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Overcoming the Principle of "Reflective Loss"

By Chris Webber and Michael Davar on 1 November 2017

In an important recent decision, the Commercial Court confirmed the availability of specific performance of a shareholder's rights under shareholder agreements as a means to dodge the difficulties created for shareholders by the principle of "reflective loss".

Background Facts

Oceanic Trans Shipping Est was one of three shareholders in two joint venture (JV) companies, who owned two very large crude oil carriers (VLCCs). The other shareholders were Latin American Investments Limited and Maroil Shipping Inc.

The shareholders were party to two shareholder agreements, under which the VLCCs had been made available to Sea Pioneer Shipping Corporation, which entered into a contract of affreightment (CoA) with an oil company, P. P subsequently assigned its rights under the CoA to the JV companies.

Disputes arose between the JV companies and P, which Maroil and Sea Pioneer settled without Oceanic's consent. The settlement sum was approximately US$30 million.

Oceanic, as a shareholder in the JV companies, alleged (a) that nothing less than US$89 million should have been accepted, and (b) that, in any event, it had not received its US$10 million share of the settlement sum. Both the JV companies and Oceanic, as shareholder, therefore suffered a loss.

In structuring its claims, Oceanic sought payment by Maroil and Sea Pioneer to the JV companies, either by way of specific performance or damages. To secure its claims, Oceanic applied for, and successfully obtained, a freezing order against Maroil and Sea Pioneer.

Relying on the principle of "reflective loss", Maroil and Sea Pioneer argued that Oceanic's claims were unsustainable and sought to set aside the freezing order.

The Principle of "Reflective Loss"

"Reflective loss" is a legal principle of company autonomy. The idea is that a company, and not its shareholders, should have the right to recover the company's losses. This principle is especially important for a company's creditors, who could otherwise find their claims frustrated if shareholders could bypass the company and recover directly. It is also important for potential defendants who could face claims from both a company and its shareholders for the same loss.

Lord Bingham explained the principle in *Johnson v. Gore Wood* [2002] 2 AC 1, as follows:

- Where a company suffers a loss caused by a breach of duty owed to it, only the company may sue for that loss
- A shareholder cannot sue for a reduction of value in their shares that merely "reflects" the loss of the company
- Where the company suffers loss but has no cause of action, the shareholder may sue even though the loss is a reduction in the value of the shareholding
- Where a company suffers loss caused by a breach of duty to it, and a shareholder suffers separate and distinct loss arising from a breach of duty owed to the shareholder, both may sue to recover their own losses, but not the loss of the other

The Commercial Court's Decision

Oceanic had a cause of action under the shareholder agreements. This cause of action was structured in favour of the JV companies. Oceanic's claims, therefore, remained consistent with the principles of company autonomy and creditor protection: it was the JV companies, and not Oceanic, who were to receive any sums paid under a court order. It also meant that there was no risk of double recovery, i.e. one defendant paying for the same loss twice.

The Commercial Court held that specific performance could arguably be awarded in favour of a third party if it was the most appropriate way to enforce a contract. As such, although the Commercial Court found that the loss claimed was technically "reflective", the claims did not breach the principles underlying the concept of "reflective loss". Maroil and Sea Pioneer's attempt to set aside the freezing order was, therefore, dismissed.

Comment

The principle of "reflective loss" is an important element of the concept that a company is a legal entity separate from its shareholders. But it can and does, in certain instances, place individual shareholders under significant constraints. The availability of specific performance as a potential remedy where a shareholder has its own cause of action is an important reminder that shareholders do not have to rely solely on the actions of a company to recover their losses. This is in addition to the suite of "derivative" claims that are available to shareholders in some circumstances.