7
Pursuing the Resolution of the Funding Problem

7.1 Introduction

In the previous chapter we saw that the operation of indemnity costs orders offers a less than adequate response to the formidable funding problem inherent in derivative actions. The existence of two-way fee shifting with liability on the nominal claimant makes pursuit of the action uneconomic, and thus the viability of the action demands some adjustment of those rules. Such adjustment should obviously heed the arguments advanced in favour of the derivative action and those against over-empowering shareholders to bring these actions, as discussed above.¹

The purpose of the chapter is to examine four possible avenues to rectify the economic impediments to derivative actions.² The first two focus on short-term solutions and involve the company and the claimant shareholder. Section 7.2.1 considers making a mandatory requirement for the company to pay the costs of the action. Section 7.2.2 then looks at the merits and demerits of rewarding the shareholder with part of the proceeds of a successful action. The last two sections concentrate on solutions in which the risk of loss is shifted on to the claimant’s attorney. Section 7.3 explores new possibilities in the guise of conditional fee agreements; Section 7.4 assesses the possibility of adopting a US-style contingency fees in the limited context of derivative actions. Section 7.5 concludes.

7.2 Menu of Options: Solutions Involving the Company and the Shareholder

7.2.1 Option One: a mandatory requirement for the company to pay the costs of the action

It is arguable that once the court grants leave to the claimant to commence the derivative action, it should be mandatory and not discretionary for the company

¹ Ch 2 under 2.2 and Ch 3 under 3.2.2.
to pay the costs of the proceedings. After all, prior to granting leave, the court must be satisfied that the claimant is acting in good faith, reasonably, and with a view to the promote the success of the company.³ If these requirements are met, it is difficult to see why the company should not be required to pay the costs of the legal action.⁴

Indeed, under s 166 of the New Zealand Companies Act 1993, when an application is made the court must order that the costs of the proceedings will be paid by the company rather than the applicant personally, unless this would be ‘unjust or inequitable’.⁵ This provision seems to be designed to overcome the disincentive to litigate stemming from the normal rule that the losing party will also pay the other side’s costs.⁶ Leaving the issue of costs and indemnification to the outcome of the substantive action results in the applicant being placed in an uncertain position. The wording of this provision should, on the face of it, provide shareholders with more confidence and security. The effectiveness of this provision in relieving the ‘deterrent effect’ has, nonetheless, been somewhat disappointing in practice.⁷

An apparently more generous provision is s 18(5) of the New Zealand Securities Amendment Act 1988, which provides that in a derivative action for insider trading brought under that Act, the company will always be liable for the shareholder’s costs, irrespective of the result.⁸ This presumption is arguably more shareholder-oriented and also less vague than the wording of s 166, where it is unclear whether liability for costs under that section proceeds on the same basis.⁹

In short, a mandatory requirement for the company to pay the costs of the action seems to improve on the English indemnity costs order, by virtue of providing a shareholder with more certainty and confidence. But although this

³ Smith v Croft [1986] 1 WLR 580; Jaybird Group Ltd v Greenwood [1986] BCLC 318; Report para 6.104 and Draft Rule 50.13; CA 2006, s 263 in addition to these factors lists additional requirements the applicant must satisfy before permission (or leave) is to be granted. See discussion in Ch 4 above under 4.3.5.


⁵ cf the case of Japan, where if a claimant wins, because the damages accrue to the company, Art 268(2) of the Commercial Code provides that the company shall pay a ‘reasonable amount’ of attorneys’ fees upon the claimant’s motion.

⁶ Section 166 clearly uses the term indemnity for costs in ‘bringing’ the action, not an indemnity for having already ‘brought’ the action. This appears to provide for the applicant to be indemnified from the time of a specific application under s 166, which in most instances will be made at the time of the hearing of the s 165 application. See P Fitzsimons ‘The Companies Act 1993: A New Approach to Shareholder Litigation in New Zealand’ (1997) 18 Company Lawyer 306, 310.

⁷ In Vrij v Boyle [1995] 3 NZLR 763, 768, the first case since the introduction of the statutory derivative action, Fisher J held that questions of costs and indemnity from the company should be reserved until after the substantive proceedings had been concluded, and decided on the basis of the outcome of the action on its merits. Since then there have been very few applications for leave to bring derivative actions. M Berkahn ‘The Derivative Action in Australia and New Zealand: Will the Statutory Provisions Improve Shareholders’ Enforcement Rights?’ (1998) 10 Bond Law Review 74, 96.

⁸ M Berkahn, above n 7, 97.

⁹ ie whether the section includes the defendant’s costs, for which the applicant may be responsible if the action is unsuccessful.
'advanced' form of indemnity order is a step in the right direction, it does not change the basic problems. First, the intention of the requirement can be easily defeated by a restricted and confined interpretation (as well illustrated by the chilling welcome it received by the judiciary in New Zealand). Secondly, even if the action is successful, a shareholder may still not be better off than fellow shareholders who made no effort to support the proceedings.¹⁰

7.2.2 Option Two: rewarding the claimant with part of the proceeds of litigation

7.2.2.1 Outline of proposal
A more beneficial step towards rectification of the funding problem would be to allow the court to use its discretion to reward successful claimants with part of the proceeds of a successful action beyond their indirect recovery.¹¹ The term ‘reward’ is deliberately used here to make a distinction between the notions of ‘award’ and ‘reward’.¹² This also clarifies that the proposal does not intend to offend against the basic principle that recovery and relief belong to the company under a derivative action. This can be made through recognition of a US-style common fund doctrine¹³ either by statute or through judicial action. From a structural point of view this seems just and fair. Once the corporate veil is pierced, we find that a shareholder has, essentially, worked for the benefit of the company and all the other shareholders.¹⁴ Since these shareholders all hold fungible interests, we can treat the fractional interest in the company as marking their precise stake in the outcome of the litigation.¹⁵ Once the action is successfully brought, the ‘champion’ shareholder is rewarded.¹⁶ Each shareholder therefore bears the same fractional interest in the payment as he obtains from the successful recovery,

¹⁰ Given that the benefit of the suit accrues to shareholders according to the size of their holding, not their efforts in bringing the action.
¹¹ See, for example, Israeli Companies Act 1999 s 201, discussed in A Reisberg ‘Promoting the Use of Derivative Actions’ (2003) 24 Company Lawyer 250, 253. Arguably, this may well be within the courts’ discretion provided by CA 2006, s 261(4), under which, 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. It should be noted again that Part 11 is expected to be supplemented by (unspecified at the time of writing) amendments to the Civil Procedure Rules. At the time of writing, of substantial changes to the spirit of CPR r 19.9.
¹² The rationale is explained below under 7.2.2.2.
¹³ See Ch 6 above n 28 and accompanying text.
¹⁴ In addition, recovery by a company in derivative action will indirectly benefit the creditors, as they will have first claim on its assets. See Ch 6 above under 6.3.3.5.
¹⁶ For example, if the claim was successful, say 5% of the recovery would be paid to the agent-shareholder: Papera Traders Co Ltd v Hyundai Merchant Marine Co Ltd (The Eurasian Dream) (No 2) [2002] EWHC 2130 (Comm).
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so that the gains from the transaction are divided up in accordance with his respective investments.¹⁷ In effect, this reward represents an efficient solution to the well-recognized ‘free-rider’ problem that arises whenever an individual must incur costs to benefit a group of which the individual is a member. Unless some mechanism exists by which to allocate these costs among the group in proportion to the respective benefits to be received, the individual (here, the claimant shareholder) has an inadequate incentive to proceed.

We should not stop here, however. Under the English fee-shifting rules, there is no reason why the company could not, in turn, be allowed some recovery of those reward fees from the wrongdoer under a winner-takes-all method.¹⁸ The reward could also be linked to a clear benefit to the company as a result of the action,¹⁹ and can be limited to a reasonable percentage of the proceeds. The court should be provided with discretion to adjust the figure, depending on a number of factors, such as novelty or complexity of issues, quality of representation, risk, and the like. In this way, the size of the reward will be derived (lineally) from the benefit it brought the company.²⁰ Looked at in this way, it does not largely offend the basic rule that the proceeds of the action belong to the company, as it is likely that the benefit to the company can be such that the detraction from the company’s proceeds to allow for such a reward may be de minimis. The idea is, after all, to make it worthwhile enough for those litigants who genuinely desire to benefit the company to embark on this risky journey. It is further submitted that a US-style common fund doctrine can be adopted, if the result of the case is beneficial to the members generally.²¹ This does not impose additional liability on the losing defendant. Rather, where one party has created or preserved a fund for the benefit of others (ie the company and its shareholders), the others should contribute to the active party’s costs.²² The payment comes from the fund itself, as a prior charge before the beneficiaries receive it.²³

¹⁷ RA Epstein, above n 15.
¹⁹ In a case where derivative litigation results in an intangible or therapeutic relief only, the courts will be able to reward the shareholder if the derivative action results in a substantial benefit to the company, whether by judgment or settlement. See also the Israeli Companies Act 1999 s 201 (discussed in Ch 6 above under 6.3.3.1).
²⁰ Very much as the substantial benefit rule works in the US, where the effect of the judgment must substantially benefit the company. See Ch 6 above under 6.2.2.
²¹ In Marx v Estates & General Investments Ltd [1976] 1 WLR 380, a shareholder was given his costs out of the company’s assets on a common fund basis since the result of the case was beneficial to the members generally. See also Wallersteiner v Moir (No 2) [1975] QB 373, 395 per Lord Denning.
²² As explained in City of Klawock v Gustafson (1978) 585 F 2d 428, 431 (9th Cir).
²³ In the US, derivative actions have been described as ‘model cases’ for using the common fund doctrine on the basis that litigation may enhance or preserve the assets of a company. In such cases, shareholders directly benefit from the augmentation of corporate assets. See Mills v Electric Auto-Lite Co 396 US 375 (1970).
7.2.2.2 Rationale explained

Let us focus now on the rationales. The basic logic is this: the knight who steps forward to maintain the suit is paid by the company out of the winning of the action. This simple expedient seems to have the right incentive features. This development is clearly warranted by a full understanding of the derivative action. The company and its creditors receive the benefit of the litigation and thus should be required to pay the costs of recovery lest they be unjustly enriched.

The primary rationale thus rests on unjust enrichment. A shareholder’s successful claim against wrongdoing directors on behalf of the company creates a public or collective good which benefits all the other shareholders at no cost. In the first place, those who make the efforts are entitled to reasonable compensation for their services from those ‘who accepted the fruits of [their] labors’. Essentially, this is a similar rationale to the one behind indemnity costs orders. The crucial difference is that here the shareholder may be better off than fellow shareholders who made no effort to support the proceedings, because he may get an additional monetary reward. In fact, this is also in line with the very nature of the derivative action, because it is both expected and hoped that a shareholder will assume the role of initiator (unless, of course, there is someone else who is expected to assume the risk of litigation). After all, without the shareholder’s willingness to initiate these actions the alternative for the company and its shareholders is to get nothing at all. But what if the action fails? Assuming that the minority shareholder had reasonable grounds for bringing the action, and that he has fulfilled the requirements under Pt 11 of CA 2006 (or that he fulfilled the FFM’s thresholds), he should not himself be liable to pay the costs of the other side, but the company itself should be liable, because he was acting for it and not for himself.

Secondly, rewarding the shareholder directly is supported by the fact that in many cases the company will be liable for the fees of its executives in

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24 RA Epstein, above n 15.
26 On the theory of unjust enrichment as support for the common fund doctrine, see Mills v Electric Auto-Lite Co 396 US 375, 372 (1970).
28 Central RR & Banking Co v Pettus 113 US 116, 127 (1885) (‘It is repugnant to fundamental principles of equity… that they should not reap where they have not sown.’).
29 In Wallersteiner v Moir (No 2) [1975] 1 QB 373, 392 Lord Denning 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’.
30 cf the situation with indemnity costs orders in Ch 6 above under 6.3.3.1.
31 As in the US, where the driving force is thought to be lawyers who stand to gain substantial fees. See Ch 6 above n 13 and accompanying text.
32 Wallersteiner v Moir (No 2) [1975] QB 373, 395. See discussion in Ch 6 above under 6.3.2.
such litigation. Indemnification of officials is justified by the theory that they act as the company and thus liability is truly that of the corporate entity. Exactly the same reasoning applies here. The claimant represents the company and recovery flows to it. As such the entity should be liable for full payment of fees. Indeed, the procedure invented by the Court of Appeal in *Wallersteiner* is predicated on the assumption that the claimant stands to the company in a relationship analogous to agent and principal or trustee and beneficiary. It is suggested therefore that the court will be guided here by the principle that the shareholder, for practical purposes, acts as the company, stepping into the shoes of those agents who are either unable or unwilling to take an action.

Thirdly, it is also possible that, although the shareholder is willing to step forward and pursue the action on behalf of the company, he may, nonetheless, simply not be willing to risk depleting his financial resources by bringing a derivative action, given that the benefits of recovery will be shared with others. In addition, rewarding the claimant with part of the spoils of litigation means that the shareholder will be in a much more secure position than under costs orders. With the latter there might be a shortfall between the amount of costs ordered to be paid and the amount of costs recovered from the defendant. For example, the defendant’s assets might be insufficient to meet the order. It is also possible that, when the costs are assessed, they will not cover the full amount of the costs incurred by the claimant, leaving a shortfall.

Finally, it is worth noting that rewarding successful claimants with part of the spoils of litigation is a method used successfully in a number of jurisdictions. For example, the Canadian, Israeli and New Zealand statutes all allow compensation to be paid to members directly rather than to the company. Admittedly, these are rules designed to bolster the incentives of potential derivative litigants. This gives recognition to the fact that, although in a technical sense the company

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53 Subject to the qualifications as discussed in Ch 5 above under 5.4.2.5.
54 JD Wilson, above n 25, 177.
55 See Ch 6 above under 6.3.2. Walton J doubted whether these procedures were strictly analogous and he put forward a number of reasons for this (*Smith v Croft* [1986] 1 WLR 580, 588). While his objections have some substance they are hardly compelling. See DD Prentice ‘*Wallersteiner v Moir: A Decade Later*’ [1987] *Conveyancer* 167, 170.
56 DD Prentice, above n 35, 173.
57 *Halle v Trax BW Ltd* [2000] BCC 1020.
58 ibid. The court also suggested that if the costs have been incurred for the purpose of obtaining damages payable to the company, the plaintiff might be able to claim a lien on the damages to reimburse his costs.
59 Under s 240 of the Canada Business Corporations Act 1985 (CBCA). But this option, although clearly permissible, has been ruled out by Canadian courts. BR Cheffins, above n 18, 257.
60 Under the Companies Act 1999 s 201.
61 The Companies Act 1993 s 167(d) provides that the court may, at any time, make an order directing that any amount ordered to be paid by a defendant in the proceedings must be paid, in whole or part, to former and present shareholders of the company or related company instead of to the company.
62 Gower considered this to be necessary to avoid someone who has bought shares obtaining effectively an unjustified reduction in the price paid, and he cited *Regal (Hastings) Ltd v Gulliver*
is the claimant in a derivative action, it is actually the minority shareholders whose interests are affected by the wrong done to the company; and it is these shareholders who are in a better position to institute proceedings on behalf of the company against the wrongdoers. Their efforts are thus more appropriately compensated by allowing the court discretion to reward them with a direct personal benefit if the claim succeeds.

It should be noted that the Law Commission rejected a somewhat similar (but not identical) suggestion that it should be open to the court to make an order granting a personal benefit to the shareholder bringing the derivative action, such as an order that the defendant wrongdoers buy the claimant’s shares. It was argued that the very nature of the derivative action is that it seeks a benefit for the company and that it is contrary to principle to permit an applicant a personal benefit. But the objection on the grounds that this may blur the distinction between personal and derivative actions is hard to reconcile with the recent decision in Clark v Cutland. Also, it is difficult to see why there should be an objection to relief of this kind in situations where justice would seem to require judgment in this form. In the US, a few exceptions have been developed wherein recovery may be paid to the shareholder, when payment to the company would permit the majority to profit from their own wrongdoing (such as when the offending directors control a majority of shares). After all, why should the court hand back the proceeds of a successful action to controlling shareholders who were actively involved in the wrongdoing to their company and are likely to repeat their actions?

7.2.2.3 Rewarding the claimant and the ‘reflective loss’ rule

It could inevitably be argued that it is not open to the shareholder to bargain away any part of the proceeds of a successful action as this could infringe the rule against ‘reflective loss’. Painting with a broad brush, this rule proscribes a shareholder from recovering for damage which is merely a reflection of the


45 [2003] EWCA Civ 810. Post-Cutland a mixture of personal and corporate issues is inevitable. See discussion in Ch 8 below under 8.3.1.

46 Arguably, the court should have been given the power to grant pro rata recovery in appropriate circumstances in small private companies. Further, an unfair prejudice petition may not always be appropriate. See AJ Boyle Minority Shareholders’ Remedies (Cambridge University Press 2002) 84–5; AJ Boyle ‘Personal and Derivative Actions’ (1999) 20 Company Lawyer 58, 59.


48 See also AJ Boyle Minority Shareholders’ Remedies, above n 46, 84–5.
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company’s damage.49 The rationale behind this rule is that the shareholder’s personal claim must fail because it is a claim to recover a diminution in the value of his shares and this is ‘merely a reflection of the loss suffered by the company’.50 It follows that the company is the primary agent to recover in such circumstances.

As is clear from the wording of the rule itself, the purpose of the rule is to determine the right course of action when personal and corporate rights may be asserted in the same action.51 Put differently, whatever the policy reasons behind this rule may be,52 it is concerned with situations where the shareholder and the company both have a cause of action against the defendant. By contrast, under the proposal put forward here, the cause of action, as well as relief, unquestionably belongs to the company. The proposal simply provides the court with discretion to reward a claimant, not because the shareholder has a cause of action but rather on the basis of the effort and work done by the shareholder in pursuing the action (a form of wages) and as a form of incentive. Secondly, when we move to ask why a shareholder should be debarred from recovering reflective loss, it is apparent that the answer lies in a series of policy premises, as advanced by the House of Lords in Johnson.53 Similarly, it is because of policy considerations that granting such a reward is justified here.54 Further, if one accepts the rationale under indemnity cost orders, there should conceptually be no difficulty in rewarding the claimant, as this is simply a logical extension in response to practical concerns.

49 This principle was clearly established in Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] 1 Ch 204, 222–3 and followed or distinguished in various cases until it was reconsidered and endorsed by the House of Lords in Johnson v Gore Wood [2002] 2 AC 1. For comment see E Ferran 'Litigation by Shareholders and Reflective Loss' (2001) 60 Cambridge Law Journal 45; P Watts ‘The Shareholder as Co-promissee’ (2001) 117 LQR 388. The CLR (para 7.51) adopted the approach in Johnson. Johnson was later significantly qualified in Giles v Rhind [2002] 4 All ER 977, where their Lordships allowed a claim for reflective loss in circumstances where a shareholder had prevented the company from pursuing its cause of action. On the effect of this decision on Johnson, see BM Hannigan Company Law (Lexis-Nexis Butterworths 2003) 468–70. See also the decision in Gardner v Parker [2004] EWCA Civ 781. Interestingly, during discussions in the Grand Committee Stage on the new derivative action procedure under Pt 11 of CA 2006, Lord Hodgson argued that under s 263 of CA 2006 (whether permission to be given) claimants may pursue a derivative claim where there has been no loss to the company ans this may be seen as an undesirable consequence of the drafting. Nowhere in the list of matters for the court to consider is this mentioned, nor is it included in the factors that trigger automatic refusal of permission by the court given in s 263(2). See Hansard HL Vol 679, Official Report, 27/2/2006, col GC30. However, Lord Goldsmith thought it is unnecessary to state this as a particular factor for the court to take into account. The general discretion and the absolute bars are better dealt with by the procedures set out in s 263(2) and (3). See Hansard HL Vol 679, Official Report, 27/2/2006, col GC30.

50 Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] 1 Ch 204 223.

51 PL Davies Gower and Davies’ Principles of Modern Company Law (7th edn Sweet & Maxwell 2003) 455.

52 It is unclear whether a shareholder is debarred because it is a loss which the shareholder should be forbidden to recover for policy reasons or because it is no loss at all: C Mitchell 'Shareholders’ Claims for Reflective Loss' (2004) 120 LQR 457.


54 ie to ensure that the exercise of bona fide shareholder power to commence litigation is not discouraged, and also to ensure that the derivative action has a fair chance to reach its potential as a tool of corporate governance.
(ie pursuing the action is uneconomic).\textsuperscript{55} In this respect, it is evolutionary, not revolutionary. Finally, as already explained, the detraction from the company’s proceeds to allow for such a reward is likely to be \textit{de minimis}, and in any case subject to judicial discretion. At worst then, this would involve \textit{de minimis} departure from principle.

\section*{7.3 Solutions Involving the Claimant’s Attorney}

It is the purpose of this section to examine possible solutions to the funding problem in which the risk of loss is shifted on to the claimant’s attorney.

\subsection*{7.3.1 Option Three: conditional fee agreements}

A recent development across the whole area of civil litigation may have opened up entirely new possibilities. In most types of civil proceedings legal aid has now been replaced by the new system of conditional fee agreement regulated under the Courts and Legal Services Act 1990 by provisions brought into force by subsequent statutory instruments.\textsuperscript{56}

\subsubsection*{7.3.1.1 How do conditional fee agreements work?}

A conditional fee agreement (CFA), also known as ‘no-win-no-fee’ agreement, allows a lawyer to agree to take a case on the understanding that if the case is lost he will not charge his client for the work he has done. If, however, the case is won, the lawyer is entitled to charge a success fee calculated as a percentage of his normal costs\textsuperscript{57} to recompense him for the risk he has run of not being paid.\textsuperscript{58} It is generally thought that lawyers working under a CFA are likely to be more concerned to ensure that they do not take on cases where the chances of success are not sufficiently good.\textsuperscript{59} The idea is that a lawyer on a CFA may expend

\textsuperscript{55} After all, it was considerations of policy that persuaded Lord Denning in \textit{Wallersteiner} to allow a US-style contingency fee in derivative actions. See also \textit{Chitty on Contracts} (29th edn Sweet & Maxwell 2004) para 16–055.


\textsuperscript{57} Of up to 100\% of the lawyer’s normal bill.

\textsuperscript{58} The success fee is set according to the risk the lawyer is taking. The higher the chance of winning, the lower the success fee should be set, and vice versa. This helps to ensure that the risks are managed by those who are in the best position to know what the risks are—the lawyers.

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considerable time urging highly meritorious issues and yet end up with no fee if he does not confer a financial benefit. Conversely, in the cases that are taken on, the lawyer is encouraged to achieve a favourable outcome for his client to earn his success fee. CFAs are usually linked with an insurance policy taken out after the event (ATE) which, if the case is lost, pays the other side’s costs and the claimant’s own out-of-pocket expenses (but, importantly, not his own lawyer’s fees).

7.3.1.2 Conditional fee agreements and derivative actions

In Wallersteiner Lord Denning was willing to authorize the continuation of the action on a US-style contingency fee basis. Scarman and Buckley LJJ rejected this on the grounds that such an innovation could only be introduced after a comprehensive assessment by a body set up to consider the issue. As it stands, US-style contingency fees are still abhorrent, while CFAs were given cautious approval. CFAs, however, may not prove to be as effective as contingency fees, for both theoretical and practical reasons.

From a theoretical viewpoint, there are two major concerns. First, it has been suggested that a CFA may not be employed in a derivative action on the basis that it detracts from the right of the company to receive all the proceeds of a successful action. It has been said to ‘require creative judicial “law making” to interpret the diversion of funds to the claimant’s lawyer as not amounting to a breach of the traditional rule’. These concerns are perhaps justified under the US model of the contingent fee. The CFA, however, differs from the US model, in that the latter allows the lawyer to share in the proceeds of a successful action (which belongs to the company). The CFA, on the other hand, allows only an uplift in the fees recoverable by the successful claimant (the company) from the losing defendants (the wrongdoers). In any event, the same argument that has already been made can be repeated: it is simply a realistic method in the modern context of financing derivative litigation which ultimately, if successful, benefits the company.


As was described shortly after the CFAs were introduced in MJ Cook Cook on Costs (Sweet & Maxwell 2001/02) Ch 42, 465.

AJ Boyle R Sykes and LS Sealy Gore-Browne on Companies (44th edn Jordans) para 28.9.2; AJ Boyle Minority Shareholders’ Remedies, above n 46, 37 and 83. In both the common law derivative action and the procedure under Pt 11 of CA 2006 the proceeds of a successful action must accrue to the company alone.

Gore-Browne on Companies, above n 64.

AJ Boyle Minority Shareholders’ Remedies, above n 46, 37. As Epstein puts it: ‘ask potential plaintiffs whether they would give up a third of the winnings for the funding of their claims, and
Turning to the second point, it is arguable that the deterrent effect of the English rule may now be mitigated by the fact that under CFAs attorneys are permitted to assume the risk of litigation, thus eliminating, to some extent, the risk from the shareholder claimant, who will normally have only a small stake in the outcome. It does not, however, reverse it as under the American contingency agreements and supplementing mechanisms. As will be seen below, when a contingency arrangement is applied to the American rule, the expected value of litigation can always be kept at the claimant’s point of indifference, as even when the value to the claimant is zero there is no liability to fees. By contrast, with a two-way fee-shifting system, the allowance of the CFA offers only a partial solution to the problem of over-deterrence, as a losing party will remain liable for the opposite party’s costs. This is likely to have a much greater freezing effect on shareholder litigation than, say, contingent fees, because there is no way around the ‘loser pays’ rule, which, in turn, makes any litigation strategy much costlier ex ante.

Deterrence consequently remains under the current system and unless some sort of mechanism is to supplement this, CFAs are not likely to make much of an impact on derivative action litigation. In practice, one way to supplement the deterrent effect that remains under the CFA is through the development of a flourishing market in innovative insurance products specifically tailored to cover the client’s potential liability for his opponent’s costs. Historically, however, there has been a limited market in legal expenses insurance in England. Also, it is still unclear whether insurance cover against the risk of losing will be available at sensible rates for a wider range of cases, as this may be very expensive.

There is also the question of disbursements. First, it is unreasonable and unrealistic to expect that lawyers should always be willing to shoulder the ‘up-front costs’ out of their pockets, whether insurance premiums or disbursements involved in


67 Access to Justice Act 1999 ss 27, 29. On the regulatory regime governing CFAs from 1 November 2005, see below n 86.


69 See also J O’Hare K Browne and R Hill O’Hare & Hill Civil Litigation (9th edn Sweet & Maxwell 2000) Ch 2.


71 ibid. The explanatory notes to the Access to Justice Bill envisaged insurance policies which can be taken out when someone is contemplating litigation to cover the costs if the case is lost. Indeed, in Callery v Gray (No 2) [2001] EWCA Civ 1246 the court held that CFAs can be signed and ‘after-the-event’ policies taken out at the outset.

72 Cover through general legal costs insurance before the event is, by comparison, relatively inexpensive, but such policies have not proved popular in England and the experience in the last 20 years suggests that this is unlikely to change significantly. See M Zander ‘The Government’s Plans on Legal Aid and Conditional Fees’ (1998) 61 MLR 538, 549.
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cases under a CFA.⁷³ Therefore, unless insurance cover can be obtained for such costs at an affordable level, or some other solution is found,⁷⁴ this will end any prospect of access in cases involving pre-trial costs that the lawyer is unwilling to bear. In practice, this means that cases with substantial initial costs are unlikely to be viable. This is likely to be a major obstacle with regard to derivative actions. Experience indicates that derivative action cases are taking longer to litigate⁷⁵ and involve more pre-trial practice.⁷⁶ Further, there are all the court fees and other disbursements during the litigation—who is to pay these? With an indemnity order this is clear: any indemnity granted is likely to have to be renewed and reviewed as the litigation proceeds, so the court has discretion to order the company to pay this.⁷⁷ Under CFAs, however, this question is unclear.⁷⁸ Finally, there is as yet very little information on a range of vital issues, including how CFA cases work out in the result, what cases are being turned down by lawyers,⁷⁹ what clients think of them and, most importantly, what impact the market for insurance will have on all these questions.⁸⁰

As compared with the right to share in the claimant’s recoveries (under contingency fee agreements), the hope of augmented costs, which can be challenged before a costs judge in more ways than one, comes a very poor second.⁸¹ In fact, CFAs have been described as ‘a scheme of Byzantine intricacy replete with opportunities for satellite litigation. It is simply too complex’.⁸² Although perhaps a little exaggerated, this description does contain an essential core of truth. It is thought that ‘CFAs are a transitional phase, and it is time to open up the debate on what might replace or supplement them’.⁸³ In support, recent studies on CFAs amount to a persuasive argument for fully fledged US-style contingency fees.⁸⁴ Opting

⁷³ MJ Cook, above n 63, 511.
⁷⁴ Interestingly, Zander notes that the Consultation Paper explained that the Government intended to establish ‘a transitional limited fund’ for high investigative cost cases, whatever that may mean: Zander, above n 72.
⁷⁵ In Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] 1 Ch 204, the minority shareholder’s action lasted, at first instance, over 70 days.
⁷⁶ In Prudential (ibid) the court considered that it would often be necessary to hold a full-scale trial of the merits of the case before it could determine whether a derivative action was permissible. See CPR r 19.9 and Wallersteiner v Moir (No 2) [1975] QB 373. Note that 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, at the time of writing, of substantial changes to the spirit of CPR r 19.9.
⁷⁷ For example, would the lawyer agree to pay these court fees and other disbursements as well? If so, would the lawyer inevitably demand to increase his fees to compensate for this?
⁷⁹ The trouble is that there are so many rules and problems that the theory that taking on a no-win-no-fee case earns a 100% uplift in the hourly rate is not something that can necessarily be enjoyed in practice. H Epstein, above n 66.
⁸⁰ H Epstein, above n 66.
⁸¹ ibid.
⁸² ibid.
then for contingency fees’ more acceptable cousin, conditional fees, is an ingenious response to the need to protect claimants from costs.⁸⁵ More specifically, in derivative action litigation it may not lift the formidable barriers of funding, as the claimant will still have to assume some risk (under the English two-way fee-shifting rule) and when personal risk in the litigation is high the result is over-deterrence of the action.

It remains to be seen in what form and for how long, CFAs will remain part of the current system of funding litigation. Responding to the mounting criticism leveled at the practicalities surrounding CFAs, the regulatory regime governing CFAs has changed from 1 November 2005.⁸⁶ Amongst other things, the CFA and Collective CFA regulations have been revoked on 1 November 2005 (see SI 2005/2305). The primary legislation (ie Access to Justice Act 1999, s 27) provides the minimum government legislative framework needed for the use of CFAs by legal representatives. Primary responsibility for client care is now focused on solicitors and the Law Society’s Professional Rules of Conduct, supporting costs guidance and the new model solicitor-client CFAs developed by the Law Society.⁸⁷ In addition, the part of the regulations (now repealed) which dealt with information to be given to the client being represented under a CFA is now covered in an amended version of the Solicitors’ Practice Rules, particularly the Information and Client Care Code.⁸⁸ For the most part the Law Society requirements in the Code simply repeat the previous regulations as to the information about costs which must be given to clients. There is one amendment to the Code and which came into force at the same time as the regulations are revoked.⁸⁹ It was hoped

⁸⁵ J Peysner, above n 83, 46. A recent study analysing the incentives that these two forms of funding provide the attorney with to work hard concluded that contingent fees are clearly better because the attorney’s effort is tied to the amount at stake, whereas under conditional fees the choice of effort is independent of the judgment. W Emons and N Garoupa, above n 59, 243.

⁸⁶ In June 2003 the Department for Constitutional Affairs published a Consultation Paper Simplifying Conditional Fee Agreements aimed at encouraging a debate about how to make the CFA regime simpler. The paper looked at whether the detailed requirements in the CFAs are still appropriate. Then, in 2004, a Consultation Paper Making Simple Conditional Fee Agreements a Reality sought views on the department’s response to the 2003 Consultation Paper. It summarized responses to the June 2003 paper and made some specific proposals. All respondents agreed that the current CFA secondary legislation is unnecessarily complex and should be simplified and the regime made more transparent. Many commented that most of the client care and contractual requirements effectively duplicated the Law Society’s Professional Rules. In August 2005, a further report was released summarizing the responses received to the 2004 Consultation Paper, and highlighting how the consultation process has influenced the final shape of the policy and the conclusions that the department reached on some of the proposals, including revoking the existing conditional fee agreements, and collective conditional fee agreement regulations. All reports are available at <http://www.dca.gov.uk/consult/confees/congate.htm>.

⁸⁷ Available at <www.lawsociety.org.uk>.

⁸⁸ Details of the regulatory changes are available on the DCA website: <http://www.dca.gov.uk/>.

⁸⁹ The amendment provides that where clients are represented under a CFA or Collective CFA the solicitor should explain the circumstances in which the client may be liable for their own costs and for the other party’s costs; the client’s right to assessment of costs, wherever the solicitor intends to seek payment of any or all of their costs from the client; and any interest a solicitor may have in recommending a particular policy or other funding. See also the decision in Deborah Garrett
that by moving the detailed requirements of the Regulations to the Law Society’s Costs Information Code it will be less likely that minor failures fully to comply will result in disproportionate sanctions.⁹⁰

7.4 Introducing Contingency Fees for Derivative Actions?

In the previous section we saw the difficulties associated with conditional fee agreements. In this section we put the case in favour of allowing contingency fee arrangements for derivative actions. We explain why the time is now ripe for such a move and ponder how in derivative action litigation this may be beneficial. There is no doubt that to permit a lawyer to conduct a derivative action on the basis of a contingency fee should be subject to proper safeguards. The final part of this section considers thus how these safeguards could be structured.

7.4.1 Introduction

A contingency fee arrangement (CGFA) is helpfully defined in the 1989 Green Paper on the subject as:⁹¹

One whereby a lawyer agrees that he will accept his client’s case on the basis that he receives no payment if the case is lost, but that if it is won, he will be paid some percentage or share of the award made by the court.

Traditionally, the English system has rejected CGFAs. There are two common objections to CGFAs:

(1) They tend to produce a conflict of interest between lawyer and client. The lawyer’s direct financial interest in the outcome is said to affect his ability to give genuinely impartial advice, for example he may be tempted to encourage early settlement against the client’s interests.⁹²
(2) They may encourage litigants to pursue unmeritorious claims, leading to an explosion of litigation.⁹³

The above views reflected the common law preoccupation with the prospect of rapacious lawyers instigating actions rather than merely being an objective

⁹⁰ See <http://www.lawsociety.org.uk/professional/conduct/guidance/view=article.law?POLICYID=257086>.
⁹¹ Green Paper Contingency Fees (Cm 571) (January 1989) para 1.1.
⁹³ Above n 91 para 1.2.
and reactive service profession. In addition, there were political reasons which blocked the way to move towards CGFAs. The outcome of the debate was described as ‘a triumph for semantics’. CGFAs were still an abhorrence, but CFAs were given cautious approval, though as Cook puts it, this was ‘a distinction without a difference’.

7.4.2 Argument One: a change in the climate

While the above objections have some substance, they are hardly compelling. The first striking point is that the traditional English approach which rejected CGFAs has clearly now been abandoned by the courts. Public policy does not today condemn a lawyer who conducts a case on the basis that he will be paid if he wins but not if he loses. Indeed, the introduction of CFAs suggested that there is now a new policy in making justice accessible to people of modest means. Objections to CGFAs founded on this consideration are therefore now outmoded. Secondly, and more importantly, both CFAs and CGFAs make the fee dependent on the outcome, so the classic objections to contingency fees apply to both. Under CFAs the lawyer clearly has also a direct financial stake in the outcome of the litigation and so the ethical ground for objection to CGFAs must therefore be regarded as having collapsed.

There is no essential difference in principle between conditional and contingency fees. Indeed, in some ways the latter may be preferable. Contingency fees create an incentive to achieve the best possible result for the client, not just a simple win. And they reward a cost-effective approach in a way that conditional fees, where the lawyers’ remuneration is still based on an hourly bill, do not.

95 Lord Irvine, the Lord Chancellor at the time, was particularly opposed to them. J Peysner, above n 83, 40.
96 MJ Cook, above n 63, 465.
97 ibid.
100 That is the very essence of CFAs under the Courts and Legal Services Act 1990, s 58 and the Conditional Fee Agreements Regulations 2000, SI 2000/692.
101 See also M Zander, above n 84.
102 ibid.
103 Zander, above n 72, 547.
104 Sir Peter Middleton Review of Civil Justice and Legal Aid (September 1997) para 5.50.
7.4.3 Argument Two: contingency fees versus conditional fees

7.4.3.1 The case for simplicity

CFAs owe something to American style CGFAs in that they are event-triggered: the claimant’s lawyer is only paid if the case is won (ie settles or is won at a trial). However, under US-style CGFAs the solicitor takes a direct proportion of the winnings. In section 7.3.1 we pointed out that the study on CFAs amounts to a persuasive argument for fully-fledged US-style CGFAs. Clearly, this is a concept which is acceptable to the clients because many of them believed that was what they were signing up to, anyway. Research has also shown that, in practice, it is impossible reliably to discharge the requirement in the regulations that the agreement be explained to the client. Overall then, clients have little hope in understanding the intricacies of CFAs, let alone that the insurance products themselves are supremely complicated and present real difficulties in comprehension to clients and lawyers. Using CGFAs, on the other hand, would also eliminate the need for the immensely complicated agreements now required for CFAs. CGFAs are straightforward and have the beauty of simplicity: they remove the need to explain about prospects for success, success fees, and the percentage cap on damages.

7.4.3.2 Settling the case too low?

Both the lawyer on a CGFA and the lawyer on a CFA may have a self-interest in an early settlement at a lower level than the full potential damages. It guarantees a fee and speeds up cash flow. Whereas fees charged under a CFA (like hourly rates) are unrelated to the level of settlement, under a CGFA, other things being equal, the greater the damages, the higher the fee. To the extent that the lawyer’s and the client’s financial interests are directly aligned, the CGFA may therefore energize the lawyer to work on the client’s behalf even more than a CFA, for instance, by devoting additional resources to investigating the claim, or in advising rejection of an early low offer of settlement where under a CFA he would advise acceptance. The CFA lawyer earns higher fees by putting in more hours.
regardless of whether it produces higher damages. The CGFA lawyer earns more by increasing the damages, but he will be concerned to see that the cost of doing so is not excessive. With regard to the fear of abuse in settlements, a common observation about the contingent fee method of compensating a lawyer is that it creates an excessive motive, relative to his client’s interest, for the lawyer to settle the case. The usual explanation is that, by settling, the lawyer obtains his share of the settlement without having to invest the additional time that would be required if the case were to go to trial. Contrary to the conventional wisdom, however, Polinsky and Rubinfeld showed recently that, relative to a benchmark in which the client’s welfare is maximized, the contingent fee system can create incentives for the attorney to settle cases less often, and for a higher amount. In any case, as explained above, in order to reduce the possibilities for ‘gold-digging’ claims against the company, settlements are controlled in derivative actions by the court.

7.4.3.3 Charging excessive fees?

Arguably, lawyers’ fees earned under CGFAs may be disproportionate to the work involved and the risks taken. But the same is true of CFAs. Research indicates that the agreed success fee in CFAs is commonly fixed at a higher percentage rate than is justified by the risks. As for the argument that CGFAs produce excessive fees, a leading US scholar has explained that, apart from spectacular exceptions available only to a few, in most cases there is not much in it.

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113 ibid.
115 The usual analysis of settlements under the contingent fee system does not take into account that, if the case were to go to trial, the lawyer would work fewer hours on the case than is in the client’s interest. It thus mistakenly concludes that lawyers necessarily settle too often and for too little under the contingent fee system. A Polinsky and L Rubinfeld ‘A Note on Settlements under the Contingent Fee Method of Compensating Lawyers’ Stanford Law School Working Paper No 224 (September 2000), available at <http://papers.ssrn.com/abstract=286055>. Several other studies have come to similar conclusions. See, for example, J Miceli ‘Do Contingent Fees Promote Excessive Litigation?’ (1994) 23 JLS 211–24; LA Bebchuk and A Guzman ‘How Would You Like to Pay for That? The Strategic Effects of Fee Arrangements on Settlement Terms’ (1996) 1 Harvard Negotiation Law Review 53.
116 See Ch 2 above under 2.4.4.
117 S Yarrow ‘Just Rewards? The Outcome of Conditional Fee Cases’ (University of Westminster December 2000) Table 7.
118 H Kritzer ‘Lawyer Fees and Lawyer Behaviour in Litigation: What Does the Empirical Literature Really Say?’ (2002) 80 Texas Law Review 1943 (‘[A]nalyses of the returns from contingency fee practice show that in a large proportion of cases lawyers actually make substantially less, on a per hour basis, than they would from work for which they could charge prevailing hourly rates’).
7.4.3.4 Increasing the costs?

The CFA has an obvious and serious perverse incentive for lawyers to increase their costs (whether by conscious or unconscious padding or doing more work) in order to increase the success fee. In this respect, CFAs are simply not as economically efficient as CGFAs, in which this factor does not operate.¹¹⁹

In a CFA the arrangement involves a multiplier of basic fees with a maximum of 100%.¹²⁰ In theory, this appears to be a good solution to the problem of potentially excessive fees. However, a major concern in setting a fee cap is whether it will provide the compensation needed to induce a lawyer to take meritorious cases and handle them properly.¹²¹ Likewise, there are those who argue that fee caps invite lawyers to under-work,¹²² and that they ‘are largely cosmetic, keeping the final fee at what seems a reasonable level to the outside observer, while still permitting the lawyer covertly to pick and then milk (through under-work) the lucrative cases’.¹²³ Another difficulty is likely to arise when the lawyer is offered a simple and effective way of cutting to the chase (such as mediation), rather than going through a great deal of litigation. If it is possible to resolve the case at an early stage this would be in the interests of the clients, the court and system as a whole but may not be perceived to be in the interests of the lawyer whose base fee is reduced and, therefore, his success fee. CGFAs, by comparison, encourage claimants’ lawyers to be efficient: they are not awarded for effort but skill.¹²⁴ Also, they give assurance to clients of their lawyer’s motivation and extra work for lawyers with higher rewards for success.¹²⁵

7.4.4 Argument Three: the myth about contingency fees and ethics

The question is whether CGFAs represent a greater challenge to ethics than CFAs? The answer is probably no. As was indicated above, the classic objections to contingency fees apply to both. This applies in particular to the objections voiced repeatedly over the years to the general effect that contingency fees would be liable to promote unethical conduct by lawyers.¹²⁶ While it is true that CGFAs offer particular challenges to solicitors to ensure that they put their client’s interest first, nonetheless the conflicts of interest are endemic to

¹¹⁹ J Peysner, above n 83, 39.
¹²⁰ This compares with the contingency fee arrangement that incorporates a fee based on a percentage of damages recovered.
¹²² ibid.
¹²³ K Clermont and J Currivan, above n 92, 536 and 581.
¹²⁴ J Peysner, above n 83, 45.
¹²⁵ MJ Cook, above n 63, 465.
¹²⁶ See, for example, Benson Royal Commission on Legal Services (Cmnd 764) (1979) para 16.4, 177.
the funding of litigation and inherent in a relationship between professional and lay client.\textsuperscript{127} Accordingly, all financing arrangements or litigation contain ethical issues and perils. In England, CFAs or CGFAs do not stand out as offering unique dangers.\textsuperscript{128} Such arguments therefore cannot sensibly be deployed to oppose CGFAs, other than on the basis that ‘we don’t want another variation on the contingency theme’.\textsuperscript{129}

7.4.5 Argument Four: the experience with contingent fees in US derivative action litigation

Opponents of CGFAs usually cite the experience of them in the US. However, as Middleton rightly noted:\textsuperscript{130}

Considering the differences between the two jurisdictions—notably the cost-shifting rule and the fact that juries here do not generally set damages—we should re-assess whether those concerns may be misplaced.

Further, a fear of the US predilection to litigate everything that comes along prejudices the opportunity to right wrongs that in the interests of justice ought to be righted. To exclude a proper remedy may amount to protection of the wrong-doer, and in extreme cases amounts to a fraudster’s charter.\textsuperscript{131} There are also structural differences between the two legal systems which suggest that CGFAs will work very differently in England. First, as explained earlier, with the cost-shifting rule, the allowance of any kind of CGFA offers only a partial solution to the problem of over-deterrence as a losing party will remain liable for the opposite party’s costs.\textsuperscript{132} Put simply, any form of a contingent fee does not eliminate the client’s financial and psychological disincentives to bringing the action, but merely reduces them.\textsuperscript{133}

As we saw, in the US the recognition of CGFAs and the ‘common fund’ doctrine permitting attorney compensation out of the amounts generated for the benefit of the corporation have created a strong interest group within the organized Bar that favours a relatively liberal scope for the remedy.\textsuperscript{134} More relevant in terms of actual practice in the US is the economics of attorney compensation.

\textsuperscript{127} S Yarrow and P Abrams ‘Conditional Fees: The Challenge to Ethics’ (1999) 2 Legal Ethics 192. There has been no large-scale research into the outcomes using solicitors’ files and, indeed, access would be very difficult to organize. J Peyser, above n 83, 43.
\textsuperscript{129} M Zander, above n 84.
\textsuperscript{130} Sir Peter Middleton Review of Civil Justice and Legal Aid (September 1997) para 5.50.
\textsuperscript{131} H Epstein, above n 66. This is reinforced by the derivative action’s raison d’être as explicated in Smith v Croft (No 2) [1988] Ch 114, 185 per Knox J.
\textsuperscript{132} See Ch 6 above under 6.2.3.
\textsuperscript{133} K Clermont and JD Currivan, above n 92, 571.
\textsuperscript{134} Ch 1 above under 1.4.1.
The vast majority of derivative actions are brought by ‘entrepreneurial’ plaintiffs’ attorneys who conduct the litigation almost entirely on their own and with virtually no monitoring by the shareholders whose name is used as the key to the courthouse door. In this respect, the shareholders’ derivative suit in the US is very similar to the class action. What is also lacking in England, but present in the US, is a strong interest group in favour of such litigation. The Bar, a natural constituency in favour of derivative litigation, has never been comfortable with conditional fee agreements, and is said to be ‘less than enthusiastic about entering into conditional fee agreements’.¹³⁵ In the US, by way of contrast, each state’s Bar is an organized political group with a strong interest in maintaining the derivative action. Because of the US rules on fees, plaintiffs’ lawyers have become specialized in class action and derivative litigation, and have become highly organized and effective lobbies to protect this source of income. The political influence of the various state Bars has apparently been strong enough to protect the derivative lawsuit against attack despite the preference of incumbent managers that it be limited in scope. Fears that the worst excesses of US-style litigation, in which there would be a proliferation of claims that we would regard as wholly unmeritorious, would propel England into a wholly unacceptable legal culture are thus completely unfounded.¹³⁶

There are additional indicators that suggest a very different practice here. First, the experience in Canada suggests that such fears have not materialized.¹³⁷ Secondly, as noted above, the floodgates argument should not be exaggerated.¹³⁸ Litigation is a daunting prospect at the best of times and in the context of companies it presents formidable difficulties. Thirdly, it is said that in the US juries allow for the impact of CGFAs by increasing the level of damages and that if CGFAs were permitted here there would have to be some equivalent raising of the level of damages.¹³⁹ However, this argument only has any relevance if either (1) the fee-shifting rule is changed, so that each side pays its own costs; or (2) the CGFA is not recoverable from the losing litigant.¹⁴⁰ With respect to (1), whatever the pros and cons of that issue, Zander believes that (at least at present) there would be little support for such a change. Turning to (2), since the success fee and insurance premium under CFAs are recoverable under the provisions of the Access to Justice Act 1999, it would be strange not to allow CGFAs equally to be recoverable. This is not to say that making success fees and insurance premiums recoverable was on balance a good idea. There is quite a case for the view that it will prove to have been a serious mistake in significantly inflating the cost of

¹³⁵ MJ Cook, above n 63, 465.
¹³⁶ See further H Epstein, above n 66.
¹³⁷ On which see below under 7.4.7.
¹³⁸ See Ch 5 above under 5.4.2.4.
¹³⁹ M Zander, above n 84.
¹⁴⁰ ibid.
litigation, not least in generating far more arguments over costs.¹⁴¹ Should the question become relevant, the position in the US is obviously different in that damages there are so often set by juries. One cannot imagine English judges increasing damages awards in respect of lawyers’ fees.¹⁴² Finally, it is not necessarily true that a contingent fee encourages the filing of speculative suits, ie suits where the probability of recovery is small but the recovery, if any, would be large, or the filing of nuisance suits, where there is a good chance that the defendant will buy off the plaintiff in order to save the costs of litigation.¹⁴³

Another argument opposing CGFAs is that because the claimant on a contingent fee agreement has nothing to lose ‘there is no reason not to pursue the case, and every incentive to do so, however lacking in merit’.¹⁴⁴ This line of argument, nonetheless, ignores the fact that no sane lawyer acting on a contingent fee would take on a likely loser.¹⁴⁵ In any event, the legal system relies on ethical and economic restraints on client and lawyer to discourage such suits.

The question then is whether changing from hourly bill to a contingent fee is likely to encourage suits of this kind. Since a contingent fee allows a plaintiff to sue without significant financial risk, contingency would seemingly encourage him to file. However, the risk of loss does not disappear; it simply shifts to the plaintiff’s lawyer. Since contingency makes his fee depend on the outcome, the lawyer would shy away from any case with a probability of success so low that it makes the case a poor investment. Thus it is not at all clear that a contingent fee encourages groundless speculative suits. Indeed, a contingent fee may even be more effective than a certain fee in deterring such suits.¹⁴⁶ Likewise, contingency itself gives little or no encouragement to nuisance suits.¹⁴⁷ CGFAs could encourage nuisance suits if the percentage is fixed high enough to overcome the lawyer’s ethical and economic reluctance. However, that problem stems from the percentage nature of the fee, not from its contingency.¹⁴⁸

7.4.6 Argument Five: contingent fees are more compatible with derivative action

In his 1997 Report, Middelton suggested that the possibility of introducing CGFAs is definitely worth exploring at this stage. He explained that it might be

¹⁴¹ ibid.
¹⁴² ibid.
¹⁴³ K Clermont and J Currivan, above n 92, 571–3; T Miceli, above n 115.
¹⁴⁵ In fact, US lawyers turn away a high proportion of would-be claimants. The most frequently given reason for refusing to act is pessimism about establishing liability. See further H Kritzer ‘The Seven Dogged Myths Concerning Contingency Fees’ (2002) 80 Washington University Law Quarterly 739.
¹⁴⁶ K Clermont and J Currivan, above n 92, 571–3.
¹⁴⁷ ibid 573.
¹⁴⁸ ibid.
particularly appropriate for very expensive cases where it was not practicable for even a large firm to bear the amount of risk involved.¹⁴⁹ As will be seen below, derivative actions are a particularly appropriate case to implement this. They can be also used as a ‘test case’ before introducing CGFAs into other areas of litigation, if one is not convinced yet of their potential contribution.¹⁵⁰ The strongest case for introducing CGFAs in the context of derivative action was made some time ago in Wallersteiner v Moir (No 2).¹⁵¹ Lord Denning was prepared to make an exception and authorize the plaintiff to enter into a CGFA (although it was unlawful at the time as being contrary to public policy on the ground that it was the offence of champerty).¹⁵² Nonetheless, Buckley and Scarman LJJ rejected this on the grounds that such an innovation could only be introduced after a comprehensive assessment by a body set up to consider the issue.¹⁵³ The passage setting out Lord Denning’s reasons deserves to be reproduced in full:¹⁵⁴

The remedy, as I see it, is to do as is done in the US—to permit a solicitor to conduct a derivative action on the basis of a contingency fee. It should be subject to proper safeguards. The action should not be started except on an opinion by leading counsel that it is a reasonable action to bring in the interests of the company. The fee should be a generous sum—by a percentage or otherwise—so as to recompense the solicitor for his work—and also for the risk that he takes of getting nothing if he loses. The other side should be notified of it from the very beginning; and it should be subject to the approval of the Law Society and of the courts. With these safeguards I think that public policy should favour a contingency fee in derivative actions—for otherwise, in many cases, justice will not be done—and wrongdoers will get away with their spoils.

It is hard to disagree with this. There are also additional strong arguments in favour of permitting lawyers to conduct a derivative action on the basis of a CGFA. First, in the context of derivative actions, under a CGFA the minority shareholder would be in a more secure position than that under the indemnity order system. In the latter situation he will be unrecompensed if the company proves to be insolvent.¹⁵⁵ Secondly, using a CGFA will eliminate a lengthy and potentially expensive procedure, as there will be no need for lengthy investigations.¹⁵⁶ Equally, there will be no room for restrictive interpretation,¹⁵⁷ and there will be no need to bring the financial status of the applicant into play.¹⁵⁸

¹⁴⁹ Sir Peter Middleton Review of Civil Justice and Legal Aid (September 1997).
¹⁵⁰ Zander urges the legitimation of CGFAs into all areas. Zander, above n 72, 549.
¹⁵² ibid 393.
¹⁵³ ibid 403.
¹⁵⁴ ibid 395.
¹⁵⁵ See Ch 6 above under 6.3.3.5.
¹⁵⁶ Recall that in Prudential the action lasted, at first instance, over 70 days. Another ‘procedural shambles’ occurred in Smith v Croft [1986] 1 WLR 580.
¹⁵⁷ See the discussion in Ch 6 above under 6.3.3.4.
¹⁵⁸ As suggested by Walton J in Smith v Croft [1986] 1 WLR 580, 597. Ch 6 above under 6.3.3.3.
It is further submitted that using a CGFA will dislodge the fundamental problem of lack of incentives to engage in the litigation in the first place under an indemnity order system.¹⁵⁹ Using CGFAs will shift the risk of litigation from the plaintiff to the attorney, who will need to assess the likelihood of success and whether substantial benefit may flow to the company justifying an order that his fees be paid by the company. This will also eliminate the over-deterrence of the derivative action in cases when the plaintiff’s personal risk in the litigation is low.¹⁶⁰ The imposition of the risk on the attorney, however, does not alter the basic deterrence offered by the fee rules in shareholder litigation: it merely alters who faces the risk of loss or a finding that the benefit was eventually not substantial. In theory, then, CGFAs may allow more litigation of cases without a clearly predictable outcome than a system without such fees.¹⁶¹

7.4.7 Argument Six: comparative perspective

Lawyers are permitted to use CGFAs in the full sense of a percentage of the damages in most Canadian provinces (except Ontario), but every province adheres to the English rule that costs normally follow the event.¹⁶² This creates a dynamic in Canadian litigation that differs from that in US litigation: CGFAs are not used as much as they are in the US.¹⁶³ The fears of abuse with CGFAs have thus not materialized. One reason may lie in the fact that the general fee-shifting rule and the lack of recognition of a common fund or substantial benefit doctrine still leave disincentives to commence derivative actions.¹⁶⁴ In response, some scholars have therefore called for the American approach to be recognized in Canada, coupled with a certification process to ensure that a substantial question is presented.¹⁶⁵ The argument is that, once permission (or leave) has been given, the plaintiff’s attorney would be entitled to fees regardless of the outcome on the merits, on the grounds that approval of the court is, for all matters, an acknowledgement that the company should have initiated the action in the first place.¹⁶⁶ Similar calls

¹⁵⁹ See Ch 6 above under 6.3.3.1.
¹⁶⁰ Attorneys are able to calculate expected value over a range of actions. This permits a process analogous to portfolio diversification and allows the prosecution of some risky cases, as there may be also relatively safer litigation in the ‘portfolio’. The attorney will normally also have a much greater monetary interest in the litigation than will the shareholder plaintiff. This gives the attorney a real incentive to commence litigation in appropriate cases. See Central RR & Banking Co of Georgia v Pettus 113 US 116 (1885); E Mackaay Economics of Information and Law (Kluwer 1982) 173.
¹⁶¹ JD Wilson, above n 25, 174.
¹⁶² McIntyre Estate v Ontario (Attorney-General) (2001) 53 OR (3d) 137 (Ont SCJ) and M Zander ‘Contingency Fees in Canada’ (June 2002) Litigation Funding.
¹⁶⁴ See Ch 6 above under 6.2.3.
¹⁶⁵ JD Wilson, above n 25, 179–80.
¹⁶⁶ ibid and Ch 2 above under 2.4.3.
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have been voiced in Australia, where the action has not been popular.¹⁶⁷ It has been suggested that unless the CGFAs are introduced together with the common fund doctrine and the substantial benefit test, the Australian statutory derivative action may not be truly effective.¹⁶⁸

7.4.8 The difficulties in introducing contingency fees into a system in which costs follow the event

Given the foregoing discussion, it becomes clear why a CGFA seems to be far more advantageous than its alternatives. Notwithstanding, Buckley LJ in Wallersteiner pointed out some of the difficulties in introducing this procedure into a system in which costs follow the event.¹⁶⁹ Let us examine carefully these objections.

7.4.8.1 The first objection

Buckley LJ explained that the use of CGFA is often explained as justified by the need for a system which opens the doors of justice to litigants too poor to risk defeat in expensive litigation. The counsel for Mr Moir submitted that, if legal aid is not available for derivative action, similar considerations to those operating in the US indicate that CGFAs in such actions in the UK would be in the public interest. In light of the discussion above, this seems like a forcible argument.¹⁷⁰ Further, as explained above, with the change in public policy the traditional English approach which rejected contingency arrangements as being against the public interest has clearly now been abandoned by the courts.¹⁷¹

7.4.8.2 The second objection

Buckley LJ also thought it was not possible to confine consideration of the introduction of CGFAs in this country to derivative actions, as there would be found to be other litigants who could make out as good a case for this sort of treatment, although maybe on different grounds. Before such a system was introduced to the English legal regime it would require comprehensive consideration by a body such as the Law Commission, the Lord Chancellor’s Law Reform Committee, or a specially appointed committee; and any change would have to be effected by an alteration in the relevant professional rules of etiquette or by legislation. All three ‘requirements’ have surely been met by now with the introduction of CFAs. Likewise, there is not much substance in the argument that it is not possible

¹⁶⁷ Since the introduction of the statutory derivative action in March 2000 very few applications have been made to the courts for leave to bring such an action and the courts have dismissed those applications. See L. Thay, above n 43, 133 and 136–7.
¹⁶⁸ L. Thay, above n 43, 137.
¹⁶⁹ Wallersteiner v Moir (No 2) [1975] QB 373, 401–3.
¹⁷⁰ On the public perspective of derivative actions see Ch 2 above under 2.4 and Ch 5 above under 5.4.3.
¹⁷¹ Above under 7.4.2.
to confine consideration of the introduction of CGFAs in this country only to derivative actions,¹⁷² and there is no evidence to suggest any corruption. Finally, as we explain below, the introduction of CGFAs should, indeed, be accompanied by protective measures such as an alteration to the relevant professional conduct rules. In this respect, this is more of a safeguard.

7.4.8.3 The third objection
A further concern was highlighted by Scarman LJ:¹⁷³

It would be strange if the company could be compelled to pay a percentage of the moneys it recovers in the action to the plaintiff’s solicitor without its consent; for the order proposed by Lord Denning MR does not and cannot depend on the consent of the company which is, ex concessis, in the control of the defendant.

There are a number of ways of responding to this. The most obvious is to point out that, as explained above, this is simply a realistic method in the modern context of financing derivative litigation which ultimately, if successful, benefits the company.¹⁷⁴ Secondly, this objection can be clearly dismissed by an understanding of the structure of the derivative action. By definition, a derivative action is commenced without the consent of the company which is in the control of the defendants. Even CPR r 19.9 expressly authorizes the court to give the claimant an indemnity against costs out of the assets of the company in such terms as it thinks appropriate.¹⁷⁵ Surely, then, the court’s discretion replaces the consent of the company, which is not possible in these circumstances. Thirdly, it is not strange at all that the company should be compelled to pay a percentage of the moneys it recovers in the action to the claimant’s solicitor, when, in fact, the company itself receives the benefit of the litigation. If anything, it is only a logical consequence that the company should be required to pay the cost of recovery lest it be unjustly enriched.¹⁷⁶ Finally, the claimant’s lawyer represents the company and recovery flows to the company. As such the entity should be liable for payment of fees.¹⁷⁷

¹⁷² Contingency fees are, for instance, common in employment tribunal work which is not regarded as litigation and are also permitted in pre-litigation—defined as being prior to the start of legal proceedings.
¹⁷³ Wallersteiner v Moir (No 2) [1975] QB 373, 408.
¹⁷⁴ See above under 7.3.1.2.
¹⁷⁵ Similarly, under CA 2006, s 261(2) the court was given power under 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. Recall also that 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, at the time of writing, of substantial changes to the spirit of CPR r 19.9.
¹⁷⁶ Above under 7.2.2.2.
¹⁷⁷ ibid.
7.4.9 Formulating proper safeguards

There is no doubt that to permit a solicitor to conduct a derivative action on the basis of a CGFA should be subject to proper safeguards. We consider next the content of these rules.

7.4.9.1 Regulation and methods to calculate fees

In Wallersteiner, Lord Denning suggested that the action should not be started except on an opinion by leading counsel that it is a reasonable action to bring in the interests of the company, and that the fee should be a generous sum so as to recompense the solicitor for his work and also for the risk that he takes of getting nothing if he loses.¹⁷⁸ Obviously, it is understandable that a contingency fee which entitles the solicitor to a reward over and above his ordinary profit costs if he wins should be condemned as tending to corrupt the administration of justice.¹⁷⁹ The general rule that fees must be reasonable and that they are always challengeable both by the client and by the losing litigant applies in any event, but some form of more detailed prescription may be sensible.

At least two possible strategies could be adopted here. First, the CGFA could be introduced with or without restrictions in regard to the percentage of damages that could be taken by the lawyer.¹⁸⁰ Regulatory rules laying down sliding scales or percentage maxima are open to objection on the ground that they are not sufficiently adjusted to the circumstances of the particular case. A partial answer to that is to give the court discretion to vary the rule, but this is open to objection as such discretion will lead to the court having to deal with endless applications for it to be exercised (more on which later).¹⁸¹ A second solution would be to have a rule that the winning litigant could only recover a contingency fee of, say, one fifth of the damages. Since there are far more small and medium size cases than large ones, this would have the effect of making the recoverable fees proportionate to the size of the claim in the great majority of cases.¹⁸²

Interestingly, the Law Reform Commission of Western Australia considered the question whether it is possible to determine ex ante whether a CGFA provides for an excessive compensation.¹⁸³ The problem arises, in part, because of

¹⁷⁸ Above under 7.4.6.
¹⁸⁰ ibid. In Canada, of the 11 provinces that permit contingency fees, 10 have no cap. British Columbia and New Brunswick have rules prohibiting the lawyer from recovering both costs from the loser and the contingency fee. In the US, on the other hand, some states have downward sliding scales depending on the level of damages on the basis that a lawyer’s efforts and risk do not rise proportionately with the level of damages.
¹⁸¹ See further M Zander, above n 84.
¹⁸² ibid. This, obviously, may affect the ‘attractiveness’ of the case in the eyes of potential lawyers.
¹⁸³ It recommended in 1999 that the CGFA be introduced into Western Australian law: Law Reform Commission of Western Australia, Review of the Civil and Criminal Justice System—Final Report (Perth: Law Reform Commission of Western Australia, 1999).
the difficulty of constructing a reasonable fee baseline against which the actual CGFA can be judged. In theory, the optimal fee is the amount required to induce a lawyer to take and properly handle a particular case. The difficulty is that the information required to construct the baseline is rarely available. The problem arises because of the practical difficulty of determining how risky is the case, its time demands, and the potential recovery before the case really begins.¹⁸⁴ This intricacy was highlighted in *Re Swartz*,¹⁸⁵ where the Arizona Supreme Court explained that a CGFA that is reasonable when initially agreed upon may later turn out to be excessive. In such a case, the court held, a lawyer has a duty to reduce his fee to a reasonable fee and to collect no more than a reasonable amount in light of the time and effort he devoted to the case.¹⁸⁶ It seems that the court would insist on using hindsight as its methodology of review, because by using hindsight it can at least gather evidence on the amount recovered, the effort expended, and the difficulties the case finally presented.¹⁸⁷ On the other hand, determining a baseline for judging the reasonableness of a fee will often be impossible. It is possible that in *Re Schwartz* the Arizona Supreme Court used the hindsight test not because it is theoretically the best measure of a fee’s reasonableness, but as a concession to the practical problems.¹⁸⁸ Perhaps a way around this would be to follow the recommendation put forward by the Western Australia Attorney-General’s Department, requiring lawyers, before proposing a CGFA, to assess the risks of winning or losing the case, advise the client in writing of that assessment, and be able to defend the imposition of a CGFA on the basis of those risks.¹⁸⁹

### 7.4.9.2 Approval of the court

There seems to be no reason why the defendants should not be notified that the case is maintained by a CGFA from the very beginning, as proposed by Lord Denning in *Wallersteiner*.¹⁹⁰ This will enable the company to deal with the application in an informed way. At the same time, to ask the court or the Law Society to approve such an arrangement in each case, as Lord Denning also recommended, would merely escalate costs while contributing little, if anything, to protecting the company. One of the main rationales for the review of the civil litigation was the costs and delays currently experienced in these proceedings.¹⁹¹

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¹⁸⁵ 686 P 2d 1236 (Ariz 1984).
¹⁸⁶ ibid 1244.
¹⁸⁷ T Schneyer, above n 121, 395.
¹⁸⁸ ibid.
¹⁹⁰ Above under 7.4.6.
¹⁹¹ *Access to Justice—Final Report—Multi-Party Actions: Chapter 17* (Lord Chancellor’s Department 1997). These are, essentially, the same reasons which induced the reforms introduced with respect to conditional fees. See above under 7.3.1.
This will certainly defeat that purpose. Also, on a practical level it will be difficult to implement. There is yet another difficulty with Lord Denning’s proposal. The Appellate Division in South Africa has pointed to the danger that disclosure of a CGFA might subconsciously induce the courts, once they are aware of the existence of a CGFA, to increase awards to offset the impact of the uplift fee which the successful litigant will have to pay.¹⁹²

Perhaps a more practical solution would be for the courts to engage in random audits of CGFAs rather than reviewing each and every agreement entered into. This will also be less expensive and, of course, will save precious judicial time. Further, the Law Society could produce guidance for solicitors about using CGFAs and a model agreement for use between clients and solicitors, in the same manner as they provided for in the case of CFAs. This would certainly help to protect the company. Finally, if the CGFA is managed properly, protection of the company’s interests can be achieved through (1) transparency, as lawyers will have to be open about what is likely to occur from the outset; and (2) proportionality, that is lawyers will seek to recover reasonable compensation which is proportionate to the resources that it is reasonable to allocate to the case.¹⁹³

7.4.9.3 Is there a need to reform attorneys’ professional ethics?

Arguably, the introduction of CGFAs should be accompanied with amendments to existing professional ethics rules. First, the claimants’ attorneys should be subject to applicable rules of legal ethics that clearly purport to constrain attorneys’ behaviour and guard clients’ interests. Secondly, courts too have a role in this regard.¹⁹⁴ The strongest disincentives to meritless or frivolous litigation should be prompt dismissal by the courts. Court control from the very early days should ensure this, so will an early determination of the merits.¹⁹⁵ Finally, courts must also be prepared to visit sanctions on lawyers who do not live up to the standards of professional behaviour expected.

7.4.9.4 Final adjustments

Side by side with the introduction of CGFAs, an important step towards rectification of the uneconomic viability of the derivative action would be the recognition of the common fund and substantial benefit either by statute or through judicial action as outlined above.¹⁹⁶

¹⁹³ See also G Robinson ‘The CFA is Here to Stay—A Litigator’s Guide to Conditional Fee Agreements and Other Funding Arrangements’ (2001) 39 Journal of Personal Injury Litigation 44.
¹⁹⁴ It was recommended that costs should be actively considered by the judge throughout the case so as to restrain lawyers’ abuse: Access to Justice, above n 191, 19.
¹⁹⁵ ibid.
¹⁹⁶ Under 7.2.2.1.
7.5 Conclusion

It is all well and good to provide shareholders with the right to initiate proceedings on behalf of the company, but if those actions cannot practically be invoked when needed because of lack of funding and the high cost of litigation, the law is a nonsense. Good claims on behalf of the company ought not to fail because of financing problems. There is much therefore to be said for a policy underlying the FFM that reduces this hurdle. Unless the Government and/or the courts can be persuaded of the need to encourage the bringing of properly funded derivative actions by modifying the conceptual analysis of the derivative action as proposed above and in the previous chapter, it remains likely that the only recourse open to a prospective claimant will be the existing system of indemnity costs orders. But this system is deeply flawed and it is highly questionable whether it provides any adequate incentives to prospective shareholders and their legal advisers. In response, this chapter examined four possible solutions to rectify the funding problem.¹⁹⁷ Although it is still early days, it is clear that the current introduction of conditional fee agreements backed by insurance is an ingenious response to the need to protect claimants from costs. Also, with the two-way fee shifting system, the allowance of the CFA offers only a partial solution to the problem of over-deterrence, as a losing party will remain liable for the opposite party’s costs. Unless some sort of mechanism is to supplement this, CFAs are not likely to make much of an impact on derivative action litigation. Similarly, making a mandatory requirement for the company to pay the costs of litigation may provide more security to shareholders, but ultimately may not alter the perverse incentives of potential derivative action litigants.

By contrast, rewarding claimants in monetary terms by providing them with part of the proceeds of a successful derivative action may bolster the incentives of potential derivative action litigants. In the short term and until US-style CGFAs

¹⁹⁷ Other creative ways should also be looked at. For example, the Israeli Securities Exchange Commission announced that it would, in principle, be ready to finance derivative actions in cases its believed are of general importance. It is reported the finance would be given for the application to leave including covering expert and legal opinions as well as any costs that are likely to be incurred in case the court should refuse leave. Implementing of this decision, however, requires an amendment in legislation (and at the time of writing there were no signs that this change was imminent). See Globes, 5 December 2005 (in Hebrew). See also recent amendments to s 199 of the Israeli Companies Act 1999 (Amendment No 3 to the Companies Act 1999, March 2005) which allow for a wider discretion for the court in relation to costs in the course of conducting a derivative claim, including lifting some of the burden in financing the claim from the claimant already at an early stage of the proceeding. This is an interesting development as the Israeli Act is already rather liberal in relation to the thorny issue of costs (see, for example, s 201 of the Companies Act 1999 discussed in Ch 6 above under 6.3.3.1, 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). However, in spite of the above and the liberal approach of the court towards derivative litigants, the legislator has felt the need to intervene as derivative claims have been far and few between since the introduction of the new Act in 2000.
are allowed in England, this may prove to be the most beneficial way towards rectification of the funding problem. It is also straightforward and easy to implement. But it is difficult to resist the conclusion that, in the long run, unless a US type of CGFA together with supporting mechanisms is adopted by the English system accompanied by proper safeguards as proposed above, it is unlikely that any reform will make the remedy more accessible. This will make litigation far more likely because it means that no individual shareholder need invest the emotional resources or time usually needed to pursue litigation, let alone the financial resources. This is clearly also warranted by an understating that CGFAs are more compatible with derivative actions as well as more advantageous than indemnity orders or conditional fee agreements. Instead of reinventing the wheel, why not adopt the US model for the derivative action and see whether over a 10-year period (litigation is a lengthy process) the benefits are clearly outweighed by any evils that may be perceived in that time?¹⁹⁸ If so, one of the major hurdles to the use of derivative action as highlighted by the FFM, that of the financing the litigation, can be lifted. This will also mean that it is likely that future discussions on derivative actions will not remain solely academic.

¹⁹⁸ Signs that this is already happening have been reported in S Ward 'Tentative Steps into Contingent Minefield' (2002) 99 Law Society Gazette 21.