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Funding Corporate Governance Litigation with the Company Coffers

On December 2, 2024 a Delaware judge upheld her prior January 2024 ruling that Elon Musk's compensation package, valued at $55.8 billion, had to be rescinded because it was approved in breach of the directors' fiduciary duties (*Tornetta v Musk)*. One month later, the same Delaware judge approved a settlement wherein Tesla's directors agreed to return or forgo $919 million in compensation, which had been subject to a separate legal complaint by the Police and Fire Retirement System of the City of Detroit (*Police & Fire Retirement System of the City of Detroit v Musk*). The two cases were brought as derivative actions on behalf of shareholders of Tesla. The former action is now subject to an appeal brought by Tesla, but also an appeal by a separate group of Florida shareholders.

Aside from their important impacts on corporate governance, and the fiduciary duties of directors, the two cases are also notable for setting Delaware records for legal fee awards, with *Tornetta* resulting in a legal fee award of $345 million, the largest such fee approval by a Delaware Court; and *Police & Fire* resulting in a $167 million fee award, the fourth largest in the history of shareholder litigation in Delaware.

Discussion

In America, and unlike in Canada, the default rule is that litigants pay for their own legal expenses. However, an important exception to this "American Rule" is for shareholder litigation that succeeds in Court, and in so doing secures a benefit common to all shareholders. This "common fund" doctrine presumes that the winning party is then entitled to have their legal fees paid out of the common benefit they have created.

Delaware case law, and in particular *Sugarland Industries Inc v Thomas* from 1980, has developed factors to award such fees primarily on the result achieved, rather than the traditional measure of billed hours. The use of "value billing" allows Courts to assess the fee holistically, and to provide incentives for counsel to take on challenging cases at the risk of recovering nothing at the end. This was a particularly important factor in *Tornetta* where the plaintiff "faced some of the best law firms in the country, who put plaintiff through their paces." The action took six years to pursue, involved an extensive trial record, and was done entirely on contingency, creating a "massive contingency risk" for the plaintiff's counsel.

In *Tornetta*, the plaintiff's counsel initially sought a staggering $5.6 billion legal fee, based on the maximum value that could be saved from the rescission of Mr. Musk's compensation. The Court described that as an unjustifiable windfall, and instead valued Mr. Musk's compensation based on its fair value at the grant date, which was $2.3 billion, and applied a "conservative" 15% fee resulting in $345 million.

Could shareholders of a Canadian company pursue a similar funding strategy to litigate director or officer breaches of fiduciary duty, or other wrongs to the corporation? While there have been no strict equivalents to the Tesla case to date, it would seem at least theoretically possible.

All Canadian jurisdictions already employ a "loser pays" model whereby a successful party to litigation is presumed to be owed legal costs, though there are provincial variances as to how those costs are calculated. But common to all Canadian jurisdictions is a presumption that, absent extraordinary circumstances, the indemnification to the successful party will only be partial (in Ontario, 60% is often cited as the normal rule). The shifting cost rules of each province are therefore unable to provide the type of litigation incentives present in the Tesla cases.

An alternative route may be reliance on the corporate statutes, which provide the mechanisms by which Canadian derivative actions may be pursued, and which also confer broad judicial discretion to make orders including for the payment of "reasonable legal fees" (see *Canada Business Corporations Act* , section 240(d) and *Business Corporations Act* (Ontario), section 247(d)). Through those provisions, parties have been able to seek advances for legal costs, though there has been marked reticence to providing them on a full indemnification basis. A key concern of the Court is that a blanket indemnity could facilitate counsel to pursue risk-free litigation regardless of its underlying merits.

It does not appear that anyone has yet attempted to use the Canadian corporate statutes to seek approval of a contingency fee agreement. A contingent arrangement avoids the risk of encouraging risk-free litigation, as litigants' counsel still bear significant risk, but they do so with the prospect of having that risk rewarded with enhanced compensation. It therefore seems to be an open question as to whether those statutory provisions could be used as such.

In Canada, a more familiar way to pursue contingency fee funding for a claim on behalf of many claimants is the *Class Proceedings Act*, which provides well established mechanisms for seeking approval of contingency fees as well as litigation funding agreements. That leads to the question of whether a derivative action can be pursued in tandem as a class action. There has been some commentary which casts doubt on this, but there is at least one authority that supports the possibility. In *Peppiatt v Nicol*, a class action was brought by equity members of a golf club non-profit corporation. The claim asserted both personal claims by the class members, but also derivative claims of the club against a bank. The Court allowed the class and derivative claims to be joined together, which ultimately succeeded against the bank. While the counsel's fee arrangement was approved by the Court under the *Class Proceedings Act*, there are no reports as to what the specific arrangement was.

Contingent fee agreements may be available for the pursuit of derivative actions for the benefit of shareholders, without shareholders having to personally fund them, but there would still seem to be one important restriction: there must be a monetary recovery.

Cases such as *Police and Fire Retirement System*, where the claim seeks a partial repayment of funds, may be viable, but cases like *Tornetta,* where the benefit to the corporation is only to be restrained from issuing cheap equity, may not. In the latter type of case, the shareholders may benefit through the increased value of their shares, but there is no obvious source of money to fund legal fees, and no mechanism equivalent to the one in Delaware to allow a Court to fashion a fee award directly payable by the company, other than the usual payment of partial indemnity costs. The shareholders in such cases may be in the classic situation of a collective action problem, where collectively they have a significant interest in the pursuit of such cases, but there are no individual incentives or other mechanisms to foster their pursuit.