6 Funding Derivative Actions: Costs and Fees as Incentives to Commence Litigation

6.1 Introduction

The argument so far has concerned itself with reformulating the application and structure of the derivative action. It is time now to put forward the second and strategic part of the FFM, namely resolving the issues relating to the costs and fees of derivative actions.

Litigation is expensive, and its cost is a major obstacle in the path of a minority shareholder bringing a derivative action on behalf of the company. A rational shareholder will normally prefer to sell his shares rather than litigate. In financial terms, a shareholder lacks any direct remedy that would make the action worthwhile for him or her. Even if the litigation is successful, any damages recovered accrue to the company and the shareholder will therefore receive only a pro rata share of the gains of a successful action.¹ There is also the prospect that the shareholder may have to pay not only the expenses of his or her litigation but also the legal expenses of the defendant if the action is unsuccessful.² A prospective claimant, being aware that the company and other shareholders will ‘free-ride’ on his or her efforts, has a strong incentive to leave it to someone else to sue. Overall then, even if shareholder litigation results in intangible deterrence benefits, there should be little reason for individual shareholders to sue. If all shareholders share the same view, then no one is likely to step forward even in situations where litigation would increase total share value.³ The use of derivative actions will therefore rarely, if ever, be rational. It would be a rare shareholder indeed who would fly in the face of this lethal mix of disincentives to commence litigation. Even in

¹ And then only indirectly and only to the extent that the proceedings cause the value of his own share to rise sufficiently, so that he might be willing to sue in order to sell his shares later at increased prices. This result, nonetheless, is far from certain as a successful action may reduce share values. Also, shareholders who own small stakes in the company have little incentive to bring a derivative action because the benefit of the suit accrues to shareholders according to the size of their holding, not their efforts in bringing the action.
² Owing to the English ‘loser-pays’ rule that costs follow the event.
appropriate circumstances, then, shareholders will be left with little alternative but to turn their backs on litigation. The question therefore is what can be done to alter the situation whereby the shareholder ‘has nothing to gain but much to lose’.

It has been recognized that monitoring will only be effective if there are sufficient financial rewards to compensate for monitoring costs. One way to provide such financial rewards is through fee rules. The treatment of fees has a direct impact on the frequency of suit. The more advantageous the fee rule is to the prospective claimant the greater the employment of litigation. This result is significant for policy analysis as it assists in the creation of rules that permit judicial determination of questions deemed important to societal interests. An understanding of the economic effect of fees on the decision to commence litigation allows the development of rules to encourage those actions which advance policy objectives.

This chapter is concerned with costs and fees in derivative actions in the context of incentives for such litigation. It explores the critical role of costs and fees in initiating and maintaining derivative actions. The chapter proceeds as follows. Section 6.2 briefly explicates the economics of derivative action litigation. As part of this, the US rules on derivative action fees are examined. After rehearsing the common law recognition of the problems of the impecunious shareholder in the form of indemnity costs orders, section 6.3 exposes major flaws in the operation of these orders. In response, possible solutions to rectify the funding problem will be examined and assessed in the next chapter. Section 6.4 concludes.

6.2 The Economics of Derivative Action Litigation

6.2.1 Introduction

In this section, the writer attempts to unravel the economic nature of derivative litigation. The shareholders’ derivative action permits the assertion of company claims by shareholders. The form of cause employed in derivative action litigation

---

4 To use the words of Lord Denning in *Wallersteiner v Moir (No 2)* [1975] QB 373, 395.
6 A major theme in the literature on the theory of litigation relates to the basic problem that the private incentives to litigate may diverge from what is socially desirable and the strategies that may be employed in order to create proper incentives to litigate. See S Shavell *Foundations of Economic Analysis of Law* (Harvard University Press 2003) Ch 18.
7 As set out by the FFM above. See further JD Wilson ‘Attorney Fees and the Decision to Commence Litigation: Analysis, Comparison and an Application to the Shareholder’s Derivative Action’ (1985) 5 *Windsor Yearbook of Access to Justice* 142, 169.
8 An earlier version of this chapter and the first three sections of Ch 7 entitled ‘Funding Derivative Actions: A Re-examination of Costs and Fees as Incentives to Commence Litigation’ appeared in (2004) 4 JCLS 345.
is deceptive, as the prosecuting shareholder is normally named as the claimant and the company named as nominal defendant.⁹ In English law, it has been described as an exception to the ‘elementary principle that A cannot, as a general rule, bring an action 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 plaintiff because C is the party injured, and, therefore, the person in whom the cause of action is vested’.¹⁰

Such a form of the action, nonetheless, conceals the true nature of the parties. In reality the company is the true claimant in interest, and in all but exceptional cases any damages or other relief obtained flow directly to the company and not to the nominal claimant. This fact has a significant impact on the nominal claimant’s decision to commence litigation, as his interest in the outcome will generally be quite diffuse and remote. It is usually thought that a litigant will commence an action only when the expected value of the litigation is equal to or greater than zero. In the classic derivative action, however, with no direct payment to the claimant, the value of the expected award will be quite low.¹¹ In listed companies, in theory there may be an increase in the value of shares as the asset base of the company is increased; nonetheless, this result is far from certain. The value of shares is determined by a large number of factors beyond the underlying asset value. In fact, a successful derivative action may reduce share values because of bad publicity about the case or because a loss of confidence in directors may result.¹² An imbalance therefore arises in derivative litigation, as the fees faced by the nominal claimant will, in most cases, outweigh the potential benefit accruing to him. This consequent deterrence to derivative actions is common to both English and American fee rules. Rational claimants therefore will rarely initiate derivative actions. Empirically, however, this is not the case in the US. The fact that the action is employed in the US is due to adjustments in the usual cost rules, the most significant of which are the ‘common fund’ and ‘substantial benefit’ doctrines and the recognition of contingency fee arrangements.¹³ The fact that no similar doctrines exist in English law may partly explain the limited use of derivative actions.¹⁴

⁹ See, for example, Taylor v NUM [1985] BCLC 237, 246.
¹¹ JD Wilson, above n 7, 171.
¹² ibid.
¹⁴ Of course this is not the whole picture. Recall the standing and policy issues discussed above in Chs 1, 2, 3, and 5 Pts A and B and accompanying text. Arguably, the differences also stem largely from the political influence of the organized Bar. Because the organized Bar in the US is usually quite influential in the design of corporate rules, it has been able to ensure a relatively wide-ranging derivative remedy despite the remedy’s unpopularity among corporate managers. See Ch 1 above under 1.4.1.
That the issue of costs has a great impact on the utility of the derivative action can also be seen from the Japanese experience.\textsuperscript{15} Japan's present statutory derivative action\textsuperscript{16} evolved from an original version that was borrowed from Germany.\textsuperscript{17} In Japan, there is a strong traditional cultural aversion to litigation as a means of settling disputes.\textsuperscript{18} Indeed, litigation, it seems, is seen as a 'dangerous characteristic of the foreigner who does not know better'.\textsuperscript{19} Notwithstanding this cultural position, Japanese shareholders have, in recent years, been stepping up lawsuits against corporate leaders using the derivative action.\textsuperscript{20} Seen against a corporate scene of management control and ignored shareholder interests, this state of affairs could indicate a general trend for increasing litigation, particularly in commercial matters, perhaps fuelled in part by the increasing exposure the Japanese have to Western influence and expressions of individualism and liberty.\textsuperscript{21} The real reason, however, is not merely the general shift in attitude but the dramatic changes in Japanese law in late 1993 making it easier and, more importantly, cheaper for shareholders to bring derivative actions.\textsuperscript{22} In this respect, one should consider the unique position in the US where the derivative action is driven not


\textsuperscript{16} Commercial Code Arts 267–268.

\textsuperscript{17} PKM Choo 'The Statutory Derivative Action in Singapore—A Critical Examination' (2001) \textit{13 Bond Law Review} 64, 92.

\textsuperscript{18} A Williams, above n 15; T L'Estrange 'Major Issues in Litigation in the Asia Pacific Rim' [1996] \textit{International Commercial Litigation} 24.

\textsuperscript{19} A Williams, above n 15.

\textsuperscript{20} While shareholders in Japan filed fewer than 20 derivative actions against directors from 1950 to 1990, West reports that by the end of 1993, 84 suits were pending in Japanese courts. By 1996, that number rose to 174, and by the end of 1999, there were 286 such suits, including 95 filed in 1999 alone. This is an increase of over 10,000%! MD West, above n 15; C Milhaupt 'Property Rights in Firms' in J Gordon and M Roe (eds) \textit{Convergence and Persistence in Corporate Governance} (Cambridge University Press 2004) 246.

\textsuperscript{21} A Williams, above n 15.

\textsuperscript{22} The 1993 lowering of filing fees from a percentage of requested damages to a flat one (¥8,200, which is about £32 in the exchange rate at the time of writing (July 2007)) explains much of the increase in cases filed. Lower the cost of suing, and more people will sue. The post-bubble decline in the Japanese economy may also influence some cases, as plaintiffs may find it easier to prove damages against failing firms. But the number of suits is nevertheless intriguing given the continuing lack of shareholder incentives to sue. Attorneys' fees, which drive US derivative litigation (see next section), have changed little in Japan. Because damages in derivative actions in Japan, as in the US, are paid to the corporation, the most a plaintiff can hope for is a pro rata increase in the value of her individual stake. In Japan, plaintiff-shareholders usually lose. And filing fees, although reduced, are still non-zero. See MD West 'Why Shareholders Sue: The Evidence from Japan' Michigan Law and Economics Research Paper No 00-010 (November 2000), available at <http://ssrn.com/abstract=251012>. At the same time, it should be noted that in Japan, where the loser pays court costs (under Minsoh (Code of Civil Procedure) Art 89), if a plaintiff wins, because the damages accrue to the company, the Commercial Code (Art 268(2)) provides that the company shall pay a 'reasonable amount' of attorneys' fees. Absent extraordinary circumstances, defendants pay their own attorneys' fees. See further MD West 'The Pricing of Shareholder Derivative Actions in Japan and the United States' (1994) \textit{88 NW University Law Review} 1436, 1459.
by incentives being made available to shareholders but by incentives available to
the legal profession. Therefore it is worth looking a little more closely at the costs
rule in the US in order to understand why this makes a difference.

6.2.2 The US rules on derivative action fees

The treatment of fee-shifting rules differs sharply between the US and the UK.²³
In the US the general rule is that each party is responsible for his own attorney’s
fees. By contrast, the English rule is that costs follow the event; that is, the unsuc-
cessful party is generally ordered to pay part of the legal expenses incurred by
the victor. This divergence provides a convenient basis for comparing the effect of the
differing treatment of fees on the decision to bring a derivative action. As we shall
see, in the context of derivative actions, the American treatment of fees in such
actions provides significantly lower disincentives to prospective claimants than
does the English rule.

The position in the US is unique, as a rather flexible costs formula is employed
in derivative action procedures. Under the US Rules of Civil Procedure the gen-
eral rule is that regardless of the outcome of the litigation both parties bear their
own legal costs.²⁴ At the same time, it is common practice to apply the contin-
gency fees arrangement, whereby an agreement is entered into by the attorney
and his client to have attorneys’ fees fixed at a percentage, based on the amount
recovered should there be a successful outcome or where the matter is settled.²⁵
In other words, the attorney fees are contingent on the case being successfully
litigated or on settlement of the case.²⁶ The question then is why would there be
an economic value for an attorney to take on a derivative action case?

When an individual shareholder is successful in a derivative action, it is the
company that is entitled to receive the amount awarded by the court and it is
this amount that will be shared by the litigant and other shareholders. The attor-
ney will usually be paid if the derivative action generates an income. But not all
actions lead to tangible relief. Without an exception to the general contingency

²³ As Wilson points out, the divergence between the jurisdictions is not altogether clear
(JD Wilson, above n 7, 142–3 and the references therein). For a stimulating account on the rela-
tionship and differences between the two legal systems, see PS Atiyah and RS Summers Form and
Substance in Anglo-American Law: A Comparative Study of Legal Reasoning, Legal Theory and Legal
Institutions (Clarendon Press 1987).

²⁴ See, for example, JC Coffee ‘The Unfaithful Champion: The Plaintiff as Monitor in
Shareholder Litigation’ (1985) 48 Law & Contemporary Problems 5, 15–16; MP Dooley Foundations
of Corporation Law (Foundation Press 1995) for a brief introduction to the trials and tribulations
of US lawyers.

²⁵ For a contribution which considers a wide variety of specific questions related to contingency
fee practice in the US, see HM Kritzer Risks, Reputations, and Rewards: Contingency Fee Legal
Practice in the United States (Stanford University Press 2004).

²⁶ It is reported that the attorney’s fees are usually in the range of 15–30% of the total recov-
ered; s 7.17 of the American Law Institute, Principles of Corporate Governance: Analysis and
In order to encourage attorneys to take on derivative actions, the courts in the US have adopted two approaches—‘the common fund’ and ‘the substantial benefit test’, the latter being an exception to the contingency fee rules. Based on these approaches, there are two methods for calculating attorneys’ fees in derivative actions. The first method is the percentage scale, which is applicable when the case generates a common fund for the company—the attorney will then be paid in the range of 20 to 30% of the common fund, depending on the prior agreement between the attorney and his client. Stated differently, a percentage scale will be used to calculate attorneys’ fees if derivative action results in a tangible monetary relief. In a case where derivative litigation results in an intangible or therapeutic relief only, the courts will apply the alternative method, known as the ‘lodestar method’, to allow attorneys to be paid for their work. The lodestar method is applicable if the derivative action results in a substantial benefit to the company, whether by judgment or settlement. As a result of the well-built fee structure in the US, it is common to see attorneys functioning more like ‘entrepreneurs’ who conduct litigation almost entirely on their own, with virtually no monitoring by the shareholders whose names are used only as the key to the courtroom door. Attorneys tend to have a liking for derivative actions more than shareholders. The contingency fees arrangement and the lodestar method are perhaps the two most

---

27 ibid.

28 According to the doctrine, when a fund is recovered which benefits a class of persons beyond the nominal plaintiff, the legal fees expended in recovery are treated as a first charge against the fund. The theory of the doctrine is based on unjust enrichment and demands that all beneficiaries contribute pro rata to the expense of recovery. In the early application of the doctrine a monetary fund had to be recovered or saved. The shortcomings of the restrictive application became obvious when injunctive or declaratory relief was sought as there was no fund to charge. This deficiency was cured by judicial innovation, which extended the doctrine to situations where a substantial, although not monetary, benefit was obtained, justifying an award of attorneys’ fees against the benefiting entity (Sprague v Ticonic National Bank (1939) 307 US 161). The literature on the common fund doctrine is vast. See, for example, s 7.17 of the American Law Institute Principles of Corporate Governance: Analysis and Recommendations (Proposed Final Draft 1992); CG Hammett ‘Attorney’s Fees in Shareholder Derivative Suits: The Substantial Benefit Rule Re-examined’ (1972) 60 California Law Review 164.


30 The lodestar method was formally recognized by the US Supreme Court in Mills v Electric Auto-Lite Co 396 US 375, 392 (1970). The court explained that the lodestar method is simply a method for calculating attorneys’ fees based on the number of hours reasonably spent on the work, multiplied by the applicable market hours rate. The lodestar method may be used irrespective of whether a common fund is generated, and the final figure calculated by the attorney is subject to the court’s scrutiny. The court has a discretion to adjust the final figure, depending on a number of factors, such as novelty or complexity of issues, quality of representation, risk and the like. See further L Thai, above n 29, 124 and the examples therein.

important mechanisms that affect not only who pays the attorneys’ fees and how these fees are calculated, but also how the plaintiffs’ attorneys conduct the derivative action litigation.³² Not surprisingly, win or lose, derivative actions appear to be fairly common in the US, compared with the UK or other Commonwealth jurisdictions, where contingency fees type arrangements are not employed in derivative action litigation.³³

6.2.3 The risk of litigation is shifted from the claimant to the attorney

Given the foregoing discussion, it becomes easier to appreciate the fundamental difference between the American and the English derivative action. The effect of the common fund doctrine and supplementing mechanisms as employed in the US is to reduce the personal risk faced by the nominal claimant. The policy underlying these exceptions to the usual American rule is that derivative actions are an efficient method of enforcing corporate duties and obligations, but without adequate fee incentives such actions would not be pursued by rational claimants.³⁴

At the same time, it should be noted that the fee incentives provided by the common fund and substantial benefit doctrines only reduce rather than eliminate the deterrent effect of fees in shareholder litigation.³⁵ With respect to the common fund doctrine, the plaintiff must prevail in order that a fund be created.³⁶ On the other hand, if the plaintiff is unsuccessful he will remain liable for lawyers’ fees. Similarly, under the substantial benefit rule, not only must the plaintiff prevail but, as is clear from the very phrasing of the rule, the effect of the judgment must substantially benefit the company. Even if successful on the merits, the plaintiff thus may still retain liability for fees.³⁷ This in turn means that, owing to the remaining liability for fees under the above exceptions to the general American rule, some disincentive or deterrence to litigation remains.³⁸

³² L Thai, above n 29, 124.
³³ ibid.
³⁴ Schechtman v Wolfson (1957) 244 F 2d (2d Cir) 537, 539.
³⁵ JD Wilson, above n 7, 172.
³⁶ See above n 28 and accompanying text.
³⁷ Schechtman v Wolfson (1957) 244 F 2d (2d Cir) 537, 540.
³⁸ In practice, however, the risk of litigation is shifted from the plaintiff to the attorney. Most American shareholder litigation appears to be handled on a contingency fee basis. See, for example, Hornstein ‘Legal Therapeutics: The “Salvage” Factor in Counsel Fee Awards’ (1956) 69 Harvard Law Review 658, 659 (arguing that the shareholder action would not be employed without contingency fees); R Romano ‘The Shareholder Suit: Litigation without Foundation?’ above n 13, 84 (‘[t]he principal beneficiaries of the litigation appear to be attorneys, who win fee awards in 90% of settled suits’). It is arguable that this assignment of risk is justified as (1) the attorney will normally have much greater monetary interest in the litigation than will the shareholder plaintiff (Central RR & Banking Co of Georgia v Pettus (1885) 113 US 116); and (2) lawyers may be better able to internalize the risk of litigation than the individual plaintiff, as they are able to calculate expected
6.3 A Re-examination of Indemnity Costs Orders

6.3.1 Introduction

By contrast to the American mechanisms employed in derivative action litigation, the traditional way in which most Commonwealth jurisdictions address the obstacle of funding in a derivative action is by recognizing that the claimant should be indemnified for costs incurred in the proceeding, usually by allowing the court discretion on this matter. This is because the rights being vindicated are those of the company and recovery flows to it. As such the entity should be liable for payments of costs. In essence, then, a prima facie right of indemnification by the company by means of an indemnity order arose ‘on the plainest principles of equity’. The question is how well does the indemnity order address the issue of costs?

It is generally thought that by providing such compensation for a shareholder with respect to costs a formidable deterrent to the commencing of a derivative action is removed. Similarly, it is believed that the possibility of awarding a cost indemnity order is a ‘significant incentive’ to use the derivative action. But, as will be seen below, these views are not entirely supported by the way in which these orders operate and are perhaps somewhat optimistic. More importantly, they ignore the realities of derivative action litigation. A closer examination reveals some fundamental flaws in the operation of these orders.

6.3.2 The common law recognition of the problems of the impecunious shareholder

The common law has recognized the problems of the impecunious shareholder, with the major modern development being the judgments in Wallersteiner where the court reasoned that in derivative actions it would be appropriate for the value over a range of actions (analogous to portfolio diversification) which allows the prosecution of some risky cases. See E Mackaay Economics of Information and Law (Kluwer 1982) 173.

39 That an action under one of the exceptions to Foss v Harbottle is truly a derivative action, rather than one brought by the minority shareholder in his own right, was a late recognition in English law (Wallersteiner v Moir [No 2] [1975] QB 373).
40 JD Wilson, above n 7, 177.
41 Wallersteiner v Moir [No 2] [1975] QB 373, 391 and 403–4 per Lord Denning and Buckley LJ.
42 See, for example, DD Prentice ‘Wallersteiner v Moir: The Demise of the Rule in Foss v Harbottle’ (1976) 40 Conveyancer 51, 59.
43 Consultation Paper para 18.1.
company to pay the shareholder’s costs in that it is the company which benefits directly from any recovery. The paragraph setting out the reasons deserves to be reproduced.\textsuperscript{46}

Suppose there is good ground for thinking that those in control of a company have been plundering its assets for their own benefit. They should be brought to book. But how is it to be done? . . . at present there is nothing effective except an action by a minority shareholder. But can a minority shareholder be really expected to take it? He has nothing to gain, but much to lose. He feels strongly that a wrong has been done—and that it should be righted. But he does not feel able to undertake it himself. Faced with an estimate of the costs, he will say: ‘I’m not going to throw away good money after bad’. Some wrongdoers know this and take advantage of it. They loot the company’s funds knowing there is little risk of an action being brought against them.

This quotation from Lord Denning’s judgment shows that the rule in \textit{Foss v Harbottle} is, in many ways, essentially an issue of costs\textsuperscript{47}—a claimant minority shareholder runs the risk of having to pay substantial costs, while the directors (against whom the action in reality is being brought) may be indemnified by the company against the costs of defending an action for breach of duty.\textsuperscript{48} Therefore ‘. . . it is not the question of standing that remains the greatest problem for the minority shareholder but the question of costs. This remains a burning issue’.\textsuperscript{49} If a procedure could be devised to compensate a shareholder, irrespective of outcome, for his costs, then a formidable deterrent to the commencing of a derivative action would be removed, or at least reduced.

The difficulties that dogged Mr Moir in his battle are well known. By the time Lord Denning MR and the other learned judges of the Court of Appeal considered his financial plight, Dr Wallersteiner had successfully delayed resolution of the case for over 10 years. Mr Moir exhausted his financial resources as well as considerable time and labour. He had obtained judgment against Dr Wallersteiner, but at the same time had been unable to enforce it and, in any event, any recovery would (directly) benefit the company alone.

Mr Moir’s plight found sympathy with the Court of Appeal, particularly with Lord Denning, who was even prepared to allow a contingency fee arrangement. Therefore the court formulated a procedure to be followed on an application by a shareholder for an indemnity order as to costs,\textsuperscript{50} which was designed to balance the interests of the minority shareholder and the company.\textsuperscript{51} The test approved

\textsuperscript{46} ibid 395.
\textsuperscript{47} DD Prentice, above n 42, 58.
\textsuperscript{48} Subject to certain qualifications. See discussion in Ch 5 above under 5.4.2.5.
\textsuperscript{49} R Baxt ‘What is the Real Fuss about \textit{Foss v Harbottle}’ (1994) 12 CSLJ 178, 180.
\textsuperscript{50} For an extensive analysis of this order and its effect see DD Prentice, above n 42, 59.
\textsuperscript{51} The court modelled the procedure for the application to claim the order on that already established in the case of a trustee, who is entitled to indemnification in respect of proceedings on behalf of the trust property or in execution of the trust. \textit{Wallersteiner v Moir (No 2) [1975]} QB 373, 404 \textit{per} Buckley LJ. See also \textit{Re A Company [1987]} BCLC 82. As to trustees see \textit{Hardoon v Belilios [1901]} AC 188 (HL).
by the majority of the court for granting such orders was that the company be ordered to pay the costs of a bona fi de claimant, when it would have been reasonable for an independent board of directors to bring such an action in the company’s name.⁵²

The court also believed that the claimant should himself be indemnified by the company in respect of his own costs even if the action fails. The court explained that it is a well-known maxim of the law that he who would take the benefit of a venture if it succeeds ought also to bear the burden if it fails. This indemnity should extend to his own costs taxed on a common fund basis⁵³ (albeit this could be less generous than an award of costs on an indemnity basis).⁵⁴ Eventually, Wallersteiner orders came to be seen as having the potential for being oppressive.⁵⁵ They were usually made without notice to the other side, shortly after the beginning of the proceeding and on affidavit evidence. The result would be that the company would thereafter find itself paying for an action which it almost invariably did not want brought, and which would usually put the whole management under intense pressure.⁵⁶ Later, the revised procedure was re-enacted in simplified form as part of the CPR r 19.9⁵⁷ which, while expressly authorizing the court to give the claimant an indemnity against costs out of the assets of the company on such terms as it thinks appropriate, also expressly requires the court’s approval for the continuance of a derivative action.⁵⁸ So the application for an indemnity has been integrated into the application for leave to proceed. This means that the price of the possibility of the company’s financial support for the claim is a greater degree of supervision by the court over the individual shareholder’s conduct.⁵⁹

In any event, any indemnity granted is likely to have to be renewed and reviewed as the litigation proceeds.⁶⁰ The order for an indemnity also requires the claimant to refer back to the court for approval of any offer of settlement of

⁵² Wallersteiner v Moir (No 2) [1975] QB 373, 404 per Buckley LJ.
⁵³ ibid 392 per Lord Denning MR, 405 per Buckley LJ.
⁵⁴ Buckley LJ (ibid 407) contemplated that this more generous measurement could be used when necessary.
⁵⁵ Smith v Croft [1986] 2 All ER 551 per Walton J, discussed below.
⁵⁷ In the past, RSC Ord 15, r 12A.
⁵⁸ CPR r 19.9(3). Portfolios of Distinction Ltd v Laird [2004] [2004] EWHC 2071 discussed in A Reisberg ‘Judicial Control of Derivative Actions’ (2005) 8 ICCLR 335 and in Ch 2 above under 2.4.3. It is noteworthy that, as was noted in Ch 4 above (see 4.3.4.1), under Pt 11 of CA 2006 which deals with derivative actions, the court was given power under s 261(2) to make consequential orders on dismissal of the application, and under s 261(4) on hearing the application, the court may give permission (or leave) to continue the claim on such terms as it thinks fit or adjourn the proceedings on the application and give such directions as it thinks fit. This would presumably relate to costs. Pt 11 is indeed expected to be supplemented by (unspecified at the time of writing) amendments to the Civil Procedure Rules, although there was no talk, at the time of writing, of substantial changes to the spirit of CPR r 19.9.
⁵⁹ PL Davies Gower and Davies’ Principles of Modern Company Law (7th edn Sweet & Maxwell 2003) 455.
⁶⁰ ibid.
the suit. This may reduce the possibilities for ‘gold-digging’ claims against the company which are settled on terms advantageous to the claimant shareholder and the defendants but which do not reflect the value of the company’s right or are not in the interests of the company. Interestingly, the provision that the court may make an order that any offer of settlement be referred back to the court for consideration is analogous to that in the US system for class and derivative actions, which does not otherwise exist in the procedure under English law.

6.3.3 Fundamental flaws in the operation of indemnity costs orders

The Wallersteiner procedure was, at the time, an imaginative attempt to deal with the problems of funding. Subsequent decisions and developments, however, have added formidable difficulties to the Wallersteiner procedure and its operation. It is the purpose of this section to examine critically the major flaws in the operation of indemnity costs orders. As will be seen, the assumption that the system of indemnity costs orders strikes the right balance in enabling minority shareholders to bring derivative actions without enormous expense is open to question.

6.3.3.1 Lack of incentives

The first fundamental point to note is that an indemnity order presupposes that a shareholder claimant will want to bring the action on behalf of the company in the first place. In other words, it does not provide the shareholder with any incentive to commence litigation, but rather, once he has made the decision to sue, allows him to be indemnified for costs involved in such a decision. It follows that there seems to be some kind of confusion with regard to what exactly can be achieved through the use of indemnity orders. The confusion seems to occur because of two separate issues: namely, providing an incentive and lifting a deterrent, which are thought to be the same. But although it is true that a deterrent to the commencing of a derivative action is removed by means of indemnity costs orders (it is possible that the shareholder will be indemnified for costs incurred in the proceeding), it does not necessarily follow that these orders offer a ‘significant incentive’ to use the derivative action. Removing a deterrent is simply
not the same as providing an incentive.⁶⁷ All that these orders do is to restore the shareholder’s position to exactly the same starting position had the shareholder not decided to pursue the action on behalf of the company, that is, with no liability for costs. Indeed, it has been explained in the case law that indemnity orders are not a direct incentive given to a shareholder to promote the use of derivative actions, but rather a reflection of the rights being protected in the action⁶⁸ or a form of legal aid.⁶⁹

In fact, despite indemnity costs orders there are still remarkable disincentives to commence litigation.⁷⁰ A person with a small shareholding has little financial incentive to sue on behalf of the company because the return to that person will be, at most, a percentage of the recovery which reflects the percentage of the shares of the company that person holds. Even then, the shareholder may not receive an immediate cash return.⁷¹ And in addition, not all actions lead to a tangible relief.⁷² These factors have a significant impact on the claimant’s decision to commence litigation, as his interest in the outcome will generally be quite diffuse and remote. As it stands, there is nothing in the way indemnity costs orders work to dislodge this.⁷³

A further difficulty lies in the fact that the court has discretion to order the claimant an indemnity against costs out of the assets of the company in such terms as ‘it thinks fit’.⁷⁴ First, given that the court has such a wide discretion, how

---

⁶⁷ An incentive can take the form of a reward given directly to shareholders in order to promote or encourage the use of derivative actions. See s 201 of the Israeli Companies Act 1999, under which the court has discretion to award successful plaintiffs part of the proceeds of a successful derivative action beyond their indirect recovery, so that the plaintiff can benefit directly in monetary terms. This may increase the accessibility of the remedy in the eyes of prospective plaintiffs, because, essentially, the shareholder can gain from the action directly. Moreover, this is an incentive because it sends a clear message to prospective shareholders that the legislator has been enthusiastic in encouraging the use of the derivative action, even at the price of detracting from the right of the company to receive all the proceeds of a successful action. See further A Reisberg ‘Promoting the Use of Derivative Actions’ (2003) 24 Company Lawyer 250, 251–3.


⁷¹ For example, the directors may choose not to pay out recovery by way of dividend and instead invest it in some other venture: PL Davies Gower and Davies, above n 59, 447.

⁷² It is not uncommon that the relief takes the form of a tracing order against and a charge over the misappropriated assets where the directors misappropriated the company’s assets. An example is Clark v Cutland [2003] EWCA Civ 810 (an unfair prejudice case, treated as if it were a derivative action, as there was a derivative action in the background with which the petition had been consolidated).

⁷³ The proposals put forward by the Law Commission have nothing to add. The Commission proposes that the court’s powers to make indemnity costs orders should remain unchanged, as the court will continue to have its power to make indemnity costs orders ‘as it thinks fit’: Report para 6.104 and Draft Rule 50.13.

⁷⁴ Report para 6.104; CPR r 19.9(7); and CA 2006, s 261(2) under which the court was given power to make consequential orders on dismissal of the application. This would presumably relate
should it go about deciding this? Secondly, it causes great concern to shareholders, even bona fide, to know that the court will only make costs orders when it considers appropriate. Finally, leaving much to the attitude of a particular judge, although commendable on grounds of flexibility, may nevertheless be counter-productive in some cases.

6.3.3.2 The problematic interrelationship between the application for an indemnity and the application for leave to proceed

(a) Procedure may result in a costly mini trial to establish entitlement

The problem with any procedure for obtaining a pre-emptive costs order is to ensure that it is not in itself so costly as to defeat the object of the exercise. In Wallersteiner the court was at pains to emphasize that an application for costs should be kept ‘simple and inexpensive’ and that it should on no account be allowed to ‘escalate into a minor trial’. Under the procedure for derivative actions the application for an indemnity has been integrated into the application for leave to proceed. In considering the claimant’s applications for permission to continue and indemnification, the court has therefore to consider whether the action has any real prospect of success. This means, as the Law Commission to costs. As already noted, Pt 11 of CA 2006 is expected to be supplemented by (unspecified at the time of writing) amendments to the Civil Procedure Rules, although there was no talk of substantial changes to the spirit of CPR r 19.9.

75 One possible way is adopting a ‘cost-effectiveness’ test as discussed in Ch 5 above under 5.4.4.3 (b).

76 It is arguable that this requirement adds nothing to the wide discretion the courts already have. When will the court consider it ‘inappropriate’ to grant a costs order? Presumably when the shareholder is motivated by malice or personal factors and the claim is not being pursued bona fide on behalf of the company (Barrett v Duckett [1995] 1 BCLC 243, 256 per Gibson LJ). But in such cases, the shareholder could also be judged to have lost the right to a costs order anyway since, prior to granting leave, the court must be satisfied that the plaintiff is acting in good faith, reasonably and with a view to the best interests of the company (for example, Smith v Croft [1986] 1 WLR 580).

77 As well illustrated in McDonald v Horn [1995] 1 All ER 961 (CA), when the court proposed further restrictions. It was suggested that the court should not normally authorize the funding of proceedings until there has been an investigation of the plaintiff’s complaints made by an independent party (but note now CPR r 19.9(7) and CA 2006, s 261(2), discussed above n 58). For an example of an unsuccessful attempt to obtain a costs order, see Halle v Trax BW Ltd [2000] BCC 1020.

78 Wallersteiner v Moir (No 2) [1975] QB 373, 394 per Lord Denning.

79 Set out in CPR r 19.9(7). But see now CA 2006, s 261(2) discussed above n 58.

acknowledged, that the standing of the member to bring a derivative action has to be established as a preliminary issue by evidence which shows a prima facie case on the merits. Without effective case management, however, this can result in a mini trial which increases the length and cost of the litigation. There is a danger that this requirement may result in the proceedings devolving into a trial on the merits as the court will have before it the evidence that is to be proven in the case, and inevitably the merits of the action will cast a shadow over the proceedings for an indemnity order. Essentially, there is the prospect that the cost of litigation may exceed the benefit realized by the company.

In particular, CPR r 19.9(4) provides that the claimant needs to support his application for permission by ‘written evidence’. In practice, written evidence supporting permission applications has done little more than verify the facts on which the claim and the entitlement to sue on behalf of the company are based, often in a brief perfunctory paragraph confirming the allegations made in the particulars of claim. In many shareholder disputes, however, there are bitter disputes of fact, and the defendant can only respond to the claimant’s allegations by showing cause against the application by a witness statement in reply. Although the permission procedure was instituted precisely to obviate the need for a defence at this stage, the defendant’s witness statement in reply, if properly particularized in responding to the claimant’s contentions of control and fraud on the company, starts looking very like a defence and can cost as much to produce.

Furthermore, even where the claimant’s factual allegations are unfounded, to prove the contrary in a complicated shareholder dispute extending over the long period during which such disputes usually develop would normally require a long witness statement in reply. The time estimate for the hearing of the permission application could correspondingly extend as the defendant’s advocate will have not only to present his client’s evidence but also to undertake an often complicated critical analysis of the claimant’s evidence. This seems a long way from the notion in Wallersteiner that the proceedings for an indemnity order are to be expeditious, simple, and designed merely to determine whether or not a reasonable independent board of directors would authorize such an action.

81 Consultation Paper para 14.1. See also the judicial case management under CPR r 1.4 (1).
82 D DeMott, above n 13, 269.
83 Similarly, CA 2006, s 261(2) states that ‘If it appears to the court that the application and the evidence filed by the applicant in support of it do not disclose a prima facie case for giving permission (or leave) the court—(a) must dismiss the application’. It is clear then that not much will change here as the applicant will still need to show a prima facie case supported by evidence if he is to get over this preliminary high hurdle. See also n 58 above.
84 R Reed, n 80 above.
85 ibid.
86 ibid.
87 ibid.
88 ibid.
89 Wallersteiner v Moir (No 2) [1975] QB 373, 397 per Lord Denning.
(b) The relationship between the indemnity procedure and the exceptions to the rule in Foss v Harbottle and its effect on the economics of litigation

There is also a related and much more complicated issue here as to the relationship between the indemnity procedure and the exceptions to the rule in Foss v Harbottle. The uneasy question of whether, and in what circumstances, Foss may be avoided is linked inextricably with the (formally) separate issue as to whether the minority shareholder is entitled to an indemnity order against the company, in accordance with Wallersteiner. In each instance, the concern has been with the extent to which argument upon the substance of the alleged abuses may be heard. The judgment in Smith v Croft illustrates how difficult it is to separate the costs point from the standing point.

This obviously has also an adverse effect on the economics of litigation, as was illustrated in the case of Prudential Assurance Co Ltd v Newman Industries Ltd, where the costs of maintaining and successfully prosecuting a derivative action, when the action was eventually concluded, far exceeded the financial benefit realized by the company. Besides the obvious implications this has on any given case, this clearly has also a substantial effect on both the practice and use of derivative actions (ie potential litigants might be deterred by such examples) and the legal system as a whole. The evidence in the UK, indeed, indicates that under the indemnity order system, derivative action cases are taking longer to litigate and involve more pre-trial practice.

---

90 It is unclear, at the time of writing, to what extent the following will remain a problem under Pt 11 of CA 2006. What is clear, however, is that provisions of Pt 11 (ss 260–269) do not formulate a substantive rule to replace the rule in Foss v Harbottle, but rather a new procedure for bringing such an action which set down criteria for the court distilled from the Foss v Harbottle jurisprudence. In other words, Part II does not seek to overturn these well-established principles. See Explanatory Notes on the Companies Act 2006 para 491, available at <http://www.dti.gov.uk/bbf/co-act-2006/index.html>. See also Explanatory Notes to the Company Law Reform Bill [HL] as introduced in the House of Lords on 1 November 2005 paras 480 and 482, available at <http://www.publications.parliament.uk/pa/ld200506/ldbills/034/en/06034x--.htm>.


94 [1982] 1 Ch 204.

95 The Court of Appeal finally determined that the defendants caused £45,000 in damage to the company, but that paled in comparison to the 'small fortune' running into six figures apparently spent by the plaintiffs on legal fees. It is not surprising therefore that the derivative action procedure was referred to as 'lamentable litigation' with its 'horrendous costs' ([1982] 1 Ch 204, 220). See in this respect the judicial case management under CPR r 1.4 (1).

96 In Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1981] Ch 257 the minority shareholder’s action lasted, at first instance, over 70 days.

(c) The court may more readily be persuaded against making an indemnity order⁹⁸

In some cases, the fact that the application for an indemnity has been integrated into the application for leave to proceed may be unfair to both the company and the shareholder. From the company’s viewpoint, an early application may fail to screen out frivolous and ill-founded action. There is a danger that an order may be made before the completion of discovery and inspection, and at this stage the claimant could inevitably swear with a clear conscience that his case is well founded.⁹⁹ Conversely, it makes the case for a shareholder very much harder when he is required to prove his entitlement, before the case has been heard on its merits, with very little evidence and facing a suspicious court.¹⁰⁰

In addition, the defendants can strongly resist any application made by the claimant for an indemnity order against the company. In the past, when the issue of the claimant’s entitlement to sue was determined as a preliminary issue, the claimant was most likely to succeed in his accompanying application for an indemnity.¹⁰¹ Now, there is a serious problem of achieving the right balance in indemnity order procedures. It is inevitable that the more evidence adduced on an application for an indemnity order the more prolonged will be the proceedings,¹⁰² which seems to defeat the notion of ‘simple and inexpensive’ procedures. Moreover, in the case of quasi-partnerships, it is the very possibility of an order for an indemnity that has often persuaded the claimant to bring a derivative action rather than seeking relief by a personal action, for example by presenting an unfair prejudice petition under s 994 of CA 2006.¹⁰³

(d) Danger of under-settling the action

In any event, the realization that the claimants will have to fund the action themselves, even though any recovery will be that of the company, may result in a serious difficulty. This may well cause the applicant to give greater consideration

⁹⁸ It is unclear, at the time of writing, to what extent the following will remain a problem under CA 2006, Pt 11. What is clear, however, is that the court was given power under s 261(2) of CA 2006 to make consequential orders on dismissal of the application. In addition, under s 261(4) on hearing the application, the court may give permission (or leave) to continue the claim on such terms as it thinks fit or adjourn the proceedings on the application and give such directions as it thinks fit. This would presumably relate to costs. See also n 58 above.
¹⁰⁰ In Smith v Croft a good portion of the judgment was taken up with analysis of the allegations against the directors and, although Walton J stressed that he was not trying the case on its merits, the refusal of an indemnity order where all the facts are before the court will often result in abandonment of the litigation at this stage. See also Barrett v Duckett [1995] 1 BCLC 243; C Baxter ‘The Role of the Judge in Enforcing Shareholder Rights’ [1983] CLJ 96, 110; GR Sullivan ‘Restating the Scope of the Derivative Action’ [1985] CLJ 236, 237.
¹⁰¹ R Reed, above n 80, 158.
¹⁰² DD Prentice, above n 62, 172.
¹⁰³ Formerly, CA 1985, s 459. R Reed, above n 80, 158. Note the decision in Clark v Cutland [2003] EWCA Civ 810; Ch 8 below under 8.1, 8.2.2 and 8.4.2.
to settlement options. In fact, this can give rise to serious possibilities of collusion because the directors can buy off the applicant in disregard of the rights of the company and its members.¹⁰⁴ One of the curiosities of the derivative action is that there is no control over the right of the claimant shareholder to reach a compromise in the action despite the fact that he appears in a representative capacity and the compromise may be on terms that are beneficial to the claimant shareholder and the defendants but not in the interests of the company.¹⁰⁵ Because of the dangers that this obviously presents, the abandonment or compromise of a derivative action is made subject to judicial control¹⁰⁶ as well as in most jurisdictions.¹⁰⁷

6.3.3.3 The problematic ‘financial need test’

Walton J in *Smith v Croft*¹⁰⁸ approached the issue of costs rather cautiously and added a further obstacle when he applied a ‘financial need test’ against the applicants. In that case, Walton J found that it would be ‘palpably unjust’ for the court to order an indemnity without full discovery: ‘Unless [everything] has been so disclosed, how is the company to be in a position to lay facts which will have the effect of demolishing the plaintiffs’ case before the court?’¹⁰⁹ Walton J then stated the rationale of *Wallersteiner* to be that a claimant should not be precluded from pursuing an ‘obviously just case’ because of lack of funds. Walton J’s standard of ‘obviously just case’ was extremely high;¹¹⁰ nonetheless, he went further and, on the basis that the company should not have to bear extra costs except in the clearest cases, brought the financial status of the applicant into play. Walton J found that justice requires that the claimant establish his genuine need for indemnification, i.e. ‘that he does not have sufficient resources to fund the action in the meantime’.¹¹¹ Regrettably, this narrow approach for indemnification has been followed by courts across the Commonwealth.¹¹²

The approach of Walton J exemplified in *Smith v Croft* was rightly criticized at the time as being an irrelevant consideration, on grounds of both principle and practicality, in deciding whether or not an indemnity order should be granted.¹¹³ Also, this more restrictive approach to *Wallersteiner* orders was not followed

¹⁰⁴ Consultation Paper 268.
¹⁰⁵ DD Prentice, above n 62, 175.
¹⁰⁶ Under CPR r 19.9(3). See also n 58 above.
¹⁰⁷ A similar requirement is found in r 23.1 of the Federal Rules of Civil Procedure in the US, in New Zealand (Companies Act 1993, s 168), under the Canada Business Corporations Act 1985, s 242 (2) and under the Israeli Companies Act 1999, s 202.
¹⁰⁹ ibid 589.
¹¹⁰ ibid 597.
¹¹¹ ibid 597.
¹¹² See, for example, the Canadian case in *Intercontinental Precious Metals Inc v Cooke* [1994] WWR 66; in the Australian case *Farrow v Register of Buildings Societies* [1991] 2 VR 589, the court held that it would grant costs if it appeared that the shareholder were destitute or so financially handicapped that the case otherwise could not proceed.
in a later case. On grounds of principle, the reason for granting the order in *Wallersteiner* was because the claimant was bringing the action as the ‘representative’ of the company and his wealth was an irrelevant consideration in determining his status to do so. There could be no question, for example, of denying a trustee or an agent an indemnity order if they were otherwise entitled to one merely on the grounds of their wealth. Indeed, in the Canadian case of *Turner v Mailhot*, the court pointed out that a test based on the financial ability of the applicant to carry on the action offended against the principle that the shareholder is acting as the agent of the company. The court also believed that an applicant who has obtained leave must have satisfied the conditions laid down in *Wallersteiner* and is therefore prima facie entitled to an order for costs. However, it is only a prima facie entitlement and thus may be displaced by other factors such as, ironically, an inability to meet the financial costs.

There are other compelling reasons why an indemnity order should be granted even if a shareholder has sufficient wealth to finance the action. A shareholder may simply not be willing to risk depleting his wealth by bringing a derivative action given that the benefits of recovery will be shared with others and the gain to the shareholder may be minimal if his holding in the company is not significant. Likewise, Walton J was concerned by the fact that the early payment as to costs under an indemnity order would impose a burden on the company. It is true that legal proceedings should only be commenced after careful thought, not least because of the significant costs that might be incurred. At the same time, the reason for granting an early payment as to costs under an indemnity order, nevertheless, is the failure of the company to bring the action in the first place and it is difficult to see therefore why this should be a factor in denying a wealthy claimant an indemnity order. The court after all enjoys considerable discretion as to the basis on which costs will be granted and this can be used to avoid any possible unfairness to the company.

---

115 DD Prentice, above n 62, 173.
116 ibid.
117 (1985) 50 OR (2d) 561.
118 ibid 567 (explaining that the section of the Canada Business Corporations Act that governs applications for leave to bring derivative actions simply states in statutory language the gist of what the judges of the court articulated in *Wallersteiner*).
119 ibid 567.
120 DD Prentice, above n 62, 173.
121 An interesting comparison can be made with insolvency procedures. When proceedings commenced in the name of a company in liquidation fail, the liquidator will not be thanked by the creditors for the fact that the company’s funds will be used to pay a likely costs award against the company. See A Key ‘Pursuing the Resolution of the Funding Problem in Insolvency Litigation’ (2002) 3 *Insolvency Lawyer Journal* 90. In *Re Exchange Travel (Holdings) Ltd (in liq) (No 3)* [1997] 2 BCLC 579, Phillips LJ observed that the costs incurred by the liquidators in a preference action exceeded what was at stake.
122 DD Prentice, above n 62, 173.
Turning to grounds of practicality, a wealth bar could be easily evaded by using as a nominal claimant a shareholder who lacked resources and who was willing to act in a ‘representative’ capacity for shareholders whose wealth would preclude them from obtaining an indemnity order. Moreover, where there is more than one claimant it would be unclear how their resources were to be pooled, if at all, in applying a rule that wealth debarred a claimant from obtaining an indemnity order. No doubt a solution could be fashioned to deal with these problems, but to do so would greatly complicate the already complicated procedure for obtaining an indemnity order and it would, in all probability, be far from simple and expeditious to apply.

It is difficult to disagree with this. If an indemnity order were to be precluded because of the wealth of the claimant, this would greatly curtail the remedy’s reach. Likewise, it would be to overlook one of the principal justifications for the existence of the derivative action in the first place, that it is a form of pleading originally introduced on the ground of necessity alone in order to prevent a wrong to the company going without redress. If this is the reason why derivative actions are allowed, then why should the wealth of a shareholder be a relevant consideration in determining his status or indeed his entitlement to be indemnified for costs, when he is bringing the action on behalf of the company and for the benefit of the company?

6.3.3.4 On what basis are indemnity costs orders awarded?

Given the foregoing discussion regarding the ‘financial test’ requirement, it becomes clear why it has been submitted that the circumstances in which indemnity orders are granted are open to restrictive interpretation. Essentially, it is unclear when and under what circumstances an application for costs and indemnity will be made in favour of shareholders. This is because the more restrictive approach to Wallersteiner orders exemplified in Smith v Croft was not followed in Jaybird Group Ltd v Greenwood. Instead there is a fundamental question which remains open, namely whether costs orders are granted as a reflection of the rights being protected in the action, as a form of legal aid (and thus subject to a means test) or perhaps on other grounds.

---

124 ibid.
125 Smith v Croft (No 2) [1988] Ch 114, 185 per Knox J.
126 Essentially, the same rationale arguably requires that equitable defences which exist between a minority shareholder personally and a wrongdoer be irrelevant for the purpose of deciding whether to allow a derivative action to proceed. See J Payne ‘Clean Hands in Derivative Actions’ [2002] 61 CLJ 76, 86 and also Ch 5 above under 5.4.4.3(f).
127 See, for example, E Ferran ‘Company Law Reform in the UK’ (2001) 5 Singapore Journal of International and Comparative Law 516.
128 ibid.
129 Jaybird Group Ltd v Greenwood [1986] BCLC 318, 328. This view is supported by PL Davies Gower and Davies, above n 59, 455.
This is one of the least intellectually satisfying rationales of indemnity costs orders. The question on which basis these orders are granted is an important one as a matter of both principle and policy. It affects the way in which the indemnity order is to be computed (ie whether on a common fund basis, on an indemnity basis, or whether subject to a means test). This affects not only the degree of availability of these orders but also their size (ie how generous they should be). This, in turn, affects the shareholder’s decision whether or not to initiate proceedings in the first place (the logic being that the more generous these costs order are, the more willing a shareholder may be to commence litigation). Likewise, this fundamental question is interlinked with the seemingly separate question to what extent these orders are (or should be) given as a form of incentive to shareholders, as was explained above. A determination of this question is vital for a principled and reasoned development of the law.

6.3.3.5 The shareholder may not be compensated if the company becomes insolvent

Another issue which is usually overlooked is that under an indemnity order the shareholder will not be recompensed if the company proves to be insolvent and the action is unsuccessful. An indemnity order does not confer any security in the nature of a lien on any part of the company’s assets. On the one hand, it should be noted that the risk of insolvency is one often faced by litigants in all sorts of cases. So in this respect there is nothing unique here. On the other hand, shareholders should not, in effect, be putting their own money at risk, or feel they are ‘going to throw away good money after bad’ when they are suing on behalf of the company and for the benefit of the company. Furthermore, in the case of an insolvent company, the claimant would gain little benefit from an indemnity order, a point that persuaded Lord Denning in Wallersteiner to

---

131 Wallersteiner v Moir (No 2) [1975] QB 373, 392 per Lord Denning MR, 405 per Buckley LJ.
132 Buckley LJ did contemplate that this more generous measurement could be used when necessary (ibid 404).
133 In case it is seen as a form of legal aid as in Smith v Croft [1986] 2 All ER 551, 565.
134 For example, it is possible that this option should be ruled out if it is accepted that these orders are granted as a reflection of the rights being protected in the action. This, in turn, would mean that other methods of funding should be sought to supplement or substitute these orders.
135 Not least because of the deterrent effect this may have on a shareholder’s decision to commence proceedings. Regrettably, the Law Commission Consultation Paper shied away from addressing this question. It seems to be too often true that when an issue is treated as a matter of procedure (the question which the rule in Foss addresses is that of locus standi) rather than one of substance, there does not appear to be the same need to justify or articulate properly the principle which is being applied. LS Sealy, above n 97, 3.
136 DD Prentice, above n 42, 59.
137 Qayoumi v Oakhouse Property Holdings plc [2003] 1 BCLC 352.
138 Wallersteiner v Moir (No 2) [1975] QB 373, 408 per Scarman LJ.
139 ibid 395 per Lord Denning.
fashion a contingent fee procedure to deal with the problem of providing funds for shareholder litigation where the company has no assets.¹⁴⁰

Interestingly, in Watts v Midland Bank plc,¹⁴¹ Gibson J did not allow a claimant to be indemnified out of the assets of the company.¹⁴² The reason for this was that the company appeared to be hopelessly insolvent and therefore Gibson J believed that there was no way in which the claimants could have benefited as shareholders from any derivative action. It is hard to agree with this. First, where the action for which the indemnity order is being sought could result in the company recovering sufficient assets so as to return to solvency, then the insolvency of the company should not be a bar to the granting of an indemnity order.¹⁴³ In this context, it is often overlooked that recovery by a company in a derivative action will indirectly benefit the creditors, as they will have first claim on its assets. This aspect of the derivative action is often lost sight of. Creditors, for example, could have benefited from a derivative action in Watts.¹⁴⁴ In any case, as a matter of principle the fact that there was no way in which the applicants could have benefited as shareholders from any derivative action should be an irrelevant consideration post-Wallersteiner. This is because, as explained above, post-Wallersteiner it is clear that a shareholder is not enforcing a right that belongs to him but rather one that is vested in and therefore derived from the company. The right question should therefore be: is there any way in which the company could have benefited from a derivative action (shareholders being but one of the constituencies of the company)?

6.4 Conclusion

This chapter has explored the critical role of costs and fees in initiating and maintaining derivative actions. We saw that the fact that the action is employed in the US is due to adjustments in the usual cost rules, the most significant of which are the ‘common fund’ and ‘substantial benefit’ doctrines and the recognition of contingency fee arrangements. In addition to the immense hurdles discussed in previous chapters, the fact that no similar doctrines exist in English law may partly explain the limited use of derivative actions.

By contrast to the American mechanisms, the traditional way in which English law has addressed the obstacle of funding in a derivative action is by recognizing that the claimant should be indemnified for costs incurred in the proceeding by allowing the court discretion on this matter. A close analysis of the operation of

¹⁴² ibid 22.
¹⁴⁴ It is clear, nonetheless, that there are other ample means available to creditors to seek redress when a company’s assets have been wrongfully dissipated.
Funding Derivative Actions

Funding Derivative Actions

indemnity costs orders has revealed serious flaws in the operation of these orders. Under the current system, it is clear that:

(1) obtaining an indemnity order does not act as an overall suppressor of the funding problem;
(2) it does not provide a positive inducement to litigate—it will still be true that the claimant in derivative proceedings concerning a company of any size will have little or nothing to gain from their successful outcome; and
(3) there is also little likelihood that this will sway shareholders to opt for the derivative action in lieu of the unfair prejudice remedy.¹⁴⁵

Overall, it is a less than adequate response to the formidable funding problem inherent in derivative actions. Regrettably, the Law Commission’s conclusion that the possibility of indemnity costs orders is a ‘significant incentive’ to use the derivative action does not appear to reflect the realities of the current position and is much too optimistic. The question is then what fee formulas or financial mechanisms can be employed in order to bolster the distorted incentives of potential derivative actions litigants. It is the purpose of the following chapter to look into a menu of possibilities.

¹⁴⁵ Particularly in light of Clark v Cutland [2003] EWCA Civ 810. See Ch 8 below under 8.1, 8.2.2 and 8.4.2.