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Access to Justice or Justice Not Accessed: Is there a Case for Public Funding of Derivative Claims?

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ACCESS TO JUSTICE OR JUSTICE NOT ACCESSED: IS THERE A CASE FOR PUBLIC FUNDING OF DERIVATIVE CLAIMS?

*Arad Reisberg**

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INTRODUCTION

This Paper examines whether there is a case, in appropriate circumstances, to provide public funding for derivative claims.¹ Claims are expensive, and their cost "is a major obstacle in the path of a minor-

1. In this paper the terms "derivative claim(s)" and "derivative action(s)" are used interchangeably. Similarly, "firm," "company," and "corporation" are used interchangeably to refer to a noncharitable limited liability incorporated company.

ity shareholder bringing a derivative action on behalf of the company.”² For example, there is nothing in the relatively new derivative claims procedure in Part 11 of the UK Companies Act 2006 that will convince a rational shareholder he is better off litigating the case on behalf of the company rather than selling his shares.³ It is unnecessary to repeat my argument from 2004⁴ and subsequent times⁵ that costs and fees rules need to be reevaluated if any real change is to occur.⁶ Indeed,

the treatment of fees has a direct impact on the frequency [of claims]. The more advantageous the fee rule is to the prospective plaintiff, the greater the employment of litigation. This [is] significant for policy analysis as it assists in the creation of rules that permit judicial determination of questions deemed important to societal interests. An understanding of the economic effect of fees on the decision to commence litigation allows the development of rules to encourage those actions, which advance policy objectives. Underlying this analysis is the question whether an action should be promoted or deterred. The determination of this question is a matter for legislation and judicial innovation.⁷

The purpose of this Paper is to highlight and analyze an interesting recent development, whereby public funding may be provided in specific cases to fund derivative claims. An amendment made to the Israeli Companies Law of 1999⁸ in May 2011 (“Amendment 16”) permits the Israeli Securities Authority (“ISA”) to fund derivative claims in cases where it

2. Arad Reisberg, *Funding Derivative Actions: A Re-examination of Costs and Fees as Incentives to Commence Litigation*, 4 J. CORP. L. STUD. 345, 345 (2004) [hereinafter Reisberg, *Funding Derivative Actions*].

3. See Arad Reisberg, *Derivative Claims under the Companies Act 2006: Much Ado About Nothing?*, in RATIONALITY IN COMPANY LAW: ESSAYS IN HONOUR OF DD PRENTICE 17, 29, 51 (John Armour & Jennifer Payne eds., 2009) [hereinafter Reisberg, *Derivative Claims*].

4. See generally Reisberg, *Funding Derivative Actions*, *supra* note 2.

5. See generally Arad Reisberg, *Derivative Actions and the Funding Problem: The Way Forward*, 2006 J. BUS. L. 445 [hereinafter Reisberg, *The Funding Problem*]; see also ARAD REISBERG, *DERIVATIVE ACTIONS AND CORPORATE GOVERNANCE: THEORY AND OPERATION* 222–73 (2007) [hereinafter REISBERG, *THEORY AND OPERATION*].

6. Reisberg, *Derivative Claims*, *supra* note 3, at 366. As stated above, this is the author’s thesis that runs throughout his works.

7. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 346 (citing STEVEN SHAVELL, *FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW* 492 (2004)); John D. Wilson, *Attorney Fees and the Decision to Commence Litigation: Analysis, Comparison and an Application to the Shareholder’s Derivative Action*, 5 WINDSOR Y.B. ACCESS TO JUST. 142, 171 (1985).

8. Companies Law, 5759–1999, 44 LSI 119 (1999) (Isr.) [hereinafter Companies Law], available at http://www.isa.gov.il/Download/IsaFile_958.pdf.

is convinced there is a public interest.⁹ This has the potential to be an important development for several reasons. First, it extends the discussion on how to address the funding problem in derivative action procedures beyond the common solutions (i.e. those involving various fee arrangements such as costs orders, rewarding the plaintiff, or contingency fees) and its “usual suspects” (i.e. plaintiff shareholders or attorneys) to an entirely novel domain—that of a public regulator—and public funding for these private actions. Second, and directly related to the previous point, providing public funding for private actions cuts across the traditional public/private dichotomy. It shows that the choice lies not solely between private and public enforcement, but also between a private enforcement aided by a public body (i.e. privately initiated and pursued litigation which is publicly funded). Finally, the Israeli solution may offer a new strategy to address a major concern in the literature on the theory of litigation, namely, the basic problem that private incentives to litigate may diverge from what is socially desirable and that strategies may be employed to tackle this.¹⁰

In this Paper, I will discuss the problem of funding of derivative actions in a different taxonomy. Despite the various fee mechanisms and fee-favoring rules available under Israeli law before the introduction of Amendment 16, the fact that parties would still not pursue these claims demonstrates the underproduction of positive externalities. Thus if we are to motivate private actions by aggrieved parties, access to funding must be considered. Put simply, the policy underlying Amendment 16 reveals a new truth: where lawsuits would produce collateral social benefits, individuals are given financial support by a public body to litigate their claims. The new mechanism of a public body internalizing the cost (ISA), and thus enabling the lawsuits to be brought, helps produce these social benefits.

The Paper is structured as follows. Section A will briefly explicate the economics of derivative claim litigation. Section B will then outline the derivative action procedure under Israeli Companies Law of 1999, looking in particular at the various costs and fees arrangements under its regime. It will also briefly look at the time, cost, and number of procedures usually expected to resolve a commercial dispute through the Israeli courts. Section C will examine the details of Amendment 16, from which derivative actions may be underwritten through public funds. It will also look into the rationales behind the law. Subsequently, this Paper will in-

9. *Id.* § 209(a).

10. SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW, *supra* note 7, at 492–93.

quire into the advantages (both theoretical and practical) of public funding of such claims as well as highlight the shortcomings of such an approach. As part of this consideration, class actions currently funded by ISA will be analyzed. Finally, the implications of the preceding discussion will be examined and assessed in Section D with a view toward determining whether public funding provides a way forward for the funding problem, and whether it could be extended to other jurisdictions.

A. THE ECONOMICS OF DERIVATIVE CLAIM LITIGATION

Derivative actions enable “shareholders, usually minority shareholders, . . . to enforce the company’s rights where directors have breached their duties (since in these circumstances it is unlikely that the directors, who usually act on behalf of the company, will want to take action).”¹¹ The prosecuting shareholder is normally named as the plaintiff and the company named as nominal defendant,¹² though this conceals the true nature of the parties.

In reality the company is the true plaintiff in interest, and in all but exceptional cases any damages or other relief obtained flow directly to the company and not to the nominal plaintiff. This fact has a significant impact on the nominal plaintiff’s decision to commence litigation, as his interest in the outcome will generally be quite diffuse and remote.¹³

In financial terms, a shareholder lacks any direct remedy that would make the action worthwhile for him or her. Despite success, “any damages recovered accrue to the company”¹⁴ and the shareholder will therefore receive only a pro rata share of the gains of a successful action.¹⁵ Under English law, the shareholder may have to pay not only the expenses of his or her litigation, but also the legal expenses of the defen-

11. REISBERG, *THEORY AND OPERATION*, *supra* note 5, at 1.

12. *See, e.g.*, *Taylor v. Nat’l Union of Mineworkers*, [1985] B.C.L.C. 237 at 246 (Eng.). The case is thus *res judicata*, i.e. the matter cannot be raised again, either in the same court or in a different court.

13. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 347.

14. Ian Ramsay, *Corporate Governance, Shareholder Litigation and the Prospects For Statutory Derivative Action*, 15 U. S. WALES L.J. 149, 163 (1992).

15. *Id.* Then only indirectly and to the extent that the proceedings cause the value of his own share to rise sufficiently, so that he might be willing to sue in order to sell his shares later at increased prices. This result, nonetheless, is far from certain as a successful action may reduce share values. Also, “shareholders who own small stakes in the company have little incentive to bring a derivative action because the benefit of the suit accrues to shareholders according to the *size* of their holding, *not* their efforts in bringing the action.” REISBERG, *THEORY AND OPERATION*, *supra* note 5, at 257–69 (emphasis in original).

dant if the action is unsuccessful.¹⁶ A prospective plaintiff, being aware that the company and other shareholders will “free-ride” on his or her efforts, is likely inclined to forgo suit in anticipation of other plaintiffs.¹⁷ Ultimately, even if shareholder litigation results in intangible deterrence benefits, there is little reason for individual shareholders to sue. Consequently, if all shareholders share this same view, “then no one is likely to step forward even in situations where litigation would increase total share value.”¹⁸ As I have explained,

An imbalance therefore arises in derivative litigation, as the fees faced by the nominal plaintiff will, in most cases, outweigh the potential benefit accruing to him. This consequent deterrence to derivative actions is common to both the English and American fee rules. [As a result,] [r]ational plaintiffs [will] therefore . . . rarely initiate derivative actions. Empirically, however, this is not the case in the United States. The fact that the action is employed in the United States is due to adjustments in the usual cost rules, the most significant of which are the “common fund”, the “substantial benefit” doctrines and the recognition of contingency fee arrangements.¹⁹

16. Owing to the English “loser-pays” rule that costs follow the event. In the United States this is, of course, different. See *infra* notes 19–20 and accompanying text.

17. Brian R. Cheffins, *Reforming the Derivative Action: The Canadian Experience and British Prospects*, 2 COMPANY FIN. & INSOLVENCY L. REV. 227, 257 (1997).

18. *Id.* at 257–58.

19. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 347–48. The pattern of derivative litigation can be explained in large measure by the incentive structure which exists for lawyers in the United States. *Id.* at 348 n.13. See, e.g., Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J.L. ECON. & ORG. 55, 85 (1991); Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 J. LEGAL STUD. 351, 366–67 (2001); Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1157 (1990); Deborah DeMott, *Shareholder Litigation in Australia and the United States: Common Problems, Uncommon Solutions*, 11 SYDNEY L. REV. 259, 273 (1987). These themes and sources are explored in Reisberg, *Funding Derivative Actions*, *supra* note 2, at 348, 348 n.13. For further information on the common fund doctrine, see *id.* at 349 n.20.

According to the doctrine, when a fund is recovered which benefits a class of persons beyond the nominal plaintiff, the legal fees expended in recovery are treated as a first charge against the fund. The theory of the doctrine is based on unjust enrichment and demands that all beneficiaries contribute pro rata to the expense of recovery. In the early application of the doctrine a monetary fund had to be recovered or saved. The shortcomings of the restrictive application became obvious when injunctive or declaratory relief was sought as there was no fund to charge. This deficiency was cured by judicial innovation, which extended the doctrine to situations where a substantial, although not monetary,

As a result of the well-built fee structure in the [United States], it is common to see attorneys functioning more like “entrepreneurs” who conduct litigation almost entirely on their own, with virtually no monitoring by the shareholders whose names are used only as the key to the courtroom door. . . . The contingency fees arrangement and the lodestar method are perhaps the two most important mechanisms that affect not only who pays the attorneys’ fees and how these fees are calculated, but also how the plaintiffs’ attorneys conduct the derivative action litigation. Not surprisingly, win or lose, derivative actions appear to be fairly common in the [United States.]²⁰

English law’s dearth of similar doctrines to derivative actions may explain their underutilization.²¹ Indeed, “the traditional way in which most

benefit was obtained, justifying an award of attorneys’ fees against the benefiting entity.

Id. (citing *Sprague v. Ticonic Nat’l Bank*, 307 U.S. 161, 169 (1939); Lang Thai, *How Popular are Statutory Derivative Actions in Australia? Comparisons with United States, Canada and New Zealand*, 30 AUSTL. BUS. L. REV. 118, 123 n.48 (2002) (citing P.A. Batista, *Counsel Fees in Derivative Litigation: End of the Golden Harvest?*, 11 SEC. REG. L.J. 153 (1983); Carol G. Hammett, *Attorney’s Fees in Shareholder Derivative Suits: The Substantial Benefit Rule Reexamined*, 60 CAL. L. REV. 164, 164–65 (1972); AM. L. INST. [A.L.I.], *PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 7.17 cmts. a & c (Proposed Final Draft 1992) [hereinafter *PRINCIPLES OF CORP. GOVERNANCE*]). For further information on the substantial benefit doctrine, see Reisberg, *Funding Derivative Actions*, *supra* note 2, at 350.

Based on these approaches, there are two methods for calculating attorneys’ fees in derivative actions. The first method is the percentage scale, which is applicable when the case generates a common fund for the company—the attorney will then be paid in the range of 20–30% of the common fund, depending on the prior agreement. Stated differently, a percentage scale will be used to calculate attorneys’ fees if derivative action results in a tangible monetary relief. In a case where derivative litigation results in an intangible or therapeutic relief only, the courts will apply the alternative method, known as the “lodestar method”, to allow attorneys to be paid for their work. The lodestar method is applicable if the derivative action results in a substantial benefit to the company, whether by judgment or settlement.

Id. (internal citations omitted).

20. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 350 (internal citations omitted); see John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation*, 54 U. CHI. L. REV. 877, 885 (1987); Jonathan Macey & Geoffrey P. Miller, *The Plaintiff’s Attorney Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 3 (1991).

21. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 348. Of course this is not the whole picture. There are other reasons, including standing and policy issues. See *id.* at 354–64.

Commonwealth jurisdictions address the obstacle of funding in a derivative action is by recognizing that the plaintiff should be indemnified for costs incurred in the proceeding, usually by allowing the court discretion on this matter.²² A major obstacle to derivative action is eliminated by compensating the shareholder's costs. In fact, "the possibility of awarding a cost indemnity order is a 'significant incentive' to use the derivative action."²³ However, as I have explained elsewhere, these arguments are flawed and "ignore the realities of derivative action litigation."²⁴ Careful inspection of the operation of indemnity costs orders reveals significant failings in the operation of these orders.²⁵ Thus, "it is a less than adequate response to the formidable funding problem inherent in derivative actions."²⁶ The common law position on costs of derivative claims has not changed.²⁷ It follows that the practicalities of financing share-

In addition, in the UK, market forces can be quite potent. It is widely acknowledged that the UK has a more robust and less regulated takeover market than the [United States], while the [United States] is more permissive towards derivative litigation. Miller argues that these differences can be viewed as reflecting alternative approaches to controlling "agency costs." Geoffrey Miller, *Political Structure and Corporate Governance: Some Points of Contrast between the United States and England*, 1998 COLUM. BUS. L. REV. 51, 52. Arguably, the differences also stem largely from the political influence of the organized bar. Because the English system until recently did not recognize any form of contingency fees, there is little support from the organized bar to push for liberalization in the rules governing derivative litigation. Thus incumbent managers, who are generally hostile to derivative litigation, exercise a great deal of control over the scope of the remedy. The recognition of contingency fees and the "common fund" doctrine . . . permitting attorney compensation out of the amounts generated for the benefit of the corporation have created a strong interest group within the organized bar that favours a relatively liberal scope for the remedy. Because the organized bar is usually quite influential in the design of corporate rules, it has been able to ensure a relatively wide-ranging derivative remedy despite the remedy's unpopularity among corporate managers. *Id.*; see also, John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1, 1-3 (1999).

Id. at 348 n.14 (adjusted for proper Bluebook form).

22. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 351.

23. *Id.* at 352 (citing D.D. Prentice, *Wallersteiner v. Moir: The Demise of the Rule in Foss v Harbottle?*, 40 CONV. & PROP. LAW. 51, 59 (1976)); LAW COMM'N, SHAREHOLDER REMEDIES (CONSULTATION), 1996, EWLC 142, ¶ 18.1 (U.K.) [hereinafter SHAREHOLDER REMEDIES CONSULTATION].

24. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 352.

25. *Id.*; see REISBERG, THEORY AND OPERATION, *supra* note 5.

26. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 365.

27. Advance indemnities, along the lines of those supported in *Wallersteiner v. Moir*, [1975] Q.B. 373 (U.K.) and Civil Procedure Rules [CPR], 1998, S.I. 1998/3132, r.

holder litigation remains a major obstacle in the new procedure under Part 11 of the U.K. Companies Act 2006.²⁸

B. THE PROCEDURE UNDER ISRAELI LAW: VARIOUS FINANCIAL INCENTIVES TO ENCOURAGE DERIVATIVE ACTIONS

1. Background

Under the Israeli Companies Law of 1999 (“Companies Law”), derivative action is defined as “an action brought by a plaintiff on behalf of a company for a wrong done to the company.”²⁹ There are no express sections under the Companies Law as to the causes of action for which the derivative action is to be available. However, a prospective plaintiff has to seek leave to bring the action beyond the preliminary stages³⁰ and the statute sets out the conditions that the court must determine are satisfied before leave can be given.³¹

The Israeli derivative action is a descendant of the common law derivative action. [The derivative action mechanism was developed by the judiciary, which followed and expanded the English doctrine on the matter.] Over the years, Israeli courts have generally shown a willingness to grant a shareholder standing where justice requires it, but unlike English courts, they have also shown an inclination to effectively “brush aside” the procedural barriers of *Foss v. Harbottle* where they stand in the way of justice being served. This attitude has continued in recent cases, with the most obvious point of contrast lying in the courts’ willingness to embrace the “interests of justice” as an exception to *Foss v. Harbottle* in its own right. This tendency culminated with the replacement of the existing derivative action procedure with a new one on a statutory footing as part of the third chapter of the Israeli Companies Law of 1999 that came into effect in February 2000.³²

19.9(7) (U.K.), where the company may reimburse the shareholder for bringing the action if the court grants leave to continue, will be difficult to obtain as the statutory reforms fail to induce the courts to rethink their cautious position here.

28. Companies Act, 2006, c. 46, § 263(2)(a) (U.K.) [hereinafter Companies Act 2006]; see also Reisberg, *Derivative Claims*, *supra* note 3; Arad Reisberg, *Shadows of the Past and Back to the Future: Part 11 of the UK Companies Act 2006 (in)action*, 6 EUR. COMPANY & FIN. L. REV. 219, 239 (2009).

29. Companies Law § 1.

30. Arad Reisberg, *Promoting the Use of Derivative Action*, 24 COMPANY LAW. 250, 250 (2003) [hereinafter Reisberg, *Derivative Action*]; Companies Law § 194 (A).

31. Reisberg, *Derivative Action*, *supra* note 30, at 250; Companies Law § 198.

32. Reisberg, *Derivative Action*, *supra* note 30, at 250 (citing *Foss v. Harbottle*, (1843) 67 Eng. Rep. 189, 2 Hare 461 (U.K.); *Neve-Yam of Arsuf Beach Hotels Ltd. v.*

One fundamental objective seems to underline the majority of sections in the statutory derivative action: encouraging or promoting the use of derivative actions.³³ The sections are designed “to turn the derivative action into a beneficial tool in enforcing corporate accountability. The derivative action is made more widely accessible for prospective plaintiffs by mitigating the effect of distorted litigation incentives”³⁴ and by limiting the financial liability plaintiffs face when initiating a derivative action. These include levying low court fees for derivative actions, granting the courts the right to award special dispensation to the filing shareholder (i.e. the possibility of rewarding the plaintiff), and transferring the costs onto the company once the claim is approved as a derivative action by the court.³⁵ Let us look at these more closely.

2. *Distributing the Burden of Court Fees*³⁶

In spite of the tendency of Israeli courts to encourage the use of derivative actions, “[o]ne of the major obstacles still in the way of bringing derivative actions is that under Israeli law the plaintiff must carry the burden of the costs of proceeding, between the stage where he is granted permission to bring the action and its final conclusion in judgment.”³⁷ Israeli courts have upheld this view, finding that the plaintiff must meet the burden of court fees.³⁸

Cohen, 30 PD 517, 528–29 [1976] (Isr.); *Gil v. Discount Bank Le-Israel Ltd.*, PM(2) 294 [1988] (Isr.). The doctrine of *Foss v. Harbottle* was well stated by Lord Davey in *Burland v. Earle* (more clearly than in *Foss* itself) where he said:

It is an elementary principle of the law relating to joint stock companies that the Court will not interfere with the internal management of companies acting within their powers, and in fact has no jurisdiction to do so. Again it is clear law that in order to redress a wrong done to the company, or to recover money or damages alleged to be due to the company, the action should *prima facie* be brought by the company itself.

Burland v. Earle, [1902] A.C. 83 (P.C.) (U.K.).

33. Reisberg, *Derivative Action*, *supra* note 30, at 250; IRIT HAVIV-SEGAL, CORPORATE LAW IN ISRAEL, AFTER THE NEW COMPANIES ACT 605 (1999) (Isr.).

34. Reisberg, *Derivative Action*, *supra* note 30, at 250.

35. *See id.* (for a fuller account). The fact that the costs of derivative actions are to be met by the company, and are not linked to the success of the case, provides more certainty to prospective plaintiffs.

36. Court fees are levy paid directly to court upon bringing any action before Israeli courts. They are set in regulations and their rate is reviewed regularly.

37. Reisberg, *Derivative Action*, *supra* note 30, at 251; HAVIV-SEGAL, *supra* note 33, at 606.

38. *Y.A.Z Investments v. Zelinger, Tak-Al*, 97(2) PD 550 (Civil Appeal Request 1470/97) (Isr.).

The Companies Law tackles this head on. Section 199(1) states that when the court has granted leave to bring a derivative action, the court may give instructions as to the manner and dates of payment of court fees—including the division of payment between the plaintiff and the company. Arguably, this may serve to alleviate some of the plaintiffs' pressures (provided, of course, the court follows the spirit of this provision). In addition, and as an exception under the Israeli legal system, court fees do not need to be paid at the same time as the application to leave is submitted. Another positive measure towards potential plaintiffs is that when leave is not granted by the court to bring a derivative action or leave is granted with changes and the plaintiff has withdrawn his case, no court fees will be paid as well. Not to be deterred by high litigation costs, plaintiffs have nothing to lose or pay from their own pockets for bearing the risk of bringing the action.³⁹

3. *Covering for Plaintiff's Expenses during the Legal Proceedings*

The arrangements under Sections 199(1) and 199(2) provide the court discretion to relieve the burden of expenses even at this early stage of proceeding. Under Section 199(2), when the court has granted leave to bring a derivative action, the court can already “order the company to pay the plaintiff such sums as it may prescribe to cover the plaintiff's costs or to deposit a security for such payment.”⁴⁰ The court has discretion to distinguish between cases brought because the company is improperly prevented from averting or remedying a self-interested board's wrong or by majority shareholders acting improperly, and frivolous cases that are brought by vexatious litigants.⁴¹ Indeed, Section 200 provides that once the court has reached a decision on the derivative action, it may, amongst other options, order the plaintiff to pay the company's expenses—part or all—according to the circumstances. Therefore, in cases where the court has shifted the burden of costs onto the company at an early stage of proceedings, it may still decide to return that burden to the plaintiff if it feels there was no justification for bringing the action retrospectively.⁴²

In order to encourage derivative actions, a number of modifications were made in the context of the Companies Law. Only a part of the court fee (not the full fee) is paid at the time that a derivative action is filed. “Regulations stipulate that when a petition for the approval of a deriva-

39. Reisberg, *Derivative Action*, *supra* note 30, at 251–52.

40. Companies Law § 199(2).

41. HAVIV-SEGAL, *supra* note 33, at 606.

42. *Id.* at 607.

tive action is filed, the petitioner will pay a petition fee of NIS 2000.”⁴³ The rest of the fee will be paid only if the petition is granted, and then by the company itself. As ISA helpfully explains, “this removes an obstacle that had blocked shareholders in the past—shareholders who refrained from filing derivative actions because of the high court fee that they were required to pay upon filing the petition.”⁴⁴

4. Costs of Derivative Actions Are to Be Met by the Company and Are Not Linked to the Success of the Case

4.1 General

Section 200 provides that “where the court has adjudicated on a derivative action, it may require the company to pay the plaintiff’s costs and it may require the plaintiff to pay costs incurred by the company, in whole or in part, taking into account the judgment and the other circumstances of the case.”⁴⁵

It is clear then, that the court’s discretion to order the company to meet the costs of proceedings is not limited to situations where the action was successful, and the court may order the company to meet the costs of proceeding when appropriate, even if the case eventually failed. Essentially, this recognizes the fact that the proceedings are those of the company. In this context, perhaps a better inquiry is whether the decision to bring the action was justified in the first place, not whether it was ultimately successful.⁴⁶ Nevertheless, the words of the Act (“taking into account the judgment and other relevant circumstances”)⁴⁷ do suggest that there is still some importance placed on the success of the case.⁴⁸ An-

43. ISRAEL SEC. AUTH. [ISA], ISRAEL SELF ASSESSMENT ACCORDING TO METHODOLOGY FOR ASSESSING THE IMPLEMENTATION OF THE OECD PRINCIPLES ON CORPORATE GOVERNANCE AS PART OF PROCESS OF ACCESSION TO THE OECD 22 (Dec. 2008) [hereinafter ISA, SELF ASSESSMENT], available at http://www.isa.gov.il/Download/IsaFile_4544.pdf. At exchange rates as of September 30, 2011, this is roughly around \$540.

44. *Id.* at 22.

45. Companies Law § 200.

46. HAVIV-SEGAL, *supra* note 33, at 607.

47. Companies Law § 200.

48. Compare the test formulated by Lord Denning in *Wallersteiner v. Moir* that even if the action fails,

assuming that the minority shareholder had reasonable ground for bringing the action—that it was a reasonable and prudent course to take in the interests of the company—he should not himself be liable to pay the costs of the other side, but the company itself should be liable, because he was acting for it and not for himself.

other possible test to determine whether the plaintiff should be entitled to be indemnified by the company against all costs and expenses reasonably incurred by him in the course of the proceedings is “whether an independent board of directors would have decided to bring the action.”⁴⁹

There is no doubt that Section 200 is potentially one of the most important sections for prospective plaintiffs, as it mitigates the effect of distorted litigation incentives. With regard to a derivative claim as well, Section 201 of the Companies Law provides that in the event of a favorable ruling in the claim, the court may order the payment of compensation to the plaintiff for the effort invested in filing the petition and proving it.⁵⁰ Section 200 also provides that when a court has awarded expenses in favor of the defendant, the company will pay the expenses that have been so awarded, unless the court rules, for special reasons which shall be recorded, that the expenses are to be paid by the plaintiff.

4.2 Addressing the Issue of Attorney’s Fees Specifically

Section 200 deals with costs⁵¹ generally, but there is little guidance to the court with regard to attorney’s fees. However, a recent amendment to the Companies Law, namely Section 200A, has expressively dealt with this issue. Amendment No. 3 to the Companies Law provides that the fees of the plaintiff’s attorney in a derivative action will be set by the court and paid by the company unless the court decides for special reasons that the plaintiff should pay its attorney’s fees.⁵²

It should be noted that the Section uses the words “will be set by the court,” which imply that this is a mandatory obligation. Interestingly, the official explanation to the Amendment provides great insight into the reasoning behind the terms. According to the document, the arrangements are similar to those in the United States and are geared toward encouraging potential plaintiffs to use the tool of the derivative action.⁵³ Essentially, it is submitted—this aligns with the fact that the proceedings are brought on behalf of the company. More importantly, although Section 200 provides that once the court has reached a judgment on the derivative action the court may order the company to meet the plaintiff’s

Wallersteiner v. Moir, [1975] Q.B. 373 (U.K.).

49. *Id.*

50. Companies Law § 201.

51. In English law the term “costs” includes lawyer’s fees, whereas in Israel the term refers to the required disbursements in bringing action, i.e. filing fees. It is useful then, in order to avoid confusion, to use the term “fees” when discussing the payment due to lawyers.

52. See Companies Law § 44 (amend. 3), 2005.

53. See Companies Bill (amend.), 2002, at 646 & § 34 (explanatory notes) (Isr.).

costs, this may not be enough, as in many cases the costs granted are not sufficient (so that it may not cover, in actual terms, for all the attorney's fees).⁵⁴ Likewise, leaving the issue of attorney's fees unarranged may deter potential plaintiffs from bringing derivative actions for fear that they will have to meet the burden of attorney's fees themselves. Undetermined payment may also deter potential attorneys from taking on the representation for fear that the fee agreements between themselves and the plaintiff will not be respected by the company.⁵⁵ The lack of plaintiff-favoring fee rules in derivative actions generally limits the use of such actions, for the potential gain to the nominal shareholder plaintiff will almost always be outweighed by the potential liability for legal fees, with the result that the expected value of litigation will normally be negative. If a procedure could be devised to compensate a shareholder by ordering the company to pay the attorney his fees, then a formidable deterrent to the commencing of derivative action would be removed. The effect of Section 200 may reduce the personal risk faced by potential plaintiffs. Again, in terms of policy objective, this underlines the fact that derivative actions efficiently enforce corporate duties and obligations, and such actions would not be pursued by rational plaintiffs absent adequate fee incentives.⁵⁶ However, as I have explained elsewhere, this only reduces, rather than eliminates, the deterrent effect of fees in litigation.⁵⁷ Under Section 200, the plaintiff must prevail for the court to order the company to pay the attorney his fees.⁵⁸ If the action is unsuccessful, the plaintiff still remains liable for lawyer's fees. This may be mitigated if the court uses its discretion and orders the company to meet the costs of proceedings in case the action was unsuccessful.

5. *The Possibility of Rewarding the Plaintiff*

Section 201 provides that "where the court rules in favor of the company, it may order the payment of a reward to the plaintiff taking into account, *inter alia*, the benefit derived by the company from filing the claim and from winning it."⁵⁹ The court therefore has the discretion to increase the share of the plaintiff in the proceeds of the successful action beyond his indirect recovery (to the extent that recovery has any actual impact on the value of his shares because of the success of the case).

54. *Id.*

55. *Id.*

56. Compare the U.S. decision in *Schechtman v. Wolfson*, 244 F.2d 537, 539 (2d Cir. 1957).

57. See Reisberg, *Funding Derivative Actions*, *supra* note 2, at 351.

58. Compare with the English indemnity costs orders, see *supra* Section B.4.

59. Companies Law § 201.

This has been described as a “major revolution” as it reflects the policy of the new Act to encourage shareholders and directors to inform the court of management irregularities by means of derivative actions.⁶⁰ In large companies, where the average holdings of shareholders is rather small, meeting the costs of bringing the action by the company may not be enough to encourage potential plaintiffs to initiate derivative action. In these types of companies an additional incentive, such as receiving part of the proceeds of a successful action, may be needed. The absence of such a direct reward prior to the Companies Law of 1999 has been offered as a possible explanation of the small number of derivative actions brought in Israel in the past.⁶¹

Essentially, the Section deals directly with a fundamental obstacle inherent in derivative litigation. An indemnity order in favor of the plaintiff out of company funds is usually ordered once a derivative action is brought. It presupposes that a shareholder would want to bring the action on behalf of the company. However, it fails to promote or give any incentive for a shareholder to commence litigation in the first place.⁶²

First, there is the expense of litigation and the prospect that the shareholder may have to pay the legal expenses of the defendant if the action is unsuccessful. . . . Second, even if the litigation is successful, any damages recovered accrue to the company . . . and not just to the shareholder bringing the action. Because the plaintiff shareholder will therefore receive only a pro rata share of the gains of a successful action (and then only indirectly and only to the extent the proceedings cause the value of his own share to rise) the fact that other shareholders will “free-ride” on the plaintiff shareholder’s action creates a disincentive to commence litigation.⁶³

This sort of free-riding effect has a strong incentive for any prospective plaintiff to leave it to someone else to sue. However, “if all shareholders share the same view, no one is likely to step forward even in situations where litigation would increase total share value.”⁶⁴ Section 201 tackles this issue by making it possible for the court to award successful plaintiffs with partial proceeds of a successful action beyond their indirect recovery. In effect then, the plaintiff can benefit directly in monetary terms, which in turn may make the remedy more worthwhile in the eyes

60. HAVIV-SEGAL, *supra* note 33, at 609.

61. Y. GROSS, ON THE NEW COMPANIES ACT, 1999, at 224 (2000) (Isr.). *But see infra* Section D.2.2.3.1.

62. On the difference between removing a deterrent and providing an incentive see REISBERG, THEORY AND OPERATION, *supra* note 5, at 232–34.

63. Ramsay, *supra* note 14, at 163.

64. Cheffins, *supra* note 17.

of prospective plaintiffs. It has been suggested that the policy considerations guiding the court in determining the extent of the reward should include the severity and the extent of the abuse or infringement. The more severe the abuse or infringement, the higher the personal reward for the plaintiff should be.⁶⁵

6. Resolving a Commercial Dispute through the Israeli Courts

Finally, and before we turn to examine the new Amendment in the following Section, it is perhaps worth putting the Israeli system in a wider context in terms of the quantifiable cost, time, and procedures usually expected to resolve a commercial dispute (such as through a derivative action) through the Israeli courts. As can be seen below under Figure 1, the Israeli system does not compare favorably with the OECD average. According to Enforcing Contracts⁶⁶ published by the *World Bank*,⁶⁷ there are 35 procedures in an average commercial trial (compared with 31 at the OECD), it lasts on average 890 days (just more than 500 days at the OECD), and it costs 25.3% of the claim to resolve a commercial dispute through the Israeli courts (19% at the OECD).

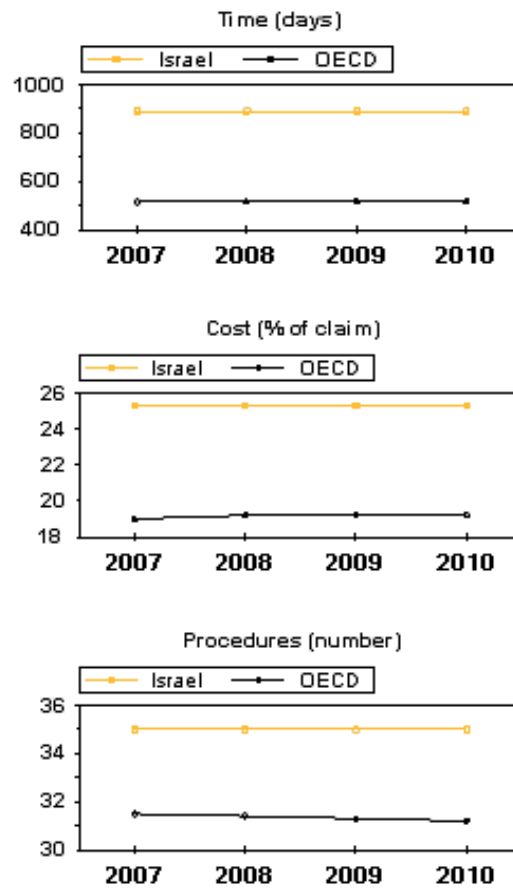
(See graphs on next page.)

65. HAVIV-SEGAL, *supra* note 33, at 608.

66. This is a slightly misleading title which measures three things: (1) number of procedures to enforce a contract, i.e. any interaction between the parties in a commercial dispute or between them and the judge or court officer, steps to file the case, steps for trial and judgment, as well as steps to enforce the judgment; (2) time required to complete procedures (calendar days), i.e. time to file and serve the case, time for trial and obtaining judgment and time to enforce the judgment; and (3) cost required to complete procedures i.e. average attorney fees, court costs, including expert fees and enforcement costs. See *Doing Business: Enforcing Contracts in Israel*, WORLD BANK (2011), www.doingbusiness.org/data/exploreeconomies/Israel/enforcing-contracts [hereinafter *Doing Business Report*].

67. *Id.*

Figure 1: Enforcing Contracts Subindicators in Israel ⁶⁸
2007–2010



68. *Id.*

C. PUBLIC FUNDING OF DERIVATIVE CLAIMS UNDER ISRAELI LAW

1. Background: The Possibility of ISA Funding for Derivative Actions

ISA⁶⁹ announced in 2005 that it would, in principle, be prepared to provide funding for derivative actions in cases it believes are “of general importance to the public.”⁷⁰ In line with this approach, Amendment 16 to the Companies Law was introduced in May 2011.⁷¹ In theory, the amendment was designed to encourage derivative actions by limiting the financial liability plaintiffs face when initiating such an action. A new Section 205 has been inserted into the Companies Law, which states as follows:

- (a) Any plaintiff, who wishes to bring a derivative action in the name of a public company or a private company, and who meets the criteria under section 171(a), is allowed to request the Israel Securities Authority to bear his costs.
- (b) If the Israel Securities Authority is convinced there is a public interest in bringing the case and there is a reasonable prospect the court would grant leave for the action to continue as a derivative action, the Authority may bear the plaintiff's costs, on such sums and conditions as it thinks fit; the Authority's decisions according to this section cannot be used as an evidence and it is not possible to submit them before the court.
- (c) If the court decided in favour of the company, the court may in its judgment provide for the company to reimburse the Israel Securities Authority for its expenses.⁷²

Section 205A makes it clear then that in order for funding to be carried out by ISA, ISA needs to be convinced that two cumulative conditions

69. The Israel Securities Authority (“ISA”) is an independent regulatory body, established under the Securities Law of 1968, whose members are appointed by the Minister of Finance. Its mandate is to protect the interests of the investing public. ISA has a wide range of responsibilities and powers. *ISA in a Nutshell*, ISA, <http://www.isa.gov.il/Default.aspx?Site=english> (last visited May 8, 2012) (for a view of the areas and issues ISA is in charge of). ISA is the Israeli equivalent of the SEC. *See infra* notes 164–73 and accompanying text.

70. *See* GLOBES, ISRAEL BUSINESS CONFERENCE 2005 REPORT: ANALYSIS SECTION (Dec. 3–5, 2005) (Isr.).

71. First, in Companies Law of 1999 Draft Bill (amend. no. 12) (Corporate Governance Efficiency) (Mar. 10, 2010), which subsequently became Companies Act (amend. no. 16), 2011 (effective May 2011) (Isr.).

72. Companies Law § 205(a)–(c).

are met: (1) there is a public interest in bringing the case⁷³ and (2) there is a reasonable prospect the court would grant leave for the action to continue as a derivative action. The rationale for this Section is explained in the following terms:

[T]he cost of funding the lawsuit may deter derivative actions from being brought, and so, in order to incentivise the plaintiff, it is proposed to introduce a similar arrangement which exists for class actions (under section 209 of the Companies Law).⁷⁴

Interestingly, the Explanatory Notes to Amendment 16 add two important points.⁷⁵ First, the plaintiff in derivative actions, in addition to benefiting himself (and like the position in class actions cases), benefits all other shareholders who are similarly positioned. Secondly, this Amendment “would strengthen enforcement in the financial markets.”⁷⁶

At first blush, this appears like a positive step forward in terms of effective corporate governance. If funding can be provided (by whatever source, even public), then this should be welcomed on the basis that it addresses the incentives problem inherent in derivative action litigation. Indeed, this amendment should be seen in its wider context—it was one of three amendments relating to derivative actions introduced as part of Amendment 16 under which the Israeli legislature sought, yet again,⁷⁷ to encourage and stimulate the use of derivative actions.⁷⁸ Nonetheless, the

73. On the public character of derivative claims see REISBERG, *THEORY AND OPERATION*, *supra* note 5, at 68–71.

74. Companies Act, (amend. no. 16), § 19 (explanatory notes) 2011.

75. *Id.*

76. *Id.* In an earlier draft of this Amendment it was stated that the derivative claim has a central role in enforcing the company’s right, including enforcing directors’ duties. It was expected the funding would be given for the application at the leave stage including covering expert and legal opinions as well as any costs that are likely to be incurred in case the court should refuse leave. See Companies Law, (amend. no. 10) para. 12 (May 2008) (Isr.).

77. Recall that, as we saw in Section C above, there were previously a number of amendments brought forward *after* the Companies Law of 1999 came into force in 2000 as the volume of derivative action litigation was perceived to be low.

78. The two additional reforms in favor of the plaintiff are as follows: first, under Section 194 the plaintiff is no longer required to make a demand first on the board before filing the suit, if the board (or most of the individuals comprising the board) have a personal interest in the lawsuit or are subject to the lawsuit or a disclosure to the board may damage the relief sought by the plaintiff. The applicant filing a derivative action can skip over this hurdle and submit the claim directly to court. Secondly, under Section 198A, an applicant filing a derivative action may now ask the court to order the company to reveal documents relating to the leave to proceed of the derivative claim. Such a request would be approved if the court is persuaded that the applicant has provided an initial evidentiary basis for the claim. It appears that this addition is introduced on the basis that this is not a

ramifications of new Section 205A require further thought. There are at least two discrete issues present. First, the details of the Section itself need to be examined. As part of this inquiry, one must look more closely at the rationales offered by the new amendment, namely, will the new rule indeed benefit all other shareholders who are similarly positioned, and would it strengthen enforcement in the financial markets. Secondly, one may wonder whether it is indeed necessarily the case that the plaintiff in derivative actions is in exactly the same position as in class actions cases. Indeed, as will be seen below, this is questionable.

2. *An Analysis of the Details of Section 205A*

This Section will first deal with the practicalities of the Section itself. Recall that ISA needs to be convinced that two conditions are met: (1) that there is a public interest in bringing the case; and (2) that there is a reasonable prospect the court would grant leave for the action to continue as a derivative action. Let us first deal with the latter.

2.1 There is a Reasonable Prospect That the Court Would Grant Leave for the Action to Continue as a Derivative Action

The second condition for deciding whether a derivative action should be allowed to proceed is spelled out in a similar fashion to other various derivative action legislations.⁷⁹ There is nothing novel about this. Indeed, it is reasonably clear what this will entail.⁸⁰ To take a recent example from the U.K., *Iesini v. Westrip Holdings Ltd*⁸¹ usefully noted some of the factors which a director, acting in accordance with Section 172 of the U.K. Companies Act 2006 (which is what the court is directed to consider) would take into account in reaching his or her decision whether to allow a derivative claim to proceed:

personal action, and as such, the shareholder plaintiff may not be in possession of all the material he needs in order to be able to establish an exhaustive and substantive claim. On the problem of access to information and discovery in derivative actions, see REISBERG, THEORY AND OPERATION, *supra* note 5, at 85–87, 216–19 (“In derivative action litigation there is an added concern. Information asymmetries accompany managerial misconduct: directors know the frequency and amount of harm caused by their misconduct, whereas shareholders do not.”).

79. See, e.g., New Zealand Companies Act 1993, § 165(1)(b) (N.Z.) (“the likelihood of the proceeding succeeding”); see also Companies Act 2006, c. 46, § 263(2)(a) (U.K.) (“Permission (or leave) must be refused if the court is satisfied—(a) that a person acting in accordance with Section 172 (duty to promote the success of the company) would not seek to continue the claim.”).

80. Companies Law § 263(2)(a) (referencing exemption and indemnification decision by directors).

81. *Ienesi v. Westrip Holdings Ltd.*, [2009] EWHC (Ch) 2526 (Eng.).

They include: the size of the claim; the strength of the claim; the cost of the proceedings; the company's ability to fund the proceedings; the ability of the potential defendants to satisfy a judgment; the impact on the company if it lost the claim and had to pay not only its own costs but the defendant's as well; any disruption to the company's activities while the claim is pursued; whether the prosecution of the claim would damage the company in other ways (e.g. by losing the services of a valuable employee or alienating a key supplier or customer) and so on. The weighing of all these considerations is essentially a commercial decision, which the court is ill-equipped to take, except in a clear case.⁸²

So far, so good. But the crucial question here is altogether different—whereas judicial oversight in deciding such factors is commonplace (i.e. in virtually all jurisdictions in which the derivative action has been put on a statutory footing the court is entrusted with this task),⁸³ and noncontroversial, it is ISA which is asked to conduct this assessment (in all likelihood *before* applying to the court) in addition to the court. Leaving aside the issue of duplication (discussed below), the question is how well can ISA perform the specific task of *evaluating* the potential success of litigation? Are ISA's officials qualified to conduct such a task? Whereas ISA has some experience and expertise in evaluating the potential success of litigation in the area of class action,⁸⁴ it is by no means on the scale or comes as "natural" as for the court. Courts have a lengthy history of determining cases involving breaches of duty and have developed considerable expertise and knowledge in this area.⁸⁵ "[T]o the extent that the determination hinges on an appraisal of the *merits* of the litigation, it has been suggested that the court's perspective and expertise are superior to the boards."⁸⁶ There is no reason why an independent expert may not, in appropriate cases, be allowed to investigate and advise ISA on the action⁸⁷ (naturally this requires allocating further financial resources too),

82. *Ienesi*, EWHC (Ch) at [85].

83. Jurisdictions including: Canada, Australia, New Zealand, Singapore, and South Africa, to name a few.

84. *See infra* C.3.

85. *See* REISBERG, *THEORY AND OPERATION*, *supra* note 5, at 232–41.

86. Ramsay, *supra* note 14, at 173–74; *see* John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 282–83 (1981).

87. The South African legislature provides, in the limited context of the statutory derivative action, a first step for the appointment by the court of a *curator ad litem*, whose role is to investigate the shareholder's complaint and advise the court whether the litigation should be allowed to proceed. Companies Act 61 of 1973 § 266 (S. Afr.). The curator is given unrestricted access to the company's books and records. Likewise in

which in turn may provide ISA with arguably better and more neutral information than either a resolution in a shareholders' meeting or the views of an allegedly biased board. Nonetheless, and although ISA's expertise can gradually develop over time, there is an inescapable problem here. Whereas the court's role in assessing this question is unquestionably unbiased (in the sense that it is not party to the litigation), ISA's position here is more akin to that of a party to the litigation rather than an independent adjudicator.⁸⁸ Once it decides to support a case by giving it a "stamp of approval" in the form of financial support, it is inevitably a party to the litigation regardless of the fact that ISA's decision to support the case cannot be used as evidence and it is not possible to submit it before the court.

2.2. Is There a Public Interest in Bringing the Case?

The Paper now turns to the first condition under Section 205A in order for funding to be carried out by ISA, namely, that there is a public interest in bringing the case. The discussion about this element needs to be broken down into a number of avenues of inquiry. These are explored in detail next.

2.2.1 Litigation is a Public Good

The argument that derivative actions solve a collective action problem rests on the premise that, very much like the class action mechanism,⁸⁹ the device enables the creation of a good that would not otherwise be produced, namely, a lawsuit. In other words, litigation can be conceptualized as a public good as "its pursuit produces positive externalities, and litigants in group-like situations therefore have incentives to free ride."⁹⁰ But Rubenstein rightly asks:

Section 247(A) of the Australian Corporations Law, the court, on application by a shareholder "acting in good faith and for a proper purpose," is authorized to order that the applicant be allowed to inspect the company's records, not personally, but through a lawyer or registered company auditor acting on his behalf, on such terms as the court thinks fit. *Corporations Act 2001* (Cth) s 247(A) (Austl.).

88. Indeed, recall that Section 209 provides that if the court decided in favor of the company, the court may in its judgment provide for the company to reimburse ISA for its expenses. Companies Law § 209(c). This is very similar to the arrangement under Section 200, *supra* Section B.4, under which the court may order the company to meet the plaintiff's costs. Companies Law § 200.

89. William B. Rubenstein, *Why Enable Litigation?: A Positive Externalities Theory of the Small Claims Class Action*, 74 UMKC L. REV. 709, 709 n.5 (2006).

90. *See id.* at 720–28.

[w]hat are the positive externalities that flow from individual litigation? Most generally, as Judge Posner explains, litigation “establishes rules of conduct designed to shape future conduct, not only the present disputants’ but also other people’s.” These “rules of conduct” constitute goods with the attributes of public goods: the rules of conduct are not diminished when used and no individual can be excluded from using them. More specifically, the positive externalities of individual lawsuits can be grouped into four sets of effects: 1) decree effects; 2) settlement effects; 3) threat effects; and 4) institutional effects.⁹¹

First, one must look at decree effects. This is based on the assumption that the legal principle developed in a particular case will generate more certainty in shaping social behavior and, at the same time, lower the need for future adjudication regarding the decided matter.⁹² It follows that a potential social benefit from derivative action litigation is solely supplementary to its role as a governance mechanism: legal rules are public goods.⁹³ In theory then, litigation can reduce legal uncertainty.

As Kamar explains, the absence of clear legal rules is costly.⁹⁴ First, it leads to variance in valuations of the legal standard and therefore to divergences of behavior from what is perceived to be the social optimum.⁹⁵ This may result in corporate fiduciaries overestimating the legal constraints and forgoing efficient transactions, while other fiduciaries may undervalue the very same restrictions and carry out inefficient transactions. Second, legal indeterminacy produces liability risk that risk-averse fiduciaries are in a somewhat poor position to bear. This is because exposing corporate fiduciaries to this risk results in their services being more costly and less productive to shareholders.⁹⁶

91. *Id.* at 723 (citations omitted) (quoting RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 530–31 (6th ed. 2003) (discussing social benefits of litigation beyond dispute resolution); see also Kenneth E. Scott, *Two Models of the Civil Process*, 27 *STAN. L. REV.* 937, 938 (1975) (describing a “behavior modification model” of litigation in which “[n]ot the resolution of the immediate dispute but its effect on the future conduct of others is the heart of the matter”).

92. *Id.*; see also HAZEL GENN, *JUDGING CIVIL JUSTICE* 74 (2010) (“an elaborated, granular body of rules in a common law system offers guidance on how to ascertain legal risk”).

93. See Romano, *supra* note 19; FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 34–35 (1991).

94. Ehud Kamar, *Shareholder Litigation Under Indeterminate Corporate Law*, 66 *U. CHI. L. REV.* 887, 888–89 (1999).

95. *Id.*

96. *Id.*

The decree effects have a number of positive externalities. First, there is a general legal effect: if future litigation does arise, the decree from the initial case will serve as *stare decisis*, hence making resolution of later cases more efficient. Second, the decree in the initial case could also be used to preclude relitigation of factual matters in future cases among the same or similarly situated litigants. Finally, the decree may necessitate a party to stop a practice affecting a wider group of individuals (that is in spite of the fact that the initial case was prosecuted by only one of them). In short, a particular lawsuit that generates a judicial decision has therefore produced noteworthy social benefits in terms of forming conduct, lessening litigation costs, and conserving judicial resources.⁹⁷

Second, individual lawsuits resulting in settlements,⁹⁸ may nevertheless produce analogous positive externalities as “settlement effects.” “If one litigant successfully challenges a policy that affects many persons, a defendant may agree to change its behavior as to the entire class.”⁹⁹ For example, in *Fletcher v. A.J. Industries, Inc.*,¹⁰⁰ a derivative action had been settled by certain agreements regarding the future conduct of corporate affairs, and the court held that the settlement had resulted in a substantial benefit to the corporation and therefore that the plaintiff was entitled to an award of attorneys’ fees despite the fact that no fund was produced.¹⁰¹

It should be highlighted that even if a defendant does not subscribe as a formal matter to alter its general policy as a result of the initial case, it may nevertheless do so informally lest it be faced with repeated lawsuits. This may be the case if a group of plaintiffs is closely related to one another or share legal counsel—in such a case, information about the initial settlement can easily be spread among similarly situated parties, who can then use it to their benefit. And vice versa: shared information about a weak settlement may dissuade litigation. In the same way, settlements by some defendants within the same industry could boost other defendant/competitors to opt for settling

97. Rubenstein, *supra* note 89, at 723–24. This is one of the primary reasons that Professor Fiss opposes settlement. See Owen M. Fiss, *Against Settlement*, 93 YALE L.J. 1073, 1085 (1984). Indeed, it is not necessarily true that an unsatisfactory settlement is better than the best trial. “Trials reduce disputes and it is profound mistake to view a trial as a failure of the civil justice system.” Patrick E. Higginbotham, *So Why Do We Call Them Trial Courts?*, 55 SMU L. REV. 1405, 1421 (2002); see also GENN, *supra* note 92, at 74.

98. After all, the vast majority of civil cases are settled. See, e.g., GENN, *supra* note 92, at 21.

99. Rubenstein, *supra* note 89, at 724.

100. *Fletcher v. A.J. Indus., Inc.*, 266 Cal. App. 2d 313, 72 Cal. Rptr. 146 (1968).

101. *Id.*

their case. In short, settlements, as well as judicial decrees, produce three major positive externalities: they alter behavior beyond the initial parties, diminish future litigation costs with settlement range determinations, and maintain judicial resources.¹⁰²

In the context of derivative actions, there is yet another strength in the settlement process that enables the derivative action to confer a public good. As seen earlier, because of his small stake in the company, the protesting shareholder has very little incentive to reflect on the gravity of the action on the company.¹⁰³ Therefore, derivative actions generate a risk of strategic behavior by minority shareholders. They open the “possibility for ‘gold-digging’ claims,”¹⁰⁴ meaning that the plaintiff shareholder and defendants pursue their own advantages while likely ignoring those interests of the company. To reduce the possibility of such claims, for example, under English law, an order for an indemnity in respect to costs awarded to a shareholder also requires court approval for any offer of settlement of the action.¹⁰⁵ “This procedure is analogous to that in the United States¹⁰⁶ and Israeli¹⁰⁷ systems for class and derivative actions, which does not otherwise exist in the procedure under English law.”¹⁰⁸ Control of settlements by the courts therefore produces a public good by guarding against abuse.¹⁰⁹

102. Rubenstein, *supra* note 89, at 724.

Unlike traditional litigation, remarkably few of the [derivative] suits in my study ended with monetary payments. Instead, these suits more commonly ended with corporations agreeing to reform their own corporate governance practices, from the number of independent directors on their boards to the method by which they compensate their top executives. These settlements reflect the rise of a new type of shareholder activism, one that has gone undocumented in the legal literature.

Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 WM. & MARY L. REV. 1749, 1749 (2010).

103. Wilson, *supra* note 7, at 179–80.

104. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 354.

105. CPR 19.9(3) (U.K.).

106. Rule 23.1(c) of the Federal Rules of Civil Procedure provides that “[a] derivative action may be settled, voluntarily dismissed, or compromised only with the court’s approval.” FED. R. CIV. P. 23(1)(c).

107. Section 202 provides that “A plaintiff shall not withdraw a derivative action, and shall not enter into an arrangement or settlement with the defendant, other than with the consent of the court; the application for such consent specify all details of the arrangement or settlement, including any payment offered to the plaintiff.” Companies Law § 202.

108. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 354.

109. See REISBERG, THEORY AND OPERATION, *supra* note 5, at 68–69.

Third, "the very threat of individual litigation, absent settlement or decree, may also produce positive social benefits"¹¹⁰ in the form of enhanced deterrence.¹¹¹ The argument for a deterrence rationale relies on a likely unknowable variable: gains to shareholders resulting from future deterred misconduct.¹¹² Although these gains cannot be quantified reliably, it is easy to understate them. This is partly because a successful derivative action likely spurs a positive externality: deterrence of misconduct in other companies.¹¹³ As a result, even if the deterrent benefits to the company in whose name the action is brought do not exceed the company's direct and indirect litigation costs, its shareholders still may benefit.¹¹⁴ In addition, arguably, a credible threat of an action, "particularly one that can get beyond a motion to dismiss,"¹¹⁵ has an important consequence. "The desire to avoid litigation . . . provides a lever for influencing the conduct of senior management and the board."¹¹⁶ Likewise, when the deterrence query is fixated upon a threatened mischief to shareholders themselves, there is then a basis to allow some recovery out of prophylactic concerns in order to reiterate that directors possess an ultimate responsibility to the shareholders.¹¹⁷

Finally, and similar to the case in class actions put forward by Rubenstein,¹¹⁸ the institutional upshot of the derivative action device is the growth of a private group of law enforcers. By enabling litigation,

110. Rubenstein, *supra* note 89, at 724.

111. See also *id.* at 59–66 (for a discussion of the role of deterrence in derivative actions).

112. John C. Coffee, Jr., *New Myths and Old Realities: The American Law Institute Faces the Derivative Action*, 48 BUS. LAW. 1407, 1428 (1993) [hereinafter Coffee, *New Myths and Old Realities*].

113. In this respect, Shavell explains that the social benefits of litigation could exceed the private benefits in some instances. An illustration would be where the action generates some beneficial deterrent effects that cause others to desist from a course of conduct that would impose externalities on society. Steven Shavell, *The Social Versus the Private Incentive to Bring Suit in a Costly Legal System*, 11 J. LEGAL STUD. 333, 334 (1982).

114. For example, a study in the United States has shown that the "impact of decisions in derivative cases like *Caremark*, *Disney*, and *Oracle* goes well beyond the outcome of the cases themselves. These decisions changed the rules for future legal practice by forcing companies to accept better conduct and procedures." Robert Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1749 (2004).

115. Robert H. Mundheim, *Commentary: The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 55, 57 (1999).

116. *Id.* In other words, education of the board and senior management may well be an ancillary benefit when assessing the impact of these actions.

117. See REISBERG, *THEORY AND OPERATION*, *supra* note 5, at 184–87.

118. *Id.*

the derivative action has the structural effect of sharing law enforcement among public agencies and private enforcers and of reallocating a substantial amount of that enforcement to the private sector. The latter may be classified as a significant value if private enforcement is, as often argued, more efficient than public enforcement. Even if private enforcement produces its own difficulties (e.g. the agency costs that derivative actions generate), “the sheer diversity of enforcers should generate more innovations than a monopolistic government enforcer would produce. These *structural effects* are not the immediate purpose of any particular piece of derivative action litigation, yet they are critical externalities of class suits.”¹¹⁹

2.2.2 The Public Character of Derivative Claims

The second question that arises asks why is it assumed in Amendment 16 that there would even be “a public interest” in bringing a derivative action? After all, in the corporate setting, a derivative action can be perceived as being just another commercial dispute as it usually addresses purely private injuries. For example, it is not uncommon for an English court to characterize its objective as simply doing justice to those harmed by the director’s misconduct, i.e. it is concerned with a resolution of a private dispute (likely compensation).¹²⁰

119. Rubenstein, *supra* note 89, at 724–25 (citation omitted). For a recent exploration of this see Lars Klöhn, *Private Versus Public Enforcement of Laws—A Law & Economics Perspective* 13–14 (Ludwig-Maximilians-Universität Munich Working Paper, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1730308. Public enforcement resources may also be inadequate. On the general problem of public law enforcement see A. Mitchell Polinsky & Steven Shavell, *The Theory of Public Enforcement of Law*, in 1 HANDBOOK OF LAW AND ECONOMICS 406–07 (A. Mitchell Polinsky & Steven Shavell eds., 2006). Standard policy analysis in corporate law strongly favors the private side. It is usually thought that “private enforcement benefits from the sharp prod of financial incentives, while public enforcers are civil servants working within burdensome administrative contexts.” W.W. Bratton & M.L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 163 (2011). “Effective public and private enforcement reinforces self discipline as the real threat of legal action compels companies to tighten their governance processes to ensure conduct consistent with the law.” MALAY. SEC. COMM’N, *Chapter 6: Public and Private Enforcement*, CORPORATE GOVERNANCE BLUEPRINT 65 (2011) [hereinafter MALAY. SEC. COMM’N REPORT], available at http://www.sc.com.my/eng/html/cg/cg2011/pdf/cg_blueprint2011.pdf. Given a limited public apparatus, it follows that any private enforcement is better than none. Bratton & Wachter, *supra*, at 70.

120. The latter objective is well illustrated in the reasoning of *Nurcombe v. Nurcombe* [1985] 1 W.L.R. 370, 378 (Lord Browne-Wilkinson, L.J.) (U.K.).

However, as Cox explained elsewhere,¹²¹ “few shareholder actions entail breaches of a private contract between the plaintiffs and the [action]’s defendants.”¹²² Instead, most actions are based on breaches of fiduciary obligations or, more commonly, fraud. It is clear then that in most derivative actions the norm invoked has a *substantial*, if not *exclusive, public source and importance*.¹²³ Indeed, it has been argued that “[t]he right for a minority shareholder to take derivative action performs the purpose of checking majority abuse of the company and is thus a *public good* provided by regulation which otherwise would not be if left to private bargain.”¹²⁴ Or as an advisory committee in Australia usefully put it, “private enforcement accomplished via shareholder litigation may be preferable to public enforcement.”¹²⁵ As such, “[t]his area of law is thus more mandatory/prohibitory in nature and should not be contractu-

121. REISBERG, THEORY AND OPERATION, *supra* note 5, at 68–69.

122. James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3, 11 (1999).

123. This point was usefully framed in *Zapata Corp. v. Maldonado* wherein the Court held that it “should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation’s best interests.” 430 A.2d 779, 789 (Del. 1981). Perhaps the best example is where a derivative action holds an entire board of experienced directors liable for breach of duty. See *Smith v. Van Gorkom*, 488 A.2d 858, 880, 893 (Del. 1985), *overruled by* *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009), *superseded by statute*, DEL. CODE ANN. tit. 8, § 102 (West). Arguably we all benefited from the “public good” provided by Mr. Moir’s plight in *Wallersteiner v. Moir*, [1975] Q.B. 373 (U.K.). There is also ample evidence from the US to support this point. *Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971) “set a standard of conduct which reverberated throughout” the mutual fund industry.

The case held that an adviser to a mutual fund occupied a fiduciary relationship to it and could not sell that position for a profit. The profit in that situation amounted to pennies per share. But the point here is that the case set a standard of conduct for an entire industry. The same could be said of many other notable [cases]: *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955); *Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971); *Fogel v. Chestnutt*, 533 F.2d 731 (2d Cir. 1975), to name a few. None of those derivative actions involved large recoveries for the [companies] for whom they were brought. And certainly if you calculated the recoveries on a share by share basis, they would have been [tiny]. But they were of immeasurable importance to the integrity of corporate governance by setting standards for corporate actors.

Stanley M. Gorssman, *Commentary: The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 47, 47–48 (1999).

124. Iris H. Chiu, *Contextualising Shareholders’ Disputes: A Way to Reconceptualise Minority Shareholder Remedies*, 2006 J. BUS. L. 312, 337 (emphasis added).

125. COMPANIES & SEC. ADVISORY COMM., REPORT ON A STATUTORY DERIVATIVE ACTION (1993).

ally waived or modified.”¹²⁶ In addition, the corporate group, rather than “private partnership,” has become “the quintessential model of corporate business activity in the late twentieth century.”¹²⁷ In this context, corporate activity (and in particular the exercising of directors’ discretion in business decision-making) has become more of a “public” concern, which should therefore be subject to greater judicial scrutiny in order to protect individual members’ rights.¹²⁸

In theory, therefore, “derivative actions provide a *public link* to the norm by requiring resolution in court, where potentially a public voice, the court, addresses the facts of each case through the lens of the applicable norm.”¹²⁹ Moreover, attracting judicial attention to the public potential of the derivative action is strongly supported by the traditional *raison d’être* of the derivative action.¹³⁰ Standing to bring a derivative action is conferred as otherwise a wrong to the company will go without redress.¹³¹ Such an approach invites early consideration of the public character of derivative actions.¹³² Moreover, as Coffee rightly noted,

126. Chiu, *supra* note 124, at 338. This is because the investor protection objective, which could be pursued in a minority derivative action in court, may not be capable of being met through private bargain. It should be noted that in the United States where the contrarian approach is more widely accepted, modification of the minority derivative action by allowing derivative grievances to be arbitrated in lieu of a derivative action in court has become acceptable. See Jeffrey A. Sanborn, *The Rise of “Shareholder Derivative Arbitration” in the Public Corporation*: In *Re Salomon Inc. Shareholders’ Derivative Litigation*, 31 WAKE FOREST L. REV. 337, 340 (1996); see also Andrew J. Sockol, *A Natural Evolution: Compulsory Arbitration of Shareholder Derivative Suits in Publicly Traded Corporations*, 77 TULANE L. REV. 1095, 1111, 1114 (2003) (arguing that shareholder arbitration should become the norm for derivative actions); Frank H. Easterbrook, *Pragmatism’s Role in Interpretation*, 31 HARV. J.L. & PUB. POL’Y 901, 905 (2008).

127. Stephen Bottomley, *Shareholders’ Derivative Actions and Public Interest Suits: Two Versions of the Same Story?*, 15 UNIV. N.S.W. L.J. 127, 141–42 (1992).

128. *Id.* For judicial recognition (in Canada) of the public role of management, and the corresponding need for strict standards of conduct see *Canadian Aero Service Ltd. v. O’Malley*, [1973] S.C.R. 592, 610 (Can.).

129. Arad Reisberg, *Shareholders’ Remedies: The Choice of Objectives and the Social Meaning of Derivative Actions*, 6 EUR. BUS. ORG. L. REV. 227 (2005) (emphasis in original). “While the reality is that most cases settle, a flow of adjudicated cases is necessary to provide guidance on the law and, most importantly, to create credible threat of litigation if settlement is not achieved.” GENN, *supra* note 92, at 21.

130. For example, the fact that a member may bring a derivative action in relation to wrongs which were done to the company before he became a member. See generally *Seaton v. Grant*, [1867] L.R. 2 Ch. App. 459 (Eng.) (which illustrates that compensation cannot be the sole rationale i.e. “true injury” is not required).

131. *Smith v. Croft* (No 2), [1988] Ch. 114 at 186 (Eng.).

132. See also Lord Wedderburn of Charlton, *The Social Responsibility of Companies*, 15 MELB. U. L. REV. 4, 24 (1985) (“[fiduciary duty] is imposed in private law, but with a

once private disputes are transported into the domain of a public courtroom, a limited public interest must be accepted as attaching to the decision procedure.¹³³ This public interest does not mean that every cause of action should be litigated at whatever cost to the company and its shareholders, nonetheless it does require that courts steer their business in a suitable fashion. For example, if a court is told that bribery is a profitable yet illegal method of doing business and a company demonstrates a plan to carry on with such conduct, then that court is morally compromised if it straightaway dismisses the action.¹³⁴

2.2.3 The "Public Interest" Fallacy?

The discussion about the "public character" of derivative actions so far presupposed a resolution of the dispute in court. However, Amendment 16 additionally provides discretion for ISA to decide on matters of "public interest." In other words, the legislature intervened in this area implying two policy premises: first, that there should be more public enforcement in this area of law (or put more accurately, that public enforcement should complement private enforcement when it is in the public "interest" to do so), and second, that it is in the "public interest" that more such cases be brought (i.e. there are not enough derivative action cases brought). This, nonetheless, raises some questions that warrant attention.

2.2.3.1 Is There a Market Failure That Requires Intervention?

The general justification for government intervention most commonly used by mainstream economists, mostly rests on the view that a particular market can be enhanced because it "fails"—that is, it does not achieve "public interest" objectives. It follows that the state should intervene to regulate what would otherwise be the market outcome.¹³⁵ This seems to be the case in this discussion. In spite of the various measures introduced for the derivative action procedure since the Israeli Companies Law was introduced in 2000,¹³⁶ very few derivative action cases are initiated by private enforcers (leaving for a second the question of whether this is

public function. It is a vehicle of a social purpose.") (emphasis in original). See generally J.E. PARKINSON, CORPORATE POWER AND RESPONSIBILITY: ISSUES IN THE THEORY OF COMPANY LAW 200–36 (1993).

133. John C. Coffee, Jr., *Litigation and Corporate Governance: An Essay on Steering between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 817 (1983).

134. *Id.*

135. JOHN BLUNDELL & COLIN ROBINSON, REGULATION WITHOUT THE STATE . . . THE DEBATE CONTINUES 3 (2000).

136. See *supra* Section C.

true or not).¹³⁷ And so a governmental body, namely ISA, is charged with improving the situation. But, as will be seen next, there are a number of fundamental problems with this “market-failure” approach to policy-making.

a. The Infrequency of Proceedings Argument

There is an important point to be made here, which relates to the arguably low number of cases brought under Israeli law. Very much like the U.K., which despite reforms¹³⁸ has not seen an increase in the number of derivative actions,¹³⁹ there are currently few derivative actions brought in Israel by private plaintiffs. Likewise in Canada, where the statutory derivative action has been part of the law for many years, although the device hasn’t been used very frequently, there have still been some influential cases. Canadian writers have therefore opined that the “statutory derivative action has failed to make a dramatic [practical] impact.”¹⁴⁰ Focusing on the infrequency of proceedings may, nonetheless, be a misleading portrayal as “[i]t is not necessarily a flaw that there may in practice be few cases brought under the derivative action jurisdiction.”¹⁴¹ Arguably, this fact is actually in line with the very nature of the derivative action, as is explained next.

First and foremost, recall that a derivative action is an action that should only be brought in exceptional circumstances. The principle underlying the limitations on the derivative action, that generally the company is the proper plaintiff and that only in exceptional circumstances cases should shareholders be able to sue on its behalf, is a sound one.¹⁴²

137. A “worrying feature” of this policy was that it “proceeded on the basis of anecdote and the partial views of different actors within the system.” GENN, *supra* note 92, at 62. This phenomena of “policy making in the dark” is, however, a common feature of civil justice reviews around the world conducted in the absence of any research or empirical data. *Id.*; see also *infra* Section C.2.2.3.1 a–c.

138. As the Company Law White Paper acknowledged it is possible but unlikely that putting derivative actions on a statutory footing will affect the low number of cases brought. DEP’T OF TRADE & INDUS., COMPANY LAW REFORM, 2005, at 275, cmt. 6454 (U.K.).

139. See, e.g., Coffee, *Privatization and Corporate Governance*, *supra* note 21, at 2 (noting the sharp contrast between the UK and US in shareholder enforcement); Eilis Ferran, *Company Law Reform in the UK*, 5 SING. J. INT’L & COMP. L. 516, 541 (2001).

140. Brian R. Cheffins & Janet M. Dine, *Shareholder Remedies: Lessons from Canada*, 13 COMPANY LAW. 89, 94 (1992).

141. S. Deakin, E. Ferran & R. Nolan, *Shareholders’ Rights and Remedies: An Overview*, 2 COMPANY FIN. & INSOLVENCY L. REV. 162, 164 (1997); Pearlie Koh Ming Choo, *The Statutory Derivative Action in Singapore—A Critical Examination*, 13 BOND L. REV. 64, 81 (2001).

142. See REISBERG, THEORY AND OPERATION, *supra* note 5, at 77–80.

No one would welcome a change in the law that opened the floodgates to corporate litigation. The real problem with the law as it presently stands is, although in theory it contains a derivative action, the rules relating to it have become so uncertain and obscure that no one can confidently predict when such an action will be allowed to proceed, if at all.¹⁴³ This last point is indeed confirmed by the view of one practitioner.¹⁴⁴

Second, given the deterrence objective of the action, a positive interpretation could be that the evidence in Canada indicates that the action is indeed working. A low number of litigated actions does not necessarily indicate that the derivative action is failing to make an impact. In fact, if the courts had been swamped with derivative applications, the fear expressed by the U.K. Law Commission and others that the availability of the action has potential to expand companies' involvement in futile and disruptive litigation¹⁴⁵ would certainly have been vindicated. There will always be fraud and corporate malpractice. The law has not eliminated these, nor will derivative actions or any other mechanism of corporate governance. It is nevertheless likely that the derivative action, if perceived as a potent threat and if freed of its procedural handcuffs, may have an effect on those involved in corporate governance and, over the long run, may change their values and the ways in which they go about their tasks. There will be cases where such proceedings justify redressing serious corporate abuse "on the ground of necessity alone in order to prevent a wrong going without redress."¹⁴⁶

Finally, the infrequency of proceedings as a likely inaccurate pointer to the effectiveness of the derivative action can also be seen from the experience with the U.K. wrongful trading actions.¹⁴⁷ The available evidence indicates a relatively low number of wrongful trading petitions, espe-

143. Deakin et al., *supra* note 141, at 164-65; see also Reisberg, *Derivative Claims*, *supra* note 3, at 47.

144. Kosmin suggests that the average practitioner often gives up in despair and turns to alternative routes, not always successful ones, and that the Law Commission's description of the law in this area as being virtually inaccessible save to lawyers specializing in the field is being too generous. Leslie Kosmin, *Minority Shareholders' Remedies: A Practitioner Perspective*, 2 COMPANY FIN. & INSOLVENCY L. REV. 201, 212-13 (1997).

145. For a firm advocate of this view see, for example, Christopher Hale, *What's Right with the Rule in Foss v. Harbottle?*, 2 COMPANY FIN. & INSOLVENCY L. REV. 219, 226 (1997).

146. *Smith v. Croft* (No 2), [1988] Ch. 114 at 185 (Eng.).

147. Insolvency Act, 1986, c. 45, § 214 (U.K.). For a stimulating discussion on what is generally the socially optimal level of litigation given its expense and how it compares to the privately determined level of litigation see generally Steven Shavell, *The Level of Litigation: Private Versus Social Optimality*, 19 INT'L REV. L. & ECON. 99 (1999).

cially compared with disqualification proceedings.¹⁴⁸ There are different views about the extent to which Section 214 of the relevant Insolvency Act has been a success.¹⁴⁹ At the same time, although there has not been an abundance of cases in the area, there have been important ones.¹⁵⁰ More notably, it has been suggested that the infrequency of proceedings is probably not an accurate pointer to the effectiveness of the sections.¹⁵¹ In many situations the wrongful trading sections are operating on the minds of directors who will have been warned about the dangers they face once the company becomes insolvent.¹⁵² It can be seen then that the legislation presents an important theoretical limitation on the otherwise prevalent doctrine of limited liability. And there is no reason to assume that the same incentives could not present themselves with respect to derivative action litigation.

Returning to the Israeli context, we already mentioned that the prevailing perception in Israel seems to be that there are not enough or sufficient derivative actions cases brought by private enforcers. Not only is this based on anecdote and the partial views of different actors within the system, but, in fact, the level of investor protection (such as by means of shareholder suits) afforded by the Israeli system is relatively high by international standards, which suggests that an argument for reform that rests predominantly on the perception of low level of litigation is misguided. For example, according to the World Bank *Doing Business 2011 Report*, Israel is ranked 5 in the world (out of 183 economies) in terms of the level of protection afforded to investors (see Figure 2 below), and its strength of investor protection index is 8.3 (out of 10), which is much higher than the OECD average of 6 (see Table 1 below). These figures makes the case for reform, which rests on the infrequency of proceed-

148. See Rizwaan J. Mokal, *An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives and the Creditors' Bargain*, 59 C.L.J. 335, 335–57 (2000). It is estimated that disqualification cases are now reaching a figure of 1,500 per year. See A. Hicks, *Wrongful Trading—Has it been a Failure?* 9 INSOLVENCY L. & PRAC. 134 (1993); Rebecca Perry & David Milman, *Transaction Avoidance Provisions in Corporate Insolvency: An Empirical Study*, 14 INSOLVENCY L. & PRAC. 280 (1998).

149. See, e.g., B.G. PETTET, *COMPANY LAW* (2005) 36–37; see also Fidelis Oditah, *Wrongful Trading*, LLOYD'S MAR. COM. L.Q. 205 (1990); Mokal, *supra* note 148, at 148.

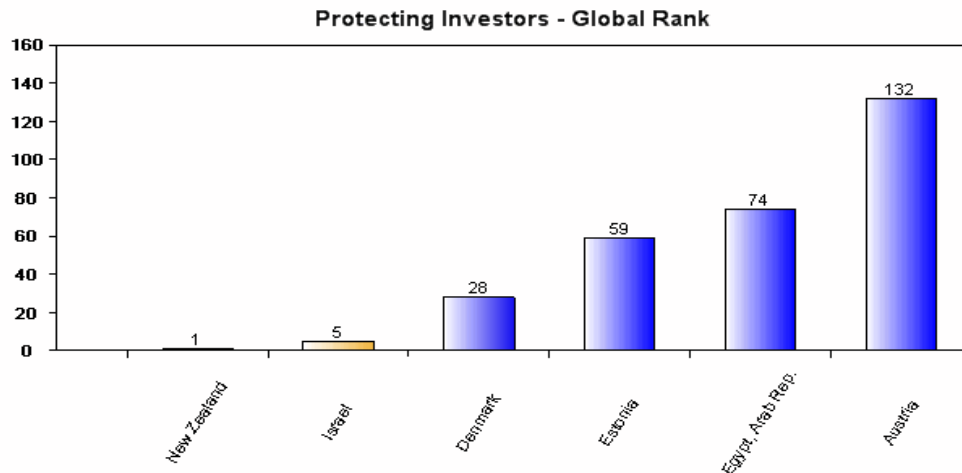
150. See generally *Re Produce Mktg. Consortium Ltd.* (No. 2), [1989] B.C.L.C. 520 (Eng.); see also *Re Hydromat (Corby) Ltd.*, [1994] 2 B.C.L.C. 180 (Eng.); *Re Sherborne Associates Ltd.* [1995] B.C.C. 40 (Eng.); *Re Brian D Pierson (Contractors) Ltd.*, [2000] 1 B.C.L.C. 275 (Eng.).

151. PETTET, *supra* note 149, at 36–37.

152. *Id.*

ings, even more shaky and raises questions as to whether there was indeed a need to go that far by providing public funding.

Figure 2¹⁵³



153. See *Doing Business Report*, *supra* note 66. This measures the strength of minority shareholder protections against misuse of corporate assets by directors for their personal gain. This methodology was developed by Simeon Djankov et al., *Debt Enforcement Around the World*, 116 J. POL. ECON. 1105 (2008). This is, of course, not the only methodology available. A number of academic works offer additional insights into investor protection. See Priya P. Lele & Mathias S. Siems, *Shareholder Protection: A Leximetric Approach*, 7 J. CORP. L. STUD. 17 (2007) (proposing a shareholder protection index for five countries and code the development of the law for over three decades); John Armour et al., *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis*, 6 J. EMPIRICAL LEGAL STUD. 343 (2009) (using a panel data set covering a range of developed and developing countries, showing that common law systems were more protective of shareholder interests than civil-law ones in the period 1995–2005 and that civilian systems were catching up, suggesting that legal origin was not much of an obstacle to formal convergence in shareholder protection law); Simon Deakin & Mathias Siems, *Comparative Law and Finance: Past, Present, and Future Research*, 166 J. INSTITUTIONAL & THEORETICAL ECON. 120 (2010) (reporting the results of a new approach to coding which has produced longitudinal data sets on shareholder, creditor, and worker protection). There has also been some academic criticism of the above overall ranking, in particular in the literature on law and finance and amongst economists. See, e.g., Claude Ménard & Bertrand du Marais, *Can We Rank Legal Systems According to Their Economic Efficiency?*, 26 WASH. U. J.L. & POL'Y 55 (2008); Benito Arruñada, *Pitfalls to Avoid When Measuring Institutions: Is Doing Business Damaging Business?*, 35 J. COMP. ECON. 729 (2007).

Table 1: Israel-OECD¹⁵⁴
Strength of Investor Protection Index¹⁵⁵

Indicator	Israel	OECD Average
Extent of disclosure index (0-10)	7	6
Extent of director liability index (0-10)	9	5.2
Ease of shareholder suits index (0-10)	9	6.9
Strength of investor protection index (0-10)	8.3	6

b. The Unattainable Ideal

The second problem with the “market-failure” approach to policy-making in this context is that, as Blundell puts it “the market-failure approach implies perfect government—an altruistic and omniscient body, which can detect and will unswervingly pursue the “public interest.” “But, of course, this disregards the self-interest of its own members or more general political considerations. The contrast between ‘imperfect’ markets with perfect governments is naturally deceptive as it leads to

154. Adapted from *Doing Business Report*, *supra* note 66.

155. The Protecting Investors indicators below measure three areas: transparency of transactions (Extent of Disclosure Index), which looks at who can approve related-party transactions and requirements for external and internal disclosure in case of related-party transactions. The second is liability for self-dealing (Extent of Director Liability Index), which consists of the ability of shareholders to hold the interested party and the approving body liable in case of a prejudicial related-party transaction, the available legal remedies (damages—repayment of profits, fines, imprisonment, and rescission of the transaction), and the ability of shareholders to sue directly or derivatively. The third area, shareholders’ ability to sue officers and directors for misconduct (Ease of Shareholder Suits Index) looks at documents and information available during trial as well as access to internal corporate documents (directly or through a government inspector). The indexes vary between 0 and 10, with higher values indicating greater disclosure, greater liability of directors, greater powers of shareholders to challenge the transaction, and better investor protection. A simple average of the extent of disclosure, the extent of director liability and ease of shareholder suits indices then makes up the overall score (i.e. the strength of investor protection index (0-10)). See *Doing Business Report*, *supra* note 66.

demands for more government intervention than would be made if the imperfections of government were taken into consideration.”¹⁵⁶ In short, the problem with this government intervention hypothesis is that it rests on uncertain foundations of principle and as such leads to practical problems. Government advocates’ frequently touted assumption that “it will on balance be beneficial and achieve that elusive concept, the ‘public interest’” is flawed and illegitimate.¹⁵⁷

Indeed, public regulators, such as ISA, cannot be insulated from political and interest group pressures.¹⁵⁸ Put simply, there may be difficulties associated with the introduction and implementation of regulatory measures (i.e. interest groups may have too large an influence on the law-making process),¹⁵⁹ or lack of familiarity with the marketplace. This may result with a distorted outcome: regulators may, in practice, serve the private interest of the regulated industry and, ironically, protect it from any competition, instead of the supposed goal to promote the public interest. This suggests that political pressures stipulate a background incentive that is somewhat different than the one that exists for private regulators.¹⁶⁰ “But worse, it is a fallacy to assume that government officials are disinterested purveyors of the public interest. They are themselves personally interested, in terms of salary and career prospects, in the outcome of the regulatory process.”¹⁶¹ Indeed, “there is no reason to believe that the priorities established by a corporate regulator for enforcement are necessarily the correct ones [or are identical to those of each and every company]. This dictates a role for private enforcement.”¹⁶² Finally,

when the legal system assigns an enforcement role [(or alternatively leaves room for) private enforcers (i.e. through litigation of derivative actions)] there is less need to rely on public agencies and in turn the tendency of such public agencies . . . to determine, sometimes arbitrar-

156. BLUNDELL, *supra* note 135, at 3–4. The “public choice” approach, which criticizes the perfect government assumption, is explained in GORDON TULLOCK, *THE VOTE MOTIVE* (2006); *see also* WILLIAM MITCHELL, *GOVERNMENT AS IT IS* (1988).

157. *See, e.g.*, REGULATION: ECONOMIC THEORY AND HISTORY (Jack High ed., 1991) (critiquing the “public interest” theory).

158. BLUNDELL, *supra* note 135, at 74–75. “In Chicago, the police cars are emblazoned with the phrase ‘we serve and protect,’ and often that phrase can be applied to public regulators.” *Id.*

159. These issues are explored in detail in BRIAN R. CHEFFINS, *COMPANY LAW: THEORY, STRUCTURE AND OPERATION* ch. 4 (1997).

160. Randall S. Kroszner, *The Role of Private Regulation in Maintaining Global Financial Stability*, 18 CATO J. 355, 359 (1999).

161. BLUNDELL, *supra* note 135, at 34.

162. Ramsay, *supra* note 14, at 152.

ily or for political reasons, not to enforce rights or duties it had previously guarded¹⁶³

is likely to be higher.

c. Limited Resources and Funding

There is a policy question that arises: should shareholders be expecting public enforcers, in this case, ISA, to pick up the bill for litigation, thereby externalizing the cost of enforcement on the taxpayers? The answer is not as straightforward as it would seem. When the Israeli legislator decided in favor of making a stronger commitment to enforcement of derivative actions by allowing ISA to fund these actions, it probably presumed that the necessary monies would be available at no extra cost to the taxpayers. In theory, this assumption is correct: ISA is funded by fees it collects from exchange transactions and related activities.¹⁶⁴ But that is not the real issue here. The true problem lies with the fact that ISA needs to allocate its resources to a wide-range of activities it oversees, supervises, and enforces. However, like many similar statutory securities bodies worldwide, it is only provided with a very limited budget.¹⁶⁵ In fact, ISA is considered to be chronically underfunded, thus foreclosing a shift to public enforcement. Indeed, limits on funding and resources of corporate regulators means that they cannot, of necessity, pursue all breaches and enforcement of the law. In this respect ISA is in a somewhat similar position to that of the SEC¹⁶⁶ or the U.K.'s Financial Services Authority

163. *Id.* (citing A.L.I., PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS Part VII, 220–21 (Tentative Draft No. 1, 1982) (on why private enforcement serves a fail-safe function and ensures greater stability in the application of law.).

164. ISA is funded by annual fees payable by companies that are subject to the Securities Law and the Joint Investment Law, fees payable for applications to receive permits to publish prospectuses, private offerings, licensing fees payable by investment advisors and investment portfolio managers, and fees payable by the Tel Aviv Stock Exchange. The budget is approved by the Minister of Finance and the Finance Committee of the Knesset.

165. The Israel Securities Authority was established under the Securities Law, 1968 and its mandate is to protect the interests of the investing public. ISA has a wide range of responsibilities and powers. *See ISA in a Nutshell*, *supra* note 69.

166. As the New York Times reported on September 20, 2011:

The near-collapse of the world financial system in the fall of 2008 and the global credit crisis that followed gave rise to widespread calls for changes in the regulatory system. A year and a half later, in July 2010, Congress passed a bill, [which later became the Dodd-Frank Act], expanding the federal government's role in the markets, reflecting a renewed mistrust of financial markets. A year after the Dodd-Frank Act was signed, necessitating the creation of thousands of job positions, the SEC has been expanding headcount.

("FSA"), and the right question, in particular in light of the recent financial crisis and what has been on the agenda in terms of reforms is as follows: has ISA got the necessary and/or adequate resources to deal with what is already on its table? ISA, like the SEC, is under huge pressures and its budget has recently been under-cut. It follows that it probably cannot, as a practical matter, allocate enough resources or time or expertise to pursue yet another regulatory role. If it does, some other area of its activities would suffer, which raises the question whether that decision would be in the "public interest".

In short, public enforcement resources are generally inadequate.¹⁶⁷ This means there is a constant and ongoing internal competition for resources and priorities within ISA, where some areas get to be prioritized over others.¹⁶⁸ In particular, it is reported that the issue of private enforcement

Financial Regulatory Reform, N.Y. TIMES, http://topics.nytimes.com/topics/reference/timestopics/subjects/c/credit_crisis/financial_regulatory_reform/index.html (last updated Sept. 20, 2011). Under the Act the SEC is responsible for implementing a series of regulatory initiatives required. *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, SEC, <http://www.sec.gov/spotlight/dodd-frank.shtml> (last modified May 8, 2012) (which expanded the SEC mandate including creating five new offices). The SEC 2011 study 'Organizational Study and Reform' (March 2011) provides a detailed account of these and other changes:

According to the SEC's 2012 budget request it hopes to fill 780 positions by 30 September 2012, the end of fiscal year 2012. [Three hundred and twelve] positions would go toward strengthening core operations, like gathering market intelligence, monitoring financial disclosures of corporations and overseeing money market funds. The other 468 positions would deal with implementing new rules from the Act relating to the derivatives market, overseeing hedge funds and whistle-blowing. In addition to examiners, the agency will hire staffers with experience in derivatives, credit default swaps, collateralized debt obligations and securitized products as well as compliance officers.

BOSTON CONSULTING GRP., U.S. SECURITIES AND EXCHANGE COMMISSION ORGANIZATIONAL STUDY AND REFORM (Mar. 2011), *available at* <http://www.sec.gov/news/studies/2011/967study.pdf>.

167. "The maximum number of approved positions at ISA as of the end of December 2009 stood at 181, in addition to eight intern positions and ten student positions." *See* ISA, ANNUAL REPORT 2009, at 3 (May 27, 2010), *available at* http://www.isa.gov.il/Download/IsaFile_5219.pdf. The SEC, by comparison, currently has a support staff of around 3,800, made up of lawyers, accountants, economists, computer experts and administrators. U.S. SEC. & EXCH. COMM. [SEC], FY 2011 PERFORMANCE AND ACCOUNTABILITY REPORT (Nov. 15, 2011), *available at* <http://www.sec.gov/about/secpar/secpar2011.pdf>.

168. This issue is well-illustrated in the annual business plan published by ISA or the U.K. Financial Services Authority which outlines regulatory and strategic priorities for the regulator each year. *See generally* FIN. SERVICES AUTH., BUSINESS PLAN 2011/12

of securities laws has *not* been one of the top priorities of ISA in recent years.¹⁶⁹ How does this sit with the new expectation that ISA funds derivative claims in appropriate cases remains to be seen. One answer to this may be to recognize that there is no need to have many cases in order to achieve high levels of deterrence. For example, the use of a few “test cases” may be sufficient to deter potential abuse by directors who are situated similarly at other companies.¹⁷⁰

2.2.4 What is the Relationship between ISA’s Recommendation and the Court’s Discretion?

Recall that 209A(b) states:

Where the Israel Securities Authority is convinced that the action is in the interests of the public and that there is a reasonable prospect that the court approve it . . . the Authority may bear the plaintiff’s costs, in such sum and on such conditions as it shall prescribe; *the Authority’s decisions according to this section cannot be used as an evidence and it is not possible to submit them before the court.*¹⁷¹

On its face, this Section recognizes that ISA’s decisions cannot be used as evidence and are inadmissible in court, which suggests that there was a fear that they would influence the court in some way. But even if the content of these decisions is now known, the fact that ISA has deliberated and concluded that public money should be spent on a case on the grounds that there is a “public interest” in the case will not escape the court. This raises panoply of interesting questions: what weight should be given to ISA’s decisions? In other words, what would be the implications for a particular case’s chances of succeeding that it is supported by ISA? Would this bias the court in favor of allowing the case to continue on the grounds that ISA has already made its own “judgment” that the case is of general interest/importance to the public? Furthermore, should the court accede to the committee’s decision or should it review the decision as if the former never occurred? If so, at what cost? Or perhaps the court should only review the committee’s decision if it is suspected to be biased? And vice versa: would the fact that ISA, for example, has decided *not* to support a case, after being approached and after investigating its merits, be used as a tactical weapon by the defendants in court to suggest that there is no “public interest” in litigating this case?

(U.K.), available at http://www.fsa.gov.uk/pubs/plan/pb2011_12.pdf; ISA ANNUAL REPORT 2009, *supra* note 167.

169. See generally ANNUAL REPORT 2009, *supra* note 167.

170. See REISBERG, THEORY AND OPERATION, *supra* note 5, at 59–66.

171. Companies Law § 209(A) (emphasis added).

It is noteworthy that a comparable problem arises in the context of judicial review of the merits of a decision of a committee of independent directors in the United States (known as a Special Litigation Committees) in derivative litigation:¹⁷²

The question is to what extent . . . should a court defer to a recommendation of [Commission]? In practice, unsurprisingly, this fundamental question has been fiercely debated in U.S. courts and proposed Model Acts with no clear resolution emerging. Secondly, if judicial review of the merits of a decision of a committee of independent directors is utilized, this may be seen as an undesirable duplication of tasks.¹⁷³

172. Arad Reisberg, *Theoretical Reflections on Derivative Actions in English Law: The Representative Problem*, 3 EUR. COMPANY & FIN. L. REV. 69, 69–108 (2006) [hereinafter Reisberg, *The Representative Problem*]; see Ramsay, *supra* note 14, at 173; Jerold Solovy, Barry Levenstam & Daniel S. Goldman, *The Role of Special Litigation Committees in Shareholder Derivative Litigation*, 25 TORT & INS. J. 864, 864–65 (1990).

173. Reisberg, *The Representative Problem*, *supra* note 172, at 89–90, 93–94; see Ramsay, *supra* note 14, at 173. While some courts have shown considerable deference to recommendations of SLCs (*Auerbach v. Bennett*, 47 N.Y.2d 619, 623 (1979)), others rejected any notion of wholesale deference to the recommendation of the SLC. For example, the influential Delaware Supreme Court decision in *Zapata Corp. v. Maldonado* applied a two-stage test on whether to accept its recommendations: “First, the Court should inquire into the independence and good faith of the committee” and the grounds supporting its recommendation. 430 A.2d 779, 788–89 (Del. 1981). Second, the court applies “its own independent business judgment” to determine whether the derivative action should be dismissed. *Id.* The *Zapata* analysis has subsequently been applied by the Delaware Court of Chancery numerous times. Outside of Delaware, in many states (including California, Colorado, Georgia, Maryland, Michigan, Ohio, and Virginia) there appears to be no clear decision by the highest state court on the status of SLCs, but federal courts hearing derivative actions based on diversity jurisdiction have reached decisions construing the authority of such a committee. Although some argue that the law on derivative actions is uniform nationally in the sense that everyone has followed Delaware, Coffee believes that it is an egregious overstatement to characterize the law on SLCs as largely resolved. See Coffee, *New Myths and Old Realities*, *supra* note 112, at 1432–33. In *In re Oracle Corp. Derivative Litigation*, the Delaware Court of Chancery denied the motion of a SLC to dismiss derivative claims brought by Oracle stockholders. 824 A.2d 917 (Del. Ch. 2003). The SLC was established by the board of directors of the Oracle Corporation to investigate claims of insider trading and breach of the fiduciary duty of loyalty brought against Oracle directors. The court based its finding on the SLC’s inability to prove the independence of its two members, and thus the committee itself, from the directors being investigated. In doing so, the court applied an independence inquiry that expanded upon the traditional “domination and control” notion of independence, to include personal and philanthropic connections with the directors, which the court concluded created an “unacceptable risk of bias.” *Id.* at 947. Arguably, this represents a broadening of the inquiry of director independence by the Delaware Court of Chancery. See Jeremy J. Kobeski, *In Re Oracle Corporation Derivative Litigation: Has a*

The same may apply to ISA's decisions. Although there is no doubt that the court is free to decide on the case regardless of (or in spite of) ISA's position, what is clear is that the balance is shifted in favor of the plaintiff even before the case or its merits are heard. No doubt, this can be rebutted. It, nonetheless, at least puts forward the notion that there is a *prima facie* case to be looked at closely.

2.2.5 ISA's Recommendation and Decision

One last issue should be considered here. On what grounds/how will ISA decide to support a case?

Since the entry into force of Amendment 16, ISA has not yet received any formal request for funding a derivative action according to Section 205A.¹⁷⁴ That said, ISA officials report “an awakening in the field” and that they have been in contact with a number of lawyers who are “sniffing” around and may be interested in filing derivative actions.¹⁷⁵ Although it is still in its early days and ISA has not yet published a guidance document on how it would finance derivatives action or about enforcement information in general,¹⁷⁶ it is expected that the issue of private enforcement of securities laws in the near future be allowed more

New Species of Director Independence Been Uncovered?, 29 DEL. J. CORP. L. 849, 850–51 (2004).

Contrast the Model Business Corporation Act (drafted by the American Bar Association's committee on Corporate Governance) which provides that a derivative action shall be dismissed by the court where a committee of independent directors has determined in its business judgment that the action is not in the best interest of the company, with that of the American Law Institute, which allows more scope for judicial review of the recommendations of SLC. See PRINCIPLES OF CORP. GOVERNANCE, *supra* note 19, at 725–66.

174. Data received from ISA Officials (based on direct conversations and e-mails) (2012) (on file with author).

175. *Id.* This may also receive a boost from a recent decision of the Economics Department at the District Court in Tel-Aviv-Jaffa to allow a double derivative action, although such an arrangement is not catered for in the Companies Law of 1999. See Jonathan Ben-Ami v. Mivtachim Holdings Ltd., TA 21785-02-11 [2011] (not yet published) (Isr.). On the importance of these type of actions see Arad Reisberg & Dan Prentice, *Multiple Derivative Actions*, 125 L.Q. REV. 209 (2009).

176. As a public body it is assumed it should provide a policy document that would help prospective litigants/lawyers assessing the chances of their respective cases being funded by ISA. Whatever the case may be, it is clear that it cannot be helpful to allow the factors which ISA will take into account in deciding whether to support a case to proliferate unnecessarily—this can prolong proceedings, create uncertainty, and result in the unprincipled development of the jurisdiction. As a public authority, it should reach its decision efficiently, speedily and with openness.

attention than before.¹⁷⁷ So it would be instructive to look at the experience ISA has had so far with funding class action litigation to get an idea on how it will operate in practice and how it may help shape its future policy.

Firstly, it is instructive to look more generally at how ISA perceives its own role. The Securities Law defines its role as the protection of investors' affairs.¹⁷⁸ It is reported that ISA interpreted this provision as defining its function as creating a fair and functioning capital market. In line with this, ISA representatives promote enforcement's role in encouraging investors' marketplace trust.¹⁷⁹ They conceive economic legislation, including corporate law legislation, "as an ordering instrument that enables the economy to work, rather than as an independent justice mechanism in its own right."¹⁸⁰ Moreover, unlike its U.S. counterpart, "ISA views the highly concentrated ownership structure of Israeli companies as the unique and main problem of the Israeli capital market. Accordingly, it justifies stricter rules as a means to protect minority shareholders against control holders."¹⁸¹

Looking more closely at the issue of enforcement, a policy document issued by ISA in April 2003 on its website¹⁸² provides details of its enforcement policy at the time and its intent to ask for amendments in the Companies Law which would allow it to enforce the Companies Law sections more forcibly.¹⁸³ The document is quite telling as it reveals some of the seeds that led to Amendment 16 as well as the policy issues and thinking behind it and more generally the Companies Law.¹⁸⁴ In the document, ISA explains that the Companies Law eliminated numerous criminal sections that were previously part of the Companies Ordinance¹⁸⁵ and instead established new enforcement arrangements.¹⁸⁶ The

177. Based on direct conversations and e-mails with ISA Officials (2012) (on file with author).

178. See Securities Law, 5728-1968, 22 LSI 266, ch. 2 (1968) (Isr.).

179. Yael T. Ben-Zion, *The Political Dynamics of Corporate Legislation: Lessons from Israel*, 11 FORDHAM J. CORP. & FIN. L. 187, 243 (2006).

180. *Id.*

181. *Id.*

182. *SEC Initiates a Change to Empower it to Enforce the Companies Act*, ISA (Apr. 7, 2003), <http://www.isa.gov.il/Default.aspx?Site=MAIN&ID=8,175,854> [hereinafter *SEC Initiates a Change*].

183. *Id.*

184. For an interesting examination of the political history that accompanied the enactment of the Companies Law of 1999 see Ben-Zion, *supra* note 179.

185. The Companies Ordinance, later replaced by the Companies Law, had been largely based on the English Act of 1929 but underwent reform several times.

186. *SEC Initiates a Change*, *supra* note 182.

basic concept that underlines the Companies Law on this subject is the idea that the most effective enforcement mechanism is the market mechanism.¹⁸⁷ In principle, the Companies Law avoided criminal sanctions, because its architects sought to move towards civil enforcement. The Companies Law also gave priority to ensuring the operation of market mechanisms as well as providing incentives for private enforcers. Importantly, ISA noted, ISA has *not* been granted administrative punishment powers or the ability to take civil proceedings, criminal sanctions, or quasi-criminal sanctions directly against companies that violate and/or breach the Companies Law.¹⁸⁸ In reality, however, ISA noted, there are repeated violations of the sections of the Companies Law, without any real possibility of enforcement. The chances that a shareholder would decide to initiate a derivative action or a class action for failing to appoint an internal auditor are very slim, because, at least in public companies, such actions are filed only when shareholders themselves have suffered direct financial loss.¹⁸⁹ It is difficult to prove a causal connection between a failure to appoint an internal auditor and direct financial loss and therefore the probability of filing a derivative action in these circumstances are virtually nil. According to the ISA document, other examples of violations that would not trigger shareholders' enforcement include the appointment of a director who was previously convicted of an offense which disqualifies him from serving as a director and convening a general meeting without providing the minimum notice as required by law.¹⁹⁰

3. What Can Be Learned from the Class Action Experience in Israel?

3.1 Are Derivative Actions the Same as Class Actions?

Recall that the rationale for Section 205A makes it clear that the new amendment establishes a similar arrangement with exists for class actions (under Section 209 of the Companies Law)¹⁹¹ and that the plaintiff in derivative actions, in addition to benefiting himself (and like the position in class actions cases) benefits all other shareholders who are similarly positioned.¹⁹² But one may wonder whether it is necessarily the case

187. *Id.*

188. *Id.*

189. *Id.*

190. *Id.* Curiously, these are precisely the instances that should trigger a derivative action. See *Foss v. Harbottle*, (1843) 67 Eng. Rep. 189, 2 Hare 461.

191. Companies Act (amend. no. 16), § 19 (explanatory notes) 2011 (Isr.).

192. In an earlier draft of the amendment it was stated that the derivative claim has a central role in enforcing the company's right, including enforcing directors' duties. It is

that the plaintiff in derivative actions is in exactly the same position as in class actions cases. While class actions and derivative actions share certain similarities, such as the fact that they usually involve multiple plaintiffs, and they both appear in the same part of the Israeli Companies Law,¹⁹³ the purposes and procedures of the two suits are very different. Class actions consolidate multiple plaintiffs' claims into a singular suit. This can be contrasted with shareholder derivative actions, which enable shareholders to seek relief for the company's injuries. This distinction can be confusing, as shareholders often pursue class action remedies for direct injuries suffered. A derivative action is utilized when a company itself is injured and first opts not to sue, but the shareholders suffer indirectly and seek action later.¹⁹⁴ Thus, the moniker "derivative" action is due to shareholders pursuing a claim for the corporation's instead of his own name.¹⁹⁵ All shareholders in a derivative action therefore benefit if a company recovers.

3.2 Funding of General Class Action Claims under Israeli Law

We now turn to examine if there is anything that can be learnt from the class action procedure and experience under Israeli law that may help assess the prospects of success of Section 205A.

The Class Action Act 2006 (the "Class Action Act"), defines a class action as:

An action that is conducted on behalf of a group of people, who have not authorised the representative plaintiff for this purpose, and which raises material questions of fact or law which are common to all the members of the class.¹⁹⁶

expected the funding would be given for the application at the leave stage including covering expert and legal opinions as well as any costs that are likely to be incurred in case the court should refuse leave. Companies Law of 1999 (amend. no. 10), para. 12 (May 2008).

193. Or to take a U.S. example: under the 2010 California Corporations Code, both class actions and derivative actions are found in Chapter 11. CAL. CORP. CODE § 11 (2010).

194. Erika Johansen, *Class Action vs. Derivative Shareholder Lawsuits*, EHOW.COM, http://www.ehow.com/about_6505005_class-vs_-derivative-shareholder-lawsuits.html (last visited May 8, 2012).

195. *What is a shareholder derivative action?*, CORPORATE LAW LEGAL RES., <http://resources.lawinfo.com/en/Legal-FAQs/corporate/Federal/what-is-a-shareholder-derivative-action.html> (last visited May 8, 2012). Interestingly, that an action is truly a derivative action, rather than one brought by the minority shareholder in his own right, was a late recognition in English law. *Wallersteiner v. Moir*, [1975] Q.B. 373 (U.K.).

196. Class Action Act, 5766-2006, 35 LSI 298, § 2 (2006) (Isr.) [hereinafter Class Action Act].

As Plato-Shinar reports, the Class Action Act was enacted “in order to encourage the filing of appropriate class actions and to remove procedural impediments. The Law perceives the class action not as a procedural arrangement of the filing of claims, but, first and foremost, as a tool for promoting public–social interests.”¹⁹⁷ It follows that the Law’s perception is that

the consideration and the advancement of the public interest should be at the heart of the court’s discretion throughout all the stages of the proceeding. At the same time, the Law attempts to contend with the risk of the exploitation of the class action in order to make private profit, without achieving benefit for the public. The Law takes into consideration the interests of the defendants as well, and tries to balance between them and those of the public.¹⁹⁸

The Israeli class action is, very much like the class action mechanism in the United States—the device serves not only the private interest of the injured parties, but also, the social-public interest. It is chiefly geared towards situations when a large company injures a group of people in such a manner that each individual suffers small damage that would not justify the filing of a claim by the individual himself. That said, all of the unique persons’ damages amass into an extensive amount, thus the class action device groups the often small interests of all the injured parties, which are often unpractical to pursue, and generates an incentive to pursue a claim. The class action is thus vitally instrumental in enforcing individual rights. Resultantly, the class action’s accumulated whole is often large and therefore deterrent. Class actions are instrumental in under-enforced areas, and often when administrative supervision is fragmented.¹⁹⁹ ISA itself has stated that with respect to potential compensation to be paid to the plaintiff, it is usually the case that

if the court rules in favor of all or part of the class with regard to all or part of a class action claim, it shall order the payment of compensation to the class action plaintiff, taking into consideration the following factors, unless it finds, for special reasons which shall be recorded, that

197. Ruth Plato-Shinar, *Israel: The New Law on Class Actions*, 2007 J. BUS. L. 527, 540.

198. *Id.*

199. *Id.* at 527, 527 n.3; *see, e.g.*, Civil (TA) 1957/03 Ar-On Investments Ltd v The First Int’l Bank of Israel, PM 8560(1) (2006). “In that case, the bank charged some 15,000 customers with interest higher than that agreed. Only by virtue of class action proceedings the Supervisor of Banks intervened and the customers were ultimately compensated.” Class Action Bill (No. 232), 5765–2005, HH 234 (Isr.); Application for Civil Appeal 4556/94 Tatzat v. Zilbershatz, 49(5) PD 774, 783–85 [1994] (Isr.); CA 2967/95 Magen Vekeshet Ltd. 527 [2007] (Isr.) (on file with the author).

such payment is not justified under the circumstances of the case: the effort invested by the class action plaintiff and the risk he took upon himself when submitting the class action and in conducting it; the benefit brought to the members of the class from the conduct of the action; . . . the degree of importance to the general public of the class action.²⁰⁰

The court may, for special reasons which shall be recorded, order the payment of compensation to an applicant or class action plaintiff even if the class action claim was not approved, or even if there was no ruling in favor of the class in the class action claim, whichever is relevant.²⁰¹

One of the most important innovations in the Class Action Act is the establishment of a Foundation for Financing Class Actions, under the auspices of the Ministry of Justice.²⁰² The foundation's objective is to assist plaintiffs in the financing of class actions, which are of public and social importance.²⁰³ The foundation's budget is determined in the Annual Budget Law, in a special plan that is included in the budget of the Ministry of Justice. The Minister of Justice is responsible for determining the criteria for granting financing to the various representatives. In any event, assistance from the foundation will not be given in order to finance class actions in the field of securities, because in these cases, financing is given by ISA.²⁰⁴ This is considered next.

3.3 Funding Class Actions in the Field of Securities by ISA

According to ISA's own report:

[t]he ISA regards class action lawsuits as an inextricable component of enforcement in the capital market. . . . The Director of Enforcement of ISA is charged with the supervision and coordination of all ISA enforcement activities, as well as trade control and class actions With regard to class actions, the Enforcement Department of ISA is charged with formulating recommendations to ISA Plenum as to applications to finance such [claims] and private expenditures relating thereto; monitoring claim proceedings and deciding whether to involve the State Attorney in cases that have ramifications on the efficacy of

200. Class Action Act, § 22(a)–(b).

201. ISA, SELF ASSESSMENT, *supra* note 43; *see also id.* § 229(c).

202. Plato-Shinar, *supra* note 197.

203. Class Action Act, § 27.

204. Companies Law § 209; Joint Investments in Trusts Law, 5754-1994, SH No. 5754 p. 308, § 41 (Isr.).

the class action mechanism and on the public's trust in the capital market.²⁰⁵

Table 2 below gives an idea about the level of activity at ISA on these issues.

Table 2: Cases forwarded to the Department of Investigations at ISA between 2005–2009, by type of violation²⁰⁶

Type of Violation	2005	2006	2007	2008	2009	Total
Securities fraud	7	5	1	2	4	19
Use of inside information	2	4	3	2	6	17
Misrepresentation (in prospectuses, financial statements, or immediate reports)	6	2	2	5	4	19
Non-filing and delinquent filing	-	1	11	1	-	3
Unlicensed portfolio management or investment advice	-	2	-	-	-	2
Judicial inquiries	2	5	8	7	9	31
Violations by employees of stock exchange members and prohibited acts by a licensed investment portfolio manager	-	1	1	-	-	2
Disciplinary violations	-	-	1	-	-	1

205. ANNUAL REPORT 2009, *supra* note 167, at 5.

The ISA Plenum deals, through the ISA's committees, with granting applications for permission to publish prospectuses; granting exemptions and extensions; stock exchange issues; issues relating to the ISA's finances and budget; the independence of auditors of companies subject to the Securities Law; issues relating to the licensing of investment advisors, investment marketers, and investment portfolio managers; issues relating to the imposition of civil fines on mutual fund managers, as well as other issues, as needed. The ISA Plenum usually convenes once a month. There are currently eight members of the ISA sitting at the ISA Plenum including the ISA's Chairman.

Id. at 2.

206. *Id.* at 129.

Violations under the Joint Investment in Trust Law	1	-	1	-	1	3
Violations under the Penal Law: Bribery, theft, obtaining by fraud	-	-	-	-	2	2
Total	18	20	18	17	26	99

Focusing back on class actions, recall that according to Section 209 of the Companies Law, “a plaintiff seeking to sue in a representative action deriving from a connection to a security of a public company may request ISA to bear his costs.”²⁰⁷ “Where the Securities Authority is convinced that the action is in the interests of the public and that there is a reasonable chance that the court will approve it as a representative action, the Authority may bear the plaintiff’s costs, in such sum and on such conditions as it shall prescribe.”²⁰⁸ As mentioned above, the outcome of the case determines the costs in Israel, which means that a plaintiff’s success garners court costs. In effect, these costs are designed to reflect the actual costs incurred by the plaintiff, but in practice often fail to cover the true time and effort expended in pursuit of litigation. Conversely, if the plaintiff loses his claim, he is liable for court costs. In case of a class action ISA may provide financial assistance and “in practice assumes approximately 80% of the costs in the failed class actions it chooses to assist. There is no set formula for calculating court costs. More often than not, the assigned costs do not cover actual expenditures.”²⁰⁹

It is reported that

[B]etween the years 2000, when the Companies Law came into force, and 2002, ISA has participated in subsidizing seven class action suits. . . . [B]etween 2000 and September 2002, the number of class action suits that were reported to ISA was fifteen, out of which eight passed the primary stage of approval as a class action by the court.²¹⁰

During 2008 two applications for funding class action law claims were submitted to ISA. In one case, the applicant withdrew the application

207. Companies Law § 209(a).

208. *Id.* § 209(b).

209. ISA, SELF ASSESSMENT, *supra* note 43, at 159.

210. Ben-Zion, *supra* note 179, at 308–09; *see e.g.*, ISA, ANNUAL REPORT 2000 (2000), available at http://www.isa.gov.il/Download/ISAFfile_163.pdf; ISA, ANNUAL REPORT 2001 (2001), available at http://www.isa.gov.il/Download/ISAFfile_162.pdf; ISA, ANNUAL REPORT 2002 (2002), available at http://www.isa.gov.il/Download/ISAFfile_161.pdf.

after ISA staff had decided against financing it, and in the other case, ISA staff agreed to fund the case. Six applications for funding class action lawsuits were received during 2009. At the time that ISA 2010 Annual Report was published these lawsuits were still pending review.²¹¹ One financing application from the previous reporting year was withdrawn by the plaintiff after ISA decided against financing the suit.²¹² It is clear then that ISA's financial support for a case is a crucial factor in its chances to be litigated at all.

A pair of important class action lawsuits completed during 2009. Both were supported by ISA.²¹³ One of these cases illustrates that ISA's decision to fund it was the right one under the theory of "public interest."²¹⁴ The case involved a class action against Reichert Industries Ltd.²¹⁵ On June 7, 2007, the Supreme Court ruled on the appeal filed by the class action plaintiff and the appeal filed by Mr. Dan Reichert against the District Court's ruling. The Supreme Court Ruling outlined principles defining the term "controlling shareholder" for accountability purposes. Arguably it is a "public good" to have a clear "normative [adjudication] and for the court to make [statements] sufficiently clear that business can abide by these rules and avoid legal risk."²¹⁶ The Supreme Court agreed

211. Because of lack of data it was not possible to verify how long it usually takes ISA to review and decide on such cases and whether this time is too excessive. According to ISA, ISA Plenum (recall that the Enforcement Department of ISA is charged with formulating recommendations to ISA Plenum as to applications to finance such claims) usually convenes once a month and in 2009, ISA Plenum held eight meetings and the committee for imposing fines as per class action suits held three meetings. *See ANNUAL REPORT 2009, supra* note 167, at 2.

212. *ANNUAL REPORT 2009, supra* note 167.

213. In the first, Case 1498/04, a class action was brought against M.P.A. Mediterranean Assets and Investments Ltd. and Mishor Hahof Construction and Assets Ltd.

The claim stated that the consideration awarded in return for the company's shares, as part of a forced purchase offer made by way of a full purchase offer to shareholders, was less than their fair value. After the proceedings in this case were suspended for a period of three years, at the end of 2007 the parties signed a settlement agreement. According to the agreement, which was approved by the Court in April 2008, NIS 0.20 per share were added for each share held by the shareholders on January 13, 2004 (date of the full purchase offer).

ISA, *ANNUAL REPORT 2008*, 134 (May 3, 2009), http://www.isa.gov.il/Download/IsaFile_4543.pdf.

214. *See supra* Section 2.2.2.

215. *ANNUAL REPORT 2008, supra* note 213, at 134–35.

216. *GENN, supra* note 92, at 74; *see also supra* Section 2.2.2. and in particular cases mentioned *supra* note 123.

that Mr. Reichert was one of the Company's "controlling shareholders" and thus held him liable for plaintiff's damages.²¹⁷

4. *Why Not Go All the Way?*

Finally, it is worth asking why instead of simply funding derivative actions in cases that are in the public interest, should ISA not litigate these cases itself once it received a request to do so. Indeed, "there are times where regulators may be compelled to step in the shoes of private individuals seeking recourse through the court systems."²¹⁸ This may arise, for example, when there is "no economic incentive for private parties to proceed with action; limited access to information to support action by private parties; or when actionable conduct may have impact on wider public interest and market confidence."²¹⁹ Put simply: if the rationale is public interest and market confidence then why should ISA not litigate these cases itself, not just lend financial support to them? In order to assist ISA, there is no reason, for instance, why an independent expert may not, in appropriate cases, be allowed to investigate and advise ISA on the action²²⁰ (naturally this requires allocating further financial resources too). After all,

much serious misconduct by directors [such as bribery and insider dealing] is often inherently unlikely to be detected by shareholders acting alone. [Derivative actions] involving these forms of wrongdoing often piggyback on criminal governmental or internal corporate investigation. Indeed, the surge of derivative action litigation in Japan has been partly explained by such piggybacking on government[] enforcement.²²¹

217. ANNUAL REPORT 2008, *supra* note 213, at 134. The Supreme Court Ruling "presented various methods for calculating damages due in a class action suit, and determined that, in this case, the appropriate method is the 'out of pocket' method, which is based on the damages principles prescribed under tort law—restoration of the status quo ante." *Id.*

218. MALAY. SEC. COMM'N REPORT, *supra* note 119, at 65.

219. *Id.*

220. As the case in South African and Australian legislation. See *supra* note 87. As Gelter points out, continental European laws have a mechanism that is intended to alleviate the information asymmetry with respect to corporate wrongdoing, namely the minority right to have the court appoint a special auditor. The required percentage to trigger such an appointment varies between jurisdictions. See Martin Gelter, *Why do Shareholder Derivative Suits Remain Rare in Continental Europe?*, 37 BROOK. J. INT'L L. 843 (2012).

221. Reinier Kraakman, Hyun Park & Steven Shavell, *When Are Shareholder Suits in Shareholder Interests*, 82 GEO. L.J. 1764, 1763–64 (1993–1994). In Japan, "information disclosure is not terribly abundant; shareholder rights to view corporate records are predicated on the holder having at least 3% of the shares; cause must be shown to appoint an

In the U.K., the Financial Services and Markets Act 2000 grants the FSA “powers to take proceedings in the civil and criminal courts to deal with misconduct relating to regulated activities.”²²² The FSA “can issue civil proceedings in the High Court against firms and individuals, including those who are not members of the regulated community.”²²³ There are several civil actions that the FSA can pursue.²²⁴ The main actions include “asking the High Court to grant injunctions” (for example to prevent a person from conducting regulated activities without authorisation or prevent a person from committing market abuse),²²⁵ “ordering the payment of restitution, and granting insolvency orders.”²²⁶ “In Hong Kong, the power to assist aggrieved individuals has been further widened to allow the Hong Kong Securities and Futures Commission (“HKSF”) to petition the court for a remedy where the affairs of a listed company are being conducted in a manner, which is oppressive or unfairly prejudicial to the interest of its shareholders.”²²⁷ The same arrangement exists under U.K. law.²²⁸ In a recent Hong-Kong case, the court ordered a company to recover the losses attributable to an alleged misconduct from its directors (for breach of fiduciary duties and conduct unfairly prejudicial to the interest of the shareholders by entering into transactions which

outside inspector; and pretrial discovery is nonexistent.” West, *supra* note 19; see REISBERG, *THEORY AND OPERATION*, *supra* note 5, at 190 (discussing the case involving Allied Irish Banks Plc). Additional factors, mainly in the form of financial incentives, are discussed in REISBERG, *THEORY AND OPERATION*, *supra* note 5, at 222–73.

222. *Enforcement in the Civil and Criminal Courts*, FIN. SERVICES AUTH. (Apr. 4, 2010), <http://www.fsa.gov.uk/Pages/doing/regulated/law/focus/courts.shtml>; see Financial Services and Markets, 2000, c.8, § 8(1) (Eng.).

223. *Enforcement in the Civil and Criminal Courts*, *supra* note 222.

224. *Id.*

225. In “May 2011 the FSA had, for the first time, obtained a final injunction restraining an individual from committing market abuse.” *FSA Bans and Fines Self Employed Trader £700,000 for Market Abuse*, FED. SEC. ADMIN. (June 14, 2011), <http://www.fsa.gov.uk/pages/Library/Communication/PR/2011/053.shtml>.

226. See *Enforcement in the Civil and Criminal Courts*, *supra* note 222.

227. *Id.*; see Securities and Futures Ordinance, (2003) Cap. 571, § 214 (H.K.).

228. According to the Companies Act 2006

if it appears to the Secretary of State that . . . (a) the company’s affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of members generally or of some part of its members, (b) or an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial, he may apply to the court by petition for an order under this Part.

Companies Act 2006 § 995. This power under this Section has rarely, if ever, been used.

resulted in significant losses).²²⁹ Interestingly, it was the HKSFC itself which petitioned the court for an order compelling the company to sue its directors.

As was noted recently, “the Hong Kong case illustrates the instances where regulators may be compelled to initiate action on behalf of shareholders to reinforce public confidence in the market.”²³⁰

Although these powers can help reinforce seal-dealing, naturally, they do not come without some drawback. “Firstly there is concern over regulators running the risk of intervening in the affairs of the company and secondly, such actions by regulators may result in shareholders becoming over reliant on regulators to take action on their behalf thus exacerbating the reluctance to institute private action.”²³¹ Then there are also the usual problems of limited resources and funding available to regulators²³² and the political and interest groups pressures²³³ that would stand in the way.²³⁴ Indeed, these concerns have caused some jurisdictions to emphasize “the need to promote private enforcement actions by shareholders [instead] and has also caused some common law countries to consider facilitating shareholders class action . . . in order to overcome these constraints and to provide greater recourse to remedy for wrongdoings.”²³⁵

CONCLUSION

It would be easy to dismiss Amendment 16—whereby public funding may be provided to fund derivative claims when ISA is convinced there is a public interest—as strictly a private Israeli affair. After all, it was introduced to complement the current funding mechanisms available under Israeli law, to deal with an allegedly (but unfounded) suboptimal enforcement levels, and to fit within Israeli companies’ highly concentrated ownership structure and the Israeli capital market. But this Author believes such dismissal would be a mistake. Dismissal overlooks three ma-

229. *Sec. & Futures Comm’n v. Cheung Keng Ching* [2010], H.C.M.O. 1869/2008 (Mar. 18, 2010) (Legal Reference System) (H.K.).

230. MALAY. SEC. COMM’N REPORT, *supra* note 119, at 66.

231. *Id.*

232. *See supra* Section 2.2.3.1 c.

233. *See supra* Section 2.2.3.1 b.

234. There is also the problem that ISA, or any other regulatory body for that matter, relies on the cases brought to it (i.e. it is passive in terms of which areas/topics are referred to it) and hence, its ability to promote areas which it deems vital to market integrity is rather limited.

235. MALAY. SEC. COMM’N REPORT, *supra* note 119, at 64–65. The Malaysian Securities Commission “recommends the establishment of a working group to study the feasibility of litigation funding by third party to assist investors in instituting private enforcement actions.” *Id.* at 67.

for benefits. First, the adoption of Amendment 16 in Israel, if successful, opens up an entirely novel domain for policy makers to address the funding problem in derivative action litigation, namely that of a public regulator and public funding for these private actions. Secondly, the formulation of the solution, combining a private enforcement aided by a public body (i.e. privately initiated and pursued litigation which are publicly funded), indicates that the response may lie in a more practical and pragmatic way forward which cuts across the traditional public/private dichotomy. Finally, the Israeli solution may offer a fresh strategy to be employed in order to create proper incentives to litigate and thus addresses a major concern in the literature on the theory of litigation, namely, the basic problem that the private incentives to litigate may diverge from what is socially desirable.

This Paper addressed derivative action funding problems in a different taxonomy. The fact that despite various fee mechanisms and fee-favoring rules available under the Israeli law, parties still would *not* pursue these claims exemplifies the underproduction of positive externalities. If funding is more forthcoming it is more likely that private actions would be pursued by aggrieved parties. Put simply, the policy underlying Amendment 16 reveals a new truth: when individuals are given financial support by a public body to litigate their claims, it is likely in recognition that these lawsuits would produce collateral social benefits. The new mechanism helps produce these benefits by internalizing a cost to a public body (ISA) that consequently enables the lawsuits to be brought.

Admittedly, these are still early days and time will tell whether this scheme under Israeli law can, or should, be followed elsewhere. Indeed, as was seen above, it is an imperfect and flawed mechanism and there are numerous difficulties that need to be addressed and overcome if this is to be implemented successfully and make any impact in practice. But so are most other mechanisms of funding, each subject to a unique benefits and costs analysis. The addition of this analysis to the scholarly literature serves several functions. Among these functions is the illumination of how a derivative action is more like other types of class action cases than generally presumed, private and public enforcement can play a complementary roles to each other, and, under this analysis, relatively unimportant the compensatory aspects of the derivative action case are compared to its other social functions. This last point is particularly important because the externality story of the derivative actions case sets the groundwork for a more general understanding of the common feature of these suits that could, in turn, facilitate private litigation as an important control tool.