

# Recent decisions in the highest courts in the UK and the Cayman Islands involving insolvent claimants on the rule which bars a shareholder from bringing a claim for loss which is a consequence of loss sustained by the company

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## Introduction

Reflective loss has become a significant issue over the past few decades for those dealing with shareholder claims, particularly in insolvency scenarios involving a group of companies. It has been increasingly important for claims to be brought by the correct claimant, and only the correct claimant, as the courts have extended the scope of reflective loss and used it to bar an increasingly broad range of claims. Recent decisions of the UK Supreme Court and Judicial Committee of the Privy Council have sought to clarify and restrict the application of what was previously known as the reflective loss rule.

The starting point for any consideration of reflective loss under English law is the rule in *Foss v Harbottle* (1843) 2 Hare 461, which provides that the only person who can seek relief for an injury done to a company, where the company has a cause of action, is the company itself. This prevents a shareholder from enforcing a cause of action belonging to the company. A shareholder's rights are to participate in the decision-making organs of the company. This preserves the rights of majority shareholders to bind the company (such as by voting to ratify an irregularity or wrong committed by the company's directors) and is the bargain which is made when becoming a shareholder: to follow the fortunes of the company.

For a long time, the practical application of the rule in *Foss v Harbottle* did not appear to give rise to

any real difficulties. It was only almost 140 years later that the practical application of the rule started to give rise to issues. In *Prudential v Newman* [1982] Ch 204, the English Court of Appeal was faced with a personal claim brought by a shareholder for fraudulent misrepresentation to recover for a diminution in the value of its shareholding in a company. It held that the personal claim would circumvent the purpose of the rule in *Foss v Harbottle*, even though it belonged to the shareholder and not to the company, because it was merely a reflection of the loss suffered by the company and recovery of that loss by the shareholder should therefore be barred. Although consistent with *Foss v Harbottle*, *Prudential* paved the way for what became known as the reflective loss rule.

The reflective loss rule was considered by the highest court in the UK (then the House of Lords) in *Johnson v Gore Wood & Co (No.1)* [2002] AC 1. The ruling became particularly significant because of the contrasting approaches adopted by Lord Bingham and Lord Millett in defining the purpose and ambit of the rule. Lord Bingham explained the rule by referring to the preservation of company autonomy and preventing one party recovering for another's loss. His approach was arguably consistent with the reasoning in the *Prudential* decision and he envisaged some flexibility when applying the rule, 'the court must be astute to ensure that the party who has in fact suffered loss is not arbitrarily denied fair compensation'. Lord Millett,

however, referred to a broader policy basis for the rule, including the avoidance of double recovery, and took a firmer approach by deciding that the automatic bar on recovery by a shareholder was a ‘matter of principle and there is no discretion involved’. Lord Millett also suggested that the rule could extend beyond claims by shareholders to, for example, claims by employees.

The reflective loss rule was then expanded well beyond its company autonomy roots and by reference to supposed policy justifications. For example, in *Gardner v Parker* [2004] 2 BCLC 554, the English Court of Appeal – relying on Lord Millett’s views in *Johnson* – extended the reflective loss rule to bar a creditor claim brought by a shareholder and stated that the foundation for the rule was to avoid double recovery. The courts began to treat the reflective loss rule as being based primarily on the avoidance of double recovery and the protection of the company’s unsecured creditors, being applicable in all situations where there are concurrent claims and one of the entities pursuing a claim is a company.

Other policy justifications were also identified by the courts during this expansionary period, including causation, conflicts of interest and company autonomy in the broader sense of prejudice to other creditors and shareholders of the company. The causation point was said to be justified on the basis that any loss suffered by the claimant/shareholder principally arose not from the wrongdoer’s conduct but from any decision by the relevant company not to pursue its claim, which cut the causal link between the wrongdoing and the claimant’s loss. The ‘conflicts of interest’ point arose because the existence of the other claim may hinder the ability of the company to settle its own claim. The ‘prejudice to others’ point aimed to prevent the claimant recovering before the company could make a recovery, in a situation where the defendant was insolvent and unable to pay both claims. The reasoning underlying all of these supposed policy justifications was far from compelling and tended to lead to unjust outcomes.

The broadening of the reflective loss rule eventually culminated in the decisions of the English Court of Appeal in *Sevilleja v Marex Financial Ltd* [2018] EWCA C iv 1468 and the Cayman Islands Court of Appeal in *Primeo Fund v Bank of Bermuda (Cayman) Ltd and HSBC Securities Services (Luxembourg) SA* [2019] (2) CILR 1].

In the *Marex* case, Marex had obtained a judgment against two companies owned and controlled by Sevilleja for US\$5.5m. Sevilleja, in breach of his duties to the companies, transferred away the companies’ assets, leaving them insolvent and without funding to pursue any claims they had against Sevilleja. Marex brought a claim in tort against Sevilleja for inducing or procuring the violation by the companies of its rights under the judgment and intentionally causing it to

suffer loss by unlawful means. The English Court of Appeal held that the reflective loss rule barred Marex from pursuing its claim against Sevilleja and endorsed the four-fold policy justifications which had emerged from the authorities since *Johnson*. The decision enabled Sevilleja to escape liability for fraudulently stripping the companies of their assets.

In the *Primeo* case, Primeo had brought claims against its administrator and custodian, both entities in the HSBC group, for losses arising out of the fraud perpetrated by Bernard L Madoff Investment Securities LLC (BLMIS). The Ponzi scheme collapsed in 2008 and caused various feeder funds, including Primeo, to be placed into liquidation. Primeo had initially invested directly in BLMIS but later restructured its BLMIS investments into indirect investments through another fund, with Primeo becoming a shareholder in that other fund, which also had claims against HSBC entities. Primeo’s liquidators pursued claims against its administrator and custodian for breaches of their contractual duties in the period prior to the restructuring of the investments.

However, on the reflective loss issue, the lower courts held that all of Primeo’s claims were barred because the time at which to consider the application of the rule was the time at which the claim was issued, not the time at which the causes of action accrued. They also rejected the Primeo liquidators’ argument that the reflective loss rule could only apply where the shareholder’s claim and the company’s claim were against the same wrongdoer. Rather, they found that any claims brought by Primeo would ultimately pass through to the same wrongdoer by reason of interlocking claims within the HSBC group, and that the rule had to be assessed by reference to the economic effect of the claims rather than by reference to the legal entities involved.

### The UK Supreme Court’s decision in *Marex*

The *Marex* case then reached the UK Supreme Court. This was the first time since *Johnson* that the reflective loss issue had returned to the highest appellate level. The UK Supreme Court allowed Marex’s appeal and gave a landmark judgment on the basis and ambit of the reflective loss rule. The majority judgment overruled many of the earlier authorities and restated the reflective loss rule as the rule in *Prudential*, holding it to be a rule of substantive company law which should be confined to its narrow origin in that decision.

The majority stated that the rule in *Prudential* bars claims that 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'. Where a shareholder's loss falls within this description, it is 'not a loss which the law recognises as being separate and distinct from the loss suffered by the company. It is for that reason that it does not give rise to an independent claim for damages on the part of the shareholders'.

The focus was directed back to the corporate capacity in which the claimant's loss was suffered and the policy justifications were found to play no role in the application of the rule.

### The Privy Council's decision in *Primeo*

The UK Supreme Court's decision in *Marex* provided welcome guidance on the scope of the rule in *Prudential* and, in most situations, it should be relatively straightforward to identify whether a shareholder's claim falls within it. However, some uncertainty remained as to how the rule should be applied.

In the *Primeo* case, the liquidators had brought an appeal to the Privy Council, which is the highest appeal court for the British overseas territories. A panel, including the same judges who had heard *Marex*, addressed the specific issues raised, particularly the time at which the rule in *Prudential* is to be assessed and whether the claims by the shareholder and the company need to be against the same wrongdoer.

The Privy Council accepted the *Primeo* liquidators' arguments on the timing issue, concluding that the rule in *Prudential* did not apply to any of *Primeo*'s claims against the administrator and custodian. It reiterated that the rule is a substantive rule of law, to be assessed by reference to the capacity in which the loss is suffered (not at the time when the claim is issued). This approach was consistent with various statements by the UK Supreme Court in *Marex* and avoided the strange and unprincipled consequences which could follow if the application of the rule is assessed at the time proceedings are issued, such as shareholders selling their shares in an attempt to circumvent the rule. The Privy Council also explained that the rule is prospective in effect and applied to causes of action arising after the claimant became a shareholder, not those arising before. It was from this point that the shareholder would 'follow the fortunes' of the company and be precluded from asserting that it had suffered a separate loss. This protected the company's cause of action to the extent required by *Foss v Harbottle* and meant that a new shareholder could not be deprived of rights that it had already acquired.

The Privy Council also accepted the *Primeo* liquidators' arguments on the common wrongdoer issue, finding that the rule in *Prudential* only excludes a claim by a shareholder where the wrong is committed by the same person against both the shareholder and the company.

Extending the scope of the rule to include a claim against a different wrongdoer based on interlocking contracts would be contrary to the decision in *Marex* and ignore the critical importance of separate legal personality. There was nothing automatic or certain about liability passing through different wrongdoers in the same group and no assumption could be made about onward claims being brought. This would undermine the 'clear bright line' test laid down in *Marex*, which was designed to simplify the application of the rule. It would also magnify the scope of the rule to work injustice (such as the obvious injustice of wrongdoers escaping liability altogether). The general position is that a claimant is entitled to seek compensation for a wrong and the rule in *Prudential* is a highly specific exception to this.

### Conclusion

The recent decisions by the highest courts in the UK and the Cayman Islands in *Marex* and *Primeo* have reined the rule in *Prudential* back to its narrow company autonomy origin. It is likely that shareholder litigants in other jurisdictions will be encouraged to pursue claims falling outside the rule in *Prudential*, and defendants may be discouraged from taking technical arguments in an attempt to avoid liability by reference to the rule.

These recent decisions also provide reassurance to insolvency professionals who act for an entity in a group that they will be able to pursue the entity's cause of action where the loss does not fall within the restated rule.

#### About the authors

**Peter Hayden** is a Partner in the Mourant Cayman Islands office with extensive experience of financial services litigation and insolvency matters. Over the last 13 years, he has acted in many of the largest and most complex cases to be litigated in the Cayman Islands. He acts for the Algosaibi family in their ongoing claims against Maan Al Sanea and his companies, successfully obtaining a US\$2.5bn judgment against Al Sanea and settling certain claims. Peter also acts for the liquidators of the Madoff-impacted *Primeo* fund, successfully resolving litigation against the Trustee in New York and the Cayman Islands, the investment manager, the Herald feeder fund – where the Privy Council has found in favour of *Primeo* on both the creditor and shareholder distribution issues – and in the ongoing litigation against the administrator and custodian.

**Jonathan Moffatt** is Counsel in the Mourant Cayman Islands litigation practice, specialising in commercial litigation and insolvency work. He has worked on a number of the firm's most complex and challenging matters including *Primeo* and *Qunar*, as well as numerous cross-border insolvency matters and fair value appraisal actions. Before joining Mourant, he practised as an English barrister at Outer Temple Chambers, London, appearing in UK courts and tribunals.

Peter Hayden and Jonathan Moffatt successfully acted for *Primeo*'s liquidators in the Privy Council.