

*OBSTACLES AND BARRIERS TO THE
DERIVATIVE ACTION: COSTS ORDERS
UNDER SECTION 165 OF THE COMPANIES
ACT OF 2008 (PART 2)*

MALEKA FEMIDA CASSIM*

Senior Lecturer, Department of Mercantile Law, University of Pretoria

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III LESSONS FROM COMPARABLE JURISDICTIONS

(a) Support for a right of indemnification

The submission is made in paragraph II above that the South African courts should extend the principled approach to costs orders propounded in *Wallersteiner v Moir (No 2)*⁹¹ to costs orders under section 165 of the Act, so as to grant to shareholders, who have already obtained leave for a derivative action, a mandatory right to an indemnity from the company (save in exceptional circumstances). This proposal is bolstered by substantial authority in comparable jurisdictions. Other Commonwealth jurisdictions have also espoused the *Wallersteiner* approach to costs orders, whether directly in legislation or through decisions of the courts.

In this regard, New Zealand law has effectively codified the indemnity order in the Companies Act⁹² itself. By contrast, in Canadian law it has been implemented by the courts. The well-known case *Turner v Mailhot*⁹³ relied on the conditions laid down in *Wallersteiner v Moir* to rule that an applicant who obtains leave for a statutory derivative action establishes a prima facie right to an indemnity or order of costs from the company.

In the United Kingdom, the discretionary power of the court to award pre-emptive costs orders or indemnity orders in favour of derivative claimants is now codified in rule 19.9.E of the Civil Procedure Rules 2000.⁹⁴ It was found in *Wishart v Castlecroft Securities Ltd*⁹⁵ that courts

*MBBCh (cum laude) LLB (cum laude) LLM (cum laude) (Wits). Senior Lecturer, Department of Mercantile Law, University of Pretoria. Attorney and Notary Public of the High Court of South Africa.

⁹¹ [1975] QB 373 (CA); see para II(c) above.

⁹² New Zealand Companies Act 1993, s 166; see para II(b) above.

⁹³ [1985] OJ No 251; 50 OR (2d) 561; 28 BLR 222 (HCJ).

⁹⁴ Previously rule 19.9(7) of the 1998 Rules.

⁹⁵ [2009] CSIH 65; 2010 SC 16; [2010] BCC 161.

have the power to make declaratory conditional orders in leave proceedings as to the costs of the main derivative litigation. The approach in *Wallersteiner* was applied in *Stainer v Lee*⁹⁶ in the context of the new statutory derivative action in the UK, pursuant to which the court decided that the claimant was entitled to be indemnified for his reasonable costs.

Likewise, the Federal Court of Australia in *Wood v Links Golf Tasmania Pty Ltd*⁹⁷ referred with approval to *Wallersteiner v Moir (No 2)* and proceeded to adopt the common-law principle that if the shareholder's action 'is bona fide to protect the [company] and the [company] will receive the benefit of success, there is no good reason why the expenses should be met out of the private resources of [the shareholder]'.⁹⁸ The court qualified this dictum by stating that costs orders may be refused in certain countervailing circumstances. In *Wood's* case⁹⁹ Finkelstein J plainly declared that:

'The purpose of permitting a person to bring an action in the name of the company is to prevent conduct which involves some element of harm. In most cases the wrongdoer will be in control of the company. That will be the reason the company itself is not bringing the action. The purpose of [the derivative action] is to increase the likelihood that someone brings a claim which the company ought to have commenced. In those circumstances, I can think of no good reason why the company should not bear the costs.'

It was consequently ordered in *Wood's* case that the company must meet the fair and reasonable costs of the action.¹⁰⁰

There thus is ample (though not consistent or unwavering)¹⁰¹ support for the proposal (made in paragraph II above) that the South African courts, when granting permission to an applicant to pursue a derivative action, should effectively implement a presumption in favour of company funding. This may be done by means of a judicially recognised right to an indemnity from the company, except where it would be unjust or inequitable in the circumstances.

⁹⁶ [2010] EWHC 1539 (Ch); [2011] BCC 134. This was subject to a limit of £40 000 since the amount of likely recovery was uncertain.

⁹⁷ *Supra* note 56 para 5.

⁹⁸ *Farrow v Registrar of Building Societies* [1991] 2 VR 589 at 595 in *Wood v Links Golf Tasmania Pty Ltd* *supra* note 97 para 5.

⁹⁹ *Wood* *supra* note 56 para 9.

¹⁰⁰ The court also noted that the order could be recalled at a later stage if the claim subsequently turned out to be unmeritorious; in this regard, see para III(c) below.

¹⁰¹ See further para III(b) below.

While the approach of most Commonwealth jurisdictions to the obstacle of costs is to allow the court a discretion to indemnify the plaintiff shareholder for costs incurred or to be incurred, a closer analysis reveals that there are serious flaws in the practical operation of indemnity and costs orders.¹⁰² The USA, by contrast, follows a different approach that resolves the issue of costs more successfully. The upshot is that the derivative suit in the USA is a much more successful tool for the control of the conduct of directors, as evidenced by the empirical studies discussed above.

Two features in particular make the derivative action more feasible in the USA. First, unlike the Commonwealth jurisdictions in which the indemnity orders are merely discretionary rather than mandatory, the US rule is that the corporation *must* pay the attorney's fees of the successful plaintiff.¹⁰³ This is referred to as the 'common fund' doctrine. Secondly, a plaintiff suing derivatively in the US has recourse to the contingency fee system, whereby fees are charged only if the lawsuit is successful or is settled out of court, usually at a rate of 20 to 30 per cent of the award to the company. The rejection of the 'loser pays' rule or fee-shifting in the USA means that each party pays his own attorney, whether he wins or loses the case. These favourable fees rules have resulted in the creation of a specialised plaintiffs' bar.¹⁰⁴

While a vigorous contingency fee system may not be practicable in South African law at this juncture, the former feature of US law (that is, the 'common fund' doctrine) is instructive. The basis of the 'common fund' doctrine is that if the litigation instituted by the plaintiff produces a common fund or recovery that benefits a class of persons (or an entity in which a class of persons has an interest), the reasonable legal expenses of the plaintiff may be deducted from the recovery. Since a whole class of persons benefits from the action, fairness dictates that they should contribute equally to the litigation expenses, for to do otherwise would be to unjustly enrich the corporation at the expense of the plaintiff.¹⁰⁵ This highly sensible doctrine may be contrasted with the much weaker position of the shareholder in South Africa and Commonwealth jurisdictions, where even successful derivative litigants run the risk of

¹⁰² See para III(b) below.

¹⁰³ See, for example, *Sprague v Ticonic National Bank*, 307 US 161 (1939). This rule originated in *Trustees v Greenough*, 105 US 527 (1881) and *Central Railroad & Banking Co. of Georgia v Pettus*, 113 US 116 (1885).

¹⁰⁴ Mark J Loewenstein 'Shareholder derivative litigation and corporate governance' (1999) 24 *Delaware Journal of Corporate Law* 1 at 1–2.

¹⁰⁵ *Mills v Electric Auto-Lite Co.*, 396 US 375, 396 (1970).

suffering a personal net loss in pursuit of the company's success.¹⁰⁶ The possibility of the unjustified enrichment of the company ought to be borne in mind by the South African courts when formulating costs orders in favour of shareholder litigants. To avoid unjustified enrichment, where the costs of the successful shareholder are not recovered from the wrongdoing directors (or other defendant), they should be paid by the company, as should all additional costs over and above party and party costs.

The US courts use two methods to calculate attorneys' fees in derivative litigation. If the case generates a common (monetary) fund the percent method applies, pursuant to which the attorney's compensation consists of a percentage, usually 20 to 30 per cent,¹⁰⁷ of the amount awarded to the company in the derivative action. If, on the other hand, the derivative action does not produce a monetary recovery for the corporation but produces a substantial non-monetary benefit (whether by judgment or settlement), the substantial benefit test is used.¹⁰⁸ An example of a substantial non-monetary benefit (or intangible relief) is where a derivative action brings about major changes to the management or power structure of the corporation designed to prevent future misconduct.¹⁰⁹ Despite the absence of a financial recovery, the corporation is none the less ordered in these cases to pay the fees of the plaintiff's attorney,¹¹⁰ who is remunerated by the 'lodestar' method for the number of hours reasonably spent at the applicable market hourly rate.¹¹¹ The substantial benefit test is a clear recognition that the benefits of a derivative action extend beyond mere monetary compensation for harmed companies, and that the remedy may validly generate intan-

¹⁰⁶ That is, to the extent that their costs and expenses are either not recovered or not recoverable from the wrongdoing defendants.

¹⁰⁷ See, for example, *In re Oracle Securities Litigation*, 852 F.Supp. 1437 (N.D.Cal., 1994); *Thomas v Kempner*, 398 A.2d 320 (Del.Ch., 1979).

¹⁰⁸ This is an extension (sometimes referred to as an exception) of the 'common fund' doctrine.

¹⁰⁹ *Fletcher v A. J. Industries, Inc*, 266 Cal.App.2d 313, 72 Cal.Rptr. 146 (Cal.App.1.Dist. 1968).

¹¹⁰ See, for example, *Bosch v. Meeker Co-op. Light and Power Ass'n*, 257 Minn. 362, 101 N.W.2d 423 (MINN 1960).

¹¹¹ See, for example, *Shlensky v. Dorsey*, 574 F.2d 131 (C.A.Pa., 1978). The lodestar method may also be used where a common fund is generated, but the courts prefer to use the percent method in these cases. See also *Southerland v. International Longshoremen's and Warehousemen's Union, Local 8*, 845 F.2d 796 (9th Cir. 1987); *Cohan v Loucks*, No 12,323, 1993 Del. Ch. LEXIS 99 (Del Ch June 11, 1993), reprinted in (1994) 19 *Delaware Journal of Corporate Law* 697; *Good v Texaco, Inc*, No 7501, 1985 WL 11536 (Del Ch Feb 19, 1985), reprinted in (1985) 10 *Delaware Journal of Corporate Law* 854. The lodestar figure may be adjusted upward or downward by the court, depending on a number of other factors (*Hensley v Eckerhart*, 461 US 424, 433 (1983)).

gible, yet valuable, relief for companies. The South African courts, in making indemnification and costs orders, should consequently avoid the temptation to limit or cap these orders to the amount of the company's likely or actual financial recovery (as done for instance in the UK case *Stainer v Lee*).¹¹² The derivative action is not merely a remedial device to obtain patrimonial compensation for corporate wrongs, but is equally a deterrent mechanism to prevent future management abuses (as previously discussed).

(b) *Flaws in indemnity and costs orders: Inconsistencies in approach*

A closer examination of the judicial trends and approaches in common law jurisdictions reveals serious flaws and stumbling blocks that must be avoided by the South African courts. Despite the high level of support for the *Wallersteiner* approach, the judicial stance on indemnity and costs orders in these jurisdictions has not always been uniform or consistent.

In Australian law, some progressive dicta initially were made that a person with judicial permission or leave to pursue a claim on behalf of a company 'should be protected, as to costs, by the company itself' on the grounds that he is 'the surrogate of the normal corporate decision makers whose decision has not been forthcoming'.¹¹³ None the less, it effectively became the common practice for Australian courts to require the shareholder in the first instance to bear the burden of costs.¹¹⁴ Even if the company was prosperous, the Australian courts were reluctant to grant costs orders against it.¹¹⁵ An empirical analysis of all decisions on the new Australian statutory derivative action in the first five years of its operation¹¹⁶ revealed that the company was ordered to pay the applicant's costs for the leave application in only 21 per cent of successful applications, and the costs of the actual derivative action in none of the cases surveyed. The courts have even contrarily or perversely ordered the shareholder in some cases to bear all or part of the *company's* costs in relation to the derivative proceedings, with the misguided intention of

¹¹² *Supra* note 96.

¹¹³ *Foyster v Foyster Holdings Pty Ltd (prov liq apptd)* (2003) 44 ACSR 705 para 13.

¹¹⁴ As acknowledged in *Sub Rosa Holdings Pty Ltd v Salsa Sudada Production Pty Ltd* [2006] NSWSC 916 para 49; see also *Wood v Links Golf Tasmania Pty Ltd* *supra* note 56 para 9.

¹¹⁵ See, for example, *Ehsmann v Nutectime International Pty Ltd* (2006) 58 ACSR 705 (though the court in this case also took into account the true defendants' stake in the company, as discussed further below in para III(c)).

¹¹⁶ Ramsay & Saunders op cit note 36 at 428.

protecting the company's financial resources.¹¹⁷ This erroneous reasoning overlooks the fundamental nature and purpose of the derivative action.

It is encouraging, however, that these conservative trends may perhaps be waning. The Federal Court of Australia, in an enlightened and lucid judgment in *Wood v Links Golf Tasmania Pty Ltd*,¹¹⁸ was sharply critical of these common practices of the Australian judiciary regarding costs orders. The court, espousing the reasoning in *Wallersteiner v Moir*, decisively declared that the company itself must generally bear the costs of derivative litigation. But bearing in mind that *Wood's* case is a decision of a single judge in a court of first instance, it would be premature to conclude that the tide has turned in Australian law. The most that may be said is that the tide is perhaps beginning to turn.

The Canadian legislation¹¹⁹ is more reassuring to prospective applicants than its South African and Australian counterparts. First, it explicitly refers to the imposition of costs orders on the *company* to bear the reasonable legal fees of the complainant, without any concomitant reference to costs orders for complainants to pay the company's costs (though the latter is not prohibited). Secondly, the legislation incorporates an express permission to seek interim costs. While on the face of it the Canadian provisions support corporate funding for shareholders, they have in practice been interpreted inconsistently and sometimes narrowly by the courts. Two main approaches emerge. The earlier and more liberal line of reasoning was laid down in *Turner v Mailhot*¹²⁰ in which the Ontario High Court, relying on the *Wallersteiner* conditions, concluded that shareholders who are granted leave for a statutory derivative action have a prima facie right to an indemnity or order of costs from the company.¹²¹ While the financial inability of an applicant to fund an action would weigh heavily in favour of an indemnity, it is not

¹¹⁷ *Roach v Winnote Pty Ltd* (2006) 57 ACSR 138 at 145; see also *Fiduciary Limited v Morningstar Research Pty Limited* [2005] NSWSC 442; 53 ACSR 732 (though in this case the court also took into account the consideration that the assertion of the claim was only one aspect of a wider dispute between the parties, as discussed further in para III(c) below). An order for indemnification for the company's costs and expenses was made in *Carpenter v Pioneer Park Pty Limited (in liq)* [2004] NSWSC 1007; 51 ACSR 299 with the rider that if the derivative action was successful and the company was compensated, the applicant could apply to court for reimbursement of these expenses.

¹¹⁸ *Supra* note 56; see para III(a) above.

¹¹⁹ See Canada Business Corporations Act, 1985, s 240(d); Ontario Business Corporations Act, 1990, s 247(d).

¹²⁰ *Supra* note 93.

¹²¹ It was stated further that the court has the discretion to set the amount on fair terms. *Turner*, in the circumstances, was given a partial indemnification; in this regard, see further para III(c) below.

a precondition for an indemnity.¹²² In other words, a shareholder's wealth, commendably, does not deprive him of an indemnity from the company.

A divergent line of Canadian cases, by contrast, established financial need as a general prerequisite for an award of interim costs.¹²³ Although a complainant will not necessarily be required to dispose of personal assets such as a home, his personal financial resources and borrowing capacity would be looked to first as a source to fund the litigation.¹²⁴ This rigid approach is based on the test in *Smith v Croft*.¹²⁵ Its rationale is that the denial of interim costs will better discipline the shareholder in the conduct of the action, as he will make litigation decisions knowing that he will not necessarily be reimbursed for the legal costs.¹²⁶ This, however, is to overshoot the mark. It is more likely to deter, rather than to temper, shareholder litigants. It is a trend that must be firmly eschewed by the South African courts, in preference for the *Turner v Mailhot* line of reasoning, discussed above.

Turning to New Zealand law, the statutory presumption in favour of company funding¹²⁷ boldly provides the greatest support for the proper funding of derivative litigation from the corporate treasury. But several New Zealand courts have surprisingly ignored the literal wording of the legislation. In the first judgment, *Vrij v Boyle*,¹²⁸ the court set the trend by refusing the shareholder's application for an indemnity for costs at the time of the grant of leave; the court instead reserved all questions of costs and indemnification pending the outcome of the full hearing, on the basis that costs follow the event. This approach is clearly at odds with the literal meaning and the intent of the legislation on awards of costs,¹²⁹ which shifts the costs of the proceedings back to the company,

¹²² *Turner v Mailhot* supra note 93 at 567.

¹²³ *Intercontinental Precious Metals Inc. v Cooke* (1994) 10 BLR (2d) 203 (BCSC) 224; *Johnson v Meyer* [1987] SJ No 668, 62 Sask R 34 at 40 (QB), which stated that interim costs may be awarded in a derivative action where it is financially necessary to ensure that the action proceeds.

¹²⁴ *McKay v Munro* (1992) 119 NSR (2d) 195 (NSSCTD).

¹²⁵ Supra note 68; see para II(b) above.

¹²⁶ *Intercontinental Precious Metals v Cooke* supra note 123; *Primex Investments Ltd v Northwest Sports Enterprises Ltd* (1995) 13 BCLR (3d) 300 (BCSC).

¹²⁷ See para II(b) above; see also *Stichbury v One4All Ltd* (2005) 9 NZCLC 263,792 (HC).

¹²⁸ [1995] 3 NZLR 763.

¹²⁹ Section 166 of the New Zealand Companies Act 105 of 1993 states that the court shall, on the application of the shareholder or director to whom leave was granted to bring or intervene in the proceedings, order that the whole or part of the reasonable costs of the proceedings must be met by the company unless the court considers that it would be unjust or inequitable for the company to bear those costs.

first, from the time of the leave application¹³⁰ and, secondly, *irrespective* of the outcome of the substantive action. It is noteworthy that a New Zealand court¹³¹ has pronounced, similarly to the ill-advised line of Canadian decisions above, that ‘[t]he discipline which costs provide in the conduct of litigation cannot be overstated’.

Subsequent to *Vri v Boyle*, orders were made in some cases that the company itself meet the costs of the derivative proceedings.¹³² But in the majority of cases, as shown by empirical data, the New Zealand courts have not ordered the company to bear the costs, often because the applicant does not apply for a costs order,¹³³ or even undertakes to bear the costs himself.¹³⁴ A strong motivation is that many applicants use the successful leave application as a tactic to facilitate a settlement of the dispute with the company and its directors, without actually commencing a substantive derivative action.¹³⁵

The decisions within the various Commonwealth jurisdictions have thus been discordant on the thorny issue of awards of costs. The South African courts would do well to avoid such uncertainty and unpredictability. This may be attained by building up a carefully reasoned framework for costs orders, resting on firm and principled foundations.

(c) *Pitfalls and traps to be avoided*

Equity demands that the South African courts should effectively implement a general principle, as proposed in paragraph II above, that successful applicants, who have obtained leave to bring a derivative action under section 165, have an automatic right of indemnification by the company, regardless of the outcome of the substantive derivative action, unless the strict interests of justice or equity dictate otherwise. For instance, an indemnity would be unjust or inequitable if the company is financially unable to bear the costs,¹³⁶ or if the company’s

¹³⁰ The application under s 166 of the New Zealand Act would usually be made at the time of leave application under s 165 of that Act.

¹³¹ *Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd (No 2)* [1993] 2 NZLR 617 at 682, which concerned a derivative action brought under the Securities Amendment Act 1988 (NZ).

¹³² For example, *MacFarlane v Barlow* (1997) 8 NZCLC 261,470.

¹³³ For example, *Thorrington v McCann* (1997) 8 NZCLC 261,564.

¹³⁴ Taylor op cit note 39 at 355, 362.

¹³⁵ Ibid.

¹³⁶ In Australian law, see *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313 para 75; *Carpenter v Pioneer Park Pty Limited (in liq)* supra note 117 para 20; *Wood v Links Golf Tasmania Pty Ltd* supra note 56 para 12. In New Zealand law, see *Re Kambrook Manufacturing (NZ) Ltd* HC Wellington M505/95, 23 May 1996.

claim is only one aspect of a much wider dispute between the parties.¹³⁷

However, drawing on the experience in comparable jurisdictions, a number of traps and pitfalls come to light, which should be pre-empted in South African law. Foremost among these snares is the test of financial hardship or the financial inability of the minority shareholder (or other applicant) to bear the costs. This test is unsound in principle, on the basis explained above,¹³⁸ and should be discarded as a prerequisite for an indemnity from the company. Other stumbling blocks to be avoided by South African courts include the following:

- (i) *The strength of the claim on its merits*.¹³⁹ Bearing in mind that a shareholder who has obtained leave to bring a derivative action under section 165 of the Act would already have established that the claim has sufficient merit for leave to be granted,¹⁴⁰ it would be odd and peculiar for the courts to revisit the merits of the action and its prospects of success when considering the shareholder's entitlement to an indemnity from the company.¹⁴¹ It would also result in time-consuming and expensive mini-trials or interim trials on the merits, thereby undermining the objectives of the new leave procedure.¹⁴²
- (ii) *The true defendant's stake in the company*: Where the true or real defendants have a substantial stake in the company, it has been contended that an indemnification by the company effectively obliges him to fund legal proceedings against himself,¹⁴³ particularly in small quasi-partnership companies or owner-managed companies. This reasoning is faulty, for it flouts the cardinal principle that the company is a separate legal entity distinct from its

¹³⁷ *Fiduciary Limited v Morningstar Research Pty Limited* supra note 117, approved in *Wood v Links Golf Tasmania Pty Ltd* supra note 56 para 10.

¹³⁸ See further paras II(c) and III(b) above.

¹³⁹ Some restrictive foreign decisions have considered indemnities and interim costs orders as an exceptional remedy to be withheld when there are doubts about the merits of the proceedings. In this regard, in Canadian law, see *Intercontinental Precious Metals v Cooke* supra note 123; *Primex Investments Ltd v Northwest Sports Enterprises Ltd* supra note 126. In New Zealand law, see *Needham v EBT Worldwide Ltd* (2006) 3 NZCCLR 57 (HC).

¹⁴⁰ Section s 165(5)(b)(ii) of the Act provides that the court, in order to grant leave, must be satisfied that there is a serious question to be tried.

¹⁴¹ See, for example, William Kaplan & Bruce Elwood "The derivative action: A shareholder's "Bleak House"?" (2003) 36 *University of British Columbia LR* 459 at 465.

¹⁴² See Maleka Femida Cassim op cit note 19.

¹⁴³ In New Zealand law, see *Frykberg v Heaven* (2002) 9 NZCLC 262,966; fortunately, *Presley v Callplus Ltd* [2008] NZCCLR 37 (HC) reduced the significance of this factor in New Zealand law. In Australian law, see *Ehlsman v Nutectime International Pty Ltd* supra note 115; *Fiduciary Limited v Morningstar Research Pty Limited* supra note 117. (See also the English cases *Halle v Trax BW Ltd* [2000] BCC 1020 and *Mumbray v Lapper* [2005] EWHC 1152 (Ch); [2005] BCC 90.)

shareholders, regardless of its size; it is the indemnifying company that would fund the derivative action, not its shareholders. Moreover, the true defendant (who frequently is a wrongdoing director) is often indemnified by the company or is insured at the company's expense — with the result that the harmed company effectively funds the defence of the alleged wrongdoer who has harmed it.¹⁴⁴

- (iii) *Whether the benefit is sought more for the company or more for the plaintiff:*¹⁴⁵ This controversial issue arises from the overlap and a blurring of the lines between personal actions, which are brought for personal redress by shareholders, and derivative actions, which are brought by shareholders seeking redress on behalf of the company.
- (iv) *The likely amount of the recovery:*¹⁴⁶ To cap an indemnity or to limit it to the likely amount of the company's financial recovery, is to ignore the primary rationale of the derivative action, which is not only aimed at obtaining monetary benefits or compensation for the company, but also at chilling future directorial misconduct and promoting accountability. Once an indemnity is justified in principle, the applicant ought to be indemnified in full, for all his reasonable costs and expenses.¹⁴⁷
- (v) *Conflation with the leave application:* Some foreign decisions have held, in the context of the application for leave to bring a derivative action, that it substantiates an applicant's claim that he is acting in good faith and/or in the interests of the company where he is willing and able to fund the derivative action himself.¹⁴⁸ This test would conflate the leave application (under section 165(5) of the

¹⁴⁴ See further para IV below.

¹⁴⁵ In Canadian law, see *Turner v Mailhot* supra note 93, where the court found that the action involved a struggle between Turner and Mailhot, rather than one for the advantage of the company (para 6). As a result, the plaintiff's indemnity was restricted to 50% of his total costs.

¹⁴⁶ The UK case *Stainer v Lee* supra note 96 found that the claimant was entitled to be indemnified for his reasonable costs, but since the likely amount of the recovery in the derivative action was uncertain, the court capped the indemnification at a limit of £40,000 (with liberty to extend its scope later).

¹⁴⁷ See the discussion of the 'substantial benefit' test in para III(a) above.

¹⁴⁸ In Canadian law, see *Intercontinental Precious Metals v Cooke* supra note 123. In Australian law, see *Fiduciary Limited v Morningstar Research Pty Limited* supra note 117; *Metyor Inc (formerly Talisman Technologies Inc) v Queensland Electronic Switching (Pty) Ltd* [2002] QCA 269; [2003] 1 Qd R 186; 42 ACSR 398 (in which the court, in deciding whether the application was in the best interests of the company, took into account the issue of legal costs, and the fact that '[i]t will be the plaintiffs, and not [the company], that will bear . . . the not inconsiderable costs of the proceedings' (para 19)). In New Zealand law, see *Needham v EBT Worldwide Ltd* supra note 139 paras 20 and 46; see also *Re Wilson Neill Ltd* (1993) 6 NZCLC 68,336, 68,362.

South African Act)¹⁴⁹ with the separate issue of costs and indemnification (under section 165(10) of the Act). These clearly are two separate and distinct inquiries in the South African context, and must remain so. A second defect is that this test may result in the unseemly refusal of leave to less wealthy applicants, such as individual minority shareholders, which would subvert their role as corporate watchdogs.

- (vi) *Connection between the wrongdoing and the applicant's financial inability*: The Canadian case *Barry Estate v Barry Estate*¹⁵⁰ advocated a strict three-part test consisting of the strength of the applicant's case; genuine financial need on the part of the applicant which, but for the interim costs order or indemnification, would prevent the pursuit of the claim; and some connection between the conduct complained of and the applicant's financial inability. While the first two branches of this test are discussed above, the third branch is equally objectionable, since the only actionable harm in a derivative action is harm done directly to the company, not to the shareholder or applicant.¹⁵¹ This test may be appropriate for a personal shareholder action, such as the oppression remedy — which appears to have been its origin.¹⁵² It clearly does not befit the derivative action.

IV DIRECTORS' INDEMNITY AND INSURANCE

Derivative actions are usually brought to remedy corporate harm inflicted by a miscreant director whom the board of directors improperly fails to sue. While a costs hurdle confronts the minority shareholder, or other stakeholder who seeks to vindicate the company's rights in a derivative action, the defendant director is conversely in a more favourable position. The defendant director has access to substantial corporate funds for his defence, as directors are invariably protected against legal costs and expenses by means of indemnification or insurance.

¹⁴⁹ This requires an applicant to establish his good faith and that the litigation is in the best interests of the company (s 165(5)(b)(i) and (iii)).

¹⁵⁰ [2001] OJ No 2991 (QL) (Sup Ct J).

¹⁵¹ Kaplan & Elwood op cit note 141 at 465.

¹⁵² See *Allers v Maurice* (1992) 5 BLR (2d) 146 (Ont Gen Div); *Wilson v Conley* (1990) 1 BLR (2d) 220 (Ont Gen Div); *Perretta v Telecaribe Inc* [1999] OJ No 4487.

(a) *Indemnification of directors*

A company is permitted, but not obliged, to provide funds to a defendant director to meet any expenses incurred or to be incurred in defending derivative proceedings. Section 78 of the Act states that a company may advance expenses to a director to defend litigation (including derivative litigation), or may indemnify the director whether directly or indirectly.

However if judgment is ultimately given against the director, on the basis of *wilful* misconduct or wilful breach of trust,¹⁵³ these costs must be refunded or repaid to the company.¹⁵⁴ By contrast, if a director is held liable to the company for *negligence*, not only his legal costs but also his liability remain indemnifiable by the company.¹⁵⁵

This is a peculiar provision. Its practical effect is that directors who have *negligently* harmed the company stand to lose nothing. They are free of any personal responsibility to the company, both for the payment of the award of damages to the company and for the payment of the legal costs of their defence. To permit the company to indemnify a negligent director who has harmed it is tantamount to an exemption from liability. A distinction must be drawn between directors' liability for negligence to third parties and liability for negligence to the company itself. Several US states logically prohibit indemnification against the latter.¹⁵⁶ The UK legislation similarly permits the indemnification of directors against liability for negligence to third parties by means of qualifying third party indemnity provisions,¹⁵⁷ while sensibly proscribing indemnification against liability for negligence to the company itself¹⁵⁸ (though this may be insured by means of directors' and officers' liability insurance).¹⁵⁹

It is submitted that the flaw in section 78 of the South African Companies Act in respect of indemnification ought to be corrected by the adoption of a similar distinction. On the one hand, directors' liability for negligence to *third parties* should remain indemnifiable by the company while, on the other hand, directors' liability for negligence to the *company itself* should logically be prohibited from indemnification.

¹⁵³ Or if the director's liability arises from reckless trading, or in terms of s 77(3)(a)–(c), or consists of a fine in terms of s 78(3).

¹⁵⁴ Section 78(4)–(6) read with s 78(8).

¹⁵⁵ Section 78(4)–(6).

¹⁵⁶ For example, New York (NY s 722), California (Cal s 317) and Delaware (s 145).

¹⁵⁷ Section 234 of the UK Companies Act 2006.

¹⁵⁸ Section 232(2) of the UK Companies Act 2006.

¹⁵⁹ Section 233 of the UK Companies Act 2006.

Bearing in mind that indemnification under section 78 of the South African Act is not an obligation of the company but merely an election, if the board of directors decides to indemnify a co-director who has been held liable to the company in a derivative action for negligence, the board decision may be open to challenge. The basis of the challenge is that the indemnification decision of the board is in breach of their fiduciary duty to act in good faith and in the best interests of the company. Where the negligent director's right to an indemnity is entrenched in his contract of service, questions may arise as to its enforceability.

(b) Insurance

Directors are often protected by directors' and officers' liability insurance ('D & O insurance'), especially in larger companies. A company, in terms of section 78 of the Act, may purchase insurance: (i) to protect its *directors* against any indemnifiable liability or expenses; or (ii) to protect the *company* against any contingency, including any indemnifiable liability, indemnifiable expenses or advanced expenses.

Consequently, a director who is sued for fraudulent or *wilful* misconduct may rely on his insurance only if the claim is abandoned or if he is exculpated, but not if the claim against him is successful.¹⁶⁰ The fraudulent or self-dealing director thus shoulders personal liability, which serves as compensation for the company and as a deterrent to others. On the other hand, if a director is held liable for *negligence*, his insurance may cover both the claim itself (that is, his liability for damages) and the legal costs of his defence. Insurance is particularly useful where the company is unable to indemnify a director because of financial difficulties, or where the company is unwilling to indemnify him. Unlike an indemnity, which the company has the power but not a duty to provide, an insurance policy contractually binds the insurer.

It is significant that the company often pays the D & O insurance premiums while the negligent director benefits from it. The question thus arises whether D & O insurance is effectively a shifting of liability to the company for negligent breaches of directors' duties, and whether it waters down or undermines the director's duty of care and skill. However, for several reasons, D & O insurance is essentially in the interests of the company. First, D & O insurance cover boosts the likelihood

¹⁶⁰ That is, if he is held liable for wilful misconduct or wilful breach of trust; or for reckless trading or other liability arising in terms of s 77(3)(a)–(c); or a fine in terms of s 78(3).

that the company would be compensated,¹⁶¹ given that directors who are held personally liable to the company may lack sufficient personal funds to compensate the company for its loss. Without adequate insurance cover, the legal action is practically superfluous. The court may even withhold leave for a derivative action if the defendant directors would be financially unable to meet a potential judgment in favour of the company, on the basis that it would not be in the company's best interests.¹⁶² Secondly, in the light of the vague distinction between a patent lack of care in decision-making and mere commercial misjudgements,¹⁶³ directors would be loath to engage in entrepreneurial risk-taking or to serve as directors, without insurance against directorial negligence. It is evidenced by statistics in the USA that successful derivative actions for directors' negligence or wasteful management are rare, and it is primarily intentional misconduct and self-dealing at which the derivative action is directed.¹⁶⁴

V ACCESS TO INFORMATION

In a dispute between a minority shareholder and the controllers of the company, a second major obstacle for the former is asymmetry of information. The minority shareholder's lack of access to inside corporate information, which is in the hands of the controllers and managers of the company, will block many derivative actions at the outset. For an effective derivative action, it is vital that shareholders have full preliminary information on the facts and the background underpinning the derivative action, beyond the company records available to them by right in terms of section 26 of the Act, in order to found their claim and to particularise their allegations of corporate misconduct. It must be kept in mind that, even with full and proper rights of access to corporate

¹⁶¹ Hans C Hirt 'The company's decision to litigate against its directors: Legal strategies to deal with the board of directors' conflict of interest' [2005] *Journal of Business Law* 159 at 160.

¹⁶² In terms of s 165(5)(b)(iii) of the Act; see Maleka Femida Cassim 'Judicial discretion in derivative actions under the Companies Act of 2008' (2013) 130 *SALJ* 778. However, the matter should not be solely determined by a cost-benefit analysis. Other factors, such as the deterrence value of the action, must also be considered by the court.

¹⁶³ Mere negligence is actionable in a statutory derivative action under s 165 of the Act. Directors' negligence no longer has to be self-serving to form the basis of a derivative action, by contrast with the common-law derivative action (now abolished) in which a complex distinction was made between negligence per se (which was not an exception to the rule in *Foss v Harbottle* (1843) 2 Hare 461; 67 ER 189) and negligence benefiting the wrongdoer (which qualified as fraud on the minority and was thus an exception to the rule in *Foss v Harbottle*); see *Pavlidis v Jensen* [1956] Ch 565; *Daniels v Daniels* [1978] Ch 406.

¹⁶⁴ Renee M Jones & Michelle Welsh 'Toward a public enforcement model for directors' duty of oversight' (2012) 45(2) *Vanderbilt Journal of Transnational Law* 343 at 343–65.

information, it may remain difficult for an outsider to unscramble the evidence and trail of wrongdoing.

The right to inspect the books of the company, under section 165(9)(e) of the Act, applies only on the grant of judicial leave to the shareholder to commence a derivative action. This right is of no use to the shareholder or applicant in the critical early stages of the procedure when preparing his application for leave in the first place.¹⁶⁵ This is a disappointing lacuna in the Act. A more balanced approach would be to grant to *prospective* applicants under section 165 a statutory right to apply to court to inspect the books of the company, provided that a 'proper purpose' were shown. A useful model or precedent is provided by section 247A(3) of the Australian Corporations Act, 2001.¹⁶⁶ A 'proper purpose' may include an inspection of the books for the pursuit of a reasonable suspicion that directors have been in breach of their duties,¹⁶⁷ while an application for inspection merely to challenge the wisdom of a routine business decision would fail for want of a proper purpose.¹⁶⁸ A further advantage is that the transparency that flows from allowing shareholders and other prospective applicants a right of inspection could prevent groundless derivative actions in some cases, and, in others, the knowledge of management that they are being watched could deter misconduct and mismanagement.

The investigation by an independent and impartial person or committee, in terms of section 165(4) of the Act, is an unsuitable channel for yielding information to applicants or prospective applicants. There are a number of inherent difficulties and uncertainties in this provision. First, the investigator is not armed by the Act with wide investigative powers, which may render the investigation a toothless one that may be thwarted by the directors, managers and controllers of the company. Secondly, the investigator is appointed by the company itself, presumably by the board of directors, which results in an inherent bias and is open to abuse. The board (who are often the wrongdoers or their supporters) is able to select, out of self-interest, an investigator who has a pro-defendant bias. The third problem is that the investigator reports directly to the board of directors, not to the court. The Act is silent on whether the investigator's report must inevitably be disclosed to the applicant and/or to the court.

¹⁶⁵ The applicant may be able make a request for information in reliance on the Promotion of Access of Information Act 2 of 2000; see, for example, *Davis v Clutchco (Pty) Ltd* 2004 (1) SA 75 (C).

¹⁶⁶ See *Stewart v Normandy NFM Ltd* (2000) 18 ACLC 814.

¹⁶⁷ *Humes Ltd v Unity APA Ltd (No 1)* [1987] VR 467; *Barrack Mines Ltd v Grants Patch Mining Ltd (No 2)* [1988] 1 Qd 606.

¹⁶⁸ *Re Augold NL* [1987] 2 Qd R 297.

The explicit statutory duty of the investigator is to report only to the board.¹⁶⁹ Section 165(4) may be contrasted with the previous statutory derivative action,¹⁷⁰ which turned on the appointment of a provisional curator ad litem, who was granted the same extensive investigatory powers as an inspector appointed by the Minister.¹⁷¹ The curator ad litem was appointed by the court and was duty-bound to report directly to the court. The result was an assurance of greater impartiality, a report that was more neutral and objective, and a clear right of access by both the court and the applicant to the information in the report. It is notable that the Australian legislation gives the court the discretionary power to appoint an independent person to investigate and to report directly to the court on the company's financial affairs, the relevant facts or circumstances, and the costs.¹⁷²

It is regrettable that the South African Act does not adequately address the minority shareholder's predicament of access to corporate information on which to found his derivative claim.

VI THE ROLE OF PUBLIC ENFORCEMENT

The Act still provides a useful mechanism to overcome the obstacles that the derivative litigant faces. The Companies and Intellectual Property Commission ('Companies Commission') is empowered to act as a watchdog both to investigate and to enforce violations of company law. An investigation by the Companies Commission surmounts the minority shareholder's hurdle of access to information, while derivative litigation by the Companies Commission averts the minority shareholder's risk of liability for legal costs.

To resort to this avenue, the minority shareholder (or other complainant) must first file a complaint with the Companies Commission,¹⁷³ which may in its discretion direct an investigation of the

¹⁶⁹ Although s 165(5)(a)(iii) of the Act gives the shareholder or applicant the right to challenge the report on the ground that it is unreasonable or inadequate, this does not necessarily imply that all applicants have an automatic right of access to the report. It merely means that a particular applicant may have been given access to the report.

¹⁷⁰ Under s 266 of the Companies Act 61 of 1973.

¹⁷¹ See s 267 and s 260 of the Companies Act 1973.

¹⁷² Section 241 of the Australian Corporations Act 2001. In French law, too, there is a useful role for an independent business expert or special auditor (*expert de gestion*) who is appointed by the court on petition by holders of at least 5% of the issued share capital, to examine certain management activities and to gather information on business decisions, often at the company's expense (Article 226 of the Companies Law 1966, as modified by the law of 1 March 1984). This may help to expose self-dealing by directors or the abuse by directors of corporate assets.

¹⁷³ Section 168(1).

complaint by an inspector or investigator.¹⁷⁴ Wide supporting powers are conferred by the Act to support investigations and inspections. These include the power to investigate any persons who are reasonably considered to have relevant information, the power to issue summons to appear to be questioned under oath or to compel the production of documents and other objects, and the power to enter and search premises on authorisation by a judge or magistrate and to take extracts from or make copies of any book or document that is on the premises, or to attach and remove from the premises anything that has a bearing on the investigation.¹⁷⁵ The shareholder or complainant has a right to receive a copy of the investigator's report,¹⁷⁶ and may thus gain access to valuable corporate information that would not otherwise be readily available to him. This information could be instrumental to the minority shareholder in establishing the factual and evidentiary basis for his derivative claim.

Following an investigation, the Companies Commission has the discretion to institute derivative proceedings to enforce corporate rights and duties in the name of (and with the consent of) the minority shareholder.¹⁷⁷ The interposition of the Companies Commission in this way removes the barrier of legal costs and funding that the derivative litigant would otherwise face.

An investigation and litigation by the Companies Commission would protect not only private interests within the company, but also the wider public interest in managerial accountability and enhanced investor confidence in the integrity of the corporate system. Whether this crucial link between investigations and subsequent derivative actions will materialise, remains to be seen. It ultimately depends on the manner in which the Companies Commission, in practice, exercises its powers and its discretion. A proper balance must be struck. The Companies Commission should not set the level too high, for this would defeat the purpose of the investigation. The standard of proof should be less rigorous than that required to gain relief under section 165. But by the same token, the Companies Commission should not permit its investigatory powers to be misused by shareholders to harass the management

¹⁷⁴ Section 169(1)(c).

¹⁷⁵ As set out in Part E of Chapter 7 of the Act; see ss 169(3) and 176–179.

¹⁷⁶ Section 170(2)(b).

¹⁷⁷ Section 165(16); see also s 170(1)(e).

of companies, or to embark on fishing expeditions to justify vague suspicions of mismanagement.¹⁷⁸

While it is envisaged or hoped¹⁷⁹ that part of the burden of enforcing directors' duties would ultimately be shifted from private enforcement by shareholders to public enforcement by the Companies Commission, South Africa lacks a well-established public enforcement agency that rigorously enforces company law. The legal control and the policing of boards of directors depends principally on shareholders and other suitable stakeholders to play an active role through the use of the statutory derivative action — despite the strong disincentives that they encounter. This key factor must be taken into account by the courts when exercising their discretion to grant leave to minority shareholders for derivative actions under section 165, and when exercising their discretion to indemnify from the corporate treasury the shareholders who take the initiative of pursuing litigation for the company's benefit.

Finally, it would be impractical to presume that the Companies Commission would in due course assume exclusive, or even primary, responsibility for the enforcement of corporate rights and directorial accountability. Investigations and inspections are bound to be costly. State regulatory bodies, no matter how strong or high-powered, frequently endure limitations on funding and other resources,¹⁸⁰ insufficient staff, and a dearth of experts. A key role will always remain for private enforcement, through civil actions and derivative actions initiated by aggrieved parties. For the effective deterrence and punishment of corporate misconduct in South African law, both public enforcement by the Companies Commission and private enforcement by stakeholders must be facilitated and encouraged, and both should work in tandem for the achievement of their individual objectives.

VII CONCLUSION

A framework has been suggested in this article for the proper and effective exercise of the judicial discretion to make orders of costs, which is known to have plagued minority shareholders wishing to bring

¹⁷⁸ See in this regard s 169(1)(a), which provides that the Companies Commission may refuse to investigate a complaint if it appears to be frivolous or vexatious, or does not allege facts that, if proven, would constitute grounds for a remedy under the Act.

¹⁷⁹ 'Company Law for the 21st Century' *Government Gazette* 26493 of 23 June 2004 para 2.2.3, para 4.4.1.

¹⁸⁰ Commendably, the Act (s 169(2)(b)) provides for cost sharing between the Companies Commission and the company, or even the imposition of the full costs of the investigation on the company itself, where the dispute is internal to the company.

derivative proceedings against miscreant directors who have wronged the company. The issue of the costs of the legal proceedings is the most formidable obstacle for minority shareholders who wish to litigate derivatively to vindicate the rights of the company. The framework suggested in this article for costs orders includes an automatic right to an indemnity from the company, issues relating to the timing of the order, the award of interim costs, the abolition of the requirement of security for costs, and the discretion to award personal recovery to shareholders in exceptional circumstances. It is of the utmost importance that the South African courts in making orders of costs exercise their judicial discretion with wisdom, and in a balanced and flexible manner. Overly cautious judicial decisions on this new remedy in its germinal stages could unwittingly reduce section 165 to a dead letter in our law.
