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AUGUST 2020

THE ENGLISH SUPREME COURT'S LANDMARK DECISION REFLECTS ON REFLECTIVE LOSS

In a landmark decision that departs from nearly 40 years' of case law, the Supreme Court has unanimously ruled[1] that the reflective loss principle does not stifle claims by unsecured creditors. This therefore means that, as in this case, shareholders (who are also creditors), can now recover the loss suffered by the reduction of their share price, as a result of the damage caused to the company by the wrongdoing of a third party.

1 [2019] QB 173

"The Supreme Court, in a move that shows the importance of this decision, comprised seven justices."

In *Sevilleja v Marex Financial Ltd*, which concerned creditor loss caused by a third party asset-stripping the company, the Supreme Court was required to consider whether the established *reflective loss principle* should apply, and to determine two questions on appeal from the Court of Appeal's judgment, namely:

1. whether the rule against recovery for reflective loss applied to unsecured creditors who are not shareholders of the relevant company; and
2. whether proceedings for losses, which are within the rule should be permitted where there would otherwise be injustice to the claimant as a result of its inability to sue.

In reaching its judgment, the court reviewed the key decisions of:

- *Foss v Harbottle*[2], which set out the well established rule that (with the exception of derivative claims) only the company itself may recover the loss it suffers.
- *Prudential Assurance v Newman Industries (No 2)*[3], which upheld and extended the rule in *Foss v Harbottle*, and held shareholders could not bring a claim for loss as a consequence of a defendant's wrongdoing against the company; and
- the subsequent House of Lords judgment in *Johnson v Gore Wood*[4], which extended the principle to prevent claims by shareholders whether brought in that capacity, as employee, or as a creditor.

The facts:

Marex claimed that Mr Sevilleja stripped two BVI foreign exchange trading companies, in his ownership and control, of their assets, including US$9million in their bank accounts by paying the money into his own account. This action left the companies unable to pay the judgment debts they owed to Marex, which amounted to some U$5million.

Marex had tried to secure the assets by way of a freezing order.

The two companies entered liquidation in 2013.

The law:

Marex sued Mr Sevilleja for the economic tort of *unlawful means conspiracy*, and for knowingly inducing and procuring the companies to act in *wrongful violation* of Marex' rights.

Mr Sevilleja challenged the English court's jurisdiction to hear the dispute, arguing that the claim could not succeed because its loss reflected the loss suffered by the two companies, and the companies themselves were not pursuing their claims, which had been settled by Mr Sevilleja (in the liquidation), and was therefore prevented under the *principle of reflective loss*.

What is the reflective loss principle?

The reflective loss principle is derived from the cases of *Foss v Harbottle*, *Prudential Assurance v Newman Industries (No 2)*, and *Johnson v Gore Wood*.

In essence, the principle developed in these three cases states that where a company suffers loss, the company itself is the only party entitled to claim for that loss – preventing shareholders from recovering the reduced value of their shares, viewing this as a "reflection" of the loss suffered by the company, and therefore not conferring a cause of action on the shareholders, hence the term *"reflective loss"*.

The basis of the principle is to prevent a double-recovery against the company, but critics have long-voiced the opinion that it unfairly prejudices creditor shareholders, especially where the company goes into liquidation and does not bring a claim - as in the case of Marex.

2 (1843) 2 Hare 461

3 [1982] 1 Ch 204

4 [2002] 2 AC 1

The judgment

The Supreme Court, in a move that shows the importance of this decision, comprised seven justices. The court unanimously overturned the Court of Appeal decision, albeit split on the reasons 4:3, and held that the claim was not prevented by the *reflective loss principle*, arriving at the decision as follows:

- the majority decision given by Lord Reed narrowed the principle; and
- the minority decision given by Lord Sales preferred to do away with the principle in its entirety

Therefore, whilst the Supreme Court justices agreed that creditors should not be prevented from bringing this type of claim, there was a difference in how shareholders should be viewed, with three of the justices being in the minority finding that these claims should be allowed on the basis that the loss is not the same as that of the company, and proposing that double recovery could be avoided by the courts.

What this means for companies and creditors

It remains to be seen how future judgments will respond to this ruling, and therefore whether we are now seeing the beginning of the end of the *reflective loss principle*.

For now, the judgment is good news for creditors: it strengthens the role of economic torts and supports creditors faced with wrongdoing by third parties, especially where fraud is involved.

As a result of this judgment, creditors will wish to consider actions for recovery of losses against directors, independent of any liquidation proceedings.

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