

Articles

COSTS ORDERS, OBSTACLES AND BARRIERS TO THE DERIVATIVE ACTION UNDER SECTION 165 OF THE COMPANIES ACT 71 OF 2008 (PART 1)

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INTRODUCTION

The greatest impediment to a derivative action by minority shareholders arises from the practical barriers to the commencement of derivative proceedings. The chief barriers are, first, the risk of the minority shareholder being burdened with liability for the costs of the derivative proceedings and, secondly, the lack of access to corporate information. As long ago as 1970 the Van Wyk De Vries Commission of Inquiry into the Companies Act¹ declared that one of the worst anomalies of the derivative action is the risk of the plaintiff shareholder having to bear the costs of an action in which he is 'in effect not the real plaintiff'. In the light of this progressive and enlightened finding, it is disappointing that the legislature has failed to adopt a more resolute approach under the Companies Act 71 of 2008 ('the Act') to the vexed issue of costs. If the new liberalised derivative action is to be a success, the courts must face this obstacle head on. It is vital that the remedy is not unwittingly suffocated by the courts, through the imposition of adverse costs orders on shareholder litigants.

A functional derivative action is essential to a sound system of corporate law. The rationale of the derivative action is explained in paragraph I of this article. Paragraph I also addresses concerns about shareholder abuse, and the exaggerated fears that the new statutory

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¹ *Main Report* (RP 45 of 1970) para 42.12; see also 'Company Law for the 21st Century' *Government Gazette* 26493 of 23 June 2004 para 2.2.2.

derivative action may open the floodgates to shareholder litigation, thus causing directors to flee the board. In paragraph II, costs orders are discussed, and a framework is proposed for the exercise of the judicial discretion to make orders of costs. Guidelines from other jurisdictions, as well as traps and pitfalls to be avoided by the South African courts in making costs orders, are discussed in paragraph III. Reference is made to the legal position in other common-law jurisdictions, specifically Australia, Canada, New Zealand and the United Kingdom, and the approach in the United States of America. Paragraph IV addresses the indemnification and insurance of directors who are defendants in derivative actions. Finally, paragraph V deals briefly with the minority shareholder's hurdle of obtaining access to inside corporate information, which usually lies in the hands of the wrongdoers.

I FOUNDATIONAL POLICIES AND PRINCIPLES

(a) *Rationale of the derivative action*

The derivative action is designed, first, as a remedial device by which shareholders² may enforce rights or recover compensation for the company when the board of directors refuses to do so and, secondly, as a deterrent device to prevent management abuse and to ensure control over the board by allowing shareholders and others to litigate against directors who have breached their fiduciary duties to the company.³ The dual objectives of the statutory derivative action have been widely recognised. In the United States, the court in *Diamond v Oreamuno*⁴ proclaimed that the purpose of the derivative suit is not merely to compensate the company, but also to deter. The derivative action is generally considered in the United States to be the 'chief regulator of corporate management',⁵ for it promotes accountability by directors and managers. Recognition was also given to this deterrent objective of

² And other applicants with standing under s 165(2) of the Act. For the purpose of convenience, this article refers mainly to shareholder applicants. However, most of the submissions made in this article apply equally to other applicants with locus standi under s 165.

³ *Richardson Greenshields of Canada Ltd v Kalmacoff* (1995) 18 BLR (2d) 197 (CA) 205. The Canadian legislation relating to the statutory derivative action inspired the approach in Australian, New Zealand and Singaporean law, among others. These Commonwealth models have exercised a strong influence on the South African statutory derivative action. The statutory derivative action in the South African Act has also been influenced by US law. The jurisprudence of these jurisdictions is accordingly relevant in the South African context. See also s 5(2) of the Act. See further para III below.

⁴ NY 2d 494, 248 NE 2d 910, 301 NYS 2d 78 (1969).

⁵ *Cohen v Beneficial Industrial Loan Corp*, 337 US 541 (1949).

the derivative action by the Ontario Court of Appeal in *Richardson Greenshields of Canada Ltd v Kalmacoff*,⁶ while in New Zealand law it was stated in *Frykberg v Heaven*⁷ that '[c]laims against employees or directors of companies who have misused information gained in confidence or who have breached fiduciary obligations are often brought not only to recover damages or seek an injunction but also to act as a deterrent to others'.

The derivative action is increasingly seen as a valuable tool of corporate governance. The role of the derivative action in corporate governance was lucidly expressed in *Seinfeld v Coker*⁸ as follows:

'It is important for shareholders to bring derivative suits because these suits, filed after the alleged wrongdoing, operate as an *ex post* check on corporate behavior. . . . When shareholder plaintiffs bring meritorious lawsuits, they deter improper behavior by similarly situated directors and managers, who want to avoid the expense of being sued and the sometimes larger reputational expense of losing in court.'

In the same vein, the first reported case on the new derivative action in Singapore⁹ declared that derivative actions 'are intended to improve the standards of private corporate governance since directors who breach their duties to the company could be made accountable'. Provided that the new statutory derivative action is properly cultivated by the South African courts to flourish as an effective remedy, it would have the added benefit of not only deterring future misconduct by directors to the advantage of shareholders, but also of preventing mismanagement by directors of other companies. The genuine prospect of liability, with attendant financial loss, reputational loss and loss of social status,¹⁰ serves as a strong deterrent to corporate wrongdoing and to violations of the duties owed by directors to their companies, and thus advances managerial accountability.

To analyse it from an economic perspective, the derivative action may perform an important function in corporate governance by serving to align the conflicting interests of managers and shareholders. It thus allays the 'agency problem' that results from the 'principal-agent' relationship between the shareholders as a whole (the 'principal') and

⁶ Supra note 3.

⁷ (2002) 9 NZCLC 262,966 at 262,974.

⁸ A.2d 330, 333 (Del. Ch. 2000).

⁹ *Teo Gek Luang v Ng Ai Tiong and Ors* [1999] 1 SLR 434 at 438.

¹⁰ John C Coffee 'New myths and old realities: The American Law Institute faces the derivative action' (1992–1993) 48 *The Business Lawyer* 1407 at 1428–9.

the board of directors and managers of the company (the ‘agent’). In so doing, the derivative action fundamentally reduces ‘agency costs’, that is, the monitoring costs that shareholders incur in ensuring that directors act in the interests of shareholders as a whole rather than in their own personal interests, when their respective interests diverge.¹¹

Although the deterrent objective of the derivative action is widely accepted, there are differing views. Some academics have questioned the role of shareholder litigation in corporate governance,¹² while some judicial decisions have (with respect incorrectly) regarded the purpose of the derivative action as purely compensatory.¹³ In many instances, the dual purposes of compensation and deterrence may be regarded as complementary. To elaborate: by empowering shareholders and other stakeholders to enforce corporate rights, a real prospect of personal liability is created which functions to deter directorial wrongdoing and improve managerial accountability. An award of damages to the company serves to compensate the company (and indirectly all its shareholders) while concurrently affirming the principle that other directors who engage in misconduct will be sanctioned.

To view the twin purposes of the derivative action as invariably complementary is, however, to gloss over the difficulties. In certain situations, the compensatory and the deterrence rationales may conflict, particularly in the public company setting where empirical studies have shown that a successful derivative action is unlikely to boost a public company’s share value or the firm’s market price.¹⁴ It is in these cases that the objective of deterrence may trump that of compensation. Three compelling objections may be raised against the contention that compensation is the only rationale, or even the primary rationale, of the derivative action.¹⁵ First, the likelihood of share transfers between the time of the wrong and the time of the recovery means that new shareholders receive a (indirect) windfall gain, while existing shareholders who sell their shares during this period do not benefit from the

¹¹ Reinier H Kraakman et al *The Anatomy of Corporate Law: A Comparative and Functional Approach* 2 ed (2009) 35–7.

¹² See, for example, Roberta Romano ‘The shareholder suit: Litigation without foundation?’ (1991) 7(1) *Journal of Law, Economics and Organization* 55.

¹³ That is, to provide compensation for the company as a whole with a consequential indirect benefit to all current shareholders. See, for example, *Bangor Punta Operations Inc v Bangor & Aroostook Railroad Co*, 417 US 703 (1974); *Home Fire Ins. Co v Barber*, 67 Neb. 644, 673, 93 NW 1024 (1903); *Westgold Resources NL v Precious Metals Australia Ltd* [2002] WASC 221 para 21.

¹⁴ Romano op cit note 12. This, however, is controversial.

¹⁵ John C Coffee & Donald E Schwartz ‘The survival of the derivative suit: An evaluation and a proposal for legislative reform’ (1981) 81 *Columbia LR* 261 at 302–5.

corporate recovery. Secondly, the injury and the gains of the company are not congruent with the injury and the gains of its shareholders. Thirdly, the recovery of shareholders on a pro-rated basis is typically a mere trivial amount (particularly in public companies where minority shareholders are more widely dispersed and have a lower individual stake). Accordingly, the rationale of the derivative action is not, and cannot, be purely remedial or compensatory.

The American Law Institute's *Principles of Corporate Governance*, in seeking to balance the rationale of compensation against the deterrent rationale, makes explicit the prophylactic function of the derivative action.¹⁶ Section 7.10(b) of the *Principles* provides that even if a derivative action will *not* produce a net financial recovery for the company, it cannot be dismissed if dismissal would permit a defendant to retain a 'significant improper benefit'.¹⁷ This patently takes into account the public interest and the deterrent value of the derivative action.

A fundamentally important practical question is whether leave applications for derivative proceedings should entail a cost-benefit analysis. On the basis of the discussion above, it is submitted that the South African courts, in assessing from a cost-benefit perspective whether the grant of leave under section 165 would be in the best interests of the company,¹⁸ must take into account not only the likely net financial recovery to the company but, more importantly, the benefit and gains to shareholders that are likely to result from the deterrence of future misconduct by directors and managers of the company.¹⁹ Moreover, for most investors who hold a diversified portfolio of shares there is a 'generic benefit' or value to a derivative action by its deterrence of directors of *other* companies, even if the action results in a net loss to the particular company that is involved in the action.²⁰ The derivative action thus yields not only private benefits but also public benefits, by its long-term deterrent value and by the social and economic value of enhanced investor confidence in the integrity of the corporate system.

In the light of these essential purposes of the derivative action, the South African courts must cease to impose artificial limits on its

¹⁶ American Law Institute *Principles of Corporate Governance: Analysis and Recommendations* (1994) at 596–99 and s 7.10(b).

¹⁷ And provided certain other conditions are met.

¹⁸ See s 165(5)(b)(iii) of the Act.

¹⁹ See further Maleka Femida Cassim 'Judicial discretion in derivative actions under the Companies Act of 2008' (2013) 130 *SALJ* 778.

²⁰ American Law Institute op cit note 16 at 597, 601 and s 7.10(b).

availability and to stultify its use by means of adverse costs orders.²¹ The derivative action could be very useful in promoting good corporate governance practices²² in South African law, provided that the courts breathe full life into it. A whole host of safeguards are already built into section 165 of the Act to snuff out the abuse of the remedy by shareholders and others.

(b) Safeguards against abuse of the derivative action

The abuse of the derivative action by predatory shareholders was described in the United States case *Cohen v Beneficial Industrial Loans Corporation*²³ as follows:

[derivative suits] sometimes were brought not to redress real wrongs, but to realize upon their nuisance value. They were bought off by secret settlements in which any wrongs to the general body of share owners were compounded by the suing stockholder, who was mollified by payments from corporate assets. These litigations were aptly characterized in professional slang as “strike suits”.

It is a practical hazard that minority shareholders and other stakeholders²⁴ may institute nuisance actions, which are frivolous, vexatious or unmeritorious, directed at harassing the management of the company. A particular form of abuse is the exploitation by opportunistic shareholders of this remedy by using it for ‘gold digging’ claims or ‘green-mail’, whereby shareholders bring (often meritless) derivative actions, not to obtain benefits for the company, but with the aim of extracting personal benefits for themselves.

Such ‘strike suits’ must be distinguished from collusive settlements or secret settlements, in which the company’s directors (who are usually the true defendants) ‘buy off’ the claim from the shareholder by using company assets, for instance, by a bribe or a costly payment to the shareholder, or even by a settlement disguised as a repurchase or buy-back of his shares at above-market price. In *Manufacturers Mutual*

²¹ See also ‘Company Law for the 21st Century’ op cit note 1 para 2.2.3, para 4.4.1; *Memorandum on the Objects of the Companies Bill, 2008*, Companies Bill [B 61D–2008] para 1.2.4; s 7 of the Act.

²² Litigation is not the primary or initial mechanism for corporate governance, nor is it the only means for holding directors accountable. It tends to be more in the nature of a mechanism of last resort. Other means for directorial accountability include social and market forces, the market for takeovers or market for corporate control, and shareholder voting. Significantly, all of these mechanisms have their own shortcomings and defects. An effective derivative action thus has a valuable role to play.

²³ *Supra* note 5 at 548.

²⁴ With standing under s 165(2) of the Act.

Fire Insurance Company of Rhode Island v Hopson,²⁵ for instance, a derivative action was discontinued by a minority shareholder when his stock was repurchased by the company at seven times its market value. While meritless ‘strike suits’ may ultimately result in collusive settlements, the risk of collusive settlements is greater when the shareholder’s claim is a meritorious one (as the defendant directors would then have a greater incentive to settle with the shareholder on an individual or personal basis, for an amount that is less than the damages likely to be awarded against them in a derivative action). Private or collusive settlements are clearly contrary to the interests of the company. Not only does the company first suffer the original damage at the hands of the wrongdoers, but in addition the subsequent settlement occurs at the expense of the company whose assets are used for the settlement, and the company is deprived of a judgment in its favour. Secret settlements also occur at the expense of the other shareholders, who are deprived of the (indirect) benefit of recovery by the company.

A number of safeguards are embodied in the Act to curb such abuses of the derivative action. The first protective device is the requirement of a demand on the board of directors,²⁶ which ensures that the minority shareholder seeking a derivative action makes reasonable efforts to cause the company to seek relief on its own behalf. Secondly, the company has the statutory right to apply to court within 15 business days to set aside a demand that is frivolous, vexatious or meritless,²⁷ without any need to investigate such nuisance demands. Thirdly, the claim of the minority shareholder (if not set aside by the court) must pass the scrutiny of an investigation conducted by an impartial person or committee that is appointed by the board of directors to screen the claim.²⁸

Fourthly, the chief safeguard against the exploitation of section 165 is the judicial control of the leave procedure. The discretion of the court to grant or withhold permission for minority shareholders to litigate a corporate cause of action — which is guided by the three gateways or threshold tests of good faith, a serious question to be tried and the best interests of the company — is clearly designed to filter out strike suits and other nuisance claims.²⁹ The fifth buffer is the court’s authority to

²⁵ NYS 2d 502 (1940).

²⁶ Section 165(2) (read with s 165(5)).

²⁷ Section 165(3).

²⁸ Section 165(4); see further para V below.

²⁹ Section 165(5)(b)(i)–(iii). For a discussion of the requirement in s 165(5)(b)(i) of ‘good faith’, see Maleka Femida Cassim ‘The statutory derivative action under the Companies Act 2008: The role of good faith’ (2013) 130 *SALJ* 496. For a discussion of the requirements in s 165(5)(b)(ii)–(iii) of ‘the trial of a serious question’ and the ‘best interests of the company’,

replace the person with control of the derivative action,³⁰ for instance, if the original applicant is not in good faith but the claim is none the less a valid one. This power is valuable also where the derivative action is misused by delinquent directors who, as a ploy to stifle successful litigation against themselves, persuade a friendly shareholder to nominally institute derivative litigation against them without any genuine intention of properly pursuing it. The statutory solution to directorial abuse of section 165 is supplemented by the shareholder's power to intervene in an action by the *company*, which is being unsatisfactorily pursued by its board of directors, and to *continue* it as a *derivative* action,³¹ thus divesting the board of control of the litigation.

The sixth protective measure against abuse is the judicial control of settlements. This is an essential safeguard. A derivative action brought or intervened in with leave under section 165 may not be discontinued, compromised or settled without the leave of the court.³² This mechanism is conceived specifically to prevent collusive settlements. Since the court would presumably consider the interests of the company and the fairness of the settlement, the court has the power to restrain the major problem of unjust or secret settlements. Applicants in most comparable jurisdictions, including the United States, New Zealand, Canada, Australia and Ghana,³³ must likewise refer any offer of settlement back to the court for approval.

Over and above this sturdy array of checks and balances, the Act contains two further ostensible or purported safeguards: first, the possibility of the minority shareholder being burdened with a costs

see Maleka Femida Cassim op cit note 19. For a discussion of the rebuttable presumption in s 165(7) and s 165(8) that the grant of leave is not in the 'best interests of the company', see Maleka Femida Cassim 'When companies are harmed by their own directors: The defects in the statutory derivative action and the cures (part 1)' (2013) 25 SA Merc LJ 168 and idem 'When companies are harmed by their own directors: The defects in the statutory derivative action and the cures (part 2)' (2013) 25 SA Merc LJ 301. For general discussion of the new statutory derivative action, see Lindi Coetzee 'A comparative analysis of the derivative litigation proceedings under the Companies Act 61 of 1973 and the Companies Act 71 of 2008' 2010 *Acta Juridica* 290; Helena H Stoop 'The derivative action provisions in the Companies Act 71 of 2008' (2012) 129 SALJ 527; and Maleka Femida Cassim 'Shareholder Remedies and Minority Protection' in Farouk H I Cassim (managing ed) et al *Contemporary Company Law* 2 ed (2012) 775–96.

³⁰ Section 165(12).

³¹ See s 165(2). See also s 165(10) and s 165(15) which contemplate that leave under s 165 may be given either to *bring* or to *intervene in* legal proceedings.

³² Section 165(15).

³³ Respectively, US Federal Rules of Civil Procedure r 23.1; New Zealand Companies Act 105 of 1993, s 168; Canada Business Corporations Act, R.S.C. 1985 c. C-44, s 242(2); Ontario Business Corporations Act R.S.O. 1990, c. B.16, s 249(2); Australian Corporations Act 2001, s 240; Ghana Companies Code, 1963, s 210(9).

order, and, secondly, the discretion of the court to order minority shareholders to furnish security for costs. Although these two provisions are intended as further curbs on shareholder abuse, their true effect may be to unwittingly derail the legitimate use of the derivative action and bring to an abrupt halt any hopes for the realisation of its worthy objectives. Simply put, these provisions are overkill. A framework for costs orders is suggested below,³⁴ which takes into account the comprehensive system of safeguards against abuse of the derivative action.

(c) *An opening of the floodgates? Evidence in comparable jurisdictions*

Concerns (which are perhaps misguided) have been raised that the new liberalised statutory derivative action, coupled with the partial codification of directors' duties in the Act, would open the floodgates of shareholder litigation, and that directors' increased exposure to personal liability could make them averse to legitimate risk-taking or even cause them to flee the board.³⁵ However, the experience of and the evidence in comparable common-law jurisdictions has shown that, despite the adoption of a more shareholder-friendly approach to the statutory derivative action, none of these fears has materialised.

The modernised and flexible approach taken by the Australian courts in granting leave for the statutory derivative action has not resulted in an increase in the number of judgments. In its first five years in operation, the number of judgments on the new statutory derivative action (31 in total) was comparable to the number of judgments on its predecessor, the common-law derivative action, in the preceding five-year period (30 in total).³⁶ Out of these applications, leave was granted in an encouraging 61.3 per cent of cases (19 cases in total) and refused in 38.7 per cent of cases (12 cases). Similarly, in Canada the derivative action has not made a dramatic impact on minority shareholder litigation. Canadian shareholders are still more likely to rely on the oppression remedy rather than the derivative action.³⁷ The oppression remedy has several procedural advantages over the derivative action. First, there is no need to

³⁴ See para II below.

³⁵ See, for example, Robert W V Dickerson, John L Howard & Leon Getz *Proposals for a New Business Corporations Laws in Canada* (1971); English Law Commission *Shareholder Remedies* (Law Com: No 246 Cm 3769) Guiding Principles para 1.9.

³⁶ Ian M Ramsay & Benjamin B Saunders 'Litigation by shareholders and directors: An empirical study of the Australian statutory derivative action' (2006) 6(2) *Journal of Corporate Law Studies* 397 at 445.

³⁷ Brian R Cheffins & Janet M Dine 'Shareholder remedies: Lessons from Canada' (1992) 13(5) *The Company Lawyer* 89 at 94.

apply to the court for leave; secondly, it may be easier to prove unfair prejudice under the oppression remedy than to prove a violation of corporate rights under the derivative action; thirdly, the shareholder or applicant benefits directly from the oppression remedy, unlike the derivative action where the recovery accrues to the company as a whole and only indirectly to the shareholder as reflected by an increase in the value of his shares; and, fourthly, a wider range of relief is available under the oppression remedy.³⁸

By contrast to the trends in Australia and Canada, the New Zealand statutory derivative action appears to have had a stronger impact. This remedy has proved to be almost as popular as the unfair prejudice remedy in New Zealand, and it has been suggested that the success of the former is at the expense of the popularity of the latter.³⁹ Applications for leave to bring derivative proceedings were shown to be reasonably prevalent in New Zealand,⁴⁰ but this has by no means opened the floodgates of shareholder litigation.

It is also noteworthy that the impact of the derivative action in common-law jurisdictions is distinctly within the private company scenario⁴¹ as opposed to the public company scenario. (Interestingly, a similar trend has been observed in China, a civil-law jurisdiction that introduced the derivative action in 2005,⁴² where it was found that the remedy was used exclusively in private companies and not even a single case over the five-year period of an empirical study had concerned a public company.⁴³) The data above strongly suggests that the fears and concerns about the availability of the new statutory derivative action are largely unfounded.

In the United States, which is known for its litigious culture, empirical studies have concluded that shareholder litigation is an infrequent experience. A study of shareholder suits in public companies from the late 1960s to 1987 found that a modest 19 per cent of the sample of 535

³⁸ See s 163 of the Act.

³⁹ Lynne Taylor 'The derivative action in the Companies Act 1993: An empirical study' (2006) 22 *New Zealand Universities LR* 333 at 334, 362–3.

⁴⁰ *Ibid.*

⁴¹ Ramsay & Saunders op cit note 36 found that 87.1% of cases (27 cases) involved private companies and only 12.9% (4 cases) involved public companies, while Taylor op cit note 39 concluded that closely held companies with 5 or fewer shareholders were involved in the overwhelming majority of New Zealand cases.

⁴² Company Law of the People's Republic of China promulgated on 29 December 1993 and amended in 2005 with effect from 1 January 2006.

⁴³ H Huang 'Shareholder derivative litigation in China: Empirical findings and comparative analysis' (2012) 27 *Banking & Finance LR* 619 at 631.

public companies had experienced a shareholder suit.⁴⁴ This is so, despite the flexible United States rules on legal fees (including the rejection of the ‘loser pays’ principle, the use of contingency fees, the common fund doctrine, and generous attorneys’ fees),⁴⁵ which are far more shareholder friendly than South Africa and other jurisdictions.

The modest impact (in terms of the number of judgments) of the statutory derivative action in the United States and in other jurisdictions must not be interpreted to mean that the remedy is ineffective or that it holds no benefits for shareholders and stakeholders. Although a derivative action may not always generate a financial or compensatory benefit, its primary value lies in its deterrent capacity to chill future corporate wrongdoing — and this effect cannot be measured by empirical studies.⁴⁶ Its importance, however, must not be underestimated.

As contrasted with its more restricted use and efficacy in the Commonwealth jurisdictions, the derivative action is utilised much more successfully in the United States. This primarily is due to the generous United States rules on costs. The rarity of derivative litigation in civil-law jurisdictions such as Japan, France, Italy and Germany⁴⁷ has been attributed directly to aspects of procedural law, particularly the burdensome rules on legal fees and costs. In consequence, the private enforcement of directors’ breaches of fiduciary duties in these jurisdictions is weak.⁴⁸ The impact of alleviating the costs barrier is reflected in the Japanese experience. Throughout the first few decades of its existence, the Japanese statutory derivative action was rarely used,⁴⁹ until dramatic changes were implemented in 1993 to the costs rules,⁵⁰ making it more affordable for shareholders to pursue derivative actions. The result was a positive spurt in derivative suits.⁵¹ In order for the South African derivative action to have any hope of surviving and thriving, the courts must exercise their discretion wisely and circumspectly, to

⁴⁴ Romano op cit note 12 at 59.

⁴⁵ See further para III below.

⁴⁶ Coffee op cit note 10 at 1428, 1436–7.

⁴⁷ Pierre-Henri Conac, Luca Enriques & Martin Gelter ‘Constraining dominant shareholders’ self-dealing: The legal framework in France, Germany, and Italy’ (2007) 4 *European Company & Financial LR* 491 at 497, 507–9.

⁴⁸ In France, this is countered to some extent by stronger public enforcement. Self-dealing French directors commonly face criminal prosecution for abus de biens sociaux (abuse of corporate assets), usually on demand by minority shareholders acting derivatively in the name of the company, for which the sanction is imprisonment for up to five years or a fine up to €375,000 (Art. L. 241–3 and Art. L 242–6 Code de Commerce).

⁴⁹ Articles 267 to 268–3 of the Commercial Code.

⁵⁰ Specifically, a change in the filing fee for derivative lawsuits from a percentage of the claim for compensation to a uniform filing fee.

⁵¹ Kraakman et al op cit note 11 at 174–5.

overcome the barrier of costs that has long plagued minority shareholders in derivative litigation.

II COSTS ORDERS

(a) *The hurdle of costs*

A minority shareholder who brings a derivative action acts for the company and not for himself. The benefit of a successful action, likewise, accrues not directly to the minority shareholder but to the company. That is to say, all the shareholders in the company share indirectly in the gains, pro rata, to the extent that there may be a rise in the value of their shares.

Since the individual shareholder brings the derivative action on behalf of a group of persons, who all share in the benefit obtained by his efforts, a ‘collective action’ problem exists.⁵² The legal costs and expenses to the individual shareholder of bringing the action typically outweigh his small pro rata benefit, so that there is no true recovery for him. Even if the litigation is a success, the plaintiff shareholder may still be out of pocket, as he would recover only some — but not all — his legal costs from the true defendant (who has harmed the company), under the ‘loser pays’ principle that costs follow the event in South African civil procedure. For him, it is a hollow victory. In addition, the risk of being saddled with the liability for his opponents’ legal costs should the derivative action fail is indisputably the worst deterrent to derivative litigation. Although it is intended as a safeguard to deter baseless actions, in reality it would frustrate and deter even bona fide applicants with meritorious grievances from instituting a derivative action. On a cost-benefit analysis, given the strong prospect of a net loss — no matter the outcome of the litigation — few shareholders would ever have any incentive to bring a derivative action for the company’s benefit even when it would be clearly justified.

The result is shareholder apathy. This is particularly intensified when shareholders have a small stake in the company, for instance in widely-held or public companies with large groups of dispersed shareholders. Shareholder apathy in the field of the derivative action is compounded by the free-rider effect. There is the obvious temptation to be a free-rider, who leaves it to a fellow shareholder to invest the time, effort and costs of bringing a derivative action, while the free-rider rides

⁵² Michael J Whincop ‘The role of the shareholder in corporate governance: A theoretical approach’ (2001) 25 *Melbourne University LR* 418 at 422–4.

on his efforts by reaping a share in the benefits of the derivative litigation despite his passivity.

It must also be borne in mind that individual shareholders often do not have the financial and other resources necessary for litigation, while institutional shareholders who do must weigh up their obligations to their beneficiaries. If the shares of the company are liquid and there is a ready market for them, a rational shareholder would be more inclined simply to exit the company by selling his shares rather than to litigate against the miscreant directors of the company.

The result of all these factors is that corporate delinquents frequently escape accountability for their misconduct, at the expense of the interests of the company itself, and the wider public interest in the proper management of companies and the integrity of the corporate system.

(b) A framework for costs orders

Section 165(10) of the Act confers on the court a wide discretion to make, at any time, any order it considers appropriate about the costs of derivative proceedings. In failing to shift the burden of the costs back to the company, which is the real plaintiff, this provision dismally fails to overcome the shareholder's disincentive to litigate stemming from the normal 'loser pays' rule. It is an overly conservative provision that leaves the minority shareholder without the assurance that he will recover his legal fees and costs from the company. This will always be subject to the uncertainty that is inherent in a discretion conferred on the court. The minority shareholder is at the mercy of the court.

In striking contrast, New Zealand law features a more encouraging and modern approach. It effectively codifies the indemnity order, by means of a statutory presumption in favour of company funding. The New Zealand Companies Act⁵³ directs the court, on application by a shareholder or other applicant to whom leave for a derivative action has been granted, to order that the whole or part of the reasonable costs of bringing the derivative proceedings must be paid by the company, unless it would be unjust or inequitable for the company to bear those costs. The clear intention is that once leave is granted for a derivative action, it is the company that should fund the action, even if the legal action ultimately fails.

⁵³ New Zealand Companies Act, 1993, s 166.

The bland South African provision, which is sourced directly from the Australian costs provisions,⁵⁴ has two apparent objectives: first, to enable the court to protect the bona fide shareholder against liability for costs by indemnifying him out of company funds, and, secondly, to provide a further safeguard against dubious or unmeritorious actions.⁵⁵ It is submitted that the first of these objectives is a worthy one which ought to be given primacy in South African law. This is buttressed by the recent case *Wood v Links Golf Tasmania Pty Ltd*⁵⁶ in which the Federal Court of Australia found that the intention of Parliament is that the costs of derivative actions should generally be met by the *company*. On the other hand, the second objective should be largely discounted by the South African courts, for a full spectrum of protective measures against shareholder abuse is already built into section 165 of the Act, as detailed in paragraph I(b) above. Where costs orders and indemnity orders are made in favour of derivative applicants, this of itself does not provide any positive incentive to sue, because the applicant will not directly receive any compensation, regardless of the outcome of the action. For the courts to use costs orders as a deterrent to doubtful or unmeritorious actions would paradoxically serve to disincentivise the pursuit of worthy and meritorious claims as well.

In view of the anaemic approach taken by the South African legislature to costs orders, the role of the courts is of fundamental importance. To ward off the possibility of corporate harm without legal remedy, the judiciary must confront the vexed issue of costs by means of a fresh, shareholder-friendly approach. Unless the judicial discretion with regard to costs is exercised in a balanced and flexible manner, it could cause the early demise of the new statutory derivative action and effectively reduce section 165 to a dead letter in our law.⁵⁷

A framework is proposed in paragraphs II(c) to II(h) below for the exercise of the discretion of the court to make costs orders.⁵⁸ Guiding principles based on the experience in other jurisdictions are canvassed, together with a list of pitfalls that the South African courts should avoid.

Under section 165(10) the courts have wide powers to make costs

⁵⁴ Section 242 of the Australian Corporations Act 2001, save that the latter explicitly provides for orders for indemnification for costs, which the South African Act fails to adopt.

⁵⁵ According to the Australian Explanatory Memorandum to the Corporate Law Economic Reform Program Bill, 1998, para 6.19; see also Van Wyk De Vries Commission of Inquiry into the Companies Act *Main Report* (RP 45 of 1970) para 42.17.

⁵⁶ [2010] FCA 570, 28 ACLC 10–042, 2010 WL 2282333, [2011] ALMD 1152.

⁵⁷ See Maleka Femida Cassim ‘Shareholder Remedies and Minority Protection’ in Farouk HI Cassim (managing ed) *Contemporary Company Law* 2 ed (2012) 792–3.

⁵⁸ *Ibid.*

orders. The order may concern the costs of the application for leave (or permission) to bring a derivative action or the actual derivative action itself. (It is noteworthy in this regard that a derivative action involves a two-pronged process: the first step is that a successful application must be made to the court for leave to bring proceedings in the name of and on behalf of the company, in terms of section 165, and the second step is the derivative action itself.) The costs order may relate to the costs of the company, the applicant (who applied for or was granted leave), or any other party (such as the true defendants, for example, the directors whose conduct is the subject of the complaint).⁵⁹ Since the court may make ‘any’ costs order ‘at any time’ under section 165(10), it has the power to order indemnification for the minority shareholder out of corporate funds, or to award interim costs to the minority shareholder to finance the derivative action on an ongoing basis until its conclusion. The courts in their discretion may also use this provision to support minority shareholders in recovering their full legal costs and expenses from the company, regardless of the ultimate success or failure of the derivative action. Notably, section 165 of the Act does not exclude the general discretion of the courts to determine costs orders without being confined to the statutory provisions,⁶⁰ and it thus appears to preserve the general judicial discretion with regard to costs orders.

(c) *A right of indemnification*

On the basis of the common law and experience in other jurisdictions, it is submitted that the South African courts ought to implement, as a general rule, the following guiding principle on costs: once the court grants leave or permission under section 165 to a minority shareholder (or other applicant) to bring a derivative action, he is entitled to be indemnified by the company for his reasonable costs and expenses, save where the interests of justice or equity dictate otherwise. In other words, the successful applicant who has obtained leave under section 165 should automatically acquire a right to an indemnity from the company.

At this stage of the proceedings, the minority shareholder will have satisfied the three threshold tests for leave for a derivative action in terms of section 165(5)(b). In other words, the court at this point would be

⁵⁹ Derivative actions under s 165 are not restricted to directorial misconduct, but may also concern wrongdoing by third parties or outsiders. For the purpose of convenience, this article refers mainly to wrongdoing directors.

⁶⁰ *Foyster v Foyster Holdings Pty Ltd (prov liq apptd)* (2003) 44 ACSR 705 at 708, and *Charlton v Baber* (2003) 47 ACSR 31 are Australian authority for the preservation of the general judicial discretion with regard to costs orders.

satisfied that the applicant is acting in good faith, that there is a serious question to be tried, and that the pursuit of the substantive derivative action is in the best interests of the *company* itself.⁶¹ It consequently is just and proper that, from this stage onwards, the company itself should bear the financial risk and the reasonable costs of the derivative proceedings — regardless of whether the substantive action ultimately fails or succeeds — since the company is the true plaintiff whose rights are being vindicated and to whom any recovery will flow.

It is only in exceptional circumstances that the company should be relieved from paying the costs, that is, where it would be unjust or inequitable to require the company to do so. This could arise, for instance, if the company is financially unable to bear the costs. Conversely, neither the financial need of the minority shareholder nor his wealth should disqualify him from indemnification, as the minority shareholder seeks the remedy not for himself personally but for the company.

Authority for this approach may be derived both from South African common law as well as from other comparable jurisdictions (which are discussed in paragraph III(a) below). The rationale at common law for an indemnity was cogently explained by Lord Denning MR in the renowned case *Wallersteiner v Moir (No 2)*⁶² as follows:⁶³

‘[T]he minority shareholder, being an agent acting on behalf of the company, is entitled to be indemnified by the company against all costs and expenses reasonably incurred by him in the course of the agency. This . . . arises on the plainest principles of equity. . . . Seeing that, if the action succeeds, the whole benefit will go to the company, it is only just that the minority shareholder should be indemnified against the costs he incurs on its behalf.’

Although *Wallersteiner’s* case concerned the common-law derivative action (which is now abolished in South Africa),⁶⁴ the broad principles laid down by the English Court of Appeal continue to be relevant to the new statutory derivative action in South African law. The conditions for an indemnity, as laid down in *Wallersteiner’s* case, are instructive. Buckley LJ stated that the company should normally be liable for the shareholder’s costs, provided that the shareholder brings the derivative

⁶¹ For a full discussion of the operation of s 165, the leave application and the three gateways for leave, see Maleka Femida Cassim op cit note 29.

⁶² [1975] QB 373 (CA). South African company law was historically based on English company law under the previous regime.

⁶³ *Idem* at 391–2.

⁶⁴ Section 165(1) of the Act.

action in *good faith* and on *reasonable grounds*.⁶⁵ Lord Denning MR added that the initiation of the action must be a reasonable and prudent course to take in the *interests of the company*.⁶⁶

It is of manifest significance that these common-law conditions for an indemnity or *Wallersteiner* order are the precise statutory prerequisites that a minority shareholder must now satisfy under section 165(5)(b) of the Act in order to obtain leave for a derivative action. Accordingly, a successful applicant who is granted leave under section 165 will already have fulfilled all the conditions for a *Wallersteiner* order. He thus rightly deserves to be indemnified by the company, from that stage onwards.

The practical consequences stemming from an indemnity — in the event of the ultimate success of the actual derivative action or its eventual failure — are as follows:⁶⁷

‘If the action succeeds, the wrongdoing director will be ordered to pay the costs: but if they are not recovered from him, they should be paid by the company. And all the additional costs (over and above party and party costs) should be taxed on a common fund basis and paid by the company.

. . . But what if the action fails? . . . [T]he minority shareholder . . . 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. In addition, he should himself be indemnified by the company in respect of his own costs even if the action fails’ (emphasis added).

These are, with respect, useful guidelines for the South African courts to follow in their application of section 165(10) of the Act.

The drawback or danger, however, is that the common-law approach to indemnification was not fully cemented. By contrast to *Wallersteiner’s* case, *Smith and Others v Croft and Others*⁶⁸ took a more restrictive approach, and held that interim funding orders for the imposition of costs on the company should be made only if the plaintiff could show a genuine financial need. On the *Smith v Croft* approach, the plaintiff’s financial status is taken into account, with the result that wealthy minority shareholders would be barred from obtaining indemnification. The financial needs test is glaringly inappropriate, for it is at odds with the essential nature of the derivative action. The plaintiff shareholder

⁶⁵ *Supra* note 62 at 403–4.

⁶⁶ *Idem* at 392.

⁶⁷ *Idem* at 391–2.

⁶⁸ [1986] 2 All ER 551.

litigates not for himself, but on behalf of and for the direct benefit of the company. Not even affluent shareholders would be prepared to risk their own wealth to litigate on behalf of another. The financial needs test, significantly, was rejected in a later English case,⁶⁹ in which an indemnity order was granted to a wealthy plaintiff.

It is respectfully submitted that the South African courts in applying section 165(10) must decisively reject the financial needs test of *Smith v Croft* if the new statutory derivative action is to take root in our law. As Lord Denning MR⁷⁰ so incisively put it, '[i]t 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'.

(d) *Timing of the order*

It is submitted that the order of indemnification or costs order ought to be made by the South African courts at the stage at which leave is granted to pursue a derivative action, on the basis explained above. To delay the order until the conclusion of the substantive action would be to create uncertainty and much inconvenience over the litigation costs. It is regrettable that the first South African case on the new statutory derivative action, *Mouritzen v Greystones Enterprises (Pty) Ltd and Another*,⁷¹ took such a tentative approach. Although the court granted leave for the derivative action, it reserved the issue of costs for determination by the court hearing the substantive action.⁷² Such reservations of costs impose a daunting financial disincentive for prospective applicants, which would undermine the effective use of the remedy by minority shareholders and others, to the ultimate detriment of the companies on whose behalf they sue. It is advisable for future courts to espouse a more balanced and robust approach to orders for costs and indemnification, which would give confidence and assurance to litigants suing derivatively.

A distinction must be drawn between the costs of the substantive derivative action itself and the costs of the prior application to court in terms of section 165 for leave to bring the derivative action. The former is discussed in the paragraph above. Regarding the latter, the unsuccessful applicant would (and should) usually be held liable for the costs of a failed application. On the other hand, a successful applicant should, as

⁶⁹ *Jaybird Group Ltd v Greenwood and Others* [1986] BCLC 319.

⁷⁰ *Wallersteiner v Moir (No 2)* supra note 62 at 392.

⁷¹ 2012 (5) SA 74 (KZD).

⁷² *Idem* para 67.

a general rule, be entitled to the immediate payment or reimbursement by the company of the costs that he has incurred in bringing the application for leave. The court is clearly empowered to make such an order in terms of section 165(10) of the Act. It is disappointing that *Mouritzen's* case declined to do so, and instead reserved the costs of the leave application also for determination by the court hearing the actual derivative action.⁷³ This narrow, conservative and retrograde approach unreasonably burdens shareholder litigants. One hopes that it does not set a trend in South African law.

(e) *Interim costs*

It is respectfully submitted that in appropriate circumstances a shareholder who has obtained leave to bring a well-founded derivative action should be given access to corporate funds, on an ongoing basis, to finance the litigation, provided that the company is financially prosperous or financially able to fund the derivative proceedings. An interim costs order in favour of the shareholder will alleviate the burden on him and ensure that he is not discouraged by a lack of funds from maintaining the substantive proceedings or by financial inability to meet the interim costs and expenses until the finalisation of the action. Furthermore, an indemnification in itself does not necessarily give the shareholder priority over the unsecured creditors, as pointed out in the English case *Qayoumi v Oakhouse Property Holdings Plc and Others*.⁷⁴

The prospect of an award of interim costs is implicit in section 165(10) of the Act, but a preferable approach would have been an explicit statutory provision for interim costs, along the lines of the Canadian legislation. In so far as the Canadian legislation specifically permits complainants to apply to the court for the interim payment of costs by the company, including legal fees and disbursements,⁷⁵ it sends a clear signal to shareholder litigants to seek relief.

(f) *Security for costs*

The South African court, in its discretion, may require the minority shareholder in derivative proceedings to provide security for costs.⁷⁶ For a number of reasons this provision is open to criticism. First, the costs

⁷³ *Idem* para 68.

⁷⁴ [2000] 1 BCLC 352.

⁷⁵ Although the applicant may be held accountable to repay the interim costs on final disposition of the application or the action; see the Canada Business Corporations Act 1985, s 242(4); Ontario Business Corporations Act, 1990, s 249(4).

⁷⁶ Section 165(11).

and the attendant amount of security required to cover them may be formidable, in view of the number of parties to a derivative action and the company's ability to indemnify⁷⁷ its defendant directors for the costs of a successful defence. It is the nature of derivative litigation for cases to be lengthy and complex and, while the true defendants have substantial financial resources at their disposal, the individual shareholder usually does not. Secondly, the minority shareholder, who must furnish security early in the legal proceedings, faces up-front costs in pursuing the action even if he is ultimately victorious.

Thirdly and most importantly, there is no true rationale for a security for costs provision. It is ostensibly designed to curb strike suits and secret settlements.⁷⁸ But as incisively contended in United States law, in which this mechanism is rooted, a demand for security for costs is no true antidote to strike suits. Where predatory shareholders bring actions directed at extorting a settlement in which the company (rather than the true defendants) pays the shareholder, the more correct and more obvious solution is to bar collusive settlements.⁷⁹ This is precisely what section 165(15) of the Act already does. So why have a provision for security for costs?

An alternative rationale is that an order for security for costs could be prompted by a desire to protect the financial resources of the company and the defendant directors,⁸⁰ particularly if there is a chance that the minority shareholder will be unable to meet their legal costs should the derivative action fail. But as a matter of principle, minority shareholders should not be disqualified from protecting corporate rights by reason of their lack of personal wealth. In any event, there are other mechanisms for shielding the financial interests of both the company and the defendant directors (that is, the company is protected by the leave procedure which is conceived specifically to filter out corrupt and frivolous actions, while the defendant directors are usually protected by indemnification and insurance in terms of section 78 of the Act).

It is significant that in the United States the use of security for costs statutes has now, for strategic reasons, effectively fallen by the wayside. Prior to the 1970s, United States shareholders were required to post a

⁷⁷ See further para IV below.

⁷⁸ See, for example, *Cohen v Beneficial Industrial Loan Corp* supra note 5.

⁷⁹ George D Hornstein 'New aspects of stockholders' derivative suits' (1947) 47 *Columbia LR* 1 at 1, 3 and 5.

⁸⁰ The Australian Corporations Act 2001 does not expressly provide for orders for security for costs. However, according to *Fiduciary Ltd v Morningstar Research Pty Ltd* (2005) 53 ACSR 732 at 744 and *Charlton v Baber* supra note 60, the legislation would permit an order for security for costs to protect the interests of the company.

deposit for the company's legal expenses,⁸¹ and this trend was followed in several United States states by the enactment of security for expenses statutes.⁸² But these statutes were subject to increasing criticism, for their true effect was to pose a serious obstacle to shareholders and to discourage even meritorious derivative actions.⁸³ Such ill effects are likely to be felt even more strongly in the South African environment, bearing in mind that, unlike the United States, South Africa does not have a litigious culture, and litigiousness is further disciplined by the 'loser pays' rule of costs.

Once again, like the previous South African Companies Act 61 of 1973, which empowered the court to order applicants to furnish security (for the costs of the application as well as the often substantial costs of the provisional curator ad litem),⁸⁴ a costs barrier is erected against the applicant which could easily reduce the effectiveness of the new remedy in South African law. It is noteworthy that Canadian legislation, perhaps relying on the experience of the United States, specifically forbids an order of security for costs as a precondition to a derivative suit.⁸⁵ It is submitted that section 165(11) of the Act ought to be amended to prohibit or disempower the courts from ordering minority shareholders and other derivative litigants to furnish security for costs, whether in connection with an application for leave or in connection with the action brought or intervened in pursuant to the grant of leave. Pending such amendment, the South African courts ought staunchly to refuse to burden derivative litigants with the additional hindrance of an order of security for costs.

(g) *Remuneration and expenses*

According to section 165(9)(a) of the Act, if the court grants leave to an applicant under section 165 for a derivative action, the court must also make an order stating who is liable for the remuneration and expenses of 'the person appointed'. This provision is ambiguous, and it is uncertain to whom 'the person appointed' refers. It may be intended to refer to the person who was appointed by the company⁸⁶ to investigate the demand,

⁸¹ *Cohen v Beneficial Industrial Loan Corp* supra note 5.

⁸² For example, New York (NY Bus Corp Law s 627) and the previous Model Business Corporation Act (1969) before 1982 (s 249). Notably, Delaware did not enact a security for expenses statute.

⁸³ See, for example, *McClure v Borne Chemical Co.* 292F 2d 824, 829 (3rd Cir 1961).

⁸⁴ Section 268 of the Companies Act 61 of 1973.

⁸⁵ Canada Business Corporations Act, 1985, s 242(3); Ontario Business Corporations Act, 1990, s 249(3).

⁸⁶ Under s 165(4).

or it could perhaps be intended to mean the person who is granted leave by the court to conduct the derivative action. Neither interpretation is free of problems. This provision is a gremlin in the Act that requires clarification by legislative amendment.

(h) Personal recovery by shareholders

While the South African Act does not allow for individual or personal recovery by shareholders in derivative actions, this is permitted in several jurisdictions, including Canada, New Zealand and Ghana.⁸⁷ The United States courts have also departed in some cases⁸⁸ from the general principle of giving relief only to the company and have, in the interests of justice, allowed payment to be made directly to shareholders of the harmed company.

The inclusion in the South African Act of a judicial power or discretion to award individual recovery to former or current shareholders would be useful in preventing inequitable results in certain exceptional circumstances. If, for instance, the shareholders at the time of the corporate injury are not shareholders at the time of the legal action, an order for pro rata relief in favour of *former* shareholders who had sold their shares at an undervalue would avoid the unjustified and undeserved enrichment of new shareholders who had bought their shares after the wrongdoing. It would thus prevent situations like the one in *Regal (Hastings) Ltd v Gulliver*,⁸⁹ where the inability to make such an order resulted in the new controllers of the company effectively recovering an undeserved portion of their purchase price which they had willingly undertaken to pay. As for an order for pro rata relief directly to *current* shareholders, this may avert abuse where the true defendants in a derivative action are the majority shareholders or controllers of the company, who are able to repeat the wrongdoing or to use the proceeds of the derivative action for other purposes, thereby denying individual shareholders of the company any (direct or indirect) benefit of the recovery.⁹⁰ In certain cases, an order of pro rata relief to individual shareholders *excluding* the wrongdoers may be useful in debarring the wrongdoers or their supporters from perversely sharing (directly or

⁸⁷ Respectively, Canada Business Corporations Act, 1985, s 240(c); Ontario Business Corporations Act, 1990, s 247(c); New Zealand Companies Act, 1993, s 167(d); Ghana Companies Code 1963, s 210(8).

⁸⁸ See, for example, *May v Midwest Refining Co*, 121 F.2d 431 (C.A.1 1941); *DiTomasso v Loverro* 250 App Div 206, 293 NYS 912 (1937).

⁸⁹ [1967] 2 AC 134.

⁹⁰ A J Boyle *Minority Shareholders' Remedies* (2002) 85.

indirectly) in the recovery. Furthermore, the possibility of payment of compensation directly to shareholders is a positive incentive for minority shareholders to take the initiative of instituting a derivative action.

If, however, the discretion to order pro rata relief to shareholders is made available in South African law, it must be exercised sparingly and reserved for exceptional situations. The general rule must remain that the essence of the derivative action is to seek relief directly for the benefit of the company. To use this power too readily would be to blur the line between personal remedies for shareholders and the derivative action for corporate redress. It could also encourage strike suits aimed primarily at personal benefit for applicants.

(To be continued.)
