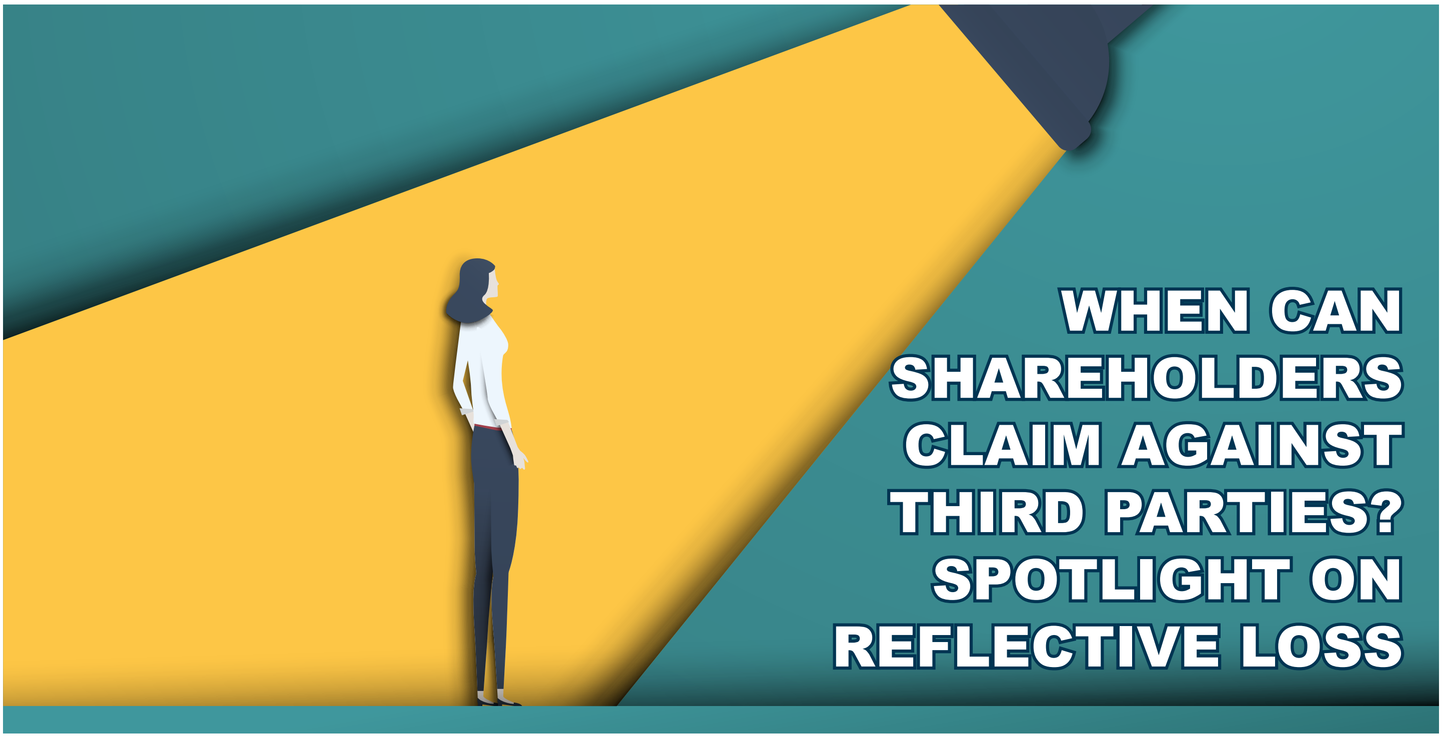

Authored by: Michael Barron, Harriet Campbell and Gruffydd Ellis – Stephenson Harwood

When a company suffers loss because of a wrong done to it by a third party, the company can sue that third party for redress. But what happens when the company does not sue? Can a shareholder ever directly sue a third party for a wrong done to the company? Enter the rule against reflective loss, and a series of complex court decisions. In this article, we distil the latest legal thinking from the courts on when shareholders may – and may not –pursue third parties for losses. We also address the practical steps that claimants can take to seek redress when faced with the rule against reflective loss.

What does the rule against reflective loss mean?

Where a duty owed to both a company and a shareholder is breached and that breach causes loss to the company and 'loss' to the shareholder (either because the share value falls or the company is unable to pay dividends), the shareholder's 'loss' is not considered to be separate from that of the company. In law, it is 'reflective' loss and the rule against reflective loss prevents the shareholder bringing a claim to recover it.

Is there an easy way to tell if your claim is barred by the reflective loss rule?

In theory, yes. In the latest case to examine the scope of the reflective loss principle (Burnford & Ors v Automobile Association Developments Ltd)[1], the court rejected an argument that the law on reflective loss was so 'fiendishly complex' and uncertain that it was inappropriate to decide it on a summary basis. It held that following the Supreme Court's decision in Sevilleja v Marex[2], the position was clear.

If (and only if) the following six conditions are met, a claim by a shareholder against a third party will be barred:

i) the shareholder suffers loss;

ii) in the capacity of a shareholder;

iii) in the form of a diminution in share value or in distributions;

iv) which is the consequence of loss sustained by the company;

v) in respect of which the company has a cause of action; and

vi) against the same wrongdoer.

If I'm not a direct shareholder is my claim still barred?

Possibly. In Broadcasting Investment Group v Smith[3], the High Court held that the rule does not apply to indirect shareholders. By indirect, the court gave the example of A owning shares in B, B owning shares in C and C owning shares in D. If D suffers a loss which lowers the value of its shares / restricts dividends resulting in loss to A, B and C, it held that only C's claim (the immediate and direct shareholder in D) will be barred by the rule against reflective loss. However, on appeal the Court of Appeal (while not deciding the point) suggested that the rule against reflective loss could bar A and B's claim as well. Further judicial clarification is required to decide this point.

1 Burnford & Ors v Automobile Association Developments Ltd [2022] EWHC 368 (Ch)
2 Sevilleja v Marex Financial Ltd [2020] UKSC 31
3 Broadcasting Investment Group Ltd v Smith [2020] EWHC 2501 (Ch) and Broadcasting Investments Group Ltd v Smith [2021] EWCA Civ 912

If I'm no longer a shareholder when I bring my claim, is it still barred?

Probably. While there are conflicting authorities, the likelihood is that the loss must be assessed at the time it is suffered and not when the claim is brought. However, the position is not clear. In Nectrus v UCP[4] (a judgment given on an application for permission to appeal), the court held that the time for assessing the loss should be the date the claim was issued. Subsequently, however, in Primeo v Bank of Bermuda[5], the Privy Council concluded that Nectrus was 'wrongly decided' and the time for assessing loss should be the date the loss was suffered. In Burnford, the court considered these conflicting authorities and determined that it was bound to follow Nectrus and not Primeo. Because it was able to distinguish Nectrus on the facts, however, it ultimately followed Primeo. While not wholly certain, for reasons discussed below, it seems likely that Primeo is the preferred judicial position.

If my loss crystallised when my shares were sold, is my claim still barred?

Probably, although it may be easier to argue that the rule against reflective loss does not apply. In Nectrus, the court held that losses incurred by an ex-shareholder who sold their shares at a loss were 'separate and distinct' from the company's losses. It was this 'passing on' of the loss which occurred in Nectrus but not in Burnford, on which the cases were distinguished. However, in Allianz Global Investors[6] (decided after Burnford), the Court of Appeal (while not deciding the issue) suggested Primeo was authority for the date for assessing loss as being the date it is incurred. Once the loss has been assessed as 'reflective' it cannot, it held, be converted into an actionable loss by the subsequent selling of the shares. Unfortunately, as this point was not directly relevant to the appeal, there remains a degree of uncertainty.

Practical considerations for shareholders

In an economic environment where insolvencies are on the increase, there may be many reasons why companies do not pursue litigation. At the time loss is sustained (and a company elects not to pursue a claim), shareholders therefore need to think carefully about how best to protect their investment.

As can be seen from this summary, significant uncertainty remains surrounding the scope of the rule against reflective loss. It is therefore worth considering whether there are any grounds for arguing that the rule against reflective loss does not apply. In particular, while the company's choice not to pursue a claim will not suffice, there may be cases where the company simply does not have a cause of action against the same wrongdoer. Further, if Primeo is to be followed, it seems likely that a claim for losses sustained prior to the claimant acquiring shares will not be barred by the rule. On the other hand, if Primeo is not followed, shareholders whose loss is crystallised on the sale or redemption of their shares may not be prevented from subsequently bringing a claim in respect of that loss. There may also be scope for arguing that claims by indirect shareholders may also not be barred. Finally, it is worth bearing in mind that in exceptional circumstances, shareholders may be permitted to bring or continue to bring a claim on behalf of the company. In that instance, the rule against reflective loss will not apply.

4 Nectrus Ltd v UCP plc [2021] EWCA Civ 57

5 Primeo Fund v Bank of Bermuda (Cayman) Ltd [2021] UKPC 22

6 Allianz Global Investors GmbH v Barclays Bank Plc [2022] EWCA Civ 353