Through a glass darkly: reflections on reflective loss

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THE DECISION

The recent Court of Appeal decision of *Marex Financial Limited* [2018] EWCA Civ 1468] handed down on 26th June 2018 answered the question of whether the rule against reflective loss (which prevents a shareholder bringing an action for loss of value of their shares) applies to unsecured creditors.

The Court held that it does, and attempted to provide some justification for a rule that seems rooted in pure pragmatism.

The facts of the case are immaterial as the only issue for which permission to appeal was granted was on the ambit of the rule.

ANALYSIS

Development of the rule
The Court considered the development of the rule of no reflective loss

Prudential Assurance v Newman Industries (No. 2) [1982] 1 Ch 204
This was the genesis of the rule which provided two justification for it:
A technical analysis of what a share in a company is at law ("a right of participation in the company on the terms of the articles of association") on which basis the shareholding plaintiff technically suffers no "loss" from a drop in the value of his shareholding;

An application of the "proper plaintiff" rule from Foss v Harbottle (1843) 2 Hare 461.

Johnson v Gore Wood [2002] 2 AC 1
Actions for loss of value of shares and loss to the value of a pension scheme due to the company's inability to make payments due to the defendant's tort were barred by the rule. Actions for loss of investment opportunity and for a drop in value of the pension scheme were not.

Lord Bingham set out three principles:

The rule bars a claim by a shareholder for a loss that the company could itself make good by successfully bringing an action.

If the company has no cause of action then the rule does not bar a shareholder who has a cause of action even if the loss complained of is a diminution of the value of his shareholding.

The rule does not bar the shareholder for suing for losses that are separate and distinct from those of the company.

Gardner v Parker [2004] EWCA Civ 781
The Court considered the application of the rule to a claim for breach of fiduciary duty and concluded that it was the type of loss that brought the rule into effect and not the type of action. The Court concluded that the justification for the rule was the prevention of double-recovery.

The Marex Court of Appeal summarised the justifications for the rule
After analysing the above developments the Court of Appeal sumamrised the justifications for the rule as follows:

The need to avoid double recovery by the claimant and the company from the defendant;

Causation, in the sense that if the company chooses not to claim against the wrongdoer, the loss to the claimant is caused by the company's decision not by the defendant's wrongdoing;

The public policy of avoiding conflicts of interest particularly that if the claimant had a separate right to claim it would discourage the company from making settlements;

The need to preserve company autonomy and avoid prejudice to minority shareholders and other creditors.

The Court concluded that based on justifications 1-3 the rule must be applied to unsecured creditors as well as shareholders. The Court considered that failing to extend the rule would create an illogical situation whereby a shareholder of a single share who was also a creditor would see his claim barred by the rule, whereas a creditor without shares or one who sold his shares prior to bringing the action would not.

The Giles v Rhind exception
This exception occurs where the wrongdoing complained of has disabled the company from pursuing the relevant cause of action.

The Court of Appeal emphasised the limited scope of the Giles exception, noting that it was not enough that the company was in practice rendered incapable of bringing an action; the wrongdoing had to be directly responsible for disabling the company from bringing an action.

It is unclear how this matches with the Court's list of justifications for the rule since the mere practical inability of the company to bring a claim would disengage justifications 1 and 2. On the other hand, if the company is directly or even intentionally disabled from bringing an action by the wrongful conduct complained of justifications 3 and 4 are engaged.

Nonetheless the Court of Appeal did not follow through and say that Giles had been wrongly decided.

Conclusion

The Court of Appeal in Marex appears to have moved away from the basis of the rule as lying partially in the nature of shares in a company and instead bases the rule on an almost entirely pragmatic footing: The rule exists because to do without it would run the risk of double-recovery by unsecured creditors and the company, and would allow unsecured creditors to leap-frog their rightful place in the hierarchy in the event of the company's insolvency. Those practical considerations will remain relevant for the foreseeable future, and the Supreme Court is unlikely to turn the rule on its head even if it is given the opportunity to do so.

IMPACT OF THE DECISION

The decision provides increased legal certainty despite the lack of solid theoretical justification for the rule. The Court of Appeal has taken the opportunity to confirm that the Giles exception is confined into near-irrelevance.

The decision is also good news for insolvency practitioners. The inability of unsecured creditors to bring an action against a company will only come into play when the company's fortunes have been so affected by a wrong that the creditors cannot be paid. The Court of Appeal has confirmed that in those circumstances the creditors' remedy lies in insolvency proceedings against the company, and the wrong complained of will be a matter for the company's liquidator.

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