

1994

## Corporate Governance and Shareholder Remedies: The US Experience and Australia's Proposals for Reform

Cindy A. Schipani  
*University of Michigan*

Follow this and additional works at: <http://epublications.bond.edu.au/blr>

---

This Article is brought to you by the Faculty of Law at [ePublications@bond](mailto:ePublications@bond). It has been accepted for inclusion in Bond Law Review by an authorized administrator of [ePublications@bond](mailto:ePublications@bond). For more information, please contact [Bond University's Repository Coordinator](#).

---

# Corporate Governance and Shareholder Remedies: The US Experience and Australia's Proposals for Reform

## **Abstract**

There is more shareholder litigation, for better or worse, in the United States than in Australia. Perhaps some of the reasons why shareholder litigation is pursued more vigorously in the US are the ability of shareholders to retain legal counsel on a contingency fee basis, the rules requiring the corporation to pay the shareholders' attorney's fees, and the shareholder derivative suit mechanism. These remedies are not commonly available in Australia.

The objective of this paper is to address some of the issues relevant to the relative ease with which injured shareholders in the United States may pursue their claims against corporate management.

## **Keywords**

shareholder litigation, corporate governance, United States, Australia, derivative suits

## **Cover Page Footnote**

The author wishes to gratefully acknowledge the helpful comments of the participants of the Bond University School of Law Conference on Corporate Governance and Shareholder Remedies. This paper is based on the presentation of the author at the Conference. The author also wishes to gratefully acknowledge the research support of the University of Michigan.

CORPORATE GOVERNANCE AND SHAREHOLDER  
REMEDIES: THE US EXPERIENCE AND AUSTRALIA'S PROPOSALS  
FOR REFORM.



By  
**Cindy A Schipani\***  
Associate Professor  
University of Michigan

There is more shareholder litigation, for better or worse, in the United States than in Australia. Perhaps some of the reasons why shareholder litigation is pursued more vigorously in the US are the ability of shareholders to retain legal counsel on a contingency fee basis, the rules requiring the corporation to pay the shareholders' attorney's fees, and the shareholder derivative suit mechanism. These remedies are not commonly available in Australia.

The objective of this paper is to address some of the issues relevant to the relative ease with which injured shareholders in the United States may pursue their claims against corporate management. Part I considers the impact of retaining legal counsel on a contingency fee basis on shareholder litigation. This discussion leads into analysis of the rules requiring the corporation to pay the shareholders' attorney's fees if the suit is successful and includes an evaluation of the various approaches the courts have utilised to calculate the plaintiff's attorney's fee award. Part II then follows with a discussion of shareholder derivative litigation in the United States. In addition to a description of the mechanism, arguments in favour of and in opposition to the use of the derivative suit as a monitor of management in the scheme of corporate governance are addressed. Parts III and IV provide a brief outline of the roles of corporate indemnification and the availability of directors' and officers' liability insurance in situations where management has been adjudged liable to the corporation in shareholder derivative litigation. In Part V, current proposals in Australia recommending adoption of a statutory derivative suit mechanism for injured shareholders and a plan to permit plaintiffs to engage counsel on a contingency fee basis are addressed. Finally, Part VI contains concluding remarks.

---

\* Copyright 1994. All rights reserved. Cindy A Schipani, JD, 1982, University of Chicago School of Law; BA, 1979, Michigan State University. The author wishes to gratefully acknowledge the helpful comments of the participants of the Bond University School of Law Conference on Corporate Governance and Shareholder Remedies. This paper is based on the presentation of the author at the Conference. The author also wishes to gratefully acknowledge the research support of the University of Michigan.

## I. CONTINGENCY FEES IN THE UNITED STATES

Generally speaking, injured persons in the US may retain counsel either under an agreement whereby they pay their attorney on an hourly basis or where they pay on a contingent fee basis. Under a contingent fee arrangement, the plaintiff only pays the attorney if the action settles or is successfully litigated. The fee is often specified as a certain percentage of the plaintiff's recovery. Thus, shareholders in the US are fairly easily able to engage counsel to pursue their claims provided that counsel is reasonably certain that the suit can be won or settled. Of course, it is unlikely unless there are good prospects of recovery that an attorney would be willing to take a case on a contingency fee basis.

The contingency fee arrangement has its critics; concerns have been expressed that it stirs up litigation, leads to inflated jury awards, overcompensates counsel and provides incentives for unethical practices.<sup>1</sup> Unfortunately, however, it is difficult to quantify whether the contingency fee arrangement has been subject to abuse. On the other hand, many injured parties would be without access to the courts if they were unable to engage counsel on a contingency fee basis. Economic studies have concluded that "a substantial number of low and middle-income plaintiffs would be deterred from filing even 'meritorious' claims in the absence of contingent fees, or some equivalent form of payment or legal insurance."<sup>2</sup> It has also been argued that without contingent fee arrangements certain areas of the law, and in particular securities laws, may develop much more slowly.<sup>3</sup>

Contingency fee arrangements arose in the United States at a time when there was much concern about victims of industrial accidents who could not afford attorneys to pursue their claims.<sup>4</sup> Today, however, it is probably true that a sizeable number of contingent fee plaintiffs probably could afford to hire counsel.<sup>5</sup> But many of these persons might not be willing to commit their own funds for attorney's fees if they could not hire on a contingent fee basis.<sup>6</sup> The majority of people who hire lawyers are probably unable to accurately judge whether the projected recovery will exceed litigation expenses.<sup>7</sup> It is this aversion to risk that leads these people into contingent fee arrangements.<sup>8</sup>

<sup>1</sup> See Jay S, "The Dilemmas of Attorney Contingent Fees" (1989) 2 *Georgetown J Legal Ethics* 813; Brickman L, "Contingent Fees Without Contingencies: *Hamlet* Without the Prince of Denmark" (1989) 37 *UCLA L Rev* 29, 47; Smith BL, Note, "Three Attorney Fee-Shifting Rules and Contingency Fees: Their Impact on Settlement Incentives" (1992) 90 *Michigan L Rev* 2154, 2163.

<sup>2</sup> Jay above n 1 at 814 citing Danzon P, "Contingent Fees for Personal Injury Litigation" (1990) at 39.

<sup>3</sup> See Jay above n 1 at 815.

<sup>4</sup> *Ibid*; Brickman above n 1 at 37.

<sup>5</sup> See Jay above n 1 at 815.

<sup>6</sup> *Ibid*; Brickman above n 1 at 43.

<sup>7</sup> See Jay above n 1 at 815.

<sup>8</sup> *Ibid*; Brickman above n 1 at 43.

### A. Rules on Payment of Attorney's Fees

A second possible incentive to shareholder litigation involves the rules on who pays the attorney's fees. Generally, in the United States, each party to an action must pay their own attorney's fees, regardless of whether they are successful on the merits. This is the American Rule, in contrast to the English Rule which operates in Australia, under which the unsuccessful litigant would be required to pay the winning party's attorneys fees. The English Rule is not common in the United States. Instead, each party generally pays their own attorney's fees regardless of whether they win or lose.

However, in the context of shareholder derivative litigation, the American Rule is suspended. Instead, under the common fund doctrine, if litigation produces a fund that benefits an entire class of persons or an entity, the plaintiff's reasonable litigation expenses may be taken out of the recovery.<sup>9</sup> Courts have also said that plaintiffs in shareholder derivative suits may recover attorney's fees from the corporation if the court finds that a "substantial benefit" has accrued to the corporation as a result of the litigation.<sup>10</sup> Under this theory, attorney's fees may be awarded even if there is no monetary award as long as there is substantial benefit.<sup>11</sup>

One of the purposes of the common fund doctrine is to encourage prosecution of meritorious actions that might not otherwise be brought.<sup>12</sup> In addition, this fee shifting arrangement is fair because the corporation is the sole beneficiary of the recovery. Thus, the corporation should compensate counsel. Moreover, very few shareholders would ever have incentive to bring a derivative suit on a cost-benefit basis, even under a contingent fee arrangement, and even if the suit would be clearly a winner, if that shareholder had to bear the expense of litigation.<sup>13</sup> This is because in order to justify the costs of litigation, the value of an individual shareholder's holdings in the corporation would have to increase, by virtue of the recovery, by an amount at least equal to the cost of attorney's fees.

<sup>9</sup> See Clark RC, *Corporate Law* (1986) at 660; Lapointe M, Note, "Attorney's Fees in Common Fund Actions" (1991) 59 *Fordham L Rev* 843, 844; Note, "Derivative Suit Settlements" (1985) 48 *Law and Contemporary Problems* 229, 248; Macey JR and Miller GP, "The Plaintiff's Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform" (1991) 58 *U Chicago L Rev* 1, 22; Thomas RS and Hansen RG, "Auctioning Class Action and Derivative Law Suits: A Critical Analysis" (1993) 87 *Northwestern U L Rev* 423, 424.

<sup>10</sup> See Clark above n 9 at 660; Vargo JF, "The American Rule on Attorney Fee Allocation: The Injured Person's Access to Justice" (1993) 42 *American U L Rev* 1567, 1581-83.

<sup>11</sup> See Clark above n 9 at 660; Vargo above n 10 at 1581-83.

<sup>12</sup> See Clark above n 9 at 659; Lapointe above n 9 at 844.

<sup>13</sup> See Clark above n 9 at 659; Shell GR, "Arbitration and Corporate Governance" (1989) 67 *North Carolina L Rev* 517, 538.

## 1. Three Alternative Methods to Calculate Fees

The attorney's fee awards have been calculated by the courts in three different ways. These methods have been termed the percentage of recovery approach, the multifactor method and the lodestar. The first method, the percentage of recovery approach, is gaining in popularity today. Under this approach the attorney receives a judicially determined percentage of the corporation's recovery.<sup>14</sup> The amount is in the court's discretion, but has generally resulted in attorney's fees of between twenty and thirty percent of the recovery.<sup>15</sup>

The second method, aptly termed the multifactor approach by one commentator, permits the courts to consider a number of factors in determining the appropriate attorney's fee award.<sup>16</sup> For example, one federal court considered 12 factors in determining the attorney's fee award.<sup>17</sup> These factors were: (1) the time and labour required; (2) the novelty and difficulty of questions; (3) the skill requisite to perform the legal service properly; (4) preclusion of other employment; (5) customary fees for similar work in the community; (6) whether the fee is fixed or contingent; (7) time limitations imposed by the client or the circumstances; (8) the amount involved and results obtained; (9) the experience, reputation, and ability of the attorney; (10) the "undesirability" of the case; (11) the nature and length of the professional relationship with the client; and (12) awards in similar cases.<sup>18</sup>

The third approach, the lodestar, is also fairly popular. This approach focuses on the number of hours spent by the attorney on the case.<sup>19</sup> The court initially determines the amount the attorney is entitled to on the basis of an hourly rate to the number of hours worked. This amount is called the lodestar. The court then considers other factors including the risk of litigation and the quality of the attorney's work. This gives the court a percentage by which to either increase or decrease the lodestar.<sup>20</sup>

## 2. Criticisms

Commentators have, however, criticised all three approaches. The percentage of settlement approach, while helping to align the interest of the attorney with the shareholders in obtaining a large settlement, evokes concern because attorneys could obtain extremely large fees without devoting much time or effort.<sup>21</sup> This approach may also encourage premature settlements

<sup>14</sup> See Lapointe above n 9 at 843; Coffee JC, "The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation" (1985) 48 *Law and Contemporary Problems* 5, 40; Note, *Derivative Suit Settlements* above n 9 at 250; Macey and Miller above n 9 at 4; Thomas above n 9 at 432.

<sup>15</sup> See Note, *Derivative Suit Settlements* above n 9 at 250; Coffee JC, "Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions" (1986) 86 *Columbia L Rev* 669, 685.

<sup>16</sup> See Note, *Derivative Suit Settlements* above n 9 at 250.

<sup>17</sup> *Johnson v Georgia Highway Express Inc* (5th Cir 1974) 488 F2d 714.

<sup>18</sup> *Ibid* at 717-20.

<sup>19</sup> See Lapointe above n 9 at 843, 846; Coffee above n 14 at 33; Note, *Derivative Suit Settlements* above n 9 at 251; Macey and Miller above n 9 at 4, 22, 50; Thomas and Hansen above n 9 at 431.

<sup>20</sup> See Lapointe above n 9 at 846-47; 860-61; Coffee above n 14 at 33; Note, *Derivative Suit Settlements* above n 9 at 251; Macey and Miller above n 9 at 22, 50; Thomas and Hansen above n 9 at 431.

<sup>21</sup> See Note, *Derivative Suit Settlements*, above n 9 at 252.

not in the best interest of the corporation.<sup>22</sup> The attorney may be satisfied with a smaller settlement amount if he or she can obtain it with little time and effort. On the other hand, the client's interest might be maximised by holding out for larger settlements no matter how much time it takes.

The second approach, the multifactor approach, has been praised due to the discretion the court has to achieve congruence between the fee and the attorney's expenditure of time and energy.<sup>23</sup> But it is also criticised because there is little predictability and consistency in the fee award.<sup>24</sup> The determination of the factors is made by the court on an ad hoc basis. Therefore, little information is conveyed to future litigants and their counsel regarding the types of activities that will be rewarded and those that will not.<sup>25</sup>

Finally, the lodestar approach, although rating favourably in producing incentives for the attorney to conduct full investigations and negotiations of derivative claims, may be criticised because attorneys are paid for the length of time spent on a case regardless of how productive they are.<sup>26</sup> This approach may therefore reward inexperience and inefficiency.<sup>27</sup> One commentator is concerned that there may also be a strong incentive to accept a settlement once the attorney has put in substantial energy to avoid the risk of losing in litigation.<sup>28</sup> This may result in accepting settlements that the client views as insufficient. Others, however, worry that the lodestar may actually encourage attorneys to delay settlement in order to add more hours to the case.<sup>29</sup> Finally, there may also be an incentive to initiate weak lawsuits because the contingency bonus increases as the risk of litigation becomes greater.<sup>30</sup> Intuitively, this result is unlikely, however, due to the all or nothing nature of contingent litigation. That is, attorneys are unlikely to initiate weak cases because they are only paid if they are successful.

### 3. Calls for Reform

Hand in hand with the criticisms are numerous calls for reform in the calculation of attorney's fee awards for shareholder derivative suits. Proposals for reform have ranged from the American Law Institute's call for using a reasonable percentage of the total recovery as a ceiling on attorney's fees,<sup>31</sup> to requiring a presumptive percentage to be applied in most

<sup>22</sup> *Ibid* at 252; Coffee above n 15 at 686-90.

<sup>23</sup> See Note, Derivative Suit Settlements, above n 9 at 252.

<sup>24</sup> *Ibid*.

<sup>25</sup> *Ibid*.

<sup>26</sup> *Ibid* at 253; Thomas and Hansen above n 9 at 432.

<sup>27</sup> See Note, Derivative Suit Settlements, above n 9 at 253.

<sup>28</sup> *Ibid* at 256.

<sup>29</sup> See Lapointe above n 9 at 848; Coffee above n 14 at 34; Macey and Miller above n 9 at 4, 22; Thomas and Hansen above n 9 at 431.

<sup>30</sup> See Note, Derivative Suit Settlements above n 9 at 257.

<sup>31</sup> *Ibid* at 251.

cases,<sup>32</sup> to Professors Jonathan Macey and Geoffrey Miller's call from the University of Chicago for an auction approach, that is to require attorneys to bid for the right to pursue shareholder claims in order to reduce agency costs and increase the efficiency of private enforcement of legal norms.<sup>33</sup> In any event, the ability of plaintiffs to hire counsel on a contingency basis and to have attorney's fees paid out of the corporate coffers upon a successful resolution of their claims gives more shareholders access to the courts than they would otherwise have.

## II. SHAREHOLDER DERIVATIVE SUITS IN THE UNITED STATES

The shareholder derivative suit is a procedural device whereby shareholders can initiate litigation for the benefit of the corporation. It is one of the many devices provided in the law for controlling the conflict of interest between managers and shareholders. It has been said that the shareholder derivative suit is one of the most controversial topics in corporate doctrine.<sup>34</sup> The US Supreme Court has praised the suit as "the chief regulator of corporate management"<sup>35</sup> while some commentators contend that very little of any value would be lost by its outright abolition.<sup>36</sup> In spite of this controversy, the derivative suit has managed to survive for over 100 years in the United States.<sup>37</sup>

In a shareholder derivative suit, the shareholder sues to enforce a claim that belongs to the corporation. The corporation must be joined as a nominal defendant in the action. If successful, the relief granted is in favour of the corporation against third persons, also named as defendants. Generally speaking, before resorting to this action, the shareholder must first demand that the corporation act in its own behalf, by making a demand on the board of directors.<sup>38</sup>

<sup>32</sup> Ibid at 254, citing *Pergament v Kaiser-Frazer Corp* (6th Cir 1955) 224 F2d 80, 82.

<sup>33</sup> See Macey and Miller above n 9 at 6, 105-16; Thomas and Hansen above n 9 at 424.

<sup>34</sup> See Ryan PJ, "Strange Bedfellows: Corporate Fiduciaries and the General Law Compliance Obligation in Section 2.01(a) of the American Law Institute's Principles of Corporate Governance" (1991) 66 Washington L Rev 413, 424.

<sup>35</sup> *Cohen v Beneficial Indus. Loan Corp* (1949) 337 US 541, 548.

<sup>36</sup> See Scott KE, "Corporate Law and The American Law Institute Corporate Governance Project" (1983) 35 Stanford L Rev 927, 937; Fischel DR and Bradley M, "The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis" (1986) 71 Cornell L Rev 261; Romano R, "The Shareholder Suit: Litigation Without Foundation?" (1991) 7 J Law Economics and Organisation 55.

<sup>37</sup> Garth BG, Nagel IH and Plager SJ, "Empirical Research and the Shareholder Derivative Suit: Toward a Better-Informed Debate" (1985) 48 Law and Contemporary Problems 137.

<sup>38</sup> See Note, "Discovery in Federal Demand-Refused Derivative Litigation" (1992) 105 Harvard L Rev 1025, 1026 [hereinafter Note, Demand-Refused Litigation]; Ellick SH, Note, "Harmonising the Procedures for Initiating and Terminating Derivative Litigation: A Modification of Delaware Law" (1992) 60 Washington L Rev 1888, 1890; Curtin DP, Note, "Demand on Directors in a Shareholder Derivative Suit When the Board Has Approved the Wrong" (1985) 26 Boston College L Rev 441, 443; Fischel DR, Note, "The Demand and Standing Requirements in Stockholder Derivative Actions" (1976) 44 U Chicago L Rev 168, 169.



## A. Two Types of Actions

There are two types of shareholder derivative actions: (1) those where demand is required and (2) those where demand is excused. Actions where demand is required are generally actions that do not implicate personal liability of the members of the board.<sup>39</sup> For example, there may be a contract claim that the shareholder wishes the corporation to pursue. In these cases, the courts generally defer to the business judgment of the board of directors regarding whether the corporation should commence litigation.<sup>40</sup> The business judgment rule will protect the board's decision unless the decision was made in bad faith or the directors failed to avail themselves of reasonably available information.<sup>41</sup>

Corporations often appoint special litigation committees composed of independent directors to decide whether the corporation will pursue a derivative action.<sup>42</sup> The refusal of the disinterested members of the board to pursue the matter will be upheld by the court unless there is evidence of bad faith.<sup>43</sup> The courts have, however, recognised a potential conflict of interest when directors are named as defendants to the lawsuit.<sup>44</sup> In these cases the shareholder has alleged that it was the action of the directors that gave rise to the corporation's cause of action. Thus, the potential liability of the directors may taint their decision regarding pursuit of the litigation.

In response to these concerns, the courts have excused the demand requirement in situations in which demand would be futile.<sup>45</sup> When the alleged wrongdoers comprise a majority of the members of the board, it is generally agreed that a presumption may be made that demand is futile.<sup>46</sup> However, the alleged wrongdoing must be more than an allegation that the directors acquiesced in the decision at issue; greater involvement in the wrong is required.<sup>47</sup>

<sup>39</sup> See Macey and Miller above n 9 at 36; Note, Demand-Refused Derivative Litigation above n 38 at 1026.

<sup>40</sup> See Macey and Miller above n 9 at 35; Easterbrook FH and Fischel DR, *The Economic Structure of Corporate Law* (1991) at 100-01; Curtin above n 38 at 445; see generally, Fischel above n 38 at 192; Block DJ, Maimone MJ and Ross SB, "The Duty of Loyalty and the Evolution of the Scope of Judicial Review" (1993) 59 Brooklyn L Rev 65, 84.

<sup>41</sup> *Aronson v Lewis* (Del 1984) 473 A2d 805, 812; *Pogostin v Rice* (Del 1984) 480 A2d 619, 624; *Levine v Smith* (Del 1991) 591 A2d 194, 210; *Spiegel v Buntrock* (Del 1990) 571 A2d 767, 777.

<sup>42</sup> See Ellick above n 38 at 1892; Note, Demand-Refused Derivative Litigation above n 38 at 1043; Mulvey RP, Note, Special Litigation Committees — An Expanding and Potent Threat to Shareholder Derivative Suits" (1980) 2 Cardozo L Rev 169.

<sup>43</sup> See sources cited above n 42.

<sup>44</sup> See Curtin above n 38 at 445; Fischel above n 38 at 173-82; Sevach M, "Deciding Who Should Dismiss Derivative Suits" (1990) 39 Emory LJ 937, 942.

<sup>45</sup> See *Lewis v Curtis* (3d Cir) 671 F2d 779, 787, cert denied, (1982) 459 US 880; *deHaas v Empire Petroleum Co* (D Colo 1968) 286 FSupp 809, 814, aff'd, (10th Cir 1970) 435 F2d 1223, 1228; *Katz v Pels* (NY 1991) 774 FSupp 121, 129; Note, Demand-Refused Derivative Litigation above n 38 at 1026; Curtin above n 38 at 445.

<sup>46</sup> See Ellick above n 38 at 1891; Curtin above n 38 at 445.

<sup>47</sup> See Ellick above n 38 at 1891; Curtin above n 38 at 445.

But even in these circumstances, where demand is excused, it is possible for the board to terminate the action.<sup>48</sup> Again, in general, the decision to terminate a derivative suit is protected by the business judgment rule if made in good faith by disinterested directors. But the tests articulated by the courts for application of the business judgment rule in the context of deciding whether to pursue or continue a derivative suit are more stringent in cases where demand is excused.<sup>49</sup> As in cases where demand is required, where demand is excused corporations may also appoint a special litigation committee of disinterested directors to decide whether the litigation should be commenced, continued, or terminated.<sup>50</sup> But unlike cases where demand is required, when demand is excused the Delaware court applies a two part test. First, the burden is on the corporation to demonstrate the good faith, independence and reasonableness of the special litigation committee.<sup>51</sup> Second, the court uses its own business judgment, assessed independently, regarding whether dismissal would be appropriate.<sup>52</sup>

## B. The Controversy

As mentioned above, there has been a fair amount of controversy in the legal literature regarding the efficacy of shareholder derivative litigation. Advocates of derivative suits see them as a necessary check on the activities of the board. Without the derivative suit, shareholders are forced to rely on the directors to authorise all causes of action the corporation may have. Of course, directors presumably have little interest in authorising a suit against themselves by the corporation. Without a device such as the derivative suit to serve as a check on their activities, directors might freely engage in wrongful acts. Proponents of the more liberal shareholder remedies would like to see the impediments to derivative litigation removed.<sup>53</sup> They have expressed concern that deference to the decisions of special litigation committees would mean the end of derivative suits.

Yet derivative suits pose great potential for abuse. "Strike suits" may be brought by minority shareholders who disagree with decisions made. Strike suits are defined as suits brought by disgruntled shareholders simply to force a settlement rather than to pursue a claim on the merits because it would be less expensive for the corporation to settle than to litigate.<sup>54</sup> There are thus concerns that the cost of abuse may more than offset the potential benefits to the corporation from the successful actions.

<sup>48</sup> *Aronson v Lewis* (Del 1984) 473 A2d 805, 812; *Zapata Corp v Maldonado* (Del 1981) 430 A2d 779, 787; *Auerbach v Bennett* (NY 1979) 393 NE2d 994, 1002.

<sup>49</sup> Swanson CB, "Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball" (1993) 77 Minnesota L Rev 1340, 1365; Ellick above n 38 at 1892.

<sup>50</sup> Ellick above n 38 at 1892.

<sup>51</sup> *Zapata v Maldonado* (Del 1981) 430 A2d 788; see Ellick above n 38 at 1892; Garth Nagel and Plager above n 37 at 141.

<sup>52</sup> *Zapata v Maldonado* (Del 1981) 430 A2d 779, 788; see Ellick above n 38 at 1893.

<sup>53</sup> See Ellick above n 38 at 1930; Coffee JC and Schwartz DE, "The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform" (1981) 81 Columbia L Rev 262, 262; Dent GW, "The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit" (1980) 75 Northwestern U L Rev 96, 144-46.

<sup>54</sup> See Coffee above n 14 at 13, Scott above n 36 at 277-87.

The law attempts to address these concerns by application of the business judgment rule and deference to the decisions of special litigation committees. But critics of legal regulation and the derivative suit focus on the costs associated with derivative suits. Although they recognise that there are certain situations in which the benefits of the derivative suit may outweigh its costs (for example, the deterrence of large, one-time frauds), they argue that these situations are limited.<sup>55</sup> Thus, they contend that legal rules should be concerned with whether the derivative suit increases shareholder wealth. If shareholders do not benefit, the availability of the derivative suit should be restricted.<sup>56</sup>

### C. Empirical Evidence

There have been recent attempts to empirically analyse the shareholder derivative suit.<sup>57</sup> For example, Professor Michael Bradley of the University of Michigan and Professor Dan Fischel of the University of Chicago conducted a study to determine the effect of derivative suits on the wealth of the firm's equity holders.<sup>58</sup> Fischel and Bradley hypothesised that if derivative suits were effective in constraining the behaviour of corporate managers, the market should respond positively to the continuance and negatively to the dismissal of a derivative suit. If derivative suits are effective monitoring devices, their use should enhance shareholder wealth. On the other hand, if the market responds negatively to the continuance and positively to the dismissal of a derivative suit, it could be argued that derivative suits overly constrain corporate managers to pursue value-maximising operating strategies.<sup>59</sup>

In their study, Fischel and Bradley found that neither the termination nor the continuation of a derivative suit significantly affected shareholder wealth.<sup>60</sup> They therefore concluded that the derivative is not a significant monitoring device.<sup>61</sup> Yet, it is important to note that, although not statistically significant, the data they reported in their study consistently indicated that shareholder wealth increases when derivative actions are allowed to proceed and decreases when they are terminated.<sup>62</sup>

---

<sup>55</sup> See Fischel and Bradley above n 36 at 277-87.

<sup>56</sup> *Ibid.*

<sup>57</sup> See eg, Fischel and Bradley above n 36; Jones, TM, "An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits", 1971-1978 (1980) 60 Boston College L Rev 306; Romano above n 36.

<sup>58</sup> Fischel and Bradley above n 36.

<sup>59</sup> *Ibid.*

<sup>60</sup> *Ibid.*

<sup>61</sup> *Ibid.*

<sup>62</sup> *Ibid.*

However, just as Fischel and Bradley argue that their result of no statistically significant increase in shareholder wealth when derivative suits were continued nor any significant decrease when dismissed is evidence that the derivative suit is not a significant monitoring device, this non-result could be interpreted to support the opposite conclusion. That the market did not act negatively when a suit was continued nor positively when dismissed may be evidence that a derivative suit is an effective monitoring device, especially in light of the non-statistically significant results showing increases in shareholder wealth when the suit was allowed to proceed and decreases when dismissed.<sup>63</sup>

But even some critics of shareholder derivative litigation admit that the mere fact that the derivative suit has survived does suggest that it has some value.<sup>64</sup> One explanation critics give for the survival of the suit is its role in deterring large one-shot frauds. Admittedly, if there were no such thing as the derivative suit, ignoring the role of criminal law, managers could, in theory decide to distribute all of the firm's assets to themselves.<sup>65</sup> But the critics further contend that these important, but limited justifications, in no way suggest that suits should be brought more frequently or that legal rules that discourage them are detrimental to investors.<sup>66</sup>

Finally, no discussion of derivative suits would be complete without mentioning the law in the US regarding the availability of indemnification and insurance to the corporate officials. Part III considers the role of corporate indemnification, followed by a discussion of directors' and officers' liability insurance in Part IV.

### III. INDEMNIFICATION

All states in the US permit corporations to indemnify directors for litigation costs directly associated with serving the corporation. Most of these states provide for both mandatory and permissive indemnification and distinguish between third-party litigation and derivative litigation.<sup>67</sup> Delaware law, for example mandates corporate indemnification of directors and officers for expenses, including attorneys' fees incurred in any proceeding to the extent the director has been successful.<sup>68</sup>

<sup>63</sup> See Bradley, M and Schipani, CA, "The Relevance of the Duty of Care Standard in Corporate Governance" (1989) 75 Iowa L Rev 1, 70.

<sup>64</sup> Fischel and Bradley above n 36 at 286.

<sup>65</sup> Ibid.

<sup>66</sup> Ibid at 287.

<sup>67</sup> See McKinney RP, Special Project Note, "Protecting Corporate Directors and Officers: Indemnification" (1987) 40 Vanderbilt L Rev 737, 738, 747; Romano R, "Corporate Governance in the Aftermath of the Insurance Crisis" (1990) 39 Emory LJ 1155, 1157.

<sup>68</sup> Del Code Ann tit 8, § 145(e) (1991).

If the director is not successful, Delaware law permits, but does not require indemnification.<sup>69</sup> Delaware law permits broader indemnification with respect to third-party actions as opposed to derivative litigation.<sup>70</sup> In both types of actions, indemnification is permitted for expenses, including attorneys' fees, actually and reasonably incurred in the defence of such actions if the director acted in good faith and in a manner reasonably believed to be in (or not opposed to) the best interests of the corporation.

If, however, the action is a derivative action, Delaware law will not permit corporate indemnification of costs and expenses incurred in defending the lawsuit when the director has been adjudged liable to the corporation unless there is a court determination that the circumstances entitle the director to indemnification.<sup>71</sup> Moreover, Delaware law does not provide for corporate indemnification against judgments, fines and amounts paid in settlement in derivative litigation, whereas these amounts are indemnifiable in third party actions.<sup>72</sup>

The reasoning for this is rather obvious. It would be anomalous for the director to be found liable to the corporation for a misdeed, then require the corporation to indemnify him or her for that liability. In such a case, the corporation would effectively be paying itself for the losses it sustained as a result of the director's conduct.<sup>73</sup>

Closely related to the director's right to obtain indemnification from the corporation is the corporation's right to procure directors' and officers' liability insurance, or D and O insurance. The next section briefly outlines some of the relevant issues regarding D and O insurance.

#### IV. DIRECTOR'S AND OFFICER'S LIABILITY INSURANCE

Delaware law allows corporations to purchase insurance on behalf of any director, officer, employee or agent of the corporation, against liability arising out of such capacity, regardless of whether the corporation would have the power to indemnify against the liability.<sup>74</sup> The typical DandO insurance policy insures against the obligation of the corporation to indemnify its

<sup>69</sup> Ibid § 145(a).

<sup>70</sup> See *ibid* §§ 145(a)-(b) (1991).

<sup>71</sup> Ibid § 145(b).

<sup>72</sup> Ibid.

<sup>73</sup> See Block DJ, Barton NE and Radin SA, "Indemnification and Insurance of Corporate Officials" (1986) 13 Securities Regulation LJ 239, 244-45; Veasey FN, Finkelstein AJ and Bigler CS, "Responses to the DandO Insurance Crisis" (1986) 19 Securities and Commodities Regulation 263, 264; McKinney above n 67 at 747.

<sup>74</sup> See Del Code Ann tit 8, § 145(g) (1991).

directors and officers and individual liability.<sup>75</sup> The individual liability protection covers the wrongful acts of the directors and officers for which the corporation has no indemnification obligation.<sup>76</sup>

In general, D and O insurance policies insure against losses, including damages, judgments and settlement costs arising out of wrongful acts occurring in connection with service to the corporation.<sup>77</sup> Wrongful acts are defined as "any breach of duty, neglect, error, misstatement, misleading statement, omission or other act done or wrongfully attempted by the Assureds . . . or any matter claimed against them solely by reason of their being Directors and Officers of the Company."<sup>78</sup> This broad statement of coverage is subject, however, to many exclusions.

Examples of typical exclusions include claims against officers and directors relating to libel and slander, illegal gains for personal profit or advantage, illegal remuneration, active and deliberate dishonesty, short-swing profits in violations of the federal securities laws, violations of the federal Employee Retirement Income Security Act, amounts covered by other policies and environmental matters.<sup>79</sup> But some of these exclusions may be insured against in other forms of corporate insurance policies.<sup>80</sup>

Although there are public policy considerations that limit the right of the corporation to purchase D and O insurance, such as prohibiting insurance against wilful misconduct, D and O policies may insure against judgments and amounts paid in settlement of derivative suits even though, as previously discussed, indemnification of these amounts would violate public policy.<sup>81</sup> Thus, a director or officer who was found liable to the corporation in a shareholder derivative suit might be able to file a claim under the corporation's D and O policy and have the amount paid by the corporation's insurance company.

<sup>75</sup> See Knepper WE and Bailey DA, "Liability of Corporate Officers and Directors (5th ed 1993) § 23-2; Block DJ, Barton NE and Garfield AE, "Advising Directors on the DandO Insurance Crisis" (1986) 14 Securities Regulation LJ 130, 132-33; Bishop JW, "The Law of Corporate Officers and Directors Indemnification and Insurance (1981) ¶ 8.03; Kurtz DL, "The Duties and Liabilities of Officers and Directors, Including a Review of Indemnification and Insurance" (1990) Practising Law Institute 431, 480.

<sup>76</sup> See Block, Barton and Radin, above n 73 at 250; Johnston JF, "Corporate Indemnification and Liability Insurance for Directors and Officers" (1978) 33 Business Lawyer 1993, 2013; Kurtz above n 75 at 480.

<sup>77</sup> See Ischel DW and Rosenbaum, "Directors' and Officers' Insurance Coverage: An Overview and Current Problems" in *Directors' and Officers' Liability: A Review of the Business Judgment Rule* (1985) 609-11.

<sup>78</sup> Johnston above n 76 at 2017; *Federal Deposit Ins Corp v Nat Union Fire Ins Co* (WD La 1986) 630 FSupp 1149, 1152.

<sup>79</sup> Johnston above n 76 at 2017-21; Rosh RH, "New York's Response to the Director and Officer Liability Crisis: A Need to Re-examine the Importance of DandO Insurance" (1989) 54 Brooklyn L Rev 1305, 1338; Romano R, "What Went Wrong with Directors' and Officers' Liability Insurance?" (1989) 14 Delaware J Corporate Law 1, 10-11.

<sup>80</sup> Knepper and Bailey above n 75 at 23-3; Schultz, "The Board of Directors: Composition, Duties and Liabilities, Meetings and Procedures" in *Corporate Practice Series* (BNA 1980) A-11 - A-12.

<sup>81</sup> See Veasey, Finkelstein and Bigler above n 73 at 264.

Note the anomaly here. The corporation has paid the premium on the insurance policy that the director or officer is filing a claim under to cover his or her personal liability back to the corporation. Effectively, the corporation is paying itself for the director's liability, by virtue of buying the insurance policy. Moreover, the extent to which directors' and officers' liability is insured against draws into question the potential deterrent effects the derivative suit may provide.

So the question is why do the courts find that corporate indemnification of directors and officers liability in derivative litigation violates public policy but corporate insurance coverage does not. It appears to be the risk-spreading nature of insurance that accounts for the distinction between permitting the corporation to pay insurance premiums versus indemnification.<sup>82</sup> By providing the corporate official with D and O liability insurance, the corporation is only paying a premium that is a small part of the potential liability and of which only a small portion represents payment for settlements and judgments in derivative litigation. This is said not to violate public policy in the same way as exposure of the corporation to the full amount of such liability would.<sup>83</sup>

## V. PROPOSALS FOR REFORM IN AUSTRALIA

Currently, in Australia, corporate reform movements include recommendations from the Companies and Securities Advisory Committee for adoption of a statutory derivative suit<sup>84</sup> as well as a proposal from the Access to Justice Committee to encourage states to permit attorneys to pursue claims on behalf of their clients on a contingency fee basis.<sup>85</sup> The combination of both devices, although different from their US counterparts, may go a long way toward providing shareholders with greater access to the courts and hopefully justice.

### A. Proposals for a Statutory Shareholder Derivative Action in Australia

In recent years, there have been a number of proposals for a statutory derivative action in Australia. In 1990, the Companies and Securities Law Review Committee ("CSLRC") recommended a statutory derivative action.<sup>86</sup> According to the CSLRC proposal, anyone who the court believes is a "proper person" may make an application to commence a derivative action. The court

<sup>82</sup> Ibid.

<sup>83</sup> Ibid.

<sup>84</sup> Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action* (July 1993).

<sup>85</sup> Access to Justice Advisory Committee, *Access to Justice an Action Plan* (1994) at 177-93.

<sup>86</sup> Companies and Securities Law Review Committee, *Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action* (Report No 12, 1990).

would then determine whether the action should proceed.<sup>87</sup> Before granting the application, the court must find that "it is probable that the company will not take proceedings," that the applicant is acting in good faith with the best interests of the company in mind, and that it appears to actually be in the best interests of the company that the action be taken.<sup>88</sup> The court also has the authority to require the company to provide for the applicant's legal costs. Once approved by the court, the action may not be discontinued or settled without leave of the court.<sup>89</sup>

In 1991, the House of Representatives Standing Committee on Legal and Constitutional Affairs ("Standing Committee") issued its report on Corporate Practices and the Rights of Shareholders.<sup>90</sup> The Standing Committee noted that current law "does not provide adequate means for enforcement of the duties of directors and officers where the company improperly refuses or fails to take action."<sup>91</sup>

The inadequacy of shareholder remedies in Australia might be said to have its origins in the rule of *Foss v Harbottle*.<sup>92</sup> According to the Standing Committee, the rule of *Foss v Harbottle* consists of the following two principles:

... the court will not interfere with the internal management of companies acting within their powers, and in fact has no jurisdiction to do so (the 'internal management' principle); and  
... in order to redress a wrong done to the company, or to recover monies or damages alleged to be due to the company, the action should prima facie be brought by the company itself (the 'proper plaintiff' principle).<sup>93</sup>

In order to bring a derivative action in Australia, it is thus necessary for the shareholder to pursue a remedy under an exception to the rule in *Foss v Harbottle*. Exceptions to the rule include acts which are ultra vires, constitute a fraud on the minority shareholders, involve special majorities or personal rights.<sup>94</sup> Noting that the "scope of the exceptions to the rule in *Foss v Harbottle* is unclear,"<sup>95</sup> the Standing Committee endorsed the proposals of

<sup>87</sup> Ibid at 7.

<sup>88</sup> Ibid at 8.

<sup>89</sup> Ibid at 9.

<sup>90</sup> Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders* (Nov 1991) [hereinafter Report of House Standing Committee]. Michael Lavarch, Australia's current Attorney General, chaired this committee.

<sup>91</sup> Ibid at 194.

<sup>92</sup> *Foss v Harbottle* (1843) 2 Hare 461; 67 ER 189.

<sup>93</sup> Report of House Standing Committee above n 90 at 192-93.

<sup>94</sup> Ibid at 193.

<sup>95</sup> Ibid.



the CSLRC for a statutory derivative suit subject to a few qualifications.<sup>96</sup>

In addition, the Standing Committee recommendation included provisions regarding financial assistance that may be provided from the company to present or former directors and officers in connection with defending these actions, a statutory right of indemnification for directors and officers who are successful in their defence and provisions permitting the company to procure suitable directors' insurance.<sup>97</sup> Effective April 15, 1994, Australian companies became permitted to indemnify corporate officers and directors in limited circumstances and to procure insurance on their behalf.<sup>98</sup>

In July, 1993, the Companies and Securities Advisory Committee (the successor to the CSLRC), in its Report on a Statutory Derivative Action, also endorsed the CSLRC recommendation, subject to a few modifications.<sup>99</sup> These modifications include: (1) abolition of the common law derivative remedy; (2) limitation of the action to current shareholders, directors, officers and the Australian Securities Commission; (3) certain notice requirements and criteria for the court in granting leave to pursue the claim; (4) provisions giving the court discretion regarding payment of and security for costs; (5) a requirement that any compensation awarded under a successful claim be paid to the company; (6) court discretion to authorise an independent body to investigate whether the claim is a good cause of action; (7) the ability but no requirement of the court to consider whether the alleged breach of duty was approved by the general meeting of shareholders; (8) requirements of disclosure of the action in the next annual report; and (9) an amendment to the Corporations Law regarding access to company records.<sup>100</sup> Finally, in 1994, Attorney General Michael Lavarch endorsed recommendations for adoption of a statutory derivative action along the lines of the CSLRC and the Companies and Securities Advisory Committee proposals.<sup>101</sup>

It thus now appears that there is strong momentum for a statutory derivative suit to become available to shareholders in Australia. However, access to a shareholder derivative mechanism probably does not go far enough in providing a shareholders' access to the courts due to the costs involved in pursuing these claims. As Professor Ramsay notes "to enable worthwhile derivative actions to be commenced, then either the company

<sup>96</sup> Ibid at 201-02. The Standing Committee recommended that any current or former shareholder and any director or officer or former director or officer of the corporation or a related corporation be granted standing to bring suit without being required to establish an exception to the rule in *Foss v Harbottle*. Ibid at 201.

<sup>97</sup> Ibid at 202.

<sup>98</sup> Corporate Law Reform Act 1994.

<sup>99</sup> Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action* (July 1993).

<sup>100</sup> Ibid at ii - iii.

<sup>101</sup> Farouque, F "Australia: Shareholder Legal Actions in Pipeline" Apr 30, 1994, *The Age* at 29.

must pay the expenses of the plaintiff shareholder or the plaintiff's attorney has to be made an interested party by the use of contingency fees."<sup>102</sup>

The Access to Justice Advisory Committee has recently recommended that contingency fees be available in Australia, albeit in a limited way.<sup>103</sup> The Access to Justice Committee proposal is discussed in Part B below.

## **B. The Access to Justice Committee Proposal on Contingency Fees**

The Access to Justice Committee ("Committee") has issued its action plan to "enhance access to justice and render the system fairer, more efficient and more effective."<sup>104</sup> Although the Committee was not considering only the plight of the injured shareholder, it has recommended that the Commonwealth encourage states "to permit lawyers to enter contingency fee arrangements with their clients."<sup>105</sup> The recommendation excludes criminal or family law matters and limits the contingency fee arrangement to one whereby the attorney may charge an uplift fee above his or her normal rate.<sup>106</sup> A number of limitations are included in the recommendation including a maximum uplift of 100% of the attorney's normal rate; a prohibition against contingency fee agreements unless the attorney, after reasonable investigation, believes that the claim has some prospect of success but the risk of failure is sufficient to justify the uplift; a requirement that the agreement be written in plain English and include a statement of the lawyer's reasons for concluding that the uplift factor is appropriate; a statement defining the outcome that will constitute success; a five day cooling off period during which the client may cancel the agreement; and a number of other disclosure requirements and review procedures.<sup>107</sup>

The Committee appeared to seriously consider both the arguments in favour of and in opposition to allowing attorneys to enter into contingency fee arrangements with their clients. Some of the arguments noted in opposition to contingency fee arrangements include concerns that increasing access to the courts will increase delays; that lawyers with financial interests in the outcome may be unable to remain dispassionate and disinterested in the litigation and may thus encourage clients to accept lower settlements to

<sup>102</sup> Ramsay, I "Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action" (1992) 15 UNSW LJ 149, 164. The call for the use of contingency fees in Australia is not new. In 1976, HH Mason similarly voiced concerns regarding the lack of adequate shareholder remedies in Australia and called for adoption of a system permitting shareholders to retain counsel on a contingency fee basis. Mason, HH "Possible Alternatives to an Australian Securities and Exchange Commission: Contingent Fees and Derivative Actions by Shareholders" (1976) 50 Australian LJ 26, 28.

<sup>103</sup> *Access to Justice an Action Plan*, above n 85.

<sup>104</sup> *Ibid* at xxiii.

<sup>105</sup> *Ibid* at 188.

<sup>106</sup> *Ibid*.

<sup>107</sup> *Ibid* at 191-92.

ensure collection of their fees and avoid the expenses of trial; that lawyers may be tempted to engage in practices inconsistent with their duties to the court such as falsifying evidence; and that the reduced risk of costs may encourage people to pursue unmeritorious claims.<sup>108</sup>

Conversely, supporters of contingency fee arrangements in Australia have argued that such fee arrangements would give plaintiffs in civil cases greater access to courts; that increased pricing options should lower costs by increasing efficiency and competition within the legal profession; that contingency fee agreements align the interests of lawyers and clients and that this alignment should promote greater diligence on the part of legal counsel; and that lawyers will filter out unmeritorious litigation.<sup>109</sup>

After consideration of both sides of the debate, the Committee opted for a recommendation to encourage contingency fee arrangements but on the very limited scale discussed above. The limitations evidence an attempt by the Committee to safeguard against the potential for abuse.

## VI. CONCLUSION

Although it is true that shareholder remedies are more available in the United States than Australia due to the ability of shareholders to hire counsel on a contingency fee basis and the derivative suit mechanism, these devices are not without controversy. But fortunately, as Ian Ramsay has commented, the view that there is excessive shareholder litigation in the United States appears to be an exaggeration.<sup>110</sup> Professor Ramsay quotes a study of 179 public corporations that found that on average a company is involved in shareholder litigation only once every 17.5 years,<sup>111</sup> which might not be too high a price to pay for the increased access to justice derivative suits provide.

It appears that Australia is moving in the direction of the United States, albeit very cautiously, in current reform efforts to enable shareholders to pursue derivative claims. Unfortunately, it is unlikely that the proposed shareholder derivative suit procedures will make a significant difference in corporate jurisprudence in Australia unless shareholders are provided with adequate means to finance the costs of litigation. The shareholder derivative suit mechanism coupled with the ability of shareholders to engage counsel on a contingency fee basis probably accounts for much of the shareholder litigation in the US.

---

<sup>108</sup> Ibid at 184-85.

<sup>109</sup> Ibid.

<sup>110</sup> Ramsay above n 102 at 155.

<sup>111</sup> Ibid citing Jones above n 57 at 313.

Yet, adoption of an Australian statutory shareholder derivative suit, if adopted together with the proposal of the Access to Justice Committee regarding contingency fee arrangements, may go a long way toward increasing shareholders' access to justice in Australia. Only time will tell, however, if adoption of these somewhat cautious proposals will go far enough to enable shareholders to realistically pursue derivative claims and thus act as a more effective monitor of management.