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CASE REVIEW SECTION

Sevilleja v Marex Financial Ltd [2020] UKSC 31

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Synopsis

The Supreme Court has recently considered the so-called 'reflective loss' principle, which in certain circumstances prevents shareholders from bringing claims against third parties, and has narrowed the scope of that principle considerably. Following this decision, the principle will apply in only very limited instances, namely to bar actions that are: (i) brought by a shareholder against a third party, (ii) in respect of loss which the shareholder has suffered in that capacity in the form of a diminution in share value or distributions, (iii) where that loss is the consequence of loss sustained by the company, and (iv) in respect of which the company has a cause of action against the wrongdoer.

Facts

Mr Sevilleja was the owner and controller of two companies incorporated in the British Virgin Islands. Marex brought proceedings against those companies in the Commercial Court of England and Wales for amounts it alleged were owed to it under contracts it had entered into with the companies. At first instance, Marex obtained judgment against the companies for more than USD 5.5 million, and was also later awarded costs.

Shortly after the parties received a confidential draft of the first instance judgment but before the judgment was formally handed down and the orders for payment were made, Mr Sevilleja procured the transfer of more than USD 9.5 million from accounts held in the companies' names. Marex argued that the object of the transfers was to ensure that Marex did not receive payment of the judgment debt.

The two companies were subsequently placed into insolvent voluntary liquidation with alleged debts exceeding USD 30 million owed to Mr Sevilleja and entities associated with him. Marex was the only non-insider creditor. Marex alleged that the liquidator effectively acted under Mr Sevilleja's control and thus had taken no steps to investigate Marex's claims or the companies' missing funds.

As a result, Marex sued Mr Sevilleja in the English courts for damages in tort for (i) inducing or procuring the violation of Marex's rights under the first instance judgment and orders, and (ii) intentionally causing Marex to suffer loss by unlawful means. Marex sought damages corresponding to (i) the amount of the judgment debt plus interest and costs (less amounts recovered in related US proceedings), and (ii) costs incurred by Marex in its attempts to obtain payment. Marex was given permission to serve the proceedings on Mr Sevilleja out of the jurisdiction.

The High Court

Mr Sevilleja applied to the High Court (Knowles J) to set aside the order granting Marex permission to serve proceedings outside the jurisdiction, on the basis that Marex did not have a good arguable case against him because the losses which Marex sought to recover were reflective of loss suffered by the companies, which had concurrent claims against Mr Sevilleja, and so could not be claimed by Marex (the so-called 'reflective loss' principle). Knowles J rejected that argument, holding that Marex had a good arguable case that its claim was *not* precluded by the reflective loss principle: [2017] EWHC 918 (Comm).

The Court of Appeal

Mr Sevilleja subsequently appealed to the Court of Appeal (Lewison, Lindblom and Flaux LJJ): [2018] EWCA Civ 1468. It fell to the Court of Appeal to determine the proper ambit of the rule against reflective loss and whether that rule applied to claims by unsecured creditors such as Marex.

Flaux LJ, giving the main judgment, allowed Mr Sevilleja's appeal in part, on the basis that the reflective loss principle was not restricted solely to claims made by a party as shareholder but also precluded claims by creditors for loss caused by the abstraction of money from the company. In other words, the Court of Appeal held that the distinction between shareholders and non-shareholder creditors was artificial when considering the reflective loss principle, and the same principle should apply to all creditors of the company. As such, the reflective loss principle applied to Marex's claims (save its claim to recover the costs of enforcement of its judgment), with the consequence that Marex was unable to pursue the majority of its claims.

According to the Court of Appeal, one possible exception to the reflective principle was the exception established in the case of *Giles v Rhind* [2002] EWCA Civ 1428, which applied where the alleged wrongdoing had caused the company to be unable to pursue the wrongdoer. The Court of Appeal found that this exception did not apply in Marex's case.

The Supreme Court

Marex sought and obtained permission to appeal to the Supreme Court.

The Supreme Court unanimously allowed Marex's appeal, and took the opportunity to restate the law on the reflective loss principle. However, while all seven Justices reached the same overall conclusion, the reasoning of the four Justices in the majority (Lord Reed, with whom Lady Black and Lord Lloyd Jones agreed, and Lord Hodge, who delivered a concurring judgment) was markedly different to that of the minority (Lord Sales, with whom Lady Hale and Lord Kitchin agreed).

The decision in Prudential

Lord Reed considered the decision of the Court of Appeal in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, which had established the reflective loss principle (that a shareholder could not claim for a diminution in the value of its shareholding). Lord Reed explained that decision as follows:

> 'where a company suffers actionable loss, and that loss results in a fall in the value of its shares (or in its distributions), the fall in share value (or in distributions) is not a loss which the law recognises as being separate and distinct from the loss sustained by the company. It is for that reason that it does not give rise to an independent claim to damages on the part of the shareholders' (at [28]).

He explained that that case had been concerned only with a diminution in the value of the shares or in distributions, suffered by a shareholder merely because the company had itself suffered actionable damage (at [26]).

Lord Reed set out the rationale for the decision in *Prudential* and the reflective loss principle (see [31]-[36]; see also the concurring judgment of Lord Hodge, in particular at [96]-[108]). He explained that a share was not a proportionate part of a company's assets, and did not confer any legal or equitable interest in the company's assets. Rather, it was simply a right of participation in the company on the terms of, and with the rights set out in, the articles of association. A fall in the value of its shares was not an inevitable consequence of loss suffered by a company, and the size of that fall would not necessarily be equivalent or even correlated to the company's loss. Where a company suffered loss and as a result acquired a right of action, the company's right to damages would restore it to the position that would have obtained but for the wrongdoing. If doing so also restored the value of the shares, then permitting shareholders to vindicate a personal right to claim in these circumstances would give rise to double recovery. Further, if the company chose not to claim for that loss, then the shareholder (even if in a minority) could exercise such rights of control over the company's decision-making, or pursue such other remedies, as have been accorded to it under the articles of association or the general law.

According to Lord Reed, the decision in *Prudential* therefore respected the 'proper plaintiff' rule derived from *Foss v Harbottle* (1843) 2 Hare 461 and the various principled and policy-driven underpinnings of that rule. Establishing a clear rule that only the company may pursue a right of action in circumstances falling within the ambit of *Prudential* also had 'pragmatic advantages' (at [38]), in not leaving the protection of creditors and other shareholders to be determined by a judge in the complexities of a trial. These included issues around the possible proliferation and multiplicity of claims, difficulties with establishing causation in the context of a fall in share value, and double recovery.

The decision in Johnson v Gore Wood *and subsequent cases*

Lord Reed then went on to consider *Johnson v Gore Wood & Co* [2002] 2 AC 1, a House of Lords case which had considered and applied *Prudential* and which was the leading authority on the reflective loss principle.

Lord Reed held that *Johnson* gave authoritative support to the decision in *Prudential* that a shareholder was normally unable to sue for the recovery of a diminution in the value of its shareholding or in the distributions it received as a shareholder which flowed from loss suffered by the company, for the recovery of which the company had a cause of action, even if it declined or failed to make good that loss (at [67]).

However, Lord Reed held that the judgment of Lord Millett and the other judges in the majority in *Johnson* (save Lord Bingham) departed from the reasoning in *Prudential* and should not be followed. In particular, Lord Millett's description of a share as representing a proportionate part of the company's net assets was incorrect, and the rule in *Prudential* was not premised on any necessary relationship between a company's assets and the value of its shares or distributions (at [49]). Further, Lord Millett's approach to the rule in *Prudential* – as being premised on the principle that double recovery should be avoided – was incorrect and did not satisfactorily explain the rule in *Prudential* (at [50]-[60]), including because (a) it assumed unrealistically that there was 'a universal and necessary relationship between changes in a company's net assets and changes in its share value', (b) it could not explain why a shareholder could not be permitted to pursue a claim where the company had declined to pursue its claim or had settled at an undervalue, and (c) double recovery could arise where there were concurrent claims by companies and persons who had suffered loss in capacities other than as shareholders, and such claims were not prohibited by the rule in *Prudential*.

Lord Reed added that, to the extent that Lord Millett intended to extend the reflective loss principle to cover *all* personal claims against a wrongdoer where the company also had a cause of action and in respect of amounts which the company would have paid to the claimant if it had had the necessary funds, that was also mistaken.

Lord Reed pointed out that *Johnson* had been followed by many cases in which litigants had sought to establish exceptions to the general reflective loss principle, or to establish that the rule against recovery of reflective loss extended more widely than had been determined in *Johnson*.

For example, in *Giles v Rhind*, the Court of Appeal held that a shareholder could recover for loss flowing from the company's loss where the company had a cause of action but failed to pursue it, in circumstances where the wrongdoer's own conduct had prevented the company from pursuing that cause of action. Lord Reed held that this decision, and *Perry v Day* [2004] EWHC 3372 (Ch) which followed it, were inconsistent with the bright-line rule in *Prudential* (at [68]-[71]), given that the rule did not take into account whether or not the company was financially able to bring proceedings to recover its loss. In addition, in *Gardner v Parker* [2004] EWCA Civ 781 and subsequent cases, the scope of the reflective loss principle had been expanded so that it had come to be treated as if it was applicable 'in all situations where there are concurrent claims and one of the claimants is a company' (at [77]), for example where the claimant is not a shareholder but a third party creditor. Lord Reed argued that '[t]he extension of the principle to such cases has the potential to have a significant impact on the law and on commercial life', and warned of the resulting increase in the 'volume of litigation and the level of uncertainty' (at [77]).

Conclusions

Having reviewed the reflective loss principle in detail, Lord Reed held that it was necessary to distinguish between two cases: (a) where claims were brought by a shareholder in respect of loss which it had suffered in that capacity in the form of a diminution in share value or distributions, where that loss was the consequence of loss sustained by the company and in respect of which the company had a cause of action against the wrongdoer, and (b) where claims were brought, whether by a shareholder or anyone else, in respect of loss not falling within that description, but where the company had a right of action in respect of substantially the same loss.

In the first category of cases, as a bright line rule, only the company has an actionable claim against the wrongdoer. That is because the shareholder has not suffered a loss which is regarded by the law as being separate and distinct from the company's loss. If the company chooses not to pursue the claim, then the shareholder may seek another available remedy (e.g. a derivative action, or equitable relief from unfairly prejudicial conduct).

However, the second category of claims are not caught by the reflective loss principle, and are therefore available to the shareholder or creditor (subject to the need to avoid double recovery).

Accordingly, the majority found that the rule in *Prudential* had no application to the present case, since the claim had not been brought by a shareholder but rather a creditor of the company. Accordingly, the court held that Marex should be permitted to pursue the entirety of its claim.

The minority judgment

Although Lord Sales (giving the judgment of the minority) reached the same conclusion as Lord Reed and the majority (i.e. that Marex's appeal should be allowed), his reasoning differed significantly in a number of respects.

In Lord Sales' view, the Court of Appeal in *Prudential* had not laid down (and did not purport to have laid down) a strict rule of law, as Lord Reed considered it had. Instead, the Court of Appeal had sought to explain why the shareholder in such a case had not *as a matter of fact* suffered any loss. Lord Sales considered that the reasoning in *Prudential* could not be supported and that there were 'clearly ... some cases where the shareholder does suffer a loss which is different from the loss suffered by the company' (at [118]). He argued in common with Lord Reed and the majority that 'the loss suffered by the shareholder is not the same as the loss suffered by the company', and that there 'is no necessary, direct correlation between the two' (at [132]).

Accordingly, Lord Sales opined that, in light of the deficiencies in the Court of Appeal's reasoning in *Prudential*, the Supreme Court could not now re-characterise that decision in the way in which the majority had sought to do. Indeed, Lord Sales believed that the majority, in deriving from the decision in *Prudential* a clear rule of law, had adopted a 'crude bright line rule which will inevitably produce injustice' (at [167]). Instead, he considered that the question as to whether a shareholder had suffered an actionable loss was one that ought to be considered on the facts of each individual case, rather than by reference to the majority's bright-line rule, and that other means such as sensible case management and subrogation were available to the court to address issues such as double recovery.

In essence, therefore, the minority went even further than the majority in limiting the scope of the reflective loss principle. Indeed, in holding that it did not apply in this case, Lord Sales went so far as to doubt whether the reflective loss principle existed at all (at [211]).

Comment

As will be evident from the fact that a panel of seven Justices was convened to hear it, this case is likely to be of major significance for various stakeholders, including companies, shareholders, creditors and insolvency practitioners. More than simply *what* was decided, the particular significance of the decision lies in *how* it was decided – in particular, in the decision of the majority to overturn two decades of established case law and establish a bright-line rule which (according to the majority) reflects the proper (narrow) basis of the decision in *Prudential*, namely that the reflective loss principle captures only claims by shareholders for loss in the form of a diminution in share value or distributions, where that loss is the consequence of loss sustained by the company and in respect of which the company has a cause of action against the wrongdoer.

The majority's approach, in its adoption of that bright-line rule, will bring helpful clarity to an area of law that has vexed litigants and the courts for years, as third party wrongdoers sought to cast the net of the reflective loss principle ever wider. In particular, the decision restores some doctrinal consistency to this area of law and limits the ability of those wrongdoers to rely on the reflective loss principle to stifle otherwise legitimate claims by shareholders and creditors. It appears likely that the majority's approach will result in a marked increase in the volume of claims brought by creditors (including shareholders) who will no longer be locked out by reason of a widely interpreted reflective loss principle.

However, a note of caution: in having decided the case by a bare majority of four to three, the Supreme Court may have left room for argument in future cases as to which side of the line any given case falls on. This may mean that, for all the helpful clarity resulting from the majority's approach, litigants may well continue to argue about the scope of the reflective loss principle for years to come.

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