Katten

CORPORATE ADVISORY

Lessons From *Burnford*: Investors, Creditors and Recovering Reflective Losses

March 1, 2023

It is an old rule of English law that the only person who can sue for a wrong done to a company is the company itself. Related to that rule is the principle that an individual shareholder cannot bring a personal claim for a loss suffered by the company, even where that shareholder has personally suffered loss as a result of the company's loss. This is known as the "no reflective loss" principle. The rule is complex and can operate against shareholders who seek to recover damages from other shareholders, so it must be considered carefully when relations between shareholders in a company break down. A recent case provides helpful guidance on its operation in the context of joint ventures.

The decision in *Burnford*

Certain shareholders (Individual Shareholders) in Motoriety Limited (the Company) entered into an investment agreement with an institutional investor (Institutional Investor) pursuant to which, amongst other things, the Institutional Investor acquired 50 percent of the equity in the Company and took a seat on the Company's board.

The investment agreement contained a call option in favour of the Institutional Investor, pursuant to which the Individual Shareholders would be paid an initial option payment and an earnout for their shares. Following the investment, the Company performed poorly and was ultimately purchased by another entity in the Institutional Investor's group for a value far less than the Institutional Investor's original investment.

The Individual Shareholders claimed that the Institutional Investor had (i) by various misrepresentations made to them and the Company, induced them to enter into the investment agreement and (ii) by a course of conduct following entry into the investment agreement, deliberately obstructed the Company's business and thereby avoided exercising the call option and subsequently paying the initial and earnout consideration to the Individual Shareholders. The Institutional Investor applied to strike out the claim on the basis that the losses claimed by the Individual Shareholders were barred by the no reflective loss principle.

The judge at first instance granted the application to strike out the claim on the basis that the claimants' losses were entirely derived from the losses of the Company (the "no reflective loss principle"). The Individual Shareholders appealed on the basis, amongst other things, that the no reflective loss principle was uncertain and developing. The Court of Appeal upheld the first instance decision in November 2022. As a result, the shareholders were unable to recover any of their losses. The judgment in the Court of Appeal provided a helpful summary of the state of the no reflective loss principle, which the court did not find to be uncertain or developing, having had its existence and application recently confirmed and explained by the Supreme Court in *Marex* and the Judicial Committee of the Privy Council in *Primeo*.

The no reflective loss principle

In summarising the extent of the principle, the court confirmed the following points:

1. It applies where a shareholder brings a claim in respect of 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 same wrongdoer.

2. Shareholders cannot escape it merely by showing that they have an independent cause of action against the defendant. They must also have suffered a separate and distinct loss. A reduction in the value of shares or distributions, which is a knock-on effect of loss suffered by the company, is not "separate and distinct."
3. There need be no exact correlation between the shareholder's loss and the company's for the no reflective loss principle to be applicable. It can apply where recovery by the company might not fully replenish the value of its shares or where the company's loss exceeds the fall in the value of its shares.
4. It will not be in point if the company has no cause of action against the defendant in respect of its loss.
5. It will not apply to a claim which is not brought as a shareholder, for example one brought by a creditor or an employee.
6. The Court has no discretion in the application of the no reflective loss principle, which is a rule of substantive law.
7. The applicability of the no reflective loss principle is to be determined by reference to the circumstances when the shareholder suffered the alleged loss (and not when the claim is made).[1]

Shareholders – Whom can they sue?

Investors should be clear that it is very unlikely that they will be able to recover any losses suffered in the form of a diminution in share value or in distributions where the Company also has a separate cause of action against the relevant wrongdoer.

Shareholders must therefore rely on the directors of the company, in whom the decision to sue or not is vested, to bring claims in order to recover (at least in part) the diminution of the value of the investors' shares or of the distributions payable to them.

Investors holding a majority stake will typically be able to compel the directors to do so, but should take advice on the steps necessary to comply with general law and the company's articles.

Minority investors will not have that power. As a result, minority investors may wish to try to seek a specific contractual provision to allow them to compel the company to bring a claim in respect of loss suffered by the company which has caused the shareholders loss that is otherwise irrecoverable under the no reflective loss principle. Such a provision might include an obligation on the directors to take reasonable steps to recover losses suffered by the company which have also caused losses to the shareholders above a certain financial threshold, or could require the directors to seek an indicative opinion from counsel on any potential claim and to litigate anything with a greater than average chance of success.

Practically speaking, such provisions may be very hard to obtain. However, they could prove valuable to investors if directors are otherwise unwilling to pursue a claim.

Creditors – Are they exempt from the no reflective loss principle?

The decisions on the principle to date suggest that in a situation where a reflective loss has been suffered, investors would benefit from being creditors of the relevant company rather than shareholders. Although the point was not in issue, the summary of the law set out in the Court of Appeal judgment in *Burnford* confirmed that the no reflective loss principle applies only to shareholders in their capacity as shareholders, and not to creditors or employees making claims in their capacity as creditors or employees.

As a result, in the event that a breach by a third party caused a company to become insolvent, thus causing the creditors to recover less than 100 percent of the debt owed to them, it appears that under the law as set out in *Burnford*, creditors would not be barred by the no reflective loss principle from bringing a claim against that third party in respect of their loss (in this example the difference between 100 percent recovery and their actual recovery from the insolvent company). Conversely, shareholders in the relevant company would be barred under the no reflective loss principle from bringing a claim against the same third party in respect of the diminished value of their shares.

[1] On this point, see also *Allianz Global Investors v Barclays & others* [2022] EWCA Civ 353 in which the Court of Appeal reached a similar conclusion.

Investors who are unable to obtain contractual rights to compel a company to litigate where reflective loss has been suffered, as suggested above, may therefore wish to consider whether their investment could be structured as debt in order to protect against the specific risk of suffering reflective loss and being unable to pursue a claim in respect of it.

Convertible Loan Notes – The best of both worlds?

If shareholders cannot sue and creditors can sue, is there a middle ground? Although the position has not been tested, had the Individual Shareholders in *Burnford* invested by subscribing to convertible loan notes rather than shares, their claim may not have been barred by the no reflective loss principle.

Had the Individual Shareholders provided their initial investment into Motoriety by a loan note convertible into ordinary shares on, or immediately prior to, the exercise of the call option by the Institutional Investor, they might have been able to argue against the strike-out application on the basis that their loss was the loss of the consideration that the Institutional Investor would have paid them for the shares into which their notes would have converted. The Individual Shareholders would not have been shareholders at the point at which they incurred the loss (as the notes would not have converted), so, arguably, the no reflective loss principle would not have applied.

It is possible, therefore, that the ability to make claims for reflective loss as a noteholder would provide downside protection to investors, albeit in quite specific circumstances.

We would note that it is not clear from case law how the no reflective loss principle would apply to convertible loan notes, and it is likely that any decision would turn on facts as well as the precise terms of the conversion.

Investors should consider these matters with their advisers as part of their wider strategy and decision-making process. The inability of the shareholders in *Burnford* to recover any of their losses (or even to have their claim proceed to a full hearing) shows the potential harm to investors of the no reflective loss principle and the importance of considering it when making investment decisions.

CONTACTS

If you would like to discuss any of the points raised in this article, please contact your Katten lawyer or either of the following contacts.

Oliver Williams
+44 (0) 7770 5212
oliver.williams@katten.co.uk

Alex Potten
+44 (0) 20 7770 5223
alex.potten@katten.co.uk

Katten katten.com

Paternoster House, 65 St Paul's Churchyard • London EC4M 8AB
+44 (0) 20 7776 7620 tel • +44 (0) 20 7776 7621 fax

Katten Muchin Rosenman UK LLP is a Limited Liability Partnership of Solicitors and Registered Foreign Lawyers registered in England & Wales, regulated by the Law Society.

A list of the members of Katten Muchin Rosenman UK LLP is available for inspection at the registered office. We use the word "partner" to refer to a member of the LLP. Attorney advertising. Published as a source of information only. The material contained herein is not to be construed as legal advice or opinion.

Katten Muchin Rosenman UK LLP of England & Wales is associated with Katten Muchin Rosenman LLP, a US Limited Liability Partnership with offices in:

CENTURY CITY | CHARLOTTE | CHICAGO | DALLAS | LOS ANGELES | NEW YORK | ORANGE COUNTY | SHANGHAI | WASHINGTON, DC

03/01/23