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THE DOCTRINE OF REFLECTIVE LOSS AND ITS APPLICABILITY IN INDIA

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STRUCTURE OF THE PRESENTATION

- Doctrine of reflective loss
- Application on the shareholders and the creditors
- Discussion on the Marex Judgement
- Duties of the directors in UK and India
- Segregation of duties into direct and indirect duties
- Understanding direct duty
- Understanding Indirect/derivative duty
- Conclusion

DOCTRINE OF REFLECTIVE LOSS

Reflective loss is a legal principle that prevents shareholders from recovering damages for

a) diminution in the value of shares or

b) reduction in the dividends received

as the same are mere reflection of the loss suffered by the company.

The rule against reflective loss stems from the rule in ***Foss v. Harbottle***, that:

“a company has its own legal identity and only the company has a cause of action in respect of wrongs done to it.”

Thus, the rule is based on two fundamental principles of company law

a) Proper Plaintiff Rule

b) Company is a separate legal personality

Continued from previous

Two fundamental principles

- Proper Plaintiff Rule
- Company is a Separate Legal personality

Based upon the **conjoint application** of the said principles the doctrine establishes that the company being a separate legal entity is the “proper plaintiff” entitled to seek relief for an injury incurred to it.

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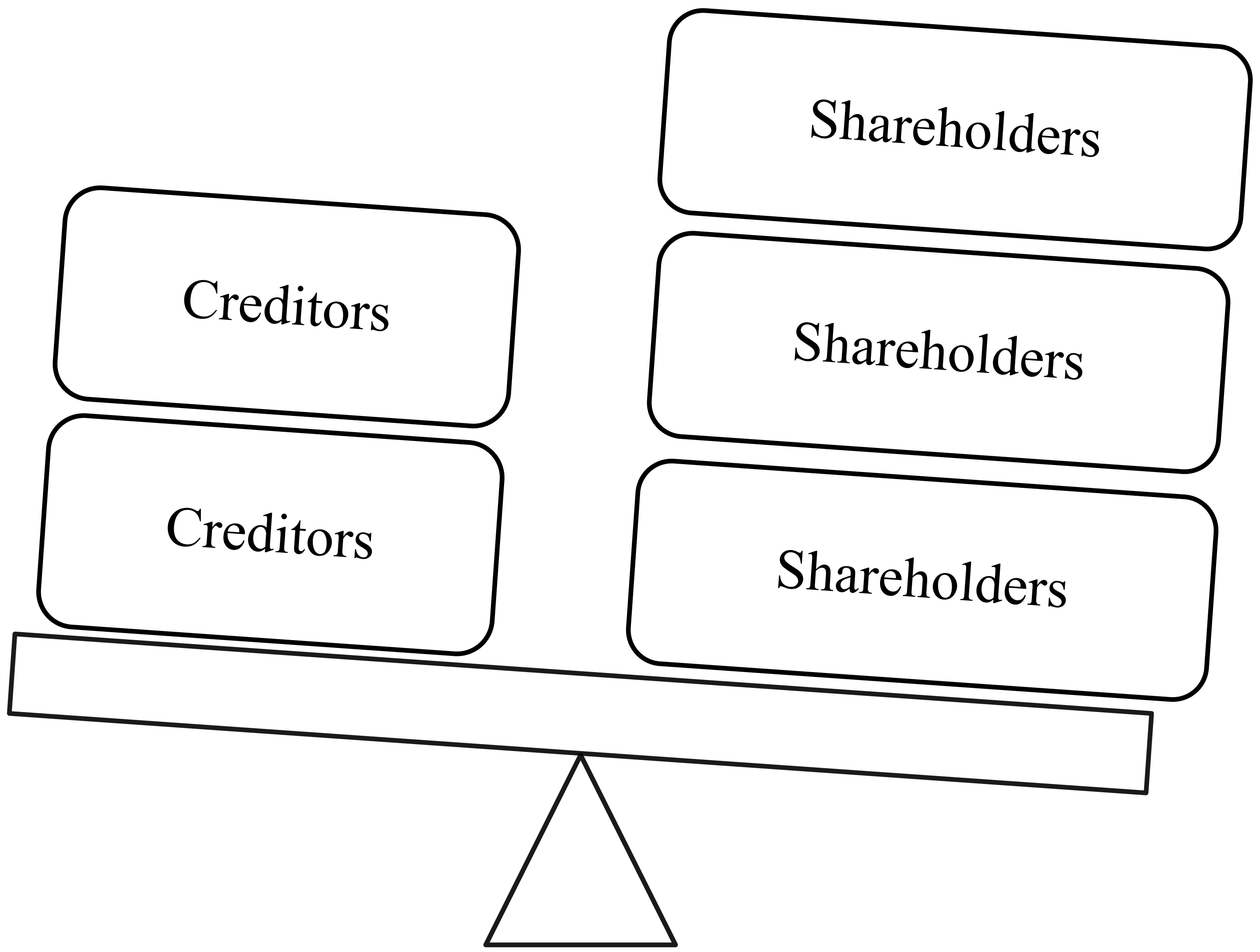
Assessing Applicability of the Doctrine on two important stakeholders of the company



SHAREHOLDERS AND CREDITORS

Shareholder: <u>Prudential Assurance v. Newman Industries [1982] 1 Ch 204</u>

"What [a shareholder] cannot do is to 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. His only 'loss' is through the company, in the diminution in the value of the net assets of the company, in which he has a shareholding."

Creditors: <u>Sevilleja v. Marex Financial</u>

- Marex was a creditor with a decree of 5 Million dollars against the company incorporated by Sevilleja. However, before Marex could have enforced the decree against the company Sevilleja misappropriated the assets of the same. Consequentially, the company was rendered judgement proof.
- The company went into liquidation and on account of a derelict liquidator Marex initiated commercial proceedings against Sevilleja for breach of fiduciary duties. Marex initiated proceedings against Sevilleja under tort seeking damages incurred.
- The question before English Court of Appeal was whether the rule of reflective loss extended to non-shareholder creditors of a company and concluded that it did.
- However the decision has now been overturned by the Supreme Court. The legal position as it exists today is that the doctrine no longer applies to claims by creditors (whether they are also shareholders or not)

DUTIES OF DIRECTOR IN INDIA

Duties of Directors in India

Can be compartmentalized into two heads

Direct duty

Indirect/ Derivative duty

WHEN DIRECTORS BREACH DUTY TOWARDS THE CREDITORS IN INDIA?

Direct Duty	Indirect/ Derivative Duty
There are instances wherein a director makes himself personally liable for the debts that the company owes to the creditor and thus there exists an independent relationship between the creditor and the director in addition to the relationship between the company and creditors	A derivative duty towards creditor is one that arises by virtue of the relationship between the company and director. The duty of the director towards the creditor thus, flows through the company.
1. Instances wherein directors stood as guarantors to the corporate debtor 2. Entered into a contract on account of misrepresentation, fraud induced by the director 3. Company into the zone of insolvency.	The directors will owe indirect/derivative duty in cases other then those enumerated under direct duty

UNDERSTANDING DIRECT DUTY

when a director stands as personal guarantor, surety, indemnity etc. of the company, his direct liability can be imputed for breach of interest of the creditors

Directors can become accountable to the creditors if held guilty of misfeasance or breach of trust. However, misfeasance cannot be imputed to a director unless he has acted dishonestly or abstained from performing his duties

when the company is in the zone of insolvency, the directors have a duty of care to *“protect the contractual and priority rights of the creditors”*

UNDERSTANDING INDIRECT/ DERIVATIVE DUTY

A derivative duty towards creditor is one that arises by virtue of the relationship between the company and director.

When the creditors deals with the company exclusively it is financially interested in the company.

In light of the same, when the third-party contracts with the company, only company can be held liable and not the directors

Thus claims arising under derivative duty involves an actual injury to the corporate entity and any harm or losses to the shareholders or creditors are purely reflective of the actual injury suffered by the company itself

THANK YOU