A quick glance at reflective loss and shareholder remedies

June 2019

This article has since been updated to reflect that the reflective loss rule no longer applies to claims by creditors, following the Supreme Court's ruling in July 2020 to reverse the Court of Appeal's decision on the cited Marex case. View the latest article here.

Background

Acquiring shares in a company is inevitably accompanied by a degree of risk. Volatile markets can often drastically impact upon the value of a company's shares, leaving shareholders elated or, alternatively, sorely disappointed.

Another reason for the fluctuation in value of a company's shares is the actions and decisions of management, i.e. the directors. For example, in circumstances where a director has breached his or her fiduciary duties and caused loss to a company, thereby spiralling its share value downwards and reducing dividends, the result is that shareholders suffer loss.

In these circumstances shareholders will often want to know what tools are available to them to try and recover compensation for their financial loss. The subtle distinction between what is the company's loss and what is the shareholder's loss can often cause confusion. Enter the rule of 'reflective loss' which has recently been extended by the English Court of Appeal in Sevilleja Garcia v Marex Financial Ltd [2018] EWCA Civ 1468 to include shareholders and creditors of a company.

The rule of reflective loss

The rule of reflective loss emerged in the early 1980s in the case of Prudential Assurance v Newman Industries (No. 2) [1982] 1 Ch 204 and prevents claims of shareholders (and now creditors) where their loss merely reflects the loss suffered by the company.

Where a company suffers a loss by a breach of duty owed to it, only the company may sue in respect of that loss. It follows that a shareholder is generally not able to bring a claim in respect of that loss as it belongs to the company. The rule was helpfully explained in Prudential as follows:

"…what [the shareholder] cannot do is to recover damages merely because the company in which he is interested has suffered damage. He cannot recover a sum equal to the diminution in the market value of his shares, or equal to the likely diminution in dividend, because such a "loss" is merely a reflection of the loss suffered by the company.

The shareholder does not suffer any personal loss. His only "loss" is through the company, in the diminution in the value of the net assets of the company, in which he has (say) a 3 per cent. shareholding. The plaintiff's shares are merely a right of participation in *the company on the terms of the articles of association. The shares themselves, his right of participation, are not directly affected by the wrongdoing. The plaintiff still holds all the shares as his own absolutely unencumbered property. The deceit practised upon the plaintiff does not affect the shares; it merely enables the defendant to rob the company."*

The Royal Court of Jersey confirmed that the rule of reflective loss is part of Jersey law in Freeman v Ansbacher [2009] JLR 1. The rule has been extended over time to not only include a diminution in share value but also reduced dividends and other payments which the shareholder might have been entitled to had the company not suffered loss.

There is a limited exception to the rule of reflective loss (discussed below) but the news that only the company can bring a claim is generally not well received by shareholders. However, the rule is underpinned by sound reasoning, as follows:

- There could be double recovery were the company and a shareholder able to both claim against the wrongdoer.
- If the company chooses not to claim against the wrongdoer, the loss to the shareholder is caused by the company's decision, not by the wrongdoer.
- There are public policy considerations surrounding the company and the shareholder having divisible rights as the company might be discouraged from entering into settlements.
- The need to preserve company autonomy and avoid prejudice to minority shareholders or other creditors.

The Giles Exception

The exception in Giles v Rhind [2002] EWCA Civ. 1428 permits a shareholder or creditor to bring a claim against the wrongdoer. However, it only applies where, as a consequence of the actions of the wrongdoer, it is impossible for the company to bring a claim (or a claim to be brought in its name) against the wrongdoer.

Importantly, the company's inability to bring the claim must be legal in nature, as opposed to factual. This means that even in circumstances where the wrongdoer stole all of a company's funds (so that it could not afford to bring a claim against the wrongdoer), the Giles exception would not apply. An injection of funds by a third party, shareholder or creditor would resolve the issue, or a third party could take an assignment of the company's claim.

Non-shareholder creditors

In Marex the Court of Appeal had to grapple with whether the rule of reflective loss extended to non-shareholder creditors of a company and concluded that it did. The basis for this decision is that the rule would apply to a shareholder who was also a creditor of the company, so there is no logical reason why it should not apply to a non-shareholder creditor. The creditor would not be able to bring a claim which belonged to the company.

Shareholder remedies

The outlook for aggrieved shareholders is not all negative, however, as a shareholder can resort to the well-established pathways of:

- an unfair prejudice claim under the Companies (Jersey) Law 1991 (as amended) (the Companies Law);
- a common law derivative claim; or

- an application to wind up the company under the Companies Law.

An unfair prejudice claim is geared towards the mismanagement of a company whereas a derivative claim is aimed at misconduct. This is an important distinction to draw when deciding which claim is suitable. We have summarised these two claims below, although they warrant their own individual guides.

The winding up of a company is, typically, very much a last resort but can also be used strategically to place pressure on the company.

Unfair prejudice

The unfair prejudice regime in Jersey is broadly similar to that in England and Wales. If the shareholder is of the view that the company's affairs are being conducted in a way which is unfairly prejudicial to the interests of all or some of the shareholders, the aggrieved shareholder can apply to the Royal Court for a wide range of orders which, by way of example:

- regulate the conduct of the company;
- refrain the company from taking certain steps or requires the company to take certain steps;
- authorises proceedings to be brought in the name and on behalf of the company; and
- requires the purchase of the aggrieved shareholder's shares (at a fair value) by other shareholders or by the company itself.

Derivative claim

A derivative claim is a claim made by a shareholder on behalf of the company and for the benefit of the company. Consequently, to the extent that funds are recovered, the company as a whole will benefit (unless the Royal Court orders otherwise).

The usual grounds for bringing a derivative claim are:

- the act complained of is ultra virus the company or illegal; and/or
- the act complained of amounts to a fraud against the minority and the wrongdoers control the company.

Strict legal thresholds must be met and, importantly, there must be no other remedy available. Derivative claims are less common as a result.

Winding up

An aggrieved shareholder can apply to wind up the company on a 'just and equitable' basis pursuant to the Companies Law which will result in the end of the life of the company.

The Royal Court has said that the words just and equitable must be given a wide and flexible interpretation, so it is not possible to give an exhaustive list of circumstances in which it will order a company to be wound up on just and equitable grounds. However, one of these grounds is a justifiable loss of confidence in the management of a company due to fraud, dishonesty or serious mismanagement of the company's business by the directors or majority shareholders.

If a winding up order is made a liquidator will be appointed to manage and wind up the company. The liquidator's fees and expenses will be paid in priority to any other claim from the assets of the company. The liquidator will then seek to realise the remainder of the assets of the company prioritising the company's creditors first and its shareholders second.

In light of the above, an application to wind up the company can be considered to be the 'nuclear' option and therefore requires careful consideration before deployment.

Summary

Jersey is a reputable and highly regulated financial centre. It has a sophisticated, responsive and modern legal framework and has consistently demonstrated a willingness to assist aggrieved shareholders where it is possible to do so. The decision in Marex provides a welcome reminder of the principles underlying the rule on reflective loss and has extended the rule to non-shareholder creditors. However, aggrieved shareholders (and creditors) still have a number of options available to them.

For more information please contact:

Simon Hurry
Partner // Jersey
t:+44 1534 601740 // e:simon.hurry@collascrill.com

WE ARE OFFSHORE LAW

BVI | Cayman | Guernsey | Jersey | London

COLLAS·CRILL