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Hazardous hypotheticals: reflections on *Sevilleja v Marex*

By Rob Blackett

This article sets out some reflections on the decision of the Supreme Court in *Sevilleja* v *Marex Financial Limited* [2020] UKSC 31 from July 2020 which clarifies the scope of the so-called 'reflective loss' rule. The first instance judgment raised some comment-worthy issues regarding the economic torts which were not the subject of any appeal. The case serves to illustrate a wider point, too, about the unforeseen consequences which can follow when judges explore hypotheticals which do not require to be decided to resolve the case before them, and which have not been the subject of detailed argument.

Sevilleja concerned a technical rule of company law called the 'reflective loss' rule. This common law rule served to bar shareholders from bringing claims for losses which they suffer but which are merely 'reflective' of the company's loss, where the company suffers a loss and that causes the value of its shares to fall, or causes it to pay a lower dividend.

In *Sevilleja* two BVI companies were ordered to pay a sum of money to an unsecured creditor. To prevent the creditor getting what was due, the man who owned and controlled the companies emptied the companies' accounts, transferring all the money to himself. He then placed the company into liquidation and paid the liquidator to procure that the liquidator took no steps to recover the companies' missing assets for the benefit of the creditor.

The judgment creditor brought a claim against the companies' owner in England, claiming the owner had committed two 'economic torts' of (i) procuring a breach by the company of its obligation to pay the creditor, and (ii) causing the creditor loss by unlawful means (i.e. by the unlawful means of taking the companies' money, in breach of the fiduciary duties he owed to his companies). The court at first instance had no difficulty finding for the creditor.

The owner argued, and the Court of Appeal accepted, largely based on a short *obiter* remark which had been made two decades earlier by Lord Millett, that the reflective loss rule did not just apply to a company's shareholders but also to its creditors. The creditor's loss (receiving no payment from the companies) was merely 'reflective' of the companies' loss (loss of the money which would otherwise have been available to pay the creditor). The creditor was thus barred from pursuing a claim against the owner. The only person who could bring a claim against the owner was the company, which was under the control of the liquidator, who was under the control of the owner and so the creditor would get nothing.

The Supreme Court reversed this (astonishing) result, and allowed the creditor to pursue its claim, unanimously holding that the reflective loss rule does not apply to creditors.

A minority of their Lordships considered that the reflective loss rule should be abolished altogether. The majority considered that a version of the rule should be retained but that it is both narrower and broader than the previous case law had suggested. It is narrower in the sense that it applies only to a narrow category of shareholder claims, not all shareholder claims. And it is wider in the sense that, for those claims where it does apply, it applies absolutely and the supposed exception to the rule, known as the *Giles* v *Rhind* exception, should be abolished.

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The hazard of hypotheticals

Sevilleja thus clarifies the scope of the reflective loss rule, but it also offers a more general illustration about the hazard of hypotheticals, showing how an innocuous *obiter* remark on a point which was not before the court resulted, two decades later, in some real-world injustice, which it took a trip to the Supreme Court to reverse.

When considering what the law is, or should be, on some issue it is often useful to test the rule which is being proposed against hypotheticals. If the law was as posited, would that lead to injustice or an absurd result in some other (realistic) scenario? Decision makers need be alert, however, to the problem of *reductio ad absurdum*, making an unjust decision in a real case based on the desire to prevent injustice in an ingenious imaginary case which may never arise.

Because judges' decisions, unlike those of arbitrators, are public and serve as precedents, hypotheticals pose a further problem for judges. This is the temptation, having already decided what the law requires in the instant case, then to expand and speculate about what one thinks the law would require in some other situation, which does not arise for a decision, is not a necessary step in one's reasoning, and has not been the subject of any detailed argument. These *obiter* musings leave tripwires threaded through the common law and can cause genuine problems years or decades hence, as *Sevilleja* illustrates.

(Assumed) facts of *Sevilleja*

The Supreme Court's decision arises out of a challenge to jurisdiction, so it was decided based on assumed facts alleged by the Claimant.

A foreign exchange broker called Marex Financial Limited ("**Marex**") brought a claim against two of its former clients, companies incorporated in the BVI (the "**Companies**"). The Companies were owned and controlled by one Carlos Sevilleja Garcia ("**Sevilleja**"), a businessman based in Dubai and Valencia, Spain.

On 19 July 2013 the Commercial Court (Field J) provided parties with a confidential draft of his judgment, finding that the Companies owed Marex more than $5 million pursuant to the terms of their various contracts.

On 26 July 2020 the judgment was handed down and the court made orders requiring the Companies to pay Marex what was owed, plus costs (later agreed at £1.65 million) and interest. The judgment is *Marex Financial Ltd* v *Creative Finance Ltd & Anor* [2013] EWHC 2155 (Comm) and is only interesting (save to the parties themselves) as offering an insight into the jargon of FX currency trading.

When the draft judgment was issued on 19 July 2013, Sevilleja's Companies had more than $9.5 million in their London bank accounts. Beginning on 19 July 2013 Sevilleja caused the Companies to transfer these monies out of their London accounts to accounts which the Companies held in Gibraltar and Dubai. Between 24 July and 12 August 2013, he caused them to be transferred out of the Companies altogether, and into his personal control.

On 14 August 2020 Marex obtained a freezing injunction. The Companies made disclosure of their assets pursuant to the Freezing Order; they stated that assets of only US$4,392.48 were held.

In December 2020 Sevilleja then placed the Companies into insolvent voluntary liquidation, so that they came under the control of a liquidator in the BVI. The liquidator, now in control of the Companies and obligated to act in the interests of their creditors, should have caused them to pursue the owner for their missing funds. The liquidator, having been paid a 'retainer' by Sevilleja, did nothing.

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The liquidator's conduct had already been considered in some US court proceedings, in which the court had found the liquidator was paid and controlled by Sevilleja, describing the liquidation as "*a device to thwart enforcement of a $5m judgment against the* [Companies] *that Marex won in the courts of England - and the most blatant effort to hinder, delay and defraud a creditor this Court has ever seen*" with Sevilleja "… *successfully … control[ling] a BVI liquidator, who was supposed to act as an independent fiduciary, by the purse strings*".

Marex's claim against Sevilleja

Having failed to recover any monies in the liquidation, Marex sought to bring a claim against Sevilleja in England.

Asked whether the law should entitle an unsecured creditor to claim from a company's owner/director in such circumstances, one suspects that the proverbial Clapham omnibus commuter (now Clapham home-worker) would agree that it should. The court at first instance (Knowles J) reached this same commonsense conclusion *Marex Financial Ltd* v *Garcia* [2017] EWHC 918 (Comm).

Marex's claim alleged that, by causing the Companies to transfer monies to him, Sevilleja had committed two torts against Marex, causing a loss to Marex in an amount equal to what was owed and which Marex had thereby been prevented from recovering. The two torts were (i) inducing breach of obligation (the *Lumley* v *Gye* tort); and (ii) causing loss by unlawful means (the *OBG* tort).

Sevilleja contested the English court's jurisdiction arguing that the facts alleged by Marex would not, if proven, give rise to any claim in English law. Sevilleja argued that:

a) It is not a tort to induce or procure another to act in breach of rights under a judgment.

b) Sevilleja's breach of fiduciary duty owed to a company, in the form of asset-stripping, does not count as 'unlawful means' for the purposes of the tort of causing loss by unlawful means.

c) The rule against reflective loss acts to bar any claim in tort which Marex might otherwise have.

It is only the third issue which was the subject of Sevilleja's appeal, and which led to the Supreme Court decision. But the first issue is also interesting and so that is discussed below too.

The *Lumley* v *Gye* tort

Marex argued that Sevilleja had induced or procured the Companies to breach their obligation to pay the judgment sum, and that this was an example of 'the *Lumley* v *Gye* tort'.

Lumley v *Gye* [1853] EWHC QB 173 is (at least according to Lord Nicholls in *OBG* v *Allan*) "*familiar to every law student*". A theatre owner was held liable in tort for having procured an opera singer called Johanna Wagner (niece of the composer Richard Wagner), who had contracted to perform exclusively at another theatre for three months, to breach her contract and agree to perform at his theatre instead.

In the event, Johanna never actually performed at either theatre, and left England for Berlin shortly thereafter. Whereas Johanna Wagner had breached her contract, presumably the rival theatre owner had deeper pockets than Johanna, and he and his assets were in England. The fact Johanna never performed at either theatre does suggest that the inducement might not really have been causative of Johanna's breach – she would have returned

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to Germany and failed to perform in any event, but this is never explored in the judgment and causation is assumed.

The ingredients of the *Lumley* v *Gye* tort are now to be found in the speech of Lord Hoffmann (with whom the majority agreed) in *OBG Ltd* v *Allan* [2008] 1 AC 1. They can be summarised as follows:

a) The third party must actually know that he is inducing a breach of contract. It is not enough that he ought to have realised that (paragraph 39).

b) Knowledge, for these purposes, includes actual knowledge, "*reckless indifference to breach*" and 'blind eye' knowledge - where the defendant actually made a conscious decision not to enquire as to the contract in question (paragraph 41).

c) The breach of contract must be either an end in itself or the means to an end. If it is merely a foreseeable consequence that is not enough (paragraph 43).

d) It is not necessary that the defendant intended to cause damage to the claimant; an intention to cause a breach of contract (in the sense described above) is both necessary and sufficient (paragraph 8).

e) There must be an actual breach of contract; merely to have hindered performance of a contract is not enough (paragraph 44).

f) The defendant's encouragement, threat, persuasion and so forth must have a sufficient causal connection with the breach by the contracting party (paragraph 36).

Inducing other wrongs

Lord Nicholls identified that in *Lumley* v *Gye* and *Allen* v *Flood*, the judges' reasoning had not been confined to the situation where a defendant induces a breach of contract, but extended to defendants who induced other wrongs:

> "[in *Lumley* v *Gye* Erle J] *said … that procurement of the violation of a right is a cause of action:*
>
> > *'It is clear that the procurement of the violation of a right is a cause of action in all instances where the violation is an actionable wrong, as in violations of a right to property, whether real or personal, or to personal security: he who procures the wrong is a joint wrongdoer, and may be sued, either alone or jointly with the agent, in the appropriate action for the wrong complained of.'*
>
> *This principle, of liability for procurement of a wrong, <u>applies to a breach of contract as well as an actionable wrong</u>: page 233. Wightman J expressed himself similarly, at page 238:*
>
> > *'It was undoubtedly prima facie an unlawful act on the part of Miss Wagner to break her contract, and therefore a tortious act of the defendant [knowingly] to procure her to do so.' ...*
>
> *This 'procurement' analysis commended itself to Lord Watson in Allen* v *Flood [1898] AC 1. Lord Watson approved Erle J's reasoning as quoted above, and continued …:*
>
> *'These statements embody an intelligible and a salutary principle, and they contain a full explanation of the law upon which the case* [Lumley v Gye*] was decided. <u>He who wilfully induces</u>*

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> *another to do an unlawful act which, but for his persuasion, would or might never have been committed, is rightly held responsible for the wrong which he procured.*'"

Sevilleja argued that "*whilst non-payment of a contract debt would be an actionable wrong by the debtor … non-payment of a judgment debt is not. The judgment ushers in a new regime, with a range of means of enforcement*". The Court dismissed this argument, saying:

> "*Non-payment of a judgment debt is an actionable wrong. The Courts have recognised "a principle that where a court of competent jurisdiction has adjudicated a certain sum to be due from one person to another, a legal obligation arises to pay that sum, on which an action of debt to enforce the judgment may be maintained": per Lord Collins in Rubin and Another* v *Eurofinance SA; In re New Cap Reinsurance Corpn Ltd [2013] 1 AC 236 … This is the theoretical basis for the enforcement of foreign judgments at common law, but it is nonetheless a principle and not a fiction confined to that area of common law.*"

An aside - the position of employees and company directors

Whenever a company breaches a contract or commits a tort, it will always have been caused to do so by a third party: a director or employee. It is important to note that no claim generally lies against an employee who, acting within the scope of his authority or employment, causes his employer to breach a contract. That is because the employee is treated for these purposes as the *alter ego* of the contract breaker *Said* v *Butt* [1920] 3 KB 497.

The position of directors is discussed in *Thames Valley Housing Association* v *Elegant (Guernsey) Thames Valley Housing Association Ltd & Anor* v *Elegant (Guernsey) Ltd & Ors.* [2011] EWHC 1288 (Ch). Lewison J appears to have considered that a director will not be liable for the tort of procuring or inducing the company to breach an obligation if he has done no more than perform his constitutional role, possibly subject to a further requirement that he has performed that role in good faith.

A company ("**Elegant**") borrowed £6.2m from a bank and granted the bank a charge over certain land. Elegant then agreed to transfer part of that land to Thames Valley Housing Association ("**TVHA**"), free from encumbrances and with full title guarantee. The company's solicitors gave an undertaking to the purchaser to procure the release of the charge. The bank refused to release the charge without payment, and Elegant failed to pay. The upshot was that the solicitors were held to be in breach of their undertaking, and liable to procure the release from the charge. The solicitors paid £1.3m to the bank to secure the release of the charge. At the time of the litigation, Elegant was in liquidation.

The solicitors sought to recover against a Mr Howard MacPherson, who was Elegant's *de facto* or shadow director. Lewison J held (emphasis added):

> "*In considering whether any personal secondary liability attaches to Mr Macpherson* [for inducing Elegant's breach] *it is a fact of vital importance that he had no formal role in the corporate governance of Elegant. The law must be wary of imposing personal liability on directors of companies who perform their constitutional role in good faith. There is, in this respect, a considerable overlap with the principles upon which a company director may be held liable as a joint tortfeasor with the company of which he is a director.*
>
> *In MCA Records Inc v. Charly Records Ltd Chadwick LJ reviewed the authorities comprehensively. His conclusions, so far as relevant to the present case were:*

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<u>i) a director will not be treated as liable with the company as a joint tortfeasor if he does no more than carry out his constitutional role in the governance of the company— that is to say, by voting at board meetings. That is what policy requires if a proper recognition is to be given to the identity of the company as a separate legal person.</u>

ii) there is no reason why a person who happens to be a director or controlling shareholder of a company should not be liable with the company as a joint tortfeasor if he is not exercising control through the constitutional organs of the company; and the circumstances are such that he would be so liable if he were not a director or controlling shareholder. In other words, if, in relation to the wrongful acts which are the subject of complaint, the liability of the individual as a joint tortfeasor with the company arises from his participation or involvement in ways which go beyond the exercise of constitutional control, then there is no reason why the individual should escape liability because he could have procured those same acts through the exercise of constitutional control.

At best, from Mr Macpherson's perspective <u>similar principles apply in deciding whether a director is personally liable for procuring or inducing a breach of contract</u> by a company. Here, however, Mr Macpherson did not exercise control over Elegant through the constitutional organs of the company. He pulled the strings from the shadows. Elegant did whatever Mr Macpherson wanted it to do."

Assume these *Charly Records* principles do apply to claims against directors for inducing companies to breach their obligations. These principles would not preclude Marex from claiming against Sevilleja. Sevilleja, like MacPherson, did not "*perform his constitutional role in good faith*". He was "*a de jure or shadow director*" of the Companies, with no constitutional role. He did not act in good faith - he appropriated the companies' funds to himself, in breach of his fiduciary duties.

A less straightforward scenario

Things might not have been so straightforward. Consider the following scenario. Sevilleja is instead a *de jure* director of his Companies. The Companies are facing a claim, but there is, as yet, no judgment or draft judgment. Sevilleja does not think it is inevitable that his Companies will be ordered to pay what Marex is claiming. In fact, he has received some very bullish legal advice, that the chance of the Companies being held liable to pay Marex is less than 10%. No interim freezing injunction has been made. He nonetheless wishes to protect against the possibility that his Companies might be found liable to Marex. He votes at a properly constituted board meeting to transfer the Companies' assets out of its London accounts and into accounts which the Companies hold in some other jurisdictions where he thinks an English judgment might not be enforced Alternatively, having done whatever the Company's constitution requires, he has the company declare a dividend, and in that way pays all the company's monies to its shareholders (himself).

All the elements of the *Lumley* v *Gye* tort are arguably present, save that Sevilleja's actions have not yet caused Marex to suffer any loss (torts being actionable only where they cause damage, not actionable *per se*). Sevilleja knows that, in the event Marex is successful and the Companies are ordered to pay Marex, his having removed the monies will cause them to breach the obligation imposed by that order. He believes it is unlikely that judgment will be given for Marex, but he is recklessly indifferent to the possibility that it might be.

Sevilleja has, however, caused his Companies to hide or dissipate their assets, by exercising constitutional control. The *Thames Valley* case seems to suggest that, in such a scenario, Sevilleja can have no liability for having procured or induced any breach of obligation save, perhaps, if he can also be characterised as having also acted in 'bad faith'.

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Is Sevilleja in bad faith? Sevilleja is not deceiving anyone or pretending to be acting from one motive when in fact acting for another. Given his views on the merits of Marex's claim, he could even argue that he was dissipating the companies' assets principally as a means of returning value to the shareholders in the ordinary course of the company's business – the fact that this will also protect the shareholders against the unlikely contingency of losing in the litigation just supplies a further reason.

Apparent endorsement of 'judgment proofing' in *LDTC* v *Ural Caspian Oil*

On the question of whether using the company's constitutional machinery to hide assets from potential creditors can give rise to liability, it is very important to note *Law Debenture Trust Corporation* v *Ural Caspian Oil Corporation Ltd* [1995] Ch 152. The case was considered only briefly in *Sevilleja*, and it is perhaps unfortunate that it was not subjected to a more thorough analysis.

In that case, four companies (the "**Russian Companies**") had been carrying on business in Russia and had their assets seized in the Russian revolution of 1917. The companies' owners wished to sell the companies, but to ensure that, if any compensation were subsequently obtained for its lost Russian assets, then it should be paid to a Trustee who would hold it for them.

The owners entered into an arrangement whereby each of the Russian Companies gave the Trustee an undertaking that it would take whatever steps were necessary to pursue its compensation claim; and pay any compensation to the Trustee, as trustee for the former shareholders.

The buyer, B1, undertook to the Trustee to procure that the companies perform these covenants and not to part control of the companies, except on terms that the transferee entered into covenants in similar form.

B1 sold the Russian Companies to B2. B1 did not require B2 to enter covenants with the trustee, and B2 did not do so. B2 sold the companies to B3. B1 did not require B2 to enter covenants with the trustee, and B2 did not do so.

In 1990 the Russian Companies received around £16 million in compensation, but failed to pay any part of it to the Trustee. The Trustee brought claims against the Russian Companies, B1, B2 and B3.

The Trustee's argument was as follows. B1 owed the Trustee a contractual obligation not to part with the shares except to a buyer bound by the same covenants. In accepting a transfer of the shares B2 committed the tort of inducing B1 to breach its covenants.

B2 also became subject to a secondary liability to undo the consequences of its tort. The Trustee could thus have restrained the transfer by B1 to B2 before it was made. After it was made, the Trustees could have obtained an order that B2 transfer the shares back to B1.

This step of the argument depended on *Esso Petroleum* v *Kingswood Motors (Addlestone) Limited* [1973] All ER 1057. K was a company which owned a garage. It entered into a *solus* agreement, requiring that it buy petrol exclusively from Esso. It also covenanted to procure a deed of adherence from any successor. K's owner sold K to a new owner. K's new owner caused K to transfer the garage to another company which it owned. K's new owner "*went into the transaction for the purpose of defeating that* [petrol] *tie if they were able*". The court held that the new owner and its subsidiary had committed a tort against Shell by procuring that K breach its obligations to K. The court made orders requiring that the new owner and its subsidiary transfer the property back to K. The court was not being asked to enforce a contractual obligation against a person who was not a party to the contract,

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but to enforce the personal liability incurred by a tortfeasor to undo the consequences of his tort which could have been restrained before it had been committed.

When B2 transferred the shares in the Russian Companies to B3, B2 breached this supposed secondary duty to undo the consequences of its tort. When it accepted the transfer of shares, B3 induced or procured that breach of duty by B3.

Bingham MR rejected this argument (emphasis added):

> "*It is not in dispute that [B2] could, on timely application, have been ordered to retransfer the shares to [B1] and restrained from transferring them on to [B3] or anyone else. It is said that [B2] could only be restrained from acting unlawfully and that it would not be liable to such restraint if such onward transfer were lawful.*
>
> *Therefore onward transfer is to be regarded as unlawful, as violating* [the Trustee's] *right that it should not take place. To my mind this chain of reasoning harbours a fallacy. It is of course true that the courts restrain the commission of unlawful acts such as threatened breaches of contract or torts or breaches of trust and grant mandatory orders for the doing of things which it would be unlawful not to do. But all injunctive orders are not of this kind. The court will restrain a defendant and potential judgment debtor from making himself judgment-proof by dissipating his assets and may order him to give disclosure of assets in support of the injunction. But the defendant violates no legal right of the plaintiff if he makes himself judgment-proof by dissipating his assets before he is enjoined from doing so and he does not act unlawfully in failing to give disclosure before he is ordered to do so. These are measures the court adopts to protect the efficacy of its orders. The Kingswood Motors injunction was, I think, of a similar kind.*
>
> [B3] *can be liable to* [the Trustee] *if and only if* [B2's] *transfer of the shares to* [B3] *was tortious. But at the time this transfer was made [B2] was the full legal and beneficial owner of the shares. It had no contractual relationship of any kind with the* [Trustee]*. It was liable to* [the Trustee] *for its tortious conduct in procuring* [B1's] *breach of its contract with* [the Trustee]*, but that was all. It was open to* [the Trustee] *to seek an interlocutory injunction restraining* [B2] *from making onward transfer and a final injunction ordering retransfer* [to B1]*, but application had not been made and injunctions had not been granted. Until some injunction was granted,* [B2] *was in my judgment entitled to do what it would with its own.*

Sevilleja argued that the underlined passage means a party does not commit an actionable wrong by making itself judgment-proof before it is enjoined (by a freezing order) from doing so.

The court in *Sevilleja* said:

> "*the Court of Appeal* [in *LDT v Ural Caspian Oil*] *was there addressing the situation (as with a claim in damages, before judgment) where there was indeed no right of the claimant before a freezing order enjoined the conduct in question. The present case differs in that the claimant had a right before judgment to be paid a contract sum, and a right after judgment to be paid the judgment sum.*"

That suggests:

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a) Where a defendant is facing a claim to *damages* for breach of contract and is disputing its liability to pay, and no freezing injunction has been made, then the company can hide or dissipate its assets in an attempt to make itself judgment-proof any time up until it is held liable and ordered to pay without thereby committing any wrong against the claimant.

b) Where a defendant is facing a claim for a *debt* alleged to be due under a contract and is disputing its liability to pay, and no freezing injunction has been made, and the defendant hides or dissipate its assets in an attempt to make itself judgment proof, the claimant thereby commits a wrong against the defendant.

There is nothing in Sir Thomas Bingham's judgment to indicate that he had in mind to distinguish between claims in debt and claims in damages. And it is hard to see that this would represent a principled distinction here: why is it a tort to disperse one's assets in response to a disputed debt claim, but not in response to a disputed damages claim? The idea that damages are contingent and that no right exists prior to judgment is not reflected elsewhere – we award interest from the date loss was suffered because we deem damages to have been due from that date loss was suffered.

A different reading of this passage of Sir Thomas Bingham's judgment might be that he was concerned with "*the potential judgment debtor*" – i.e. someone against whom judgment has not yet been given and who is not the subject of any interim freezing injunction. A company which is facing a disputed claim, whether for debt or for damages, does not owe the claimant any obligation in tort to preserve assets with which to satisfy the claim if it succeeds. The defendant does not commit the tort against the claimant by dissipating its assets pre-judgment in these circumstances, and the directors who cause the company to do so are not procuring any breach of obligation because such obligation has not yet been established.

Once judgment has been given and the company's liability to pay has been established in that judgment, the position changes. From that point the Company is under a liability to pay and removing the companies' assets is an instance of the *Lumley* v *Gye* tort.

This is not to say that pre-judgment dissipation of assets is of no consequence – only that it might not amount to the *Lumley* v *Gye* tort. Such pre-judgment dissipation of assets can obviously give rise to claims against the directors or the shareholders by the liquidator:

a) **Section 213, Fraudulent trading**. If the business of the company was carried on with intent to defraud creditors the court, on the application of the liquidator, can order any persons knowingly party to carrying on the business in that manner to make contributions to the company's assets.

b) **Section 214, Insolvency Act 1986, Wrongful trading**. The liquidator can ask for an order making a director personally liable to contribute to the company's assets if the director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation and then failed to take every step with a view to minimising the potential loss to the company's creditors as he ought to have taken. (In the scenario posited above, the director would claim he did not think insolvency was inevitable, pointing to the bullish legal advice).

c) **Section 238, transaction at an undervalue**. A transaction at an undervalue occurs when a company disposes of its assets for significantly less than they are worth. A liquidator can apply to have the

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transaction set aside if it occurred within two years of the company's liquidation. Transfers of assets out of the company are vulnerable to challenge under this provision.

d) **Section 239, preference**. A preference is a transaction which has the effect of placing a creditor in a better position if the company goes into liquidation than if the transaction had not occurred. If the transaction occurs within six months before the company's liquidation, the liquidator can apply to have it set aside but he must prove that the directors in entering into the transaction were influenced by a desire to produce the preferential effect. In the case of a transaction with a creditor who is a connected person (for example any of the company's shareholders, subsidiaries or directors) the period of six months is extended to two years and it is also presumed (unless the contrary can be proved) that there was a desire to prefer the creditor.

This armamentarium is of no assistance to a creditor in the position *Marex* found itself in, however, with the liquidator being controlled by Sevilleja.

Causing loss by unlawful means

In *OBG* v *Allan*, the House of Lords confirmed the existence of a tort, which has not always been referred to consistently in the case law, but is now generally called 'causing loss by unlawful means' or the 'OBG tort'. The tort operates to give C a claim against D where:

a) D does (or threatens to do) something which is unlawful in the sense that it either: (i) gives rise to a civil claim by T against D; or (ii) does not give rise to a civil claim by T only by reason of the fact that T suffers no loss.

b) D's act interferes with the freedom of T to deal with C; and

c) D's act is intended to cause loss to C.

Sevilleja argued that asset stripping did not interfere with the freedom of the company to deal with the claimant "*it only means that, for the time being, the company has fewer assets with which to pay (and it may pay later)*". The court dismissed this argument: "[the] *point of asset-stripping in this context is to take away from the company the freedom to meet its obligation to the claimant*".

Reflective loss

Sevilleja argued that the facts alleged by Marex would not, if proven, give rise to any claim in English law, because Marex's claim was barred by the so-called 'reflective loss rule'. Hence the English court had no jurisdiction.

The court at first instance did not think much of this 'reflective loss' argument, remarking that the law was "*very strongly in favour of Marex*". Sevilleja appealed. The Court of Appeal agreed with Sevilleja, that Marex's claim was barred by the 'reflective-loss rule', and it would take a trip to the Supreme Court to restore the commonsense result, four years after Marex began its claim against Sevilleja.

Proper claimant rule

There is a common law rule known as the 'proper plaintiff' or 'proper claimant' rule or the 'rule in *Foss* v *Harbottle*'. It is that A cannot, as a general rule, bring a claim against B to recover damages or secure other relief on behalf of C for an injury done by B to C. C is the proper claimant because C is the party injured, and, therefore, the

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person in whom the cause of action is vested. This was described (by the Court of Appeal in *Prudential* – see below) as "*an elementary principle … fundamental to any rational system of jurisprudence*".

In company law, the effect of this general rule is that the only person who can seek relief for an injury done to a company, where the company has a cause of action, is the company itself. It is up to the company, through its organs (i.e. its directors in the first instance, ultimately a majority of its shareholders in a general meeting), to decide whether to pursue, or settle, litigation in respect of a breach of an obligation owed to the company. A company, by its organs, might choose not to pursue some claim in circumstances where a minority shareholder would prefer that it do so.

This rule is unproblematic where there is a good faith disagreement about whether to pursue the litigation i.e. where the directors and a majority of the shareholders on the one hand and the minority shareholder on the other have different attitudes to the risks of litigation or different views about the claim's merits, the likely costs (financial, temporal, relational and reputational) of pursing the claim and the chances of being able to enforce any judgment or award. When a shareholder invests in a company, they entrust the management of their investment to a system of majority decision making. Inherent in that is the possibility that the majority might make decisions which the shareholder does not agree with.

The rule would become problematic, however, where the question faced by the company was whether to bring a claim against a director, a majority shareholder or some party in which the director or majority shareholder is interested and which is alleged to have committed some wrong against the company. The paradigm example is where the directors, who also control the general meeting, take assets from the company.

Derivative action

In *Foss* v *Harbottle* (1843) 2 Hare 461 the court said that: "*If a case should arise of injury to a corporation by some of its members, for which no adequate remedy remained, except that of a suit by individual corporators in their private characters, and asking in such character the protection of those rights to which in their corporate character they were entitled, I cannot but think that … the claims of justice would be found superior to any difficulties arising out of technical rules respecting the mode in which corporations are required to sue*"

The rule was thus made subject to a limited exception whereby a shareholder would be permitted to bring a 'derivative action' alleging a breach of a duty owed to the company, and seeking to recover the company's loss in circumstances where: (i) a breach of duty by the directors had injured the company and benefitted the directors personally (i.e. 'fraud'); and (ii) the directors in question also had control of the general meeting of the company through their shares.

That narrow exception, however, was not sufficient to capture every circumstance in which the rule might lead to injustice. Derivative actions were not available in a situation where the directors had merely been negligent, not fraudulent. Directors who had control of the general meeting through their shares could thus act negligently with impunity, as the company would never claim against them. Derivative actions would also never be available against the director of a widely-held company, since the director would never have control of the general meeting.

A new regime for bringing derivative claims would thus ultimately be set out in Part 11 of the Companies Act 2006. This did away with the 'fraud' requirement and allowed derivative actions to be brought for breach of other duties. The Act did not set out any requirement that the wrongdoer control the general meeting.

Unfair prejudice

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Section 994 of the Companies Act 2006 provides a minority shareholder with a further protection, allowing a company to apply for relief where the affairs of the company are being, or have been, or are proposed to be conducted in a manner that is unfairly prejudicial to the interests of members generally, or some part to be of its members, in their capacity as such (including at least himself). The most common relief ordered is for the minority shareholder's shares to be bought by other members of the company

Prudential

Thirty eight years ago, in *Prudential Assurance Co Ltd* v *Newman Industries Ltd (No 2)* [1982] Ch 204 the Court of Appeal invented (or discovered) a further rule, termed the 'rule against reflective (or reflected) loss'.

Directors of a company were alleged to have made a fraudulent misrepresentation in a circular distributed to its shareholders, so as to induce them to approve the purchase of assets at an overvalue from another company in which the directors were interested. Prudential, which was a minority shareholder in the company, claimed that in doing this, the directors had not just committed a tort against the company, but had also committed a tort against Prudential and the other shareholders. The company had suffered a loss (insofar as it had overpaid) and Prudential had suffered a fall in the value of its shares.

The Court of Appeal held that the shareholder had no such 'personal action'. A shareholder, it was said:

> "*cannot … 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.*"

Prudential proposed that "*the personal action will lie if the company's remedy is for some reason not pursued*". Of this, the Court of Appeal said:

> "*how can the failure of the company to pursue its remedy against the robber entitle the shareholder to recover for himself? What happens if the robbery takes place in year 1, the shareholder sues in year 2, and the company makes up its mind in year 3 to pursue its remedy? Is the shareholder's action stayed, if still on foot? Supposing judgment has already been recovered by the shareholder and satisfied, what then? … A personal action would subvert the rule in Foss v. Harbottle and that rule is not merely a tiresome procedural obstacle placed in the path of a shareholder by a legalistic judiciary. The rule is the consequence of the fact that a corporation is a separate legal entity.*"

A shareholder could not bring a claim in respect of a diminution in the value of his shareholding, or a reduction in the distributions which he receives by virtue of his shareholding, which is merely the result of a loss suffered by the company in consequence of a wrong done to the company by the defendant, even if the defendant's conduct also involved the commission of a wrong against the shareholder, and even if no proceedings have been brought by the company. The Court of Appeal characterised the imposition of the rule against reflected loss as necessary to prevent the circumvention of the proper claimant rule.

Johnson

Eighteen years ago, in *Johnson* v *Gore Wood & Co* [2002] 2 AC 1 the House of Lords considered the rule against reflective loss. Negligence on the part of solicitors acting for a private company caused it to suffer loss. All but two shares in the company were owned by a Mr. Johnson who was also its managing director. The company was

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"*the corporate embodiment of Mr. Johnson*". The company brought a claim against the solicitors which was settled at trial for a substantial proportion of the sum claimed. Mr. Johnson then brought his own claim against the solicitors, alleging they had also breached duties owed to him and that he had suffered personal losses. He complained (amongst other things) that the value of his shares had diminished and that, as a result of the company's loss having deprived it of funds, he had lost out on contributions to his pension which the company would otherwise have paid.

Lord Bingham derived three propositions from the authorities:

> *(1) Where a company suffers loss caused by a breach of duty owed to it, only the company may sue in respect of that loss. No action lies at the suit of a shareholder suing in that capacity and no other to make good a diminution in the value of the shareholder's shareholding where that merely reflects the loss suffered by the company. A claim will not lie by a shareholder to make good a loss which would be made good if the company's assets were replenished through action against the party responsible for the loss, even if the company, acting through its constitutional organs, has declined or failed to make good that loss ... (2) Where a company suffers loss but has no cause of action to sue to recover that loss, the shareholder in the company may sue in respect of it (if the shareholder has a cause of action to do so), even though the loss is a diminution in the value of the shareholding ... (3) Where a company suffers loss caused by a breach of duty to it, and a shareholder suffers a loss separate and distinct from that suffered by the company caused by breach of a duty independently owed to the shareholder, each may sue to recover the loss caused to it by breach of the duty owed to it but neither may recover loss caused to the other by breach of the duty owed to that other.*

The House of Lords struck out Mr. Johnson's claim for the fall in value of his shareholding, (an obvious example of a reflected loss) but also his claim for loss of pension contributions. Crucially, the judgments in Johnson nowhere that the company was under any <u>obligation</u> to Mr. Johnson to pay the pension contributions, or that he had an entitlement, as against the company, to receive any particular pension contributions. That claim was not being brought as a creditor of the company. Rather, pension contributions were just one way in which he would have distributed the companies' profits to himself, the company's 99% shareholder as a tax efficient alternative to the payment of dividends or bonuses.

Lord Millett suggested four reasons for the rule:

a) The need to avoid double recovery by the claimant and the company from the defendant.

   i. *"… the shareholder's loss, insofar as this is measured by the diminution in value of his shareholding or the loss of dividends, merely reflects the loss suffered by the company in respect of which the company has its own cause of action. If the shareholder is allowed to recover in respect of such loss, then either there will be double recovery at the expense of the defendant or the shareholder will recover at the expense of the company and its creditors and other shareholders. Neither course can be permitted. This is a matter of principle; there is no discretion involved. Justice to the defendant requires the exclusion of one claim or the other; protection of the interests of the company's creditors requires that it is the company which is allowed to recover to the exclusion of the shareholder."*

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b) 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.

c) 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.

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

Lord Millett suggested that the reflective loss rule would not only operate to prevent claims by shareholders:

> *"The same 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."*

Mr. Johnson was not claiming that the solicitor's negligence and the company's subsequent losses had prevented it paying him money which he was owed pursuant to a contract of employment. This point did not arise for a decision, was not a necessary step in Lord Millet's reasoning and (since it was not in issue) would not have been the subject of any detailed argument.

Giles

In *Giles* v *Rhind* [2002] EWCA Civ 1428, a company brought proceedings against a wrongdoing director alleging that the director had diverted a profitable contract from the company to another business in which he was interested, ultimately causing the company to be placed into administrative receivership. The director demanded and obtained an order for security for costs which successfully stifled the proceedings, as the company's impecuniosity prevented it providing the requisite security. The company discontinued its action. A shareholder brought a claim against the director on its own behalf to recover its own loss. This was conceded to be a reflective loss, but the court permitted the action to proceed. It held that the rule did not apply to a case where the wrong done to the company had made it impossible for the company to pursue its own remedy against the wrongdoer.

Gardner

In *Gardner* v *Parker* [2004] EWCA Civ 781 (23 June 2004) a director of a company was alleged to have procured that the company sell its principal assets at an undervalue to another entity in which he had an interest, rendering the company insolvent and preventing it from paying a debt which it owed to a creditor, which also happened to be one of the company's shareholders. The director argued that this claim was barred by the rule against reflective loss.

The Court of Appeal (Neuberger LJ) referred to Lord Millett's *dictum* and the striking out of Mr. Johnson's pension claim and said:

> "*It is clear from those observations, and indeed from that aspect of the decision, in Johnson's case that the rule against reflective loss is not limited to claims brought by a shareholder in his capacity as such; it would also apply to him in his capacity as an employee of the company with a right (or even an expectation) of receiving contributions to his pension fund. On that basis, there is no logical reason why it should not apply to a shareholder in his capacity as a creditor of the company*

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expecting repayment of his debt. Indeed, it is hard to see why the rule should not apply to a claim brought by a creditor (or indeed, an employee) of the company concerned, even if he is not a shareholder. While it is unnecessary to decide the point, as BDC was a shareholder in Scoutvale, it is hard to see any logical or commercial reason why the rule against reflective loss should apply to a claim brought by a creditor or employee, who happens to be a shareholder, of the company, if it does not equally apply to an otherwise identical claim by another creditor or employee, who is not a shareholder in the company."

Court of Appeal decision in *Sevilleja*

The Court of Appeal (Flaux LJ) observed that the rationale of the decision in *Prudential* was that a personal action by a shareholder would subvert the rule in *Foss* v *Harbottle*, and that if the rule against reflective loss had rested there, it would only apply to claims by shareholders.

Gardner however was binding authority that a claim by a shareholder as creditor is barred by the rule (it was suggested that *Johnson* was authority for the same – mischaracterising the pension contributions claim as having been based on a contractual entitlement). Once it was accepted that a shareholder claiming as creditor was caught by the rule:

"*It is difficult to see why a claim by a creditor who has one share in a company should be barred by the rule against reflective loss whereas a claim by a creditor who is not a shareholder is not. That point is well illustrated by the example of a creditor who owns shares in the company, whose claim is initially barred by the rule, but, on this hypothesis, if he sells the shares, the rule no longer bars his claim. That makes no logical or legal sense at all.*"

The Court of Appeal also saw considerable force in the following:

"*If the creditor were able to pursue a claim in relation to the asset stripping of the company such as in the present case, that would bypass and subvert the pari passu principle, applicable to the unsecured creditors of the company in the event of liquidation, that the assets of the company be distributed rateably. On this hypothesis, if a creditor were able to pursue a claim for reflective loss, it could make a full recovery of its debt against the wrongdoer to the prejudice of the other creditors, whereas if the liquidator were to pursue the company's claim against the wrongdoer and thereby replenish its assets, they would be available for distribution to the general body of creditors.*"

Marex submitted that, in *Johnson* and *Gardner*

"*the law had effectively taken a wrong turn when the Courts had extended the rule beyond the original justification for the rule in Prudential Assurance v Newman Industries … that a shareholder cannot recover for a loss which is on analysis the company's loss, such as the diminution of the value of its shares. … two wrongs do not make a right and … this Court should make a start in putting the law back on … the right course, by refusing to extend the rule against reflective loss beyond shareholders to creditors who are not shareholders. …*".

The Court of Appeal rejected this because it would "*perpetuate the illogical and unprincipled distinction between the shareholder with one share who is a creditor and the creditor with no shares or who has sold his shares …*". Lewison LJ said:

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"*It is not a question, in this court, whether "two wrongs make a right" as Mr Choo Choy put it. Rather is a question of coherence in the law. If the coherent application of the law in the current state of the authorities is wrong, it is for the Supreme Court to put it right*'

The Court of Appeal considered that about 90% of Marex's claim was barred by the reflective loss. The other 10% was Marex's claim to recover its costs of the US proceedings, which was not reflective of any loss the Companies had suffered, but was a new loss. The Court of Appeal gave permission to appeal.

***Sevilleja* in the Supreme Court**

The majority (Lord Reed, Lady Black, Lord Lloyd-Jones, Lord Hodge) considered that the reflected loss rule was properly that which had been set out in *Prudential* and then by Lord Bingham in Johnson. The rule bars shareholders from claiming that, as a result of loss suffered by their company in respect of which the company has a cause of action, the value of their shares, or of the distributions they receive as shareholders, has been diminished. Other claims, whether by shareholders or anyone else, are not subject to the rule. The justification for the rule is that stated in *Prudential* – to prevent a shareholder from circumventing the proper claimant rule.

The majority did not consider that the reasons advanced by Lord Millett in *Johnson* justified extending the reflected loss rule beyond that category of cases.

A desire to prevent double recovery was not the justification for the rule, because in a case where the company did pursue a claim, there could be no double recovery, but the rule still barred the shareholder from bringing a claim. Also: "*companies vary greatly, and the value of their shares can fluctuate upwards or downwards in response to a wide variety of factors. In the case of a small private company, there is likely to be a close correlation between losses suffered by the company and the value of its shares. In the case of a large public company whose shares are traded on a stock market, on the other hand, a loss may have little or no impact on its share value. If there is an impact on share value, it will reflect … "market sentiment", and will not necessarily be equivalent to the company's loss*". Given there may not be a close correlation between the company's loss and any fall in share value, the avoidance of double recovery cannot be the justification for the rule.

Their Lordships did not accept the causation argument – that the true cause of the shareholder's / creditor's loss is the company's decision not to pursue the claim rather than the defendant's wrongdoing. The very reason why the company does not bring a claim might be due to a lack of funds caused by the wrongdoing.

Their Lordships were not impressed by the argument that allowing the creditor to claim a 'reflected' loss would undermine the *pari passu* principle:

"*That principle requires that, in a winding-up, a company's assets must be distributed rateably among its ordinary creditors. The proceeds of its recovery from a wrongdoer will form part of its assets available for distribution (subject to the claims of secured and preferred creditors). But the pari passu principle does not give the company, or its liquidator, a preferential claim on the assets of the wrongdoer, over the claim of any other person with rights against the wrongdoer, even if that claimant is also a creditor of the company. In other words, the pari passu principle may restrict a creditor of an insolvent company to the receipt of a dividend on the amount which the company owes him, but it does not prevent him from enforcing his own right to recover damages from a third party, or confer on the company's right against the third party an automatic priority. In the event that the third party cannot satisfy all the claims made against him, the position will be regulated by the law of (his) insolvency*".

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The "*critical point*" militating against extending the rule to creditors was:

> "*… that the shareholder has not suffered a loss which is regarded by the law as being separate and distinct from the company's loss, and therefore has no claim to recover it. As a shareholder (and unlike a creditor or an employee), he does, however, have a variety of other rights which may be relevant in a context of this kind, including the right to bring a derivative claim to enforce the company's rights if the relevant conditions are met, and the right to seek relief in respect of unfairly prejudicial conduct of the company's affairs.*"

Minority judgment

Lord Sales gave the judgment for the 3-4 minority. The minority agreed the appeal should be allowed, but suggested that none of the policy justifications sufficiently explained why the rule should be retained even in the narrow category of cases identified by the majority. The rule was founded on an idea that the shareholder suffered no loss, when there are clearly cases where the shareholder suffers a different loss:

> "*It is a very strong thing for a bright line rule to be introduced in the common law as a matter of policy to preclude what are otherwise, according to ordinary common law principles, valid causes of action; … Whilst … it would allow for simple and speedy resolution of disputes, the price to be paid for that is too high. The effect … would be disproportionate and arbitrary. So long as there is any degree of overlap between the company's loss and the shareholder's loss, however small the degree of overlap and however large the shareholder's loss might be, it seems that the shareholder's claim must fail in limine. And this is so even though … the claimant shareholder's loss would be calculated after due allowance for the effect of rights of action which the company would have against the wrongdoing defendant ….*"

As to how the shareholder's loss would be calculated:

> "*If, after the wrongdoing of the defendant, the company is still trading and the claimant shareholder has not sold his shares, he retains shares of some worth in the market which reflects, among other things, the value of the company's own claims against the defendant. In my view, the claimant would then be entitled to claim damages in respect of the reduced market value of his shares due to the wrong against him committed by the defendant (by* the *means of or in parallel with his commission of a wrong against the company), i.e. their market value absent the wrong done to the company (and to the shareholder) less their actual current market value, reflecting among other things the company's claims against the defendant. Accordingly, it can be said that in such a case due allowance in respect of the company's claims against the defendant is reflected in what is recoverable by the claimant. It does not, then, seem to me to be unjust to allow both the claimant and the company to pursue their separate claims for their different losses against the defendant*".

The majority proposed that: "*the position be fully explored case by case in the light of all the facts, with the benefit of expert evidence in relation to valuation of shares*".

Lessons?

Marex was forced to incur the costs of two appeals. There is no mention in the judgments of Sevilleja having been ordered to provide any security for these. Such costs will be subject to assessment in the usual way. Sevilleja has had an extra three years in which to hide or spend the money he took from his Companies.

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Every judgment is *in media res*. We do not know all that has gone before and we will probably never learn what happened next. The $5.5 million question is whether Marex will ever get its money. Marex evidently thinks Sevilleja worth pursuing and so presumably does have some real prospect of getting what it is claiming. If not, then the above is all money down the drain.

What could someone in Marex's position have done differently to achieve a better outcome? It is tempting to say that the chief lesson to be learned here is not to deal with unscrupulous people like Mr Sevilleja, or else to limit one's exposure to them, or insist that they provide some security.

Marex had, however, had a long relationship with Mr Sevilleja, and it might be that Marex still made a net profit out of him overall, notwithstanding his Companies' eventual default. The $5.5 million debt which the Companies ended up owing Marex arose when an earthquake and tsunami struck Japan on 11 March 2011, causing the value of the Yen to fall greatly at a time when the companies were committed to buy NZD and Euros for Yen. It may be that, prior to this misfortune, Mr Sevilleja had been a model customer.

Marex did not obtain a freezing injunction until around three weeks after the draft judgment was issued, by which time the money had already gone. It is tempting to say that Marex should have applied for a freezing injunction at an earlier stage. But it hard to say whether that would have been realistic without knowing more about the facts, and the grounds on which Marex eventually sought and was awarded the injunction. It may even be the case that Marex did apply for a pre-judgment freezing injunction earlier and its application was unsuccessful. The highest it can be put is to say that claimants should generally have a low threshold for seeking freezing injunctions early when they are claiming significant amounts from private companies incorporated in offshore jurisdictions, which are wholly owned and controlled by wealthy, sophisticated people who are themselves outside the jurisdiction and where the companies' assets are liable to be highly liquid.

Does the case offer any lessons for someone who owns and controls a company which is facing a claim, and wants to remove assets from that company whilst minimising the chance of an economic tort claim being made against them personally? Such a person might conclude that they should remove assets from the jurisdiction, or from the company, before judgment rather than after and then only by means of the company's constitutional mechanisms – i.e. by voting in board meetings and at general meetings – thus preserving the possibility of a *Thames Valley* type argument. As noted in the body of this article, the same case does suggest that a lack of good faith is required to fix directors with liability for inducing breach. Such people should therefore always seek to obtain legal advice as to the merits of the claims against them. The fact that they had received bullish advice about their prospects might support a later argument that they were acting in good faith.

Oddly, though, Marex might conceivably end up better off as a result of Sevilleja having stripped the companies of their assets before Marex obtained a freezing injunction.

Suppose Sevilleja had left the $9.5 million in the Companies offshore accounts to be divided *pari passu* among the creditors by his tame BVI liquidator. It was claimed in the liquidation that the Companies owed $30 million to Sevilleja and other persons or entities associated with or controlled by him (debts Marex says are bogus). The Companies were ordered to pay Marex approximately $5.5 million, plus £1.65 million (say $2.1 million) costs, so that Marex's $7.6 million claim represented around 20% of the $37.6 total claimed in the liquidation. Sevilleja's liquidator would no doubt have upheld all the insider claims and so Marex would have recovered 20% of the $9.5 million, or around $1.9 million instead of the $5.5 million + £2.1 million + costs + interest Sevilleja was ordered to pay. Sevilleja would also have avoided paying his own, and Marex's costs of the case Marex brought against him in England, including two appeals, and would, by paying sooner have paid a lesser amount of 8% judgment-rate interest.

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One step which could potentially have helped Marex might have been to commence insolvency proceedings itself and appoint a reputable liquidator before Sevilleja did. But, to form a view about whether that is something which Marex could realistically have done depends on the insolvency regime in the BVI, and an enquiry into how that might have worked is somewhat beyond the scope of this article.

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