Shareholder Personal Action in Respect of a Loss Suffered by the Company: The Problem of Overlapping Claims and "Reflective Loss" in English Company Law

GIORA SHAPIRA*

I. Introduction

Can a shareholder recover a personal loss resulting from a loss suffered by the company? Unfortunately, that apparently simple question has no simple answer (in fact, at times, it gets excessively complicated). The company lawyer may argue that the answer lies in basic company law—as a separate legal entity, it is the company itself that must sue to recoup its own losses. That leaves the shareholder with no cause of action and no standing to sue. The shareholder derivative action, available under certain conditions, is still a corporate action, seeking relief for the company itself. Simply, that means that a shareholder cannot recover damages suffered by the company. But, as demonstrated below, the problem may not end here. Depending on the bargain, a duty in contract or in tort may be owed by the defendant to the shareholder *personally* (alone, or together with an overlapping duty to the company) *relating* to the company's business. From an obligation/damages point of view, an action by a dominant shareholder in respect of loss of share value and dividend, reflecting loss to the company caused by loss inflicted on the company, is not far-fetched. The elements of causation, foreseeability and proximity of damages may well exist. Such an action spans a number of legal areas, giving rise to a complex matrix of fact and law. Policy wise, it requires a careful consideration of individual property rights balanced against the function of companies. This article discusses the problem, and its recent debate and resolution in English law.

First, what is meant by "personal shareholder loss"? Economically, the company's loss is ultimately born by the shareholders. Perhaps the best example is a once-prosperous, one-person company that fails. In that case, the owners are evidently that much the poorer. The

*Giora Shapira graduated M Jur with Distinction; Hebrew University, Jerusalem, and LLM, University of London. Professor Shapira has taught in Israel, Canada, New Zealand, and the United States (SMU). His areas of expertise are Corporations Law, Corporate Governance, and Conflict of Laws, and he has published widely in these areas. Professor Shapira is presently Senior Lecturer, University of Otago, New Zealand.

law, however, puts a different gloss on it. The company's depletion of assets is not a loss legally born by the shareholders. The corresponding shareholder loss is by *diminution in value of shares*. That distinction has major property and enforcement implications. It stems from the fundamental legal separation between company and shareholders, and consequently, their respective assets.[1] On this basis, say the courts, the shareholder's own personal loss merely reflects the reduction in the company's net value; and as such, it is not recoverable by the shareholder. The respective losses are, in fact, identical. These courts set up a single right of recovery for the company.

> Hence the salutary rule that where the loss consists in diminution in the value of the shares which is fully reflected in the loss suffered by the company. . ., then the company coffers must be filled first before the spoils of litigation are put in the pocket of the shareholder.[2]

The phrase "no reflective loss" rule is used in this article as shorthand for the rule disallowing shareholder personal recovery in respect of loss of share value, dividend, and other company payouts, because the company has a claim in respect of the same economic loss.

Two points may be made here. First, it is conceivable that an individual shareholder would suffer a consequential *distinct or additional private loss* (original loss) caused by the company's loss. For example, if the company collapses, the shareholder would obviously be worse off financially. This may lead to further costs caused by enforcement of personal guarantees—inability to finance other business, extra borrowing, inter-group ramifications, inability to raise personal finance against the company's assets, and other like expenditures. Second, reflective loss is a real economic loss to the shareholder (it can be realistically termed "impactive damage"). The fact that it is irrecoverable creates a problem for the law of damages.

The problem, then, can be re-stated. When a dominant shareholder suffers a personal loss as a result of harm to the company, caused by a breach of duty to the company and/or to the shareholder, can the shareholder sue the wrongdoer, and in what respect?

Shareholders in both large and small companies may be affected. In the large company, the problem arises in two situations. One problem involves directors' breach of duties arguably owed to the shareholders personally. The loss may be original to the shareholder, or merely reflective. The other problem is the parent/subsidiary relationship. In this situation the parent company sues the wrongdoer for loss of its own value due to loss wrongly inflicted on a fully owned subsidiary.

On the other side of the scale, the typical case concerns a tightly held company whose controlling, working shareholders deal with third parties, commonly professional advisers, in both personal and corporate capacities. A business person who runs his/her business through one or more companies may receive ongoing services or professional advice concerning a variety of business interests. The adviser, in this situation, would be acting for both the shareholder personally and the company.

1. English company law insists on a total dichotomy between shareholder and company assets. Shareholders have no legal or equitable rights in their company's assets—Macaura v. Northern Assurance Co. Ltd. [1925] A.C. 619. In that case, the House of Lords denied a sole shareholder an insurable interest in the company's assets and, consequently, recovery under an insurance issued to him personally over the company's property. (Contrast Constitution Ins. Co. of Can. v. Kosmopoulos, [1987] 34 D.L.R. (4th) 208, where the High Court of Canada, without lifting the corporate veil, allowed a sole shareholder to recover in similar circumstances by expanding "insurable interest" to cover interests of a sole shareholder in the company's assets.).

2. Johnson v. Gore Wood & Co., 1999 B.C.C. 474, 499A (Eng. C.A.).

A typical fact pattern: D (defendant) gives negligent professional advice to P (plaintiff). P is the sole shareholder and manager of a company through which the business or investments based on D's advice are conducted. D is also retained by the company. The company suffers a serious loss (which may lead to insolvency). P accuses D of breach of duty of care owed not only to the company, but also to him (P) personally (though related to the company's business). D, claiming exclusive bargain with *the company*, contests P's (1) standing, (2) cause of action, and (3) recoverable damages. Such circumstances, said the English Court of Appeals recently, demonstrate "the impact of company law on professional liability."[3]

The situation is not uncommon; but despite a flurry of litigation in the last twenty years, the legal principles remained uncertain until recently. In addition to questions of liability, the cases raise a wide array of issues: cause of action, standing to sue, heads and remoteness of damages, creditor protection, insolvency, and double recovery. The principles involved are from the law of obligations, the law of damages, rules of civil procedure, and the law of companies.

With such complicated mapping, no wonder the law has lost direction. As the English Court of Appeal has recently stated:

> We have not found these cases easy to reconcile and we must embark upon a lengthy examination of their facts and their reasoning with a view, eventually, to identifying the permutations of duty and damage so that one can see how the principles fit the differing circumstances depending upon whether a duty is owed to the shareholder/holding company or to the company/subsidiary or to both, then which one or whether both suffer damage, and finally whether it is the same duty and the same damage.[4]

"Shareholder actions,"[5] a notoriously obscure area of English company law, is not helped by this twist. The appeal that has recently reached the House of Lords on preliminary issues is indicative of the difficulties. Indeed the House, dealing with this matter for the first time, was determined to lay down the law. The decision and the Court of Appeal's judgment leading to it are examined below.

II. *Johnson v. Gore Wood & Co.*[6]

A. The Background

As can be appreciated, the decisions are fact specific. Factually, it is often difficult to distinguish individual and corporate activity when the company is tightly held and the two are closely entwined.

In the case at bar the plaintiff, Mr. Johnson (J), was an entrepreneur who conducted his business through a number of companies. Westway Homes Ltd. (WWH) was fully owned and controlled by J, who also guaranteed its debts. WWH had a valuable option to purchase

3. Day v. Cook [2002] 1 B.C.L.C. 1, 3 (Eng. C.A.).

4. Johnson v. Gore Wood & Co., 1999 B.C.C. 474, 487 (Eng. C.A.).

5. For a review and reform proposals, see English Law Commission, Shareholder Remedies (Law Com No 246, 1997), *at* http://www.lawcom.gov.uk/122.htm (last visited Jan. 22, 2003).

6. Johnson v. Gore Wood & Co., [2002] 2 A.C. 1 (Eng. H.L.) *rev'g* Johnson v. Gore Wood & Co., 1999 B.C.C. 474 (Eng. C.A.) (on the "abuse of process" ground only—*see* note 10, *infra*). For commentary, see Eilis Ferran, *Litigation by Shareholders and Reflective Loss*, 2001 Cambridge L.J. 245 (2001); P. Watts, *The Shareholder as Co-Promisee*, 117 L. Q. Rev. 388 (2001).

land for property development. The defendant, Gore Wood & Co. (GW), was a solicitors' firm. It provided J with legal advice concerning his various interests. GW also acted for WWH. At one point, GW was instructed to exercise WWH's option. It was clear that J's personal assets would be used to finance the building project and GW was retained to act in that matter.

GW failed to exercise the option properly—it served the notice on the vendor's solicitor instead of on the vendor himself, and did not include the required deposit. The mistakes were later corrected, but the vendor, wishing to take advantage of a booming property market, refused to complete the sale. He contended that the option had not been validly exercised. On GW's advice, WWH commenced proceedings against the vendor for specific performance and damages for breach of contract, and against the vendor's solicitor for breach of warranty of authority.

GW advised J that the proceedings would be concluded successfully within six months and advised him on financial strategy for his funding of the company through the litigation when he would also need to borrow money to fund his other businesses. J went ahead on the basis of a quick and certain victory.

It took two years for the case to come to trial. A judgment was given against the vendor, but the action against the vendor's solicitor was dismissed. The vendor and WWH appealed and both appeals were dismissed, with costs in the second appeal against WWH. The delays in the litigation and subsequent delay in acquiring the land coincided with a collapse in the property market that resulted in a financial disaster on the project for WWH. The business failure had severe ramifications for J. By the time he issued his own writ against GW he "claimed his life was in ruins, his opportunities to acquire prosperity dashed, his reputation in tatters and his income reduced to Social Security benefits."[7]

WWH commenced an action for professional negligence against GW, claiming well over two million pounds. Six weeks into the hearing, the action was compromised without admission of liability by GW.[8] GW was notified that J intended to bring a further, personal action against GW and that action was, indeed, written into the settlement with WWH. A few months after the WWH compromise, J issued a writ against GW, claiming two million pounds for loss and damage suffered by J. These were related to GW's negligence while acting as solicitors of both WWH and J personally, in breach of duty of care owed by GW to J personally. The heads of damages included personal losses of J largely in relation to liabilities and losses of WWH, and diminution of value of J's shareholding in WWH.[9]

GW applied to have the statement of claim struck out (in the United States—a motion to dismiss). To proceed, the plaintiff must only show an arguable case. J had to convince the court that, on the facts as pled he had a chance of success. Thus, the trial of preliminary issues concerned:

(i) whether the facts pleaded were capable of establishing any relevant duty owed by GW to J personally, and

7. Johnson v. Gore Wood & Co., 1999 B.C.C. 474, 475 (Eng. C.A.).

8. GW agreed to pay 1.48 million pounds for damages and 320,000 pounds for costs, WWH agreeing that any of J's personal guarantees for WWH liabilities would be discharged out of the damages sum.

9. J also claimed damages for mental distress and anxiety and aggravated damages for injury to J's pride and dignity. While the Court of Appeal declined to strike them out, the House of Lords did. It held that such heads of damages were not available in respect of breach of normal commercial contract.

(ii) whether any of the heads of damages claimed were irrecoverable company losses or whether they were capable of amounting to personal losses capable in law of being recoverable by J.

The trial judge found in favour of J on both issues. The judge also dismissed an application by GW under the Supreme Court rule that the statement of claim be struck out as an abuse of the process of the court.[10] GW appealed to the Court of Appeal.

B. The Court of Appeal[11]

The Court noted that J had pleaded his claim in the following terms:

1. Damages for loss and damage suffered by the plaintiff as a result of the negligence of the defendants arising out of their acts and/or omissions *whilst acting as solicitors for [WWH]*, of which the plaintiff was at all material times a Director. . . . in breach of the duty of care owed by the defendants to the plaintiff.
2. Damages for loss and damage suffered as a result of the negligence and/or breach of contract of the defendants *as the plaintiff's solicitors*. . . .[12]

The analysis proceeded under the headings formulated by the trial judge (quoted above). They can be abbreviated into the "duty" issue, and the "recoverable damages" issue.

On the duty issue, the question of contractual or tortious duties owed by the defendants to J personally, the Court found that such duties did exist in law. J paid a personal "general retainer" to GW in addition to the retainer paid by WWH, and GW could owe a contractual duty to J. Alternatively, GW could owe a tortious duty to J[13] since it was arguable that his personal loss was foreseeable, and that the relationship of solicitor and client, though general, put the parties in sufficient proximity. J's personal affairs and his business dealings were so intimately entwined that it was quite possible that any professional person advising on all the various business interests, and in particular on WWH's option, would not distinguish between J and his company.

The analysis so far, it can be noted, is mostly conventional. The one exception is overlapping claims. On that, the Court effectively affirmed that as a matter of law, A was capable, in principle, of incurring liability to both B and C in respect of an undertaking to B. GW could, therefore, owe contractual or tortious duties to J in respect of work done for WWH.

The Court's reasoning got J over the first hurdle. To complete his cause of action, though, he had to show recoverable damages. The "recoverable damages" issue is the most interesting part of the judgment.

Here, the Court turned to its own earlier decision in *Prudential Assurance Co. Ltd. v. Newman Industries (No 2)*,[14] the founding authority on "reflective loss." The Court noted:

10. That argument was based on the rule against "double action," which prohibits a plaintiff to sue twice in respect of the same claim. The Court of Appeal struck out J's claim as an abuse of process in view of the successive actions and the two year delay in bringing J's personal action. The House of Lords reversed. For commentary on this aspect of the case, *see* Sara Robertson, *Successive Actions: Abuse of Process and Damages*, 2001 Solic. J. 458; A. Beck, *Relitigation: The House of Lords Rules* [2001] N.Z.L.R. 145; Ian Gordon, *Res Judicata and Settlement Agreements*, 1999 New L.J. 348 (commenting on the Court of Appeal judgment).

11. Johnson v. Gore Wood & Co., 1999 B.C.C. 474 (Eng. C.A.) (Judgment of the Court).

12. *Id.* at 481 (emphasis added by the Court).

13. Following the leading authority on professional negligence, Caparo Indus. Plc v. Dickman [1990] 2 A.C. 605 (Eng. H.L.).

14. Prudential Assurance Co. Ltd. v. Newman Indus. (No. 2) [1982] Ch. 204.

> Prudential Assurance is the leading case. It builds upon the rule in Foss v. Harbottle (1843) 2 Hare 461 which establishes that the proper plaintiff in an action in respect of a wrong alleged to be done to a corporation is, prima facie, the corporation.[15]

The facts were then summarised:

> The Prudential, which held a 3.5 [percent] shareholding in Newman Industries Ltd, a quoted public company, claimed damages against two of Newman's directors alleging that they had fraudulently misrepresented to the shareholders the value of certain other companies which were then acquired by Newmans but at a loss because the value had been inflated. The Prudential claimed damages first on the basis of an action on behalf of the company, and secondly in a personal claim. The rule in Foss v. Harbottle defeated the first claim. The basis for the second claim was that, but for the fraud, Newman's indebtedness to its bankers would have been [smaller] than it was and that the fraud therefore reduced the quoted price of Newman's shares.[16]

The *Johnson* Court then quoted the key passages from the *Prudential Assurance* case. This seminal analysis is worth reproducing here in some length:

> It is of course correct . . . that (the directors), in advising the shareholders to support the resolution approving the agreement, owed the shareholders a duty to give such advice in good faith and not fraudulently. It is also correct that if directors convene a meeting on the basis of a fraudulent circular, a shareholder will have a right of action to recover any loss which he has been personally caused in consequence of the fraudulent circular; this might include the expense of attending the meeting. But what he 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. . . The shares themselves, his right of participation, are not directly affected by the wrongdoing. The plaintiff still holds all the shares as his own absolutely unencumbered property. The deceit practised upon the plaintiff does not affect the shares; it merely enables the defendant to rob the company. A simple illustration will prove the logic of this approach. Suppose that the sole asset of a company is a cash box containing £ 100,000. The company has an issued share capital of 100 shares, of which 99 are held by the plaintiff. The plaintiff holds the key of the cash box. The defendant by a fraudulent misrepresentation persuades the plaintiff to part with the key. The defendant then robs the company of all its money. The effect of the fraud and the subsequent robbery, assuming that the defendant successfully flees with his plunder, is (i) to denude the company of all its assets; (ii) to reduce the sale value of the plaintiff's shares from a figure approaching £ 100,000 to nil. There are two wrongs, the deceit practised on the plaintiff and robbery of the company. But the deceit on the plaintiff causes the plaintiff no loss which is separate and distinct from the loss to the company. The deceit was merely a step in the robbery. The plaintiff obviously cannot recover personally some £ 100,000 damages in addition to the £ 100,000 damages recoverable by the company.
>
> . . .
>
> A personal action would subvert the rule in Foss-v-Harbottle[17] and that rule is not merely a

15. Johnson v. Gore Wood & Co., 1999 B.C.C. 474, 487 (Eng. C.A.).

16. *Id.*

17. Foss v. Harbottle (1843) 2 Hare 461. The Rule establishes that the proper plaintiff in an action in respect of a wrong to a corporation is the corporation itself—not a shareholder. Shareholder actions in English

> 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. Other consequences are limited liability and limited rights. The company is liable for its contracts and torts; the shareholder has no such liability. The company acquires causes of action for breaches of contract and for torts which damage the company. No cause of action vests in the shareholder. When the shareholder acquires a share he accepts the fact that the value of his investment follows the fortunes of the company and that he can only exercise his influence over the fortunes of the company by the exercise of his voting rights in general meeting.[18]

Notably, the *Prudential Assurance* Court expressly recognizes overlapping company/shareholder claims in respect of the same wrong. However, the shareholder cannot proceed without having suffered loss; and a fall in value of the shares is not a distinct personal loss—it merely reflects corporate loss. The shareholder continues to own the same proportional part of the enterprise, only the enterprise is worth less. The concern is to preserve exclusive enforcement rights to the company. The relief is a corporate asset, and should be available, through the corporate mechanism, to all corporate participants. For the shareholder to recover personally would be an appropriation of corporate assets (a point to which we shall return later).

Still, a shareholder with an overlapping claim may sue in respect of original distinct or additional damage—which does not reflect company loss. Canvassing the authorities, the *Johnson* Court gleaned the following principles:[19]

1. The rule in Foss-v-Harbottle provides the starting point that A cannot bring an action against B to recover damages for an injury done by B to C.
2. Where the shareholder's loss is not separate and distinct from but is reflective of the direct loss suffered by the company as a result of the defendant's conduct, then no personal loss from the diminution in the market value of the shares arises and accordingly the shareholder has no right of action: Prudential Assurance.
3. The gloss on this is that the defendant's conduct can cause loss in two directions—one, arising as a shortfall of assets or profits, being a loss to the coffers of the company; the other being a loss to his own pocket as when he is induced to part with his shares at an undervalue: the Heron distinction.[20]

---

common law are in two categories: (i) under the "fraud exception" to the rule in *Foss v. Harbottle*—the "derivative action," which allows a shareholder to sue on behalf of the corporation in respect of "fraud" by those in control of the company; and (ii) an ill defined "personal shareholder action" against the company and/or the directors, to enforce duties owed to the shareholder personally. The plaintiff in Prudential Assurance attempted, unsuccessfully, to bring itself under the exception to *Foss v. Harbottle*. It also proceeded in a parallel "personal action" for being given fraudulent information. The Court viewed the personal action as an attempt to subvert the rule *in Foss v. Harbottle*. For a useful recent judicial summery of the English derivative action, see Konamaneni v. Rolls-Royce Industrial [2002] 1 B.C.L.C. 336, 345–48 (Ch.).

18. Johnson v. Gore Wood & Co., 1999 B.C.C. 474, 488 (Eng. C.A.), *citing* Prudential Assurance (No. 2) [1982] Ch. 204, 222G-223D, 224A-B. (Footnote added).

19. Johnson v. Gore Wood & Co., 1999 B.C.C. 475, 497–498 (Eng. C.A.).

20. Heron Int'l Ltd. v. Lord Grade [1983] B.C.L.C. 244 (Eng. C.A.). The shareholders sued the directors for breach of their duties to the shareholders and to the company in negligently recommending a takeover of the company. Damages were claimed (a) for depreciation of assets by loss to a subsidiary and (b) because the shares in the company would command a lower price than a price potentially available from a rival bidder. The Court of Appeal held that damages under (a) were not available to the shareholders personally, as they merely reflected the alleged company loss. The loss under (b) on the other hand was, in principle, recoverable, being "a loss suffered exclusively to the pockets of the shareholders, and is in no sense a loss to the coffers of the company, which remains totally unaffected."

4. If the duty is owed to the shareholder only and ex hypothesi the company has no cause of action, then the shareholder can recover such losses, if not too remote, as he can prove to have been caused by the defendant's conduct no matter that the losses arises [sic] through loss of dividends or his share of profits in the company or a fall in value of his shares: George Fischer[21] and Gerber.[22]

For the actual result, the Court returned to the pleadings. On the assumption that the pleadings were right and the defendant owed a personal duty of care to the plaintiff, which was breached, heads of damages, representing personal (original) rather than "reflective" loss, were recognized as arguably recoverable. These damages included loss of investments in the plaintiff's other companies made in reliance on the optimistic advice about the future prospects of WWH; the plaintiff's borrowing to support his different needs, business and personal; certain losses derived from the inability to derive income from WWH, though "some less than others." By the same token, the claim for diminution of the value of J's shareholding in WHH was a reflection of the company's own loss, and as such, unrecoverable. Thus, it was struck out.[23]

C. Commentary

Classified that way, the authorities make sense. Nevertheless, some doubts remained. The Court acknowledged that some authorities did not fit its analysis. The principles affecting the paradigmatic case—a shareholder's overlapping claim for loss of share capital and dividend by a breach of a duty owed to the shareholder personally, but also actionable by the company—remained uncertain.

The inconsistency, it would appear, stems from different interpretations of *Prudential Assurance*. One view considers that case as entirely about a *cause of action*. In its vigorous reaffirmation of the rule in *Foss v. Harbottle*,[24] the *Prudential Assurance* Court rejected the

21. George Fischer (Great Britain) Ltd. v. Multi Constr. Ltd., Dexion Ltd. (third party) [1995] B.C.C. 310 (Eng. C.A.). The plaintiff holding company contracted with the defendant to install certain equipment at the premises where the subsidiaries carried on business. It was faulty. The plaintiff claimed that the loss of sales and increased operating costs that were suffered directly by the subsidiaries were also suffered indirectly by it and its losses were measured by the loss of profits to the subsidiaries. The issue was whether the shareholder was entitled to recover damages for the diminution in the value of its shareholding in the company or distribution of dividend, where such loss was inflicted on the company by the defendant's breach of contract with the shareholder. The Court of Appeal held that the case was quite unaffected by *Foss v. Harbottle* and *Prudential Assurance*, as the plaintiff clearly had a cause of action which the harmed companies did not have. The plaintiff's damages resulting from fall of share value and loss of dividend were, in principle, recoverable.

22. Gerber Garment Tech. Inc. v. Lectra Sys. Ltd. [1997] R.P.C. 443 (Eng. C.A.), where a parent company that held certain patents rights, and to whom, therefore the duties were owed, claimed damages caused to its subsidiary by infringement of these rights. Following *George Fischer*, it was held that when the shareholder had a cause of action and the company did not, the shareholder could sue for personal damages including diminution of share value and loss of dividend.

23. *See* specification of heads of damages claimed by the plaintiff—Johnson v. Gore Wood & Co., 1999 B.C.C. 477, 486–487 (Eng. C.A.). Out of the eleven heads of damages claimed, only one (paragraph (k)) was struck out.

24. The Rule has come under pressure for generating mammoth litigation on the right to litigate. The prime example is *Prudential Assurance* itself.

accompanying shareholder's personal action for conspiracy to defraud, as a subversion of the rule. The Court emphasised that the action for alleged fraud was reserved exclusively to the company, calling the shareholder's bluff in mounting a personal action. The cash box analogy, according to this view, was merely a further explanation of why the shareholder had no standing to sue. So viewed, *Prudential Assurance* is merely a revamp of *Foss v. Harbottle*. Consequently, once a distinct personal shareholder cause of action *is* established (especially against an outsider third party) *Prudential Assurance* is irrelevant. Ergo, the shareholder is entitled to sue for damages suffered personally (subject to remoteness), *including* diminished share value and loss of dividends.[25]

Under the second view *Prudential Assurance* established a discreet rule of damages. Even if the shareholder has a prima facie cause of action for breach of duty owed to the shareholder personally (overlapping a duty to the company), he/she cannot recover for loss of share value or dividend when the company can sue to recover the same underlying loss.[26]

The most prominent example of the first view (namely, that loss of share value and dividend income are in principle claimable by the shareholder to whom the duty is owed personally, even if the same loss is actionable by the company) is *Christensen v. Scott*.[27] The facts and the decision of the New Zealand Court of Appeal were summarised by the *Johnson* Court as follows:

> The plaintiffs were equal shareholders in a potato farming company and, acting on the defendant's advice, the company took a lease of farm land without obtaining the consent of the lessor's mortgagee. The lessors defaulted; the mortgagees took possession and harvested the potato crop. The company's claim against the negligent advisers was settled. The appeal related to whether or not the shareholders' claim for damages for breach of duty also owed by the professional advisers to them personally should be struck out. The damages claimed were for the diminution of the value of their shareholding and the cost of meeting guarantees to cover company debts. It was held that it was arguable that the advisers owed the shareholders an independent duty of care giving rise to a duty to handle and complete matters pertaining to the company with due care and skill. On the question of damages the New Zealand Court of Appeal accepted that a member had no right to sue directly in respect of a breach of duty owed to the company as laid down in *Foss v. Harbottle* and *Prudential Assurance*. But this did not necessarily exclude a claim brought by a party, who might also be a member, to whom a separate duty was owed, and who suffered a personal loss as a result of a breach of that duty. Thomas J, giving the judgment of the court, said:
>
> Where such a party, irrespective that he or she is a member, has personal rights and these rights are invaded, the rule in *Foss v. Harbottle* is irrelevant. Nor would the claim necessarily have the calamitous consequences predicted by counsel in respect of the concept of corporate personality and limited liability. The loss arises not from a breach of duty owed the company but from a breach of duty owed to the individuals. The individual is simply suing to vindicate his own right or redress a wrong done to him or her giving rise to a personal loss.
>
> We consider, therefore, that it is certainly arguable that, where there is an independent duty owed to the plaintiff and a breach of that duty occurs, the resulting loss may be recovered by the plaintiff. The fact that the loss may also be suffered by the company does not mean that

25. *See*, in particular, per Lord Cooke in Johnson v. Gore Wood & Co. [2002] 2 A.C. 1, 42–43 (Eng. A.C.).

26. *See id.* at 54, in particular, per Lord Hutton *id.* at 54, and per Lord Millett, at 63E-F.

27. Christensen v. Scott [1996] 1 N.Z.L.R. 273. *Christensen* was followed in England in *Barings plc (in admin.) v. Coopers & Lybrand* [1997] B.C.C. 498 (Court of Appeal).

> it is not also a personal loss to the individual. Indeed, the diminution in the value of [the shareholders'] share in the company is by definition a personal and not a corporate loss. The loss suffered by the company is the loss of the lease and the profit which would have been obtained from harvesting the potato crop. The loss is reflected in the diminution in the value of [the shareholders] shares. They can no longer realise their shares at the value they enjoyed prior to the alleged default of their accounts and solicitors.[28]

The *Christensen* Court acknowledged the problem of double recovery when both company and shareholder sue the wrongdoer in respect of the same loss in separate proceedings; but concluded that this could be overcome by adjusting the relief.

The contrary view on reflective damage is more intricate. The logical explanation why such loss is not recoverable by the shareholder is "causation." Personal loss of share value and dividend is not caused by the wrongdoer but by the loss suffered by the company. Since the company acquires a right of action in respect of the loss, it can, in principle, recoup it. Theoretically, then, the company acquires a receivable (legally—a choice in action), which potentially tops up its assets to their previous level. Once that happens, the shareholder had suffered nothing. If the shareholder is allowed to recover in a personal action, and the company subsequently, successfully sues, the shareholder is doubly compensated. If the company fails to recover, or to fully recover, it is this failure, not the underlying wrongdoing that affects the shareholder.

That position is based on policy. The main concern is double recovery but, as we shall soon see, other considerations also apply. A good exposition is in *Gerber Garment Technology Inc. v. Lectra Systems Ltd*:

> As the judgment [in Prudential Assurance] implies, the shareholder will ordinarily have difficulty in proving that he has suffered a loss caused by the fault of the third party. If the company is able to recover from the third party, the company will be indemnified and the value of the shareholder's shares will not have been reduced. If the company chooses not to exercise its remedy, the loss to the shareholder will have been caused by the decision of the company not to pursue its remedy, not by the defendant's fault. The type of situation with which the Court of Appeal was faced in the Prudential case was therefore one which inevitably impacted on the rule in Foss v. Harbottle. As a matter of causation, the Prudential could not escape from the conclusion that they were seeking, however they presented their case, to recover the company's loss not their own.[29]

Accordingly, a shareholder who has a personal cause of action, which overlaps with that of the company, is unable to recover in respect of the loss primarily suffered by the company, despite the personal loss of share value and dividend income.[30]

---

28. Johnson v. Gore Wood & Co., 1999 E.C.C. 475 (Eng. C.A.), at 491.

29. *Gerber* [1997] R.P.C. 443, at 471. For similar reasoning, see Stein v Blake [1998] B.C.C. 316 (Eng. C.A.), at 318F.

30. The rule in *Prudential Assurance* received statutory authority in New Zealand. Companies Act 1993, § 169(1) (N.Z.) allows shareholders to sue the directors for breach of certain statutory duties owed by the directors to the shareholders personally. However, under subsection (2) no action may be brought "to recover any loss in the form of a reduction in the value of shares in the company or a failure of the shares to increase in value by reason only of a loss suffered, or gain forgone, by the company." Clearly, that sets up a special rule of damages in respect of a recognized cause of action.

D. THE HOUSE OF LORDS[31]

Essentially affirming the Court of Appeal on its material points, the House also added its own gloss. It still had to rule on conflicting lines of authorities.[32] Of the five speeches, the principal ones are Lord Bingham's and Lord Millet's. Lord Bingham formulated three propositions:

(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.[33]
(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 in diminution in the value of the shareholding.[34]
(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.[35]

On policy, His Lordship explained:

> On the one hand the court must respect the principle of company autonomy, ensure that the company's creditors are not prejudiced by the action of individual shareholders and ensure that a party does not recover compensation for a loss which another party has suffered. On the other, the court must be astute to ensure that the party who has in fact suffered loss is not arbitrarily denied fair compensation.[36]

A distinction had to be made between reflective loss—loss of share value and dividend "which would be made good if the company had enforced its full rights against the party responsible" and "a loss unrelated to the business of the company." J's heads of damages, as pleaded, were scrutinized in that light:

(1) [Related companies]. The claim is for sums which Mr Johnson, acting on GW's advice, invested in these companies and lost. This claim is unobjectionable in principle. . . .
(2) Cost of personal borrowings: loan capital and interest. The claim is for sums which Mr Johnson claims he was obliged to borrow at punitive rates of interest to fund his personal

31. Johnson v. Gore Wood & Co. [2002] 2 A.C. 1 (Eng. C.A.).

32. To add to the confusion, the *Johnson* Court of Appeal at once disapproved *Christensen* and followed the similarly premised *Barings*, *supra* note 27. Johnson v. Gore Wood & Co., 1999 B.C.C. 474, 498B–499B (Eng. C.A.). The House of Lords eventually overruled both *Christensen* and *Barings*. Johnson v. Gore Wood & Co. [2002] A.C. 1, 36B (Eng. C.A.).

33. *Id.* at 35–36.

34. *Id.*

35. *Id.*

36. *Id.* at 36.

outgoings and those of his businesses. Both the ingredients and the quantum of this claim will call for close examination, among other things to be sure that it is not a disguised claim for loss of dividend, but it cannot at this stage be struck out as bad on its face. The same is true of Mr Johnson's claims for bank interest and charges and mortgage charges and interest (which will raise obvious questions of remoteness).

(3) Diminution in value of Mr Johnson's pension and majority shareholding in WWH. In part this claim relates to payments which the company would have made into a pension fund for Mr Johnson. I think it plain that this claim is merely a reflection of the company's loss and I would strike it out. In part the claim relates to enhancement of the value of Mr Johnson's pension if the payments had been duly made. I do not regard this part of the claim as objectionable in principle. An alternative claim, based on the supposition that the company would not have made the pension payments, that its assets would thereby have been increased and that the value of Mr Johnson's shareholding would thereby have been enhanced, is also a reflection of the company's loss and I would strike it out.

(4) Loss of 12.5% of Mr Johnson's shareholding in WWH. Mr Johnson claims that he transferred these shares to a lender as a security for a loan and that because of his lack of funds, caused by GW's breach of duty, he was unable to buy them back. This claim is not in my view objectionable in principle.

(5) Additional tax liability. If proved, this is a personal loss and I would not strike it out.[37]

Lord Millet's speech is the most insightful. This is how he sets up the scene:

> A company is a legal entity separate and distinct from its shareholders. It has its own assets and liabilities and its own creditors. The company's property belongs to the company and not to its shareholders. If the company has a cause of action, this is a legal chose in action which represents part of its assets. Accordingly, where a company suffers loss as a result of an actionable wrong done to it, the cause of action is vested in the company and the company alone can sue. No action lies at the suit of a shareholder suing as such, though exceptionally he may be permitted to bring a derivative action in right of the company and recover damages on its behalf. . . . Correspondingly, of course, a company's shares are the property of the shareholder and not of the company, and if he suffers loss as a result of an actionable wrong done to him, then prima facie he alone can sue and the company cannot. On the other hand, although a share is an identifiable piece of property which belongs to the shareholder and has an ascertainable value, it also represents a proportionate part of the company's net assets, and if these are depleted the diminution in its assets will be reflected in the diminution in the value of the shares. The correspondence may not be exact, especially in the case of a company whose shares are publicly traded, since their value depends on market sentiment. But in a case of a small private company like this company, the correspondence is exact.[38]

When the company has a right of action and the shareholder has none only the company can sue; and vice versa. In the latter case, the shareholder can recover loss of share value and dividend because the company cannot recover the underlying loss. As to the more difficult case:

> The position is, however, different where the company suffers loss caused by a breach of a duty owed both to the company and to the shareholder. In such a case the shareholder's loss, in so far 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,

37. *Id.*

38. Johnson v. Gore Wood & Co. [2002] 2 A.C. 1, 61–62 (Eng. C.A.).

> 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 company's creditors requires that it is the company which is allowed to recover to the exclusion of the shareholder.[39]

His Lordship later rejected *Christensen* as not representing the position in English law.[40] Turning to policy considerations, Lord Millet said:

> But there is more to it than causation. The disallowance of the shareholder's claim in respect of reflective loss is driven by policy considerations. In my opinion, these preclude the shareholder from going behind the settlement of the company's claim. If he were allowed to do so then, if the company's action were brought by its directors, they would be placed in a position where their interest conflicted with their duty; while if it were brought by the liquidator, it would make it difficult for him to settle the action and would effectively take the conduct of the litigation out of his hands. The present case is a fortiori; Mr Johnson cannot be permitted to challenge in one capacity the adequacy of the terms he agreed in another.[41]

As to what constitutes reflective loss, His Lordship said:

> Reflective loss extends beyond the diminution of the value of the shares; it extends to the loss of dividends . . . and all other payments which the shareholder might have obtained from the company if it had not been deprived of its funds. All transactions or putative transactions between the company and its shareholders must be disregarded. Payment to the one diminishes the assets of the other. In economic terms, the shareholder has two pockets, and cannot hold the defendant liable for his inability to transfer money from one pocket to the other. In principle, the company and the shareholder cannot together recover more than the shareholder would have recovered if he had carried on business in his own name instead of through the medium of a company. On the other hand, he is entitled (subject to the rules on remoteness of damage) to recover in respect of a loss which he has sustained by reason of his inability to have recourse to the company's funds and which the company would not have sustained itself.
>
> 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. The plaintiff's primary claim lies against the company and the existence of the liability does not increase the total recoverable by the company, for this already includes the amount necessary to enable the company to meet it.[42]

E. Commentary

The bottom line issues for the House of Lords were: (1) whether a merely reflective loss was, in principle, recoverable, and, consequently (2) which of J's pleaded damages should be recognized. The Law Lords were united on issue two but differed on issue one. Lord Cooke (of the New Zealand Court of Appeal presided over the *Christensen* Court) continued to uphold that case (with a caveat against double recovery). Lord Hutton, acknowledging

39. *Id.* at 62.
40. *Id.* at 66.
41. *Id.*
42. *Id.* at 66–67.

the conflict between *Christensen* and *Prudential Assurance*, was skeptical about the latter. He favoured the rationale of *Christensen*, which allowed, in principle, a shareholder with a personal cause of action to sue in respect of loss of share value and other corporate payouts, reflecting the company's loss. Lord Hutton however, did not knock *Prudential Assurance* off its perch; it had twenty years of authority and policy on its side. Both Lord Bingham and Lord Millet categorically disapproved *Christensen*.

The underlying theory of the *Prudential Assurance*'s "no reflective loss" is indeed debatable. To say that such loss is merely imaginary for being reflective, and is not caused by the wrongdoing but by the company failure to recover, is unrealistic. Logically, it is difficult to see why enforcement of obligations duly owed to the shareholder should be barred just because the damage is to financial assets rather than to other assets. As one commentator suggested (commenting on *Prudential Assurance*): "[I]f necessary a share can be regarded as a piece of personal property and a shareholder could be allowed to sue for injury to it."[43]

"Reflective loss" is a legal conclusion. Realistically, loss of investment and income, especially if a closely held company is involved, is a loss acutely felt by the shareholder. The term "impactive damage" may therefore be more appropriate (suggesting a different conclusion). Yet the House of Lords insisted that it was merely a phantom. To reach this conclusion, the House has to subordinate breach of duty of care to company law principles. However, the policy considerations, succinctly stated by Lord Millet, are compelling. They deserve to be highlighted.

III. Policy Considerations

The emerging law on reflective damages has compelling policy grounds. They can be summarized as follows:

- *Double recovery.* This aspect, and its flip side, the wrongdoers' double exposure, have been amply explained in the quotes above. The House of Lords, unlike the *Christensen* Court, saw that ground, in itself, as compelling.
- *Conflict of interest.* A shareholder who is also a director may be tempted to settle the company's claim at below par. That way he or she would be able to appropriate the remainder in a personal action.
- *Difficulty in settling claims.* Receivers and liquidators would have difficulties in settling claims because of lack of finality.
- *Protection of creditors.* Shareholder limited liability restricts creditor's recovery to corporate assets. A company right of recovery of wrongful damage is one such asset. If a shareholder is allowed to appropriate this asset by a personal action, the guarantee fund available to creditors suffers.
- *Protection of co–shareholders.* A shareholder who personally recovers an underlying company loss deprives other shareholders of their proportional entitlements.

Reflective loss is thus potentially disruptive to the basic corporate scheme. This concern highlights the nature of the company as a piece of legal machinery. The company operates

43. M. J. Sterling, *The Theory and Policy of Shareholder Actions in Tort* (1987), 50 MOD. L. REV. 468, 471 (1987), cited with approval by Lord Hutton, Johnson v. Gore Wood & Co. [2002] 2 A.C. 1, 54 (Eng. C.A.).

as a clearing house; it allocates claims, duties and entitlements to corporate participants. For the scheme to work properly, claims, including enforcement rights, must be channelled through the company. The following example illustrates the point. Assuming the company, represented by the liquidator, settles a claim for a million dollars. A shareholder with an overlapping cause of action successfully claims undervalue and recovers an additional half a million dollars as the true measure of the company loss. Both the company's and the shareholder's recovery are in respect of the same loss. Both are part of the same award. Yet the amount recovered by the company benefits all corporate claimants, while the shareholder's recovery is exclusively personal. That does not make sense. The way to go about it is this: the shareholder should seek to hold the liquidator liable for negligence in settling the company's claim at an undervalue (if that can be proved). The liquidator then should pay over the deficit to the company.

IV. Conclusions

Johnson has clarified and restated the law. It has also given the no reflective loss rule the House of Lords' imprimatur. Put simply, it is a rule against counting the same loss twice. As with many legal principles, here too, the proof of the pudding is in the taste. How workable is the rule? Does it help business people plan and legal advisers advise?

Planning in advance is irrelevant. The cases show that all planning is done in retrospect—for legal purposes. As between the shareholder, the company, possibly other, related companies, and the party allegedly at fault, the transactions eventuate in the ordinary course of business. Commonly in such environment no special attention is paid as to who exactly, as between the entrepreneur and his various companies (or a parent and its various subsidiaries) is the party to the transaction. Only when it comes to litigation the question of who had undertaken what to whom becomes crucial. And since original loss must be consequential to reflective loss (otherwise there is no causation), it is often difficult to say when one ends and the other begins. Thus, stating the law presents the lesser difficulty. The real difficulty is applying the law to the facts.[44]

Recoverability of shareholder original loss, by contrast to a merely reflective loss, creates a notable anomaly. The rule allows the shareholder to recover a consequential loss, *caused* by a loss suffered by the company, but not the immediate loss itself (the diminution of share value). As far as damages go, this is a peculiar position. As a general rule, direct damages are recoverable while consequential damages may be too remote. Two examples can be drawn from *Johnson* itself. Johnson could not recover reduction of value of his pension due to the company's inability to continue to contribute to the pension fund. That merely reflected the company's own loss. But he could, in principle, recover loss of "enhancement" of the pension value if the payments had been duly made.[45] Again, he could not claim for loss of loan capital and interest, but was entitled to claim in respect of punitive interest rates he had to pay to fund his personal outgoings and those of his business. The same applied to bank charges and interest, and mortgage charges and interest. Those losses were

44. A good example of the typical tangle is in *Day v. Cook* [2002] 1 B.C.L.C. 1 (Eng. C.A.). That case, also involving alleged liability of a solicitor in advising a shareholder client and a number of his companies, went to the Court of Appeal. The *Johnson* principles were applied, but the case had to be remitted to the trial judge for a rehearing to clarify points of fact.

45. Johnson v. Gore Wood & Co. [2002] 2 A.C. 1, 36 (Eng. C.A.).

not suffered by the company but were personal to Johnson. They could be characterised as a *personal* cost of borrowing. The anomaly pointed out here does not devalue the rule; it is simply the nature of the beast.

Empirically, the cases provide interesting information. The recent spate of litigation in England and in Australia[46] indicates that the legal profession has caught on to something. By and large, the cases appear like an attempt to salvage something for the dominant shareholder that could not be achieved in the normal liquidation process. If this is so, then the *Johnson's* restrains are well conceived.

Finally, on the fundamental level, *Johnson* is yet another example of the pivotal role of "corporate entity." Paradoxically, that key concept supports both sides of the argument. On the one hand, since shareholder and company are separate entities, both should be entitled to sue in respect of breach of duties owed to them personally. And each should be entitled to recover a loss suffered personally. One right of enforcement should not interfere with the other (the *Christensen* position, which received some support in the House of Lords). On the other hand, it has to be recognised that the company is not just a separate entity. It is, at the same time, the collective shareholder interest. Consequently, the shareholder fortunes rise and fall with those of the company. That, rightly, underlies *Johnson.*

The answer, then, to the question posed at the head of this article is: yes, a shareholder can sue in respect of a loss suffered by the company provided that: (a) the shareholder has a personal cause of action, distinct from that of the company, and (b) that the personal loss suffered by the shareholder is *consequential* to the loss suffered by the company—not merely reflective of it (and not too remote).

46. In the absence, until recently, of Australian authority the early Australian cases on this topic followed English authority (preferring *Johnson* over *Christensen*): Heedes v. Telstra Corp. Ltd. [2001] W.A.S.C. 297 (Austl.); Nestegg Holding Party Ltd. v. Smith [2001] W.A.S.C. 227 (Austl.); Milfull v. Terranora Lakes Country Club Ltd. [2002] F.C.A. 178 (Austl.).