KEY POINTS

- The English reflective loss rule is likely to be a rule of substantive, not procedural, law.
- There is conflicting High Court authority on whether the *lex causae* or the law of the place of incorporation of the company in question governs the ability of shareholders to recover for losses when a wrong has been done to both the company and the shareholders.
- There are cogent reasons why the law of the place of incorporation of the company in question should prevail.
- In Rome II cases, reflective loss is neither an overriding mandatory provision nor an English rule of public policy; rather it is a matter governed by the law of the tort falling within Art 15.

Feature

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Reflective loss and the applicable law conundrum

The recent Supreme Court decision in *Sevilleja Garcia v Marex Financial Limited* [2020] UKSC 31 (featured in the October edition – (2020) 9 JIBFL 599) has focused the spotlight on the scope – and limitations – of the English rule against reflective loss. Whilst much of the common law world has adopted a reflective loss rule, the rule – and particularly the English version of it – is far from universally recognised in other jurisdictions.

In cross-border cases, and particularly in multi-jurisdictional civil fraud cases, the battleground is increasingly centred on whether English law applies to determine the issue at all, or whether the law of another jurisdiction applies – and if so, which.

RECAP ON REFLECTIVE LOSS IN ENGLISH LAW

Since *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 there has been a general prohibition on a shareholder bringing a claim against a wrongdoer for the diminution in the value of its shareholding (and for a shortfall in dividends) resulting from a loss suffered by the company as a result of the wrong.

Twenty years later, the House of Lords in *Johnson v Gore-Wood* [2002] 2 AC 1 applied *Prudential v Newman* to a claim by a shareholder against a firm of solicitors which had already settled an action brought by the company in question. The House of Lords was unanimous in dismissing the claim of the shareholder. In obiter dicta subsequently widely followed, Lord Millett explained that the rule against reflective loss "applies to other payments which the company would have made if it had had the necessary funds even if the plaintiff would have received them qua employee and not qua shareholder and even if he would have had a legal claim to be paid. His loss is still an indirect and reflective loss which is included in the company's claim" (at p 67).

In subsequent cases Lord Millett's reasoning was relied upon to widen the scope of the "reflective loss" principle to bar claims against a wrongdoer brought by employees and creditors of a company where the loss claimed flowed from the company's inability to pay them as a result of the wrongdoing.

The principle causes issues in civil fraud cases where the wrongdoer has asset-stripped or otherwise caused loss to companies in which the claimant has an interest. The facts of *Marex* are not atypical: creditors of two companies alleged that the companies' director had asset-stripped the companies, in breach of his director's duties, to avoid satisfying judgment debts owed to the creditors.

As a result of the Supreme Court decision in *Marex*, the rule against reflective loss does not apply to creditors, such that creditor claims are not barred. In the obiter view of the majority, it is necessary to distinguish between:

(i) cases where claims are brought by a shareholder in respect of a 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 wrongdoer; and

(ii) cases where claims are brought, whether by a shareholder or by anyone else, in respect of loss which does not fall within that description, but where the company has a right of action in respect of substantially the same loss.

The reflective loss rule bars claims falling within (i) but not (ii), which the law regards as giving rise to a loss which is separate and distinct from the company's loss.

Notwithstanding that narrowing of the reflective loss rule, *Marex* has affirmed the core existence of the rule in shareholder cases, and so shareholders in a company which is a victim of a fraud will continue in many cases to face difficulties obtaining a remedy against the wrongdoer.

CHARACTERISATION IN PRIVATE INTERNATIONAL LAW

In a cross-border case, when an English court is faced with an argument that a shareholder's claim is barred due to the (or a) rule against reflective loss, three possibilities may be argued for:

- First, that the English rule is a rule of procedural law, such that it should be applied as part of the *lex fori* no matter what the relevant systems of foreign law might provide as to any such rule.
- Second, that the law of the place of incorporation of the company in question should be applied when considering whether there is any such rule, and if so its content and effect.
- Third, that the law applicable to the relevant cause of action should be applied in order to determine that question.

Two recent High Court decisions – *KMG International NV v Chen* [2019] EWHC 3634 (Comm) and *UCP Plc v Nectrus Limited* [2019] EWHC 3274 (Comm) – provide

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authority that the rule is not procedural but provide conflicting authority on the latter two of those points.

THE HIGH COURT DECISIONS

In a case decided before the Supreme Court decision in *Marex, KMG International NV v Chen*, the claimant had obtained an arbitration award against a company incorporated in the Netherlands. It alleged that, in breach of duty, the company's former managing director and a company controlled by her had diminished the company's assets which, in turn, meant the company could not satisfy the arbitration award. The claimant brought an action in tort against the defendants. It was agreed that the claim was a claim to enforce a non-contractual obligation and thus fell to be dealt with according to Regulation (EC) No 864/2007 (Rome II). Rome II applied Dutch law as the *lex causae* and the evidence was that Dutch law did not prohibit recovery for reflective loss.

The defendants applied to strike out the claim or alternatively for summary judgment on the grounds that the English reflective loss rule barred the Dutch tort claims because:

- it was a mandatory overriding rule of English law within the meaning of Art 16 of Rome II; and/or
- any derogation from the reflective loss rule would be manifestly incompatible with English public policy within the meaning of Art 26 of Rome II; and/or
- it was a rule of procedure governed by the *lex fori*.

In the subsequent case of *UCP Plc v Nectrus Limited*, a former shareholder in a company brought a claim against the defendant, an investment manager. The company in question was incorporated in Mauritius, the former shareholder was a company incorporated in the Isle of Man and the defendant was a company incorporated in Cyprus which in turn was a sub-subsidiary of an Indian real-estate company. It was alleged that the defendant had breached its duties pursuant to the investment management agreement with the company in question by causing substantial sums of money to be "lost or 'stranded'" in India. The claimant had sold its shareholding at a discount to reflect the lost deposits and it sought to recover damages representing the discount, giving credit for the modest deposits recovered. The evidence was that the law of Mauritius did not bar recovery for reflective loss.

A RULE OF PROCEDURAL OR SUBSTANTIVE LAW?

As noted above, in *KMG International NV v Chen* the defendant sought to strike out the claim on a number of bases. In a decision which will remain relevant after the end of the transition period following the UK's withdrawal from the EU, as a result of the Law Applicable to Contractual Obligations and Non-Contractual Obligations (Amendment etc.) (EU Exit) Regulations 2019/834, Christopher Hancock QC, sitting as a Deputy High Court Judge, decided the case by reference to the arguments in relation to Rome II.

He began by interpreting Art 1.3 of Rome II which provides:

> "This Regulation shall not apply to evidence and procedure … ."

The judge held that the exclusionary Art 1.3 had to be read in conjunction with Art 15, which sets out the scope of issues governed by the applicable law of the tort under Rome II. Article 1.3 was to be given a narrow construction and did not catch the reflective loss rule which was not "an indispensable feature of the forum's legal framework for resolving disputes". For similar reasons he also held that the reflective loss rule was not a mandatory overriding provision within the meaning of Art 16 of Rome II nor was the Dutch law manifestly incompatible with the public policy of the forum, by reason of its divergence as regards the reflective loss rule, within the meaning of Art 26 of Rome II.

Having dismissed the strike out application on the ground that the applicable law was governed by Rome II which applied Dutch law, Christopher Hancock QC went on to deal obiter – but in detail – with the argument that if Rome II did not apply, then the reflective loss rule was an English procedural rule at common law. The learned judge expressed the view that the reflective loss rule is one relating to the kinds of damage recoverable, comparable to the rules of remoteness, mitigation and the like, and thus was a rule of substantive law. He was also of the view that, so far as choice of law is concerned, it is the *lex causae* that governs the question of the existence and content of a reflective loss principle.

It is likely that the procedural vs substantive controversy has now been put beyond doubt as a result of the Supreme Court decision in *Marex*. Lord Reed PSC, with whom Lady Black, Lord Lloyd-Jones and Lord Hodge DPSC agreed, held that "the decision in *Prudential* established a rule of company law, applying specifically to companies and their shareholders in the particular circumstances described, and having no wider ambit" (at para [9]). Lord Hodge expressed the view that "the problems and uncertainties which have emerged in the law have arisen because the 'principle' of reflective loss has broken from its moorings in company law" (para [96]).

DETERMINING THE APPLICABLE SUBSTANTIVE LAW

As just noted, in *KMG International NV v Chen*, Christopher Hancock QC observed obiter that the issue whether a claimant could recover for reflective loss was governed by the *lex causae* at common law. On the facts of that case however Rome II, rather than the common law, applied. He held that the reflective loss issue fell within Art 15, which sets out the scope of the applicable law as determined under Rome II, and thus the law applicable to the non-contractual obligation applied to govern the question of recoverability of reflective loss.

In the subsequent case of *UCP Plc v Nectrus Limited*, Burton J decided that the rule against reflective loss did not bar claims by ex-shareholders who had been forced to sell at a discount, and who sued to recover that shortfall. He remarked obiter that had it been necessary to decide the point, he would have held that the law of the place of incorporation of the company in question should be applied to determine

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the question of whether reflective loss barred the claim.

Where the *lex causae* and the law of the place of incorporation are the same, no issue arises. But in other cases where the *lex causae* and the law of the place of incorporation point to different systems of law, the issue may be pivotal.

THE LAW OF THE CAUSE OF ACTION OR THE LAW OF THE PLACE OF INCORPORATION

Burton J had the benefit of the judgment in *KMG International NV v Chen* but indicated that he would not have followed the approach suggested in that case. Rather, he preferred an analogy between the reflective loss rule and the question whether a shareholder was entitled to bring a derivative action. In *Konamaneni v Rolls Royce Industrial Power (India) Ltd* [2002] 1 WLR 1269, Lawrence Collins J (as he then was), had held that the availability of a derivative action was governed by the law of the place of incorporation of the company. Burton J's view was that both could be characterised in broad terms as issues related to shareholder remedies, and that a common categorisation leading to the same applicable law was attractive.

The issue in *Chen* was framed by the learned judge as:

> "Is the rule within article 15 of Rome II or is it excluded from Rome II by virtue of article 1(3)?"

Having assumed that the issue was binary and that Art 15 applied the *lex causae*, it is perhaps easy to see why the learned judge may have been led to comment obiter that at common law the issue was governed by the *lex causae*.

Yet if Burton J is correct then it raises serious doubts about the line of cases (including *Barings v Coopers & Lybrand* [2002] PNLR 16 and *Shaker v Al-Bedrawi* [2003] Ch. 350) which have applied the English reflective loss rule to companies incorporated outside England. Applying the reflective loss rule to these cases carries the implication that the English law rule is not confined to companies incorporated in England and Wales.

As Burton J noted, in none of those cases was the point actually argued. Most recently the Supreme Court in *Marex* was invited to apply the English reflective loss rule to companies incorporated in the British Virgin Islands. It does not appear from the judgment that there was any argument or discussion about this aspect of the case. It may be possible to justify the results in all or some of these cases on the basis that they were decided upon the footing that, absent any evidence to the contrary, there is a presumption that foreign law is the same as English law, although they were not expressly decided upon that basis.

The argument in favour of a similar approach to both the availability of a derivative action and the existence and content of a reflective loss rule is attractive. Prior to *Marex* the obvious counter-argument to this approach was that the reflective loss rule was much broader than a shareholder rule and applied to a multitude of legal relationships, such that a conflict of law rule based on the law of the place of incorporation looked unduly narrow.

Yet with the Supreme Court decision in *Marex* confining reflective loss to its original narrow shareholder focus, that counterargument has been undermined. Indeed it may now be said that adopting the *KMG International NV v Chen* approach would mean that the choice of law for the application of reflective loss rules will depend on the characterisation of the cause of action, with scope for claimants to frame their cause of action so as to circumvent the reflective loss rule. Further, there would be scope for cases where the English rule may apply to bar one cause of action (for which the *lex causae* is English) but not another (for which the *lex causae* is that of a different jurisdiction, which contains no analogue rule).

In contrast, the *UCP Plc v Nectrus Limited and Konamaneni* approach would provide consistent approaches to reflective loss and derivative action rules in respect of shareholder claims in cross-border actions. Given the close relationship between the two, there is a cogent argument that this is desirable.

THE FUTURE

Whilst the Supreme Court has now settled the issue of the scope of reflective loss in English law, the battleground over reflective loss in cross-border cases remains fertile, and as noted above, depending on the content of the competing foreign laws, the outcome of this issue can be case-dispositive. A further High Court decision on the issue may well be given in due course in *The Kingdom of Sweden v Serwin*.[1]

There is much to commend categorising the reflective loss rule as an issue for the law of the place of incorporation, but such an approach does raise doubts about the applicability of the reflective loss rule to companies incorporated other than in England and Wales. The debate over reflective loss continues. ■

1 See [2020] EWHC 1251 (Comm) for a recent judgment by Butcher J granting leave to enforce a freezing order abroad.

Further Reading:

- *Sevilleja v Marex Financial Ltd*: a new look at reflective loss (2020) 9 JIBFL 599.
- The rule against reflective loss: A will o' the wisp? A clown? Or finally pinned down? (2018) 9 JIBFL 558.
- LexisPSL: Practice Note: reflective loss.