Mirror Mirror: Is the law now clear on reflective loss?

Update prepared by Peter Hayden (Mourant Ozannes (Cayman) LLP), Helen Evan QC and Usman Roohani (4 New Square Chambers).

The principle of reflective loss has reared its head in multiple cases since 2020. Although the Supreme Court's judgment in *Sevilleja v Marex Financial Ltd* [2020] UKSC 31 clearly aimed to narrow the scope of the principle, multiple cases since that date have grappled with precisely where the new boundaries lie. In this article, Helen Evans QC and Usman Roohani of 4 New Square Chambers in London, along with Peter Hayden of Mourant Ozannes in the Cayman Islands explain where the law now stands, how we got here, and whether any issues remain up for grabs.

Where did the principle of reflective loss come from and why?

The early case law

In order to understand the recent case law, it is necessary to start with a brief explanation of why the principle of reflective loss came into being. As made clear by the Supreme Court in *Marex*, the starting point is *Foss v Harbottle* (1843) 2 Hare 461. At the time of that judgment, the courts were developing the concept of separate corporate personality and *Foss* held that the only claimant who can seek relief for an injury done to a company, where the company has a cause of action, is the company itself. That proposition does not appear to have caused any real difficulties for around 140 years.

The point arose again in *Prudential v Newman Industries* [1982] Ch 204, to similar effect to *Foss*. The *Prudential* case was concerned with a claim for the diminution in the value of shares or in distributions arising from shares suffered by a shareholder merely because the company had itself suffered actionable damage. The plaintiff was pursuing a derivative claim on behalf of the company and a personal claim for its own loss. Both arose out of the same facts and were essentially identical. The English Court of Appeal held that the personal claim was barred because it "reflected" the company's loss. The "reflective loss" rule as expressed in *Prudential* was designed to ensure that the older rule in *Foss* could not be easily circumvented by a shareholder bringing its own claim, and was narrow in scope.

However, difficulties started to arise some twenty years later following the House of Lords decision in *Johnson v Gore Wood* [2002] 2 AC 1 The leading judgment in that case was given by Lord Bingham. He perceived the rule as a matter of company autonomy, as developed in *Foss* and *Prudential* and explained above. However, Lord Millett took a different approach. He sought to explain the rule as being based on the need to avoid double recovery and suggested that it applied to employees as well as to shareholders. His approach led to a very significant expansion of the rule in subsequent cases.

It soon became apparent that an expansion of the principles of reflective loss could produce arbitrary and unjust outcomes- effectively shutting out claims. In *Giles v Rhind* [2003] Ch 618, the English Court of Appeal

sought to develop a fraud exception to mitigate the impact of the expanded rule, and found that it did not apply when the wrongdoer's actions had the effect of preventing the company from bringing its own claim.

The high point for the reflective loss principle

Subsequent cases, however, expanded the rule further. The high point was reached in 2018-19 in the cases of *Marex v Sevilleja* [2018] EWCA Civ 1468 and *Primeo v Bank of Bermuda* as they then stood. In *Marex*, the English Court of Appeal held that the rule preventing recovery of "reflective loss" was not limited to shareholders, and applied to creditors as well. It stressed four justifications[1] for the rule, the primary one being the avoidance of double recovery. The fraud exception was also construed very narrowly to only apply in circumstances where it was impossible for the company to bring a claim.

The Cayman Islands Court of Appeal relied on that decision and went even further in *Primeo*. It found that the rule against reflective loss was not narrow and that it did not matter in what capacity the plaintiff was bringing the claim. It also held that the application of the principle was to be judged at the time the claim was brought, rather than when the cause of action accrued. In *Primeo* it was held that the rule still applied even though the plaintiff's and the company's claims arose under different contracts and at different times, and were against different defendants.

The waning tide: the principle of reflective loss narrowed and restated

The law was then reviewed by a seven member panel of the UK Supreme Court in *Marex*. Lord Reed, giving the majority judgment, re-stated the rule and took it back to its origins in *Foss* and *Prudential*. In particular, the majority of the Supreme Court:

- Explained that the rule was limited to shareholders who had suffered a diminution in the value of their shareholding or a reduction in distributions attributable to their shareholding, which was merely the result of a loss suffered by the company.
- Explained that *Prudential* established a substantive rule of company law applying specifically to companies and their shareholders in those particular circumstances and with no wider ambit.
- Made clear that the rule is not part of the law of damages and is not based on the avoidance of double recovery. It is instead an aspect of the rule in *Foss* and is based on the shareholder agreeing to follow the fortunes of the company when acquiring shares and to be bound by decisions taken by the company's organs as to whether claims should be brought to recover loss.
- Overturned the "fraud exception", because it was seen as being unnecessary in the context of the narrower rule.

It followed from the *Marex* judgment that the capacity in which a claim is brought is crucial, since it is only claims brought in the capacity of shareholder which may be caught by the re-stated rule. Likewise, the nature of the loss is crucial, since it only applies to diminution in the value of shareholding and reductions in share related distributions.

The minority of the Supreme Court in *Marex* advocated for a more radical departure from the existing law, in effect disposing of the rule altogether. It is not clear how that would work in practice though and whether it would risk erosion of the rule in *Foss*.

Notwithstanding the wide ranging review of the law carried out by the Supreme Court, a number of issues remained unanswered. Many of them were considered by the Privy Council in *Primeo*:

- The first of these was the question as to *when* the court considers whether the claim is reflective (i.e. whether it is at the time when the cause of action accrues or when the claim is brought). In *Nectrus Ltd v UCP Ltd* [2021] EWCA Civ 57, relying in part on the Court of Appeal decision in *Primeo*, Flaux LJ held that matters should be assessed at the time the claim was brought. However, as the Privy Council in *Primeo* noted, if that was correct the rule could very easily be circumvented by a shareholder selling their shares

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[1] The others being causation, the public policy of avoiding conflicts of interest and finally the need to preserve company autonomy and avoid minority prejudice.

before bringing a claim. The Privy Council therefore found that *Nectrus* was wrongly decided and that, because the rule was a substantive rule of company law and not merely a rule of procedure, the position was to be assessed at the time the loss was suffered.

- The second issue considered by the Privy Council was whether the subsequent transfer of assets by Primeo, into another company that also had claims in relation to those assets, could bar the loss. This question was answered in the negative for the same reasons. The Privy Council explained that the "follow the fortunes" bargain which arises when shares are acquired is forward looking, not backward looking and the rule cannot deprive a new shareholder of rights which it had already acquired prior to becoming a shareholder.
- A further issue that arose in *Primeo* was whether there had to be a common wrongdoer, such that the shareholder and company had claims against the same person. The Privy Council held that it is an inherent part of the rule that it only applies where the claims are against the same wrongdoer.

One issue that it was not necessary for the Privy Council to decide in *Primeo*, in light of its other findings, concerned the merits test (namely how strong the company's claim has to be to bar the shareholder's claim in the circumstances where the rule applies). Some early authorities had considered whether the company had to have an arguable claim or whether the company had to have a good claim on a balance of probabilities basis. The Privy Council left this point open, indicating that the previous decisions should not be considered authoritative.

Recent attempts to challenge aspects of reflective loss

The Supreme Court judgment in *Marex* and the Privy Council decision in *Primeo* had a substantial impact on many cases that were in the pipeline and had to be repackaged in the light of the courts' decision. Some of the reformulations adopted by parties involved significant changes of tack; others sought to exploit (real or alleged) unresolved issues or chip away at the edges of the restated rules on reflective loss.

Two doomed attempts to sidestep reflective loss problems: Breeze v Chief Constable of Norfolk

In *Breeze v Chief Constable of Norfolk* [2022] EWHC 942 (QB), the claimants issued proceedings before judgment was handed down by the Supreme Court in *Marex*. The claim arose out of a discontinued fraud prosecution of the two claimants who were shareholders in a company. By the time that they were acquitted, their company, together with its subsidiaries, had become insolvent. The claimants contended that this was directly due to the wrongful prosecution, and sought damages of over £15 million each. However, after the Supreme Court gave judgment in *Marex*, the defendant applied to strike out the central claims on the basis that they were caught by the rule on reflective loss. The claimants were left trying to find ways round the Supreme Court's approach.

Their first line of attack concerned whether the *Giles v Rhind* exception, described above, had survived. In *Breeze*, the Master acknowledged that, while there was some argument in a Cambridge Law Journal article to the effect that the exception remains open for argument, in her view the exception was "*dead for all intents and purposes on any straightforward interpretation of Marex*".

The claimants' second line of argument was to assert that, but for their arrest and prosecution, they would have succeeded in selling the shares in their company. They therefore sought to recover in damages the lost consideration for such a sale.

The claimants argued that this loss was not suffered at the company level and merely carried up into the value of the shares. Instead, they contended that such a loss can only arise directly at shareholder level, because it consisted of an inability to sell the shares themselves.

This argument was rejected. In short, the Master held that the claimants' losses in this regard were not "separate and distinct" from their position as shareholders as required by *Marex*. The Master was also influenced by the fact that *Primeo* had emphasised that the rule on reflective loss reflects the fact that shareholders are required to "follow the fortunes" of the company in which they are members.

The Russian doll argument and the position of indirect shareholders

In both *Breeze* and another case, called *Broadcasting Investment Group Ltd v Smith* [2022] 1 WLR 1, the claimants sought to circumvent reflective loss problems by arguing that the principle does not bar claims by indirect shareholders (being shareholders who hold an interest in a company by virtue of a shareholding higher up in the corporate chain). Is such an arrangement enough to oust the principles on reflective loss?

Although in *BIG v Smith*, the issue did not ultimately need to be decided, Arnold LJ made the obiter observation that it was "*well arguable*" that the rule against reflective loss would apply to indirect shareholders "*in appropriate circumstances*". Arnold LJ had in mind what is sometimes referred to as the 'Russian doll' scenario, where a shareholder in Company A is, in fact, the ultimate beneficial owner of all of the shares in Company C, by reason of Company A holding 100% of the shares in Company B, which holds 100% of the shares in Company C. He suggested that the mere interposition of a wholly-owned subsidiary cannot be enough to result in the reflective loss doctrine no longer applying. However, nothing was said on what the position would be for a shareholder who indirectly holds not all, but only some, of the shares in a company with its own cause of action.

In *Breeze*, the Master took a similar approach. The Master concluded that it was "*very dubious whether* [the indirect shareholder claims] *would survive post-Marex*" and said that the law was not clear enough to say that the claims would be "*bound to fail*", but held that it was "*very borderline*" as to whether the claims were even properly arguable. Ultimately, the *Breeze* claim was not allowed to proceed, but that decision was also based on other factors, such as the claimants' unjustified delay and a lack of clarity as to their case.

Accordingly, neither *BIG v Smith* nor *Breeze* contains the final words as to which indirect shareholder claims will be barred by the reflective loss doctrine and which will not. However, neither case offers much encouragement to claimants. Indeed, the various attempts to argue that aspects of the reflective loss doctrine remain open for fresh determination have not met with great success since the Privy Council's decision in *Primeo*.

Allianz Global v Barclays Bank: taking the long route to an unexpected destination

Allianz Global Investors v Barclays Bank & Ors [2022] EWCA Civ 353 is a rather different demonstration of the changing fortunes of a party taking points against a backdrop of fast moving appellate decisions on reflective loss. It illuminates a different risk- namely that focusing too heavily on reflective loss can mask other lines of argument.

What was the case about?

In *Allianz*, the Claimants were all funds. They alleged that they had suffered loss when they engaged in unsatisfactory forex trading as a result of infringements of competition law in the forex market by various banks between 2003 and 2013. Some of the funds were structured as companies, and allowed investors to redeem their shares by reference to the current "net asset value" of the fund in question. It was this issue that lay behind the banks' initial answer to the claims. The banks argued that:

- Even if the funds' criticisms were correct, the effect of the banks' breaches of competition law would have been to reduce the funds' net asset value.
- Where investors had redeemed their investments, they had received less than they would otherwise have done.
- By paying out reduced redemption monies, the funds had passed any losses on to the investors and had no ability to sue. The principles of reflective loss did not apply because the shareholders who had redeemed had effectively broken rank with the company.

The funds did not accept that the banks' analysis was correct. They applied to strike out the parts of the banks' defence which relied on these "no title to sue" arguments. The funds contended that even if the shareholders had suffered a fall in the value of their investments, they could not bring a claim because their loss was merely reflective of the loss of the funds.

In turn, the banks' answer to the funds' point was that the reflective loss principle does not prevent claims by former shareholders.

The first instance judgment

The *Allianz* case was heard at first instance after the judgments of the Supreme Court in *Marex* and the Court of Appeal in *Nectrus*, but before the decision of the Privy Council in *Primeo.* As at that brief snapshot of time, as noted above, the reported cases suggested that the application of the rule against reflective loss should be assessed when the claim is made, and that it did not bar claims by former shareholders.

Sir Nigel Teare handed down the first instance judgment in *Allianz* on 23 March 2021. He dismissed the funds' application to strike out the offending parts of the Defendant banks' defence. The Judge found that the banks were right and the funds were wrong, and that the principles of reflective loss would not prevent a former shareholder from suing. It was apparent, however, that grappling with *Marex* had caused some difficulty.

Despite this, the Judge concluded that the rules were different for former rather than current shareholders. The two principal justifications he identified were that:

- Where a shareholder redeems his shares, the loss becomes separate and distinct to that of the company;
- Such a claim therefore did not risk subverting the rule in *Foss v Harbottle*.

Allianz on appeal

The funds were dissatisfied with the outcome and appealed. In the hiatus between the first instance judgment and the appeal, the law swung in their favour. In particular, in August 2021, the decision in *Primeo* was handed down. As explained above, that decision made clear that:

- The time to consider the application of the reflective loss rule was when the cause of action accrued and not when the claim was made;
- The rules on reflective loss were prospective and required shareholders to "follow the fortunes" of the company.

The *Primeo* decision therefore cut the ground from underneath the feet of the banks. They had been relying on *Nectrus*, and *Primeo* made it clear that *Nectrus* was wrong. The banks therefore had no choice but to repackage their arguments. They shifted the emphasis away from reflective loss and argued instead that by passing on the losses in net asset value to former shareholders, the funds had avoided suffering a loss.

Again, the funds had an answer to this point. They contended that the fact that the shareholders received lower sums on redemption was a "collateral benefit" which should be ignored for the purposes of assessing the funds' damages.

The focus therefore veered away from the *Marex* and *Primeo* line of authorities and on to the Supreme Court case of *Swynson v Lowick Rose* [2017] UKSC 32. This is the leading authority on avoided loss. Although this is itself a complex area, the starting point is that loss which has been avoided is not recoverable as damages. However, there is an exception for "collateral benefits", which the law treats as not having made good a claimant's loss. These are things like insurance payments or gifts, and the justification for this approach is that they arise from a relationship or circumstance that is independent of the loss.

In practice, it can often be difficult to work out whether such a benefit is connected to a loss or not. If an investor had become disillusioned with the funds' performance as a result of the banks' breaches and had redeemed at a lower value as a result, would that be a connected or collateral benefit to the company?

In *Allianz*, the Court of Appeal made clear that the core focus should be on the mechanism that allowed the shareholder to redeem rather than the redemption decision itself. Shareholders were permitted to redeem as a result of the pre-existing relationship between them and the company, and not as a result of the banks' breaches. Therefore, such redemption decisions fell to be treated as a collateral benefit and ignored when calculating loss.

In *Allianz*, the outcome was that the banks lost on both the reflective loss and avoided loss arguments. But the Court of Appeal could not resist pondering on the chaos that would ensure if the banks' approach to reflective loss had been right.

What do the attempts to challenge the new boundaries to the reflective loss principles tell us?

Although the case changed tack, in *Allianz* the Court of Appeal analysed the logical consequences of the banks being right about their reflective loss arguments. This type of exercise had started in *Primeo,* where the Privy Council had pointed out that allowing former shareholders to sue in their own name could cause chaos, with wrongdoers becoming wary of settling claims brought by companies for fear of further claims by former shareholders coming out of the woodwork.

In *Allianz*, the Court of Appeal developed this line of thinking further. It pointed out that if the banks' approach had been correct:

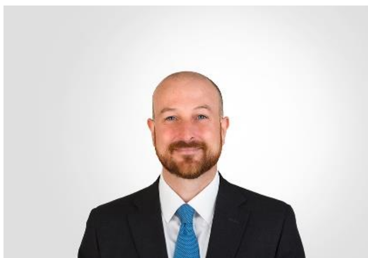
- In every claim for damages brought by a company, there would have to be a cumbersome investigation of each and every change in the share capital from the date when the cause of action accrued to the date of judgment;
- Very many corporate claimants had been over-compensated in the past.

Furthermore, the Court of Appeal could not resist observing that the ultimate conclusion of the banks' argument would be that no company could ever suffer recoverable loss because that loss would, in the end, be avoided when the company's assets were distributed.

The Court of Appeal therefore concluded that the consequence of the banks' avoided loss argument would be a negation of the corporate entity doctrine, treating losses as suffered by investors rather than by the company which had been established as the vehicle for the investments.

So by the end, the *Allianz* case had come full circle, and reaffirmed by a very circuitous route the rule in *Foss v Harbottle*, which is where this article started.

Contacts



Peter Hayden
Partner
Mourant Ozannes (Cayman) LLP
+1 345 814 9108
peter.hayden@mourant.com

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