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The rule against reflective loss: A will o' the wisp? A clown? Or finally pinned down?

Imagine a company has been dishonestly asset-stripped by one of its directors. The assets have gone into his own pocket. The company is wound up. The shareholders and creditors have little hope of recovering much from it. The obvious next step is to pursue the director. But the shareholders cannot recover the loss in value of their shareholding against him; that claim is barred by the rule against reflective loss. Is a claim by an unsecured creditor who is not a shareholder similarly barred? In *Garcia v Marex Financial Limited* [2018] EWCA Civ 1468, the Court of Appeal held that it was. This article examines how it reached that decision, and the wider implications for the finance industry.

THE FACTS

Marex was a foreign exchange broker. It brought a claim in contract against two BVI companies which had been its clients. Those companies were controlled by Mr Sevilija.

Marex's claims were tried, and a draft judgment was circulated on 19 July 2013. The draft indicated that Marex had been successful, and consequently the companies would be obliged to pay over some \$5m.

A week later, on 26 July, the final judgment was handed down. Marex obtained a freezing order against the companies on 14 August. But disclosure of the companies' assets revealed that they now had just \$4,000 to their name. They later went into liquidation.

Marex then issued proceedings against Mr Sevilija. It accused him of dishonestly asset-stripping some \$9.5m from the companies, following receipt of the draft judgment, in order to put those assets out of Marex's reach and thus avoid enforcement of that judgment.

Marex obtained permission to serve Mr Sevilija out of the jurisdiction. He applied to set aside service and to dispute jurisdiction, arguing that Marex could not show a completed cause of action against him. That argument was founded, in part, on a submission that the sums claimed by Marex were barred by the rule against reflective loss.

WHAT IS THE RULE AGAINST REFLECTIVE LOSS?

The rule originates from the principle that, where a company has suffered a loss as the

result of an actionable wrong, it is *prima facie* the company (or a legally appointed representative) who must sue to recover that loss (*Foss v Harbottle* (1843) 2 Hare 461).

Where an individual also suffers loss, the courts will consider whether that individual loss would be made good if the company's assets were replenished via a claim by the company (*Johnson v Gore Wood & Co (No 1)* [2002] 2 AC 1 HL per Lord Bingham at 35F).

If so, then the individual's claim is for reflective loss. As long as the company has its own cause of action to recover that loss, the proper claimant is the company and the "reflective" claim by the individual is not permitted – even if the company ultimately chooses not to bring proceedings to recover the loss (*Johnson (No 1)* per Lord Bingham at 35G).

How the rule has evolved

The rule has famously been described as being a "will o' the wisp" in need of clarification (*Johnson v Gore Wood (No 2)* [2003] EWCA Civ 1728 per Arden LJ at [162]). It began life applying only to shareholders who sought to recover the diminution in value of their shareholding, or a diminution in dividend: "such a 'loss' is merely a reflection of the 'loss' suffered by the company" (*Prudential Assurance Co v Newman Industries (No 2)* [1982] Ch 204 at 223A). The principle was then gradually extended to cover:

- not just shareholdings and dividends, but "all transactions or putative transactions between the company and its shareholders"

(*Johnson (No 1)* per Lord Millett at 66H);

- claims by individuals with an equitable (rather than legal) interest in shares (*Shaker v Al-Bedrawi* [2005] Ch 350); and
- claims by employees or unsecured creditors who were not shareholders (first explored *obiter* in *Johnson (No 1)* (per Lord Millett at 67B) and *Gardner v Parker* [2004] EWCA Civ 781 (per Neuberger LJ at [70]) before being decided in *International Leisure Ltd v First National Trustee Co UK Ltd* [2012] EWHC 1971).

However, the rule would not bar:

- losses suffered by a secured creditor (*International Leisure*); or
- reflective claims brought in situations where "the wrongdoer, by the breach of duty owed to the shareholder, has actually disabled the company from pursuing such a cause of action as the company had" (*Giles v Rhind* [2002] EWCA Civ 1428 per Waller LJ at [34]).

All this may look relatively settled and straightforward. But the apple cart was upset in 2013 by two decisions of Flaux J (as he then was) in *Fortress Value Recovery Fund LLC v Blue Sky Special Opportunities Fund LP* [2013] EWHC 14 and *Erste Group Bank AG (London) v JSC (VMZ Red October)* [2013] EWHC 2926.

In both cases, the claimants were unsecured creditors seeking to recover "reflective" losses. Following *International Leisure*, those claims ought to have been barred. But Flaux J instead concluded, in both cases, that it was "arguable" that the rule against reflective loss did *not* apply. However, neither of these was a final decision on the merits of the argument. They instead concerned an application to strike out (*Fortress*) and an application to set aside service (*Erste*); consequently, Flaux J merely had to decide whether the point should be allowed to proceed to trial. He decided that it should. In doing so, he reopened the argument, and set the stage for *Marex*.

THE JUDGMENTS IN MAREX

At first instance

The judgment of Knowles J ([2017] EWHC 918 (Comm)) found in favour of Marex, dismissing Mr Sevilija's applications. The judge concluded that Marex had the better argument on reflective loss, and therefore the claim ought to proceed to trial.

To understand how that decision was reached, it is necessary to look in more detail at what the judge was being asked to decide.

The main issue on the application appeared to be the possible existence of a new tort. Marex argued that there was a tort of "inducing or procuring the violation of [Marex's] rights under [the judgment] dated 26 July 2013" [8], which was a species of the *Lumley v Gye* tort. Mr Sevilija said that this supposed new tort did not exist. He was unsuccessful; again, Marex was found to have "the better argument" [28].

This finding was hailed as a significant development for the economic torts and attracted much attention, particularly in the financial sector. It is not uncommon for banks and other lenders to find themselves trying to recoup debts from companies that have been strategically asset-stripped and wound up, only to be later replaced by a similar "phoenix" entity. In those circumstances, unsecured creditors have few options other than to prove in the insolvency, often receiving just a few pence in the pound. Knowles J's judgment appeared to offer a welcome and important weapon in the fight to avoid that result. Although, again, his judgment was not a final decision on the issue, it was put in strong terms, going as far as to say that all the signs pointed "very strongly in favour of Marex" [47].

That is what underpinned his decision that the reflective loss rule did not apply. Although he referred to much of the relevant case law on the rule, ultimately his judgment appeared to be framed by a simple desire to keep his newly-discovered tort alive:

"Were the position otherwise these torts would be left with little application in situations where, in my view, they have a principled part to play ... I strongly resist the proposition that the claimant is then to be confined to remedies against the third

party, perhaps often (as here) remedies in its insolvency. I strongly resist the proposition that the defendant is answerable in law, and for damages, only to the third party for what he has done" [42].

Marex had also sought to rely, in the alternative, on the *Giles v Rhind* exception, but in view of his conclusions, Knowles J did not feel the need to decide that point [43].

Mr Sevilija appealed the decision on the reflective loss rule. Marex, in response, sought to uphold the judgment on the alternative *Giles v Rhind* ground.

On appeal

The Court of Appeal ([2018] EWCA Civ 1468) overturned Knowles J's decision on the reflective loss rule.

After a detailed exposition of the relevant jurisprudence, Flaux LJ concluded that the rule was not concerned with barring certain causes of action, but with barring recovery of certain types of loss. Knowles J's conclusion had been reached by reference to the nature of the torts in question, not to the losses claimed. That analysis was wrong and went against existing jurisprudence [27-28]

Flaux LJ also noted that the rationale for the rule was based on four key considerations [32]:

- the need to avoid double recovery from the defendant;
- causation: if the company chooses not to claim against the wrongdoer, then the loss to the claimant is caused by that decision, and not by the wrongdoer;
- public policy considerations: if the creditor had a separate right to claim, this might discourage the company from settling and thus give rise to a conflict of interest; and
- company autonomy and the need to protect minority shareholders and other creditors from the prejudice posed by a claimant creditor jumping the queue.

In light of this wide range of justifications, it was difficult to draw any principled or logical decision between a claim by a shareholder *qua* creditor and a claim by any other creditor [33].

Marex's attempt to rely on the *Giles v Rhind* exception was given similarly short shrift. The key points made by Flaux LJ were:

- the exception only applied in "limited circumstances" where the defendant's wrongdoing had actually made it impossible for the company to bring a claim [56];
- the exception was narrow and the impossibility had to be a legal, and not merely factual, one; impecuniosity, without more, was not enough [57]; and
- if the company could have brought a claim via an injection of funds from a third-party shareholder or creditor, or could have assigned the claim to a third party, the test of "impossibility" would not be satisfied and therefore the exception would not be made out [58].

Flaux LJ noted that there was no evidence before the court that Mr Sevilija had made a claim by the company impossible. In particular, there was nothing to suggest Marex could not simply have taken an assignment of the claim [60]. Therefore, it could not satisfy the test.

The result was that Marex's claims for the recovery of the judgment debt, together with interest and associated costs, were barred from proceeding by the rule against reflective loss. However, a further claim to recover the costs associated with various enforcement proceedings was allowed to proceed, on the basis that it was not reflective of the company's loss.

THE IMPACT OF THE DECISION ON BANKS AND OTHER CREDITORS

What is immediately striking about this judgment is the Court of Appeal's apparent disinterest in controlling the alleged abusive conduct by Mr Sevilija. It is a significant (and disappointing) step back from Knowles J's eagerness to stamp out this kind of behaviour.

The judgment does offer some clarity on the scope of the reflective loss rule. This has been much needed, particularly since the Flaux J judgments in 2013. It is now clear that:

- the rule will apply to unsecured creditors;
- the *Giles v Rhind* exception is very narrow, and seems unlikely to be of much assistance save in exceptional cases. Even if any and all attempts to mount a claim by alternative means (such as by a cash injection or assignment) fail, it is probable that any claim by the company would still need to

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meet the requirement for *legal* impossibility to benefit from this exception;

- the applicability of the rule depends on the nature of the losses claimed, *not* the causes of action giving rise to them.

However, that claim to clarity is undermined by two points.

First, a number of new questions are left unanswered by the judgment. One of these is the position of secured creditors; the judgment at [1] indicates it is concerned only with unsecured creditors (and therefore appears to leave the decision in *International Leisure* undisturbed), but at [33] the term “creditors” is used indiscriminately and without clarification. Another is the question of whether the rule against reflective loss may apply even in cases where the underlying loss is suffered by an individual, not a company – which was contemplated, but left open [38].

Second, there may still be scope for a further appeal. The thrust of *Marex*'s submissions below was that the law following *Prudential* “had taken a wrong turn” [35]. This was, as Lewison LJ noted at [71], an argument that properly belonged in the Supreme Court. *Marex* may seek to resurrect it there.

This is significant, given that the Court of Appeal decision effectively emasculates the new tort identified by Knowles J. If loss of a judgment debt is barred by the rule against reflective loss, it is difficult to see how that new tort could usefully be employed. But that decision is the result of a line of authority which mostly pre-dates the modern development of the economic torts (in *OBG v Allen* [2007] UKHL 21 and *Total Network* [2008] UKHL 19). *Marex* may be able to persuade the Supreme Court that the reflective loss rule should be reconsidered from scratch, in light of the potential role that these torts may be able to play.

PRACTICAL STEPS TO TAKE

For now, however, those in the business of lending money will need to consider how best to arm themselves against the risk of assets being dissipated to evade enforcement. Some practical advice is set out below.

Prior to the transaction:

- it pays to think ahead and consider, before

entering into any transaction, what potential methods of enforcement are available and their comparative risks and costs;

- proper checks on individuals and entities seeking to borrow are crucial. Look out for any warning signs: are there complex corporate structures or multiple holding companies involved? Do the company accounts disclose regular intra-group transfers? Are there signs of “phoenixing”? Have the directors or key individuals been involved in other entities which have folded suddenly or soon after being established?
- pay close attention to intra-group corporate structures and try to identify each entity’s role clearly at the outset;
- lending should always be secured against a fixed asset where possible (although, as noted above, this is not a fail-safe; it is now arguably unclear whether a secured creditor would fall foul of the rule against reflective loss).

When commencing litigation, try to frame any claim as:

- a claim to the diminution in value of an asset, where the claimant is a secured creditor;
- a claim for loss of an investment opportunity (this type of claim was permitted to go to trial in *Johnson*);
- a claim for specific performance or injunctive relief. The first instance decisions in *Peak Hotels and Resorts v Tarek Investments* [2015] EWHC 3048 (Ch) and *Latin American Investments Ltd v Maroil Trading* [2017] EWHC 1254 (Comm) suggest these remedies are not barred by the rule. However, a word of caution: the Court of Appeal did not take the opportunity to clarify its stance on these in *Marex*. Again, therefore, they are far from being fail-safe options and potentially remain open to challenge.

If all else fails and there appears to be an immediate risk of assets being dissipated, consider:

- A freezing injunction – in *Marex*, it is not clear why this was not sought until after the final judgment had been

handed down. It may be that the risk of dissipation was viewed differently post-judgment, but this was not explained by either Knowles J or the Court of Appeal.

- A notification injunction – this would prevent the respondent from dealing with or disposing of assets without first notifying the applicant (see eg *Holyoake v Candy* [2017] EWCA Civ 92). These are less onerous and easier to get than freezing injunctions, but it is still necessary to show a risk of dissipation.
- Drawing the other party’s attention to the risk of being found in contempt of court if asset-stripping occurs following release of a draft judgment. This point was specifically highlighted by Knowles J at [54-57].

CONCLUSION

The potential new tort identified by Knowles J caused much excitement. But its wide application, eagerly awaited by banks and other lenders frustrated by “straw men” corporate defendants, now seems unlikely to materialise. Instead, those lenders will have to wait in line for the payment waterfall, along with other unsecured creditors.

In 2003, Arden LJ expressed her hope that the rule against reflective loss “will be clarified before long” (*Johnson (No 2)* at [162]). Fifteen years later, the position is undoubtedly clearer. But the widening of the rule has also raised new, unanswered questions, which have left it unable to fully shake off its “will o’ the wisp” character. There is clearly still some way to go. ■

Further Reading:

- The rule against reflective loss and large-scale securities frauds (2012) 4 JIBFL 213.
- The multiple derivative action Parts 1 and 2 (2009) 2 JIBFL 61; (2009) 3 JIBFL 115.
- LexisPSL: Restructuring and Insolvency: Reconsidering reflective loss: Are creditors barred from recovery?