problem (*Sevilleja v Marex Financial Ltd [2020] UKSC 31*). The decision gives creditors of companies that have been asset-stripped an easier path to direct recovery against the wrongdoer.

The liquidation

The defendant, Mr Sevilleja, owned and controlled two British Virgin Islands (BVI) companies (the companies) which he used as vehicles for foreign exchange trading. In July 2013, Marex Financial Ltd (Marex) obtained a High Court judgment against the companies in excess of $5.5 million for amounts due under various contracts (the judgment). Marex then alleged that between the dissemination of a confidential draft of the judgment and the hand-down date, Mr Sevilleja had procured the transfer of over $9.5 million from the companies' London accounts into his personal control. By August 2013, the companies' assets were just over $4,300. In December 2013, the companies were unable to meet the judgment debt and Mr Sevilleja placed them into insolvent voluntary liquidation in the BVI, owing alleged debts exceeding $30 million to creditors including Mr Sevilleja and Marex.

Asset stripping

Marex argued that Mr Sevilleja had stripped the companies of assets in breach of duties owed to the companies for the purpose of frustrating the satisfaction of the judgment debt. Since Marex was concerned that the BVI liquidator had taken inadequate steps to investigate the claims, Marex claimed against Mr Sevilleja directly for the economic torts of:

- Inducing or procuring the violation of its rights under the judgment, referred to as the *Lumley v Gye* tort, named after the case that established the tort of inducing a breach of contract (*(1853) 2E&B 216*).

- Intentionally causing Marex to suffer loss by unlawful means, referred to as the OBG tort, named after *OBG Ltd and others v Allan and others; Douglas and others v Hello! Ltd and others (No 3); Mainstream Properties Ltd v Young and others ([2007] UKHL 21; www.practicallaw.com/6-364-4986*).

The context of the dispute was the correctness of permission to serve out. Mr Sevilleja had applied to set aside the order granting permission to serve the claims out of the jurisdiction on the basis that the reflective loss rule applied because the losses that Marex was seeking to recover were reflective of the loss suffered by the companies since the companies had concurrent claims against Mr Sevilleja for the alleged conduct of diverting assets out of the companies' accounts (*see box "The reflective loss rule"*).

The High Court had ruled in favour of Marex to hold that the reflective loss rule barred the claim by Marex (*[2017] EWHC 918 (Comm)*). The Court of Appeal overturned the High Court's decision (*[2018] EWCA Civ 1468*).

Unanimous decision

The court unanimously allowed Marex's appeal. However, the judges disagreed as to the nature and effect of the reflective loss principle. Lord Reed gave the majority judgment.

His starting point was that it is not uncommon for two persons, A and B, to suffer loss as a result of the conduct of a third person, C. A and B are both at liberty to sue C whenever they please and C is normally liable to compensate them both for the loss that they have suffered. Lord Reed noted that the position can become more complicated where A and B have concurrent claims in respect of losses that are interrelated in such a way that a payment by C to one of them will have the practical effect of remedying the loss suffered by the other. However, he noted that the principle against double recovery does not prevent a claimant from bringing proceedings for the recovery of his loss. Instead, the court will have to consider how to avoid double recovery in situations where the issue is properly before it.

Lord Reed clarified that the principle laid down by *Prudential Assurance Co Ltd v Newman Industries Ltd* was a rule of company law under which, if a company suffers actionable loss and that loss results in a fall in the value of its shares, that fall in share value does not amount to a loss for shareholders that is separate and distinct from the loss which is sustained by the company (*[1982] Ch 204*). On that basis the loss does not give the shareholders an independent claim for damages.

The limits of the rule

Lord Reed was careful to identify the limits of the rule. In particular, he distinguished between two scenarios:

- The first scenario concerns cases where claims are brought by a shareholder in respect of a loss which it has suffered in that capacity, in the form of a diminution in share value, 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. In that scenario, the shareholder is barred from bringing a claim for the reflective loss rule because the shareholder has no direct interest in the company's assets.

- The second scenario concerns 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 happens to have a right of action in respect of substantially the same loss. This scenario is distinct from the first scenario because there is no correlation between the value of the company's assets and the loss which that party suffered.

On that basis, Lord Reed held that the reflective loss rule applies only to cases in the first scenario, not the second.

For a claim to be barred by the reflective loss rule it must therefore meet the following criteria:

- It is brought by a shareholder.

- It relates only to the diminution in value of shares.

- That diminution in value is the result of the company having suffered damage.

- The company can claim for that damage against the same wrongdoer against whom the shareholder is bringing the action.

The court confirmed that this rule applies even where the company in question chooses not to bring a claim. This is because the

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The reflective loss rule

The reflective loss rule stems from two major authorities: *Prudential Assurance Co Ltd v Newman Industries Ltd* and *Johnson v Gore Wood & Co* (*[1982] Ch 204; [2000] UKHL 65, www.practicallaw.com/2-101-5778*).

In *Prudential*, a minority shareholder, Prudential, brought a claim against the directors of the company for fraudulent misrepresentation in a circular distributed to the shareholders. The claim was disallowed on the grounds that Prudential had not suffered a loss that was distinct from the loss of value in its shareholding. The High Court in *Prudential* held that a shareholder cannot recover damages merely because the company in which it is interested has suffered damage. It cannot recover a sum equal to the diminution in the market value of its shares or the likely diminution in dividend because the so-called "loss" is merely a reflection of the loss suffered by the company. This was later noted as the "reflective loss" rule in *Johnson*.

management of a company's affairs has been entrusted to the decision-making organs established by its articles of association. This includes, ultimately, the majority of members voting in a general meeting. If a decision is taken otherwise than in the proper exercise of the relevant powers, then the law provides the shareholder with a number of remedies, including a derivative action and equitable relief from unfairly prejudicial conduct.

As a result, the reflective loss rule did not bar Marex's claim as it was a creditor of the companies, not a shareholder.

Previous authority overruled

In reaching its conclusion, the majority judgment overruled a significant portion of previous authority, including *Giles v Rhind*, *Perry v Day* and *Gardner v Parker* (*[2002] EWCA Civ 1428, www.practicallaw.com/2-101-8277; [2004] EWHC 1398 (Ch), www.practicallaw.com/6-103-2417; [2004] EWCA Civ 781, www.practicallaw.com/5-102-8878*). The speeches in *Johnson v Gore Wood & Co*, apart from Lord Bingham's, should also no longer be followed insofar as they relate to the reflective loss principle and are inconsistent with the majority in *Sevilleja* (*[2000] UKHL 65*).

Lord Reed disagreed with Lord Millet's judgment in *Johnson* that the reflective loss rule in *Prudential* could be explained or justified by the court's concern to avoid double recovery. That explanation led to an unrealistic assumption that there is a universal and necessary relationship between changes in a company's net assets and changes in its share value. In addition, Lord Millet's interpretation could not explain why a shareholder cannot pursue a claim against a wrongdoer where the company has declined to pursue a claim, in which circumstances the risk of double recovery is removed. Lord Reed was careful to distinguish the reflective loss rule from the court's concern with double recovery which he noted was addressed by specific rules, such as the rules around subrogation or the requirement in certain circumstances for one successful claimant to account to another.

Exception overturned

Importantly, Lord Reed overturned the exception to the reflective loss rule in *Giles*. That case had identified an exception to the reflective loss rule where the reason why the company could not bring a claim was because the wrongdoer's conduct had prevented that claim. For example, in *Giles*, the company was unable to pursue a claim against the wrongdoer because impecuniosity as a result of the wrongdoing meant that it could not put up security for costs.

However, in light of the narrowing of the rule against reflective loss, Lord Reed held that *Giles* had been wrongly decided. He held that the rule in *Prudential* is limited to claims by shareholders that, as a result of actionable loss suffered by their company, the value of their 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.

Minority judgment

Lord Sales gave the minority judgment, which chose not to address the exception in *Giles.* However, Lord Sales noted, obiter, that the exception was identified in an effort to achieve practical justice against the backdrop of an assumption that the reflective loss principle stated in *Prudential* was valid. If *Prudential* is held to lay down a bright line rule of law deeming reflective loss not to be a loss, whatever the true position on the facts, and that bright line rule is endorsed, cases such as *Giles*, which exemplify the dissonance between the rule and practical justice on the facts, will continue to arise. This will put pressure on the acceptability of the rule.

Practical impact for creditors

The decision shines an important light on a genuinely practical problem. Creditors of companies that have been asset-stripped now have an easier path to direct recovery against the wrongdoer. As a result, creditors in Marex's position need not be concerned that their direct claim would be barred because of the reflective loss rule. Had the reflective loss rule been held to bar Marex's claim, a creditor in Marex's position would have had to pursue claims through a liquidator of the impecunious company. Interestingly, in Marex, it was a frustration with the adequacy of the steps taken by the liquidator, who had been appointed by the wrongdoer, to investigate the claims that led to Marex pursuing its own claims. In the past, a creditor in the shoes of Marex might seek the appointment of a "conflicts liquidator" to pursue the claims against another major creditor who has appointed the original liquidator. Again, this mechanism can now be side-stepped.

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